

EXPOSURE DRAFT

TAX AND SUPERANNUATION LAWS AMENDMENT (2015 MEASURES NO. #)
BILL 2015: CONSOLIDATION

EXPLANATORY MATERIALS

Table of contents

Chapter 1	Consolidation	5
-----------	---------------------	---

Chapter 1

Consolidation

Outline of chapter

- 1.1 Schedule # to this Exposure Draft Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to improve the integrity of the consolidation regime.
- 1.2 All legislative references in this Chapter are to the ITAA 1997 unless otherwise indicated.

Context of amendments

- 1.3 The consolidation regime applies primarily to a wholly owned group of Australian resident entities that chooses to form a consolidated group for income tax purposes. A consolidated group generally consists of an Australian resident head company and all of its wholly owned resident subsidiaries.
- 1.4 Specific rules also allow certain resident wholly owned subsidiaries of a foreign holding company to consolidate by forming a multiple entry consolidated group (a MEC group). Unless otherwise specified, references in this Chapter to a consolidated group include a MEC group.
- 1.5 If a wholly owned group of entities chooses to form a consolidated group or MEC group, the group is treated as a single entity for income tax purposes.
- 1.6 The consolidation regime was introduced in 2002. The Board of Taxation commenced a post implementation review of certain aspects of the consolidation regime in 2009. As a result of its review, the Board presented two reports:
- the first report (*Post implementation review of certain aspects of the consolidation regime*) was finalised in June 2012 (the June 2012 Report); and
 - the second report (*Post implementation review of certain aspects of the consolidation tax cost setting process*) was finalised in April 2013 (the April 2013 Report).

1.7 This Exposure Draft Bill implements some of the recommendations made by the Board of Taxation to improve the integrity of the consolidation regime. It also implements other changes which are consistent with the Board's recommendations.

1.8 In particular, the integrity of the consolidation regime will be improved by:

- removing a double benefit (or double detriment) that can arise in respect of certain liabilities held by a joining entity that is acquired by a consolidated group (the acquired liabilities measure);
- removing anomalies that arise when an entity joins or leaves a tax consolidated group where the entity has securitised an asset (the securitised assets measure);
- preventing the tax costs of a joining entity's assets from being uplifted where no tax is payable by a foreign resident owner on the disposal of the joining entity in certain circumstances (the churning measure);
- clarifying the operation of the Taxation of Financial Arrangements (TOFA) provisions when an intra-group asset or liability that is, or is part of, a Division 230 financial arrangement emerges from a consolidated group because a subsidiary member leaves the group (the TOFA measure); and
- removing anomalies that arise when an entity leaves a consolidated group holding an asset that corresponds to a liability owed to it by the old group because the value of the asset taken into account for tax cost setting purposes is not always appropriate (the value shifting measure).

1.9 These measures (except for the securitised assets measure) were originally announced by the former Government in the 2013-14 Budget as part of the reforms to protect the corporate tax base from erosion and loopholes.

1.10 The securitised assets measure was announced as part of the 2014-15 Budget. This measure removes anomalies that arise under the existing law and improves the integrity of the tax system.

Summary of new law

1.11 Schedule # to this Exposure Draft Bill amends the ITAA 1997 to improve the integrity of the consolidation regime. In particular:

- the acquired liabilities measure removes a double benefit (or a double detriment) which can arise in respect of certain deductible liabilities held by a joining entity that is acquired by a consolidated group by making the amount included in the entry allocable cost amount for the liabilities assessable (or deductible) over a period of time;
- the securitised assets measure removes anomalies that arise when an entity that has securitised assets joins or leaves a tax consolidated group by modifying the tax cost setting rules to disregard liabilities relating to the securitised assets;
- the churning measure prevents the tax costs of a joining entity's assets from being uplifted in certain circumstances where no tax is payable by a foreign resident owner when it ceases to hold membership interests in the joining entity by switching off the entry tax cost setting rules when there has been no change in the majority economic ownership of the joining entity for a period of at least 12 months before the joining time;
- the TOFA measure clarifies the operation of the TOFA provisions by setting a tax value for an intra-group asset or liability that is, or is part of, a Division 230 financial arrangement when the asset or liability emerges from a consolidated group because a subsidiary member leaves the group; and
- the value shifting measure removes anomalies that arise when an entity leaves a consolidated group holding an asset that corresponds to a liability owed to it by the old group by ensuring that the amount taken into account under the exit tax cost setting rules for the asset is aligned with the tax cost setting amount for the corresponding asset of the leaving entity.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>The acquired liabilities measure removes the double benefit (or double detriment) which can arise in respect of certain liabilities held by a joining entity.</p> <p>To remove this double benefit for deductible liabilities, the amount of the deductible liability will be included in the assessable income of the head company:</p> <ul style="list-style-type: none"> • if the deductible liability is a current liability — over a 12 month period following the joining time; and • if the deductible liability is a non-current liability — over the four year period following the joining time. <p>To remove the double detriment for unrealised foreign exchange gains on deductible liabilities, the head company will be able to deduct an amount equal to the unrealised gain amount over an equivalent period.</p>	<p>When an entity that holds a deductible liability becomes a member of a consolidated group, a double benefit arises because:</p> <ul style="list-style-type: none"> • the liability increases the entry allocable cost amount for the joining entity and therefore effectively increases the tax costs of the joining entity's assets (resulting in, for example, higher capital allowance deductions and reduced capital gains); and • the head company can deduct the amount paid to discharge the liability when it is discharged. <p>Similarly, if the joining entity has an unrealised foreign exchange gain on a deductible liability at the joining time, a double detriment arises for the group because:</p> <ul style="list-style-type: none"> • the amount of the liability included in the entry allocable cost amount for the joining entity is less than it otherwise would be; and • the head company is liable to pay tax on the gain when a forex realisation event happens in relation to the gain.
<p>The securitised assets measure modifies the entry and exit tax cost setting rules to remove anomalies that arise when an entity that has securitised assets joins or leaves a tax consolidated group by ensuring that the corresponding liability is disregarded.</p>	<p>If an entity that joins or leaves a tax consolidated group has securitised assets, a mismatch occurs under the entry and exit tax cost setting rules because the securitised asset and the corresponding liability are not recognised in the same way for tax consolidation purposes.</p>
<p>The churning measure will prevent the tax costs of a joining entity's assets from being uplifted in certain circumstances where no tax is payable by a foreign resident owner when it ceases to hold membership interests in the joining entity by</p>	<p>When an entity is acquired by a consolidated group from a foreign resident, the entry tax cost setting rules apply to reset the tax costs of the joining entity's assets even if the foreign resident is exempt from tax on any capital gain made when it</p>

switching off the entry tax cost setting rules when there has been no change in the majority economic ownership of the joining entity for a period of at least 12 months before the joining time.	ceases to hold membership interests in the joining entity.
The TOFA measure will set a tax value for an intra-group asset or liability that is, or is part of, a Division 230 financial arrangement when the asset or liability emerges from a consolidated group because a subsidiary member leaves the group. This will clarify the operation of the TOFA provisions to these financial arrangements.	The tax value for an intra-group asset or liability that is, or is part of, a Division 230 financial arrangement which emerges from a consolidated group because a subsidiary member leaves the group is unclear. As a result, the operation of the TOFA provisions to these financial arrangements is also unclear.
The value shifting measure will remove anomalies that arise when an entity leaves a consolidated group holding an asset that corresponds to a liability owed to it by the old group by ensuring that the amount taken into account under the exit tax cost setting rules for the asset is aligned with the tax cost setting amount for the corresponding asset of the leaving entity.	When an entity leaves a consolidated group holding an asset that corresponds to a liability owed to it by the old group, the amount taken into account under the exit tax cost setting rules for the asset is, with some specific exceptions, the market value of the asset. If an exception applies, the amount taken into account under the exit tax cost setting rules for the asset generally reflects the tax cost of the asset. As the exceptions have a limited scope, circumstances arise where economic gains made by the old group are sheltered from the appropriate tax consequences.

Detailed explanation of new law

1.12 This Exposure Draft Bill implements some of the recommendations made by the Board of Taxation to improve the integrity of the consolidation regime. In particular:

- the acquired liabilities measure removes a double benefit (or a double detriment) which can arise in respect of certain deductible liabilities held by a joining entity that is acquired by a consolidated group by making the amount included in the entry allocable cost amount for the liabilities assessable (or deductible) over a period of time (Part 1 of Schedule # to the Bill);

- the securitised assets measure removes anomalies that arise when an entity that has securitised assets joins or leaves a tax consolidated group by modifying the tax cost setting rules to disregard liabilities relating to the securitised assets (Part 2 of Schedule # to the Bill);
- the churning measure prevents the tax costs of a joining entity's assets from being uplifted in certain circumstances where no tax is payable by a foreign resident owner when it ceases to hold membership interests in the joining entity by switching off the entry tax cost setting rules when there has been no change in the majority economic ownership of the joining entity for a period of at least 12 months before the joining time (Part 3 of Schedule # to the Bill);
- the TOFA measure clarifies the operation of the TOFA provisions by setting a tax value for an intra-group asset or liability that is, or is part of, a Division 230 financial arrangement when the asset or liability emerges from a consolidated group because a subsidiary member leaves the group (Part 4 of Schedule # to the Bill); and
- the value shifting measure removes anomalies that arise when an entity leaves a consolidated group holding an asset that corresponds to a liability owed to it by the old group by ensuring that the amount taken into account under the exit tax cost setting rules for the asset is aligned with the tax cost setting amount for the corresponding asset of the leaving entity (Part 5 of Schedule # to the Bill).

Part 1 — The acquired liabilities measure

1.13 The acquired liabilities measure in Part 1 of Schedule # to the Bill removes a double benefit (or a double detriment) which can arise in respect of certain deductible liabilities held by a joining entity that is acquired by a consolidated group by making the amount included in the entry allocable cost amount for the liabilities assessable (or deductible) over a period of time.

1.14 One of the objects of the consolidation regime (as set out in section 700-10) is to prevent double taxation and a double tax benefit from being realised by a consolidated group.

1.15 The Board of Taxation raised concerns that a consolidated group can obtain a double benefit in respect of deductible liabilities (including the unrealised foreign exchange (forex) loss component of a liability held

by a joining entity that is an obligation to pay foreign currency) held by a joining entity that is acquired by the group (see Chapter 2 of the Board's April 2013 Report).

1.16 The Board also raised concerns that a double detriment can arise for the unrealised forex gain component of a deductible liability held by a joining entity that is an obligation to pay foreign currency.

1.17 To overcome these concerns, the Board recommended (Recommendation 2.1 of the Board's April 2013 Report) that, broadly:

- where a consolidated group obtains a double benefit because an acquired deductible liability is included in step 2 of the entry allocable cost amount, an equivalent amount should be included in the assessable income of the head company; and
- where a consolidated group obtains a double detriment because the amount of a liability included in step 2 of the entry allocable cost amount is less than it otherwise would be because of an unrealised forex gain related to the liability, the head company should be entitled to a deduction for an equivalent amount.

Deductible liabilities

1.18 The Board of Taxation raised concerns that a consolidated group can obtain a double benefit when an entity that holds a deductible liability becomes a member of a consolidated group. This double benefit arises because:

- the liability increases the entry allocable cost amount for the joining entity and therefore effectively increases the tax costs of the joining entity's assets (resulting in, for example, higher capital allowance deductions and reduced capital gains); and
- the head company can deduct the amount paid to discharge the liability when it is discharged.

1.19 To overcome this concern, the Board recommended (Recommendation 2.1 of the Board's April 2013 Report) that, broadly, where a consolidated group obtains a double benefit because an acquired deductible liability is included in step 2 of the entry allocable cost amount, an equivalent amount should be included in the assessable income of the head company.

1.20 Therefore, the operation of the consolidation tax cost setting rules will be modified where:

- an entity (the joining entity) becomes a member of a consolidated group (because the group acquires the membership interests in the joining entity);
- the joining entity holds an accounting liability (a joining liability) that is added to step 2 of the entry allocable cost amount;
- because the joining entity became a member of the group, an amount (the deduction-related amount) that is all or part of the joining liability would result in a deduction to the head company if, just after the joining time, the head company had made a payment to discharge the joining liability; and
- the joining liability is not covered by subsection 705-75(1A) — that is, a liability that is covered by subsection 705-75(1A) is excluded from the scope of section 716-420.

[Schedule #, Part 1, item 12, subsection 716-420(1)]

1.21 The amount of a joining liability will be a deduction-related amount if, for example, the liability is an accounting liability that is:

- a provision for future expenses (such as an accrued leave liability); or
- the net forex loss component of a liability held by a joining entity that is an obligation to pay foreign currency.

1.22 The value of these accounting liabilities is often based on an estimate of a future liability. Consequently, the quantum of the future deductible amount may be unclear. Therefore, for the purpose of working out the amount of a joining liability that is a deduction-related amount, the head company of the group is taken to have made a payment to discharge the joining liability just after the joining time. *[Schedule #, Part 1, item 12, paragraph 716-420(1)(c)]*

1.23 If the head company would be entitled to a deduction as a result of the discharge of the liability, the amount that would be deductible is the deduction-related amount in relation to the liability.

Example 1.1

Head Co acquires all of the membership interests in Joining Co on 30 September 2016. At the joining time, Joining Co holds an accounting liability that is a provision for long service leave of

\$150,000. This amount is included in step 2 of the entry allocable cost amount for the Joining Co.

Head Co can deduct an amount for long service leave when it is paid to an individual to whom the leave relates (or, if the individual has died, to that individual's dependant or legal personal representative) (section 26-10). Therefore, the amount of Joining Co's accounting liability that will actually be deductible to Head Co is uncertain as it is contingent on the amount of leave payments that are actually paid.

If Head Co made a payment to discharge the joining liability just after the joining time, it would need to make a payment of \$150,000. Therefore, the deduction-related amount in relation to the long service leave liability is \$150,000.

1.24 A liability that is covered by subsection 705-75(1A) is excluded from the scope of section 716-420 because, for example, it is already covered by a specific liabilities regime and have specific treatment under the consolidation regime. *[Schedule #, Part 1, item 12, paragraph 716-420(1)(d)]*

1.25 The current entry tax cost setting rules (section 705-70 to 705-85) and exit tax cost setting rules (section 711-45) will continue to apply to these excluded liabilities. For example, to the extent that they give rise to a future income tax deduction, subsection 705-75(1A) of the entry tax cost setting rules will continue to apply to these liabilities.

1.26 The liabilities that are covered by subsection 705-75(1A) are:

- policy liabilities held by a life insurance company that joins or leaves a consolidated group (which are liabilities of the type referred to in section 713-520);
- policy liabilities and reserves held by a general insurance company that joins or leaves a consolidated group (which are liabilities of the type referred to in section 713-710);
- accounting liabilities that are, or are a part of, a financial arrangement that is covered by the TOFA rules held by an entity that joins or leaves a consolidated group (which are liabilities of the type referred to in section 715-375); and
- liabilities that arise under a retirement village residence contract or a retirement village services contract held by an entity that joins or leaves a consolidated group.

[Schedule #, Part 1, items 6 and 12, paragraphs 705-75(1A)(a), 705-75(1A)(b) and 716-420(1)(d)]

1.27 In addition, a joining liability will be excluded from the scope of section 716-420 if:

- in the income year in which the joining time occurs, an entity (which may or may not be the joining entity) leaves the consolidated group;
- the leaving entity takes the liability with it — that is, the liability ceases to be a liability of the head company at the leaving time;
- the amount of the joining liability at the leaving time is substantially the same as the amount of the joining liability at the joining time; and
- the circumstances that resulted in the leaving entity ceasing to be a member of a consolidated group also resulted in a CGT event happening to one or more membership interests in the leaving entity held by a member of the group.

[Schedule #, Part 1, items 6 and 12, paragraph 705-75(1A)(c), paragraph 716-420(1)(d) and section 716-435]

1.28 One of the requirements in section 716-435 is that the amount of the joining liability at the leaving time must be substantially the same as the amount of the joining liability at the joining time. This requirement will be satisfied if the liability is predominantly the same, but there is a slight variation in the value of the liability. For example, in the case of an accrued leave liability held by a joining entity, the amount of the liability will be substantially the same at the leaving time if :

- the amount of the liability has altered between the joining time and the leaving time due to changes in salary or wage rates, but the liability relates to the same group of employees; or
- the amount of the liability has altered because, between the joining time and the leaving time, additional leave entitlements have accrued.

1.29 The purpose of excluding liabilities that are covered by section 716-435 is to ensure that anomalies do not arise where:

- a liability comes into the group with a joining entity; and

- the same liability (or a liability which is substantially the same) is taken out of a consolidated group by a leaving entity in the same income year.

Owned part of a deductible joining liability — Liability excluded from step 2 of the entry allocable cost amount

1.30 If section 716-420 applies to an accounting liability that is a deductible liability, the amount of the accounting liability which is added at step 2 of the entry allocable cost amount will not include the owned part of that deductible liability. *[Schedule #, Part 1, items 3, 4 and 12, note after subsection 705-70(1) and subsection 716-420(2)]*

1.31 Therefore, in working out the step 2 amount for an accounting liability of a joining entity, the head company will need to work through the following steps.

- First, the head company will need to determine whether section 716-420 applies to the liability — in this regard, if a liability is covered by section 705-75(1A), section 716-420 does not apply to the liability.
- Second, if section 716-420 does not apply to the liability, the step 2 amount will be worked out under the current law — that is, by applying sections 705-70 to 705-85.
- Third, if section 716-420 does apply to the liability, the head company will need to work out the owned part and the acquired part of the liability under section 716-425.
 - The owned part of the liability is not taken into account in working out the step 2 amount — that is, it is not an accounting liability that is added under section 705-70.
 - The acquired part of the liability is taken into account in working out the step 2 amount — that is, it is an accounting liability that is added under section 705-70, but the adjustments in sections 705-75, 705-80 and 705-85 do not apply to the liability.

1.32 The exclusion of the owned part of a deductible liability from step 2 of the entry allocable cost amount is consistent with the Board of Taxation recommendations. In this regard, the Board considered three shortcut methods which could be applied to determine the acquired component of deductible liabilities in progressive acquisition cases. Those methods are outlined in paragraph 2.74 of the Board's April 2013 Report as follows:

Method 1 — The deductible liabilities of a joining entity at the joining time would be taken to have been acquired by the consolidated group if at least 20 per cent of the membership interests in the joining entity had been acquired by the group in the 12 month period before joining time. Otherwise, the deductible liabilities would be taken to be owned by the group.

Method 2 — The deductible liabilities of a joining entity at the joining time would be split into an owned component and an acquired component. The current law would apply to the owned component of deductible liabilities. Therefore, the alternative approach would apply only to the acquired component of deductible liabilities.

Method 3 — This is similar to Method 2, the primary difference being that the owned component of the deductible liabilities would be disregarded for the purposes of working out the step 2 amount of the entry tax cost setting amount (as opposed to applying the current law). Here, the deductible liabilities of a joining entity at the joining time would be split into an owned component and an acquired component using the same methodology as Method 2.

1.33 The Board concluded (at paragraph 2.76 of the April 2013 Report) that Methods 2 and 3 should be further considered during the development of the legislation to implement the recommendation. However, to reduce compliance costs, any shortcut method should be mandatory.

1.34 Method 3 has been adopted on the basis that, by removing the owned component of deductible liabilities from step 2 of the entry allocable cost amount, the correct outcomes arise and the complexity of the tax cost setting rules is reduced. The method for working out the owned part of a joining deductible liability is consistent with the approach recommended by the Board.

1.35 If the joining liability is a current liability of the joining entity for accounting purposes just before the joining time, the owned part of a joining liability is worked out as follows:

$$\text{Joining liability} \times \frac{\text{Market value of membership interests held by the group 1 year before the joining time}}{\text{Market value of all membership interests 1 year before the joining time}}$$

[Schedule #, Part 1, item 12, subsections 716-425(1), (3) and (4)]

1.36 If the joining liability is a non-current liability of the joining entity for accounting purposes just before the joining time, the owned part of a joining liability is worked out as follows:

$$\text{Joining liability} \times \frac{\text{Market value of membership interests held by the group} \\ \text{4 years before the joining time}}{\text{Market value of all membership interests} \\ \text{4 years before the joining time}}$$

[Schedule #, Part 1, item 12, subsections 716-425(1), (3) and (4)]

1.37 If the market value of each membership interest in the joining entity at a relevant time is the same, it is not necessary to work out the market value in order to calculate the owned part of a joining liability. In these circumstances, the fraction can be worked out based on the number of membership interests that are held at the relevant time.

1.38 However, if the joining entity has more than one class of membership interests, the market value for each class of membership interests is likely to be different. In these circumstances, the market value of the membership interests held at the relevant times should be worked out on a reasonable basis that is consistent with the way that other steps of the entry allocable cost amount are worked out and having regard to the objects of the tax cost setting provisions.

Example 1.2

Head Co acquires all of the membership interests in Joining Co on 30 September 2016. Joining Co has 100,000 ordinary shares on issue. It has only one class of shares. At the joining time, Joining Co holds liabilities of \$2 million. \$500,000 of these liabilities are deductible liabilities. For accounting purposes:

- \$300,000 of these deductible liabilities are current liabilities; and
- \$200,000 of these deductible liabilities are non-current liabilities.

On 30 September 2015 (one year before the joining time) Head Co held 60 per cent of the membership interests (that is, 60,000 shares) in Joining Co. Therefore, in the case of the current liabilities, the owned part of the joining deductible liabilities is:

$$\begin{aligned} & \$300,000 \times \frac{60,000}{100,000} \\ & = \$180,000. \end{aligned}$$

On 30 September 2012 (four years before the joining time) Head Co held 25 per cent of the membership interests (that is, 25,000 shares) in Joining Co. Therefore, in the case of the non-current liabilities, the owned part of the joining deductible liabilities is:

$$\begin{aligned} & \$200,000 \times \frac{25,000}{100,000} \\ & = \$50,000. \end{aligned}$$

As section 716-420 applies to the deductible liabilities, subsection 716-420(2) applies to exclude the owned part of deductible liabilities from the amount included at step 2 of the entry tax cost setting amount.

Therefore, the step 2 amount for Joining Co is \$1,770,000 — that is:

- \$1,500,000 of liabilities that are not deductible liabilities;
- \$120,000 of deductible current liabilities — that is, the total amount of deductible current liabilities (\$300,000) reduced by the owned part of those liabilities (\$180,000); and
- \$150,000 of deductible non-current liabilities — that is, the total amount of deductible non-current liabilities (\$200,000) reduced by the owned part of those liabilities (\$50,000).

Acquired part of a deductible joining liability — Step 2 amount included in assessable income

1.39 The head company of a consolidated group must include an amount equal to the deduction-related amount that is attributable to the acquired part of a joining liability in its assessable income. The amount included in a particular income year depends on whether the joining liability is a current liability or non-current liability of the joining entity for accounting purposes just before the joining time. *[Schedule #, Part 1, item 12, subsection 716-420(3), paragraph 716-420(5)(a), paragraph 716-420(7)(a) and subsection 716-420(8)]*

1.40 The acquired part of a joining liability is the amount of the joining liability reduced by the owned part of the joining liability. *[Schedule #, Part 1, item 12, subsection 716-425(2)]*

1.41 Where the deduction-related amount of a joining liability is the whole amount of that liability, the acquired part of the liability is the amount of the liability reduced by the owned part of the liability. However, where the deduction-related amount of a joining liability is a part of the amount of that liability (such as the net forex loss on a debt), the acquired part of the liability is the deduction-related amount of the liability reduced by the owned part of that deduction-related amount.

1.42 To the extent that the joining liability was a current liability of the joining entity for accounting purposes just before the joining time, the

deduction-related amount that is attributable to the acquired part of the joining liability will be included in the assessable income of the head company over the 12 month period following the joining time, as follows:

- the amount included in the head company's assessable income in the income year in which the joining time occurs is worked out based on the number of days between the day on which the joining time occurs and the end of the income year; and
- the balance is included in assessable income in the following income year.

[Schedule #, Part 1, item 12, subsections 716-420(4) and (5)]

Example 1.3

Head Co, from Example 1.2, acquires all of the membership interests in Joining Co on 30 September 2016. Joining Co becomes a subsidiary member of Head Co's consolidated group on that day.

The acquired part of deductible current liabilities included in step 2 of the entry allocable cost amount for Joining Co is \$120,000. This amount will be included in Head Co's assessable income as follows:

- as there are 274 days between 30 September 2016 and 30 June 2017, \$90,082 (that is, $\$120,000 \times 274/365$) will be included in Head Co's assessable income for the 2016-17 income year; and
- the balance of \$29,918 (that is, $\$120,000 - \$90,082$) will be included in Head Co's assessable income for the 2017-18 income year.

1.43 To the extent that the joining liability was a non-current liability of the joining entity for accounting purposes just before the joining time, the deduction-related amount that is attributable to the acquired part of the joining liability will be included in the assessable income of the head company over the four year period following the joining time, as follows:

- the amount included in the head company's assessable income in the income year in which the joining time occurs is worked out based on 25 per cent of the amount of the acquired part of the joining liability and the number of days between the day on which the joining time occurs and the end of the income year;

- 25 per cent of the amount of the acquired part of the joining liability will be included in the head company's assessable income in each of the following three income years; and
- the balance is included in the head company's assessable income in the following income year.

[Schedule #, Part 1, item 12, subsection 716-420(6) and (7)]

1.44 In relation to spreading the assessable income relating to the deduction-related amount that is attributable to the acquired part of the joining liability that is a non-current liability over a four year period following the joining time, the Board (at paragraphs 2.54 to 2.56 of the April 2013 Report) stated that:

The Board also sought to balance the elimination of loss and gain duplication on deductible liabilities with the need to minimise complexity, uncertainty and compliance costs. The Board accepts that the proposed treatment of deductible non-current liabilities (spreading the assessable amount over a period of 48 months following the joining time) reflects an inexact proxy of when the deduction might be incurred. However, this approach represents a reasonable compromise as it addresses concerns about the compliance costs associated with precisely tracking every type of deductible liability.

The Board also considered the Corporate Tax Association's proposal to make this alternative approach optional, so that taxpayers who could individually track the deductible liabilities would be given the option to progressively deny themselves the quantum of those deductions in the particular income years. However, in light of the concerns raised by stakeholders with regard to the compliance burden and the difficulties with tracking these liabilities, the Board's preference is for the application of the alternative approach to all full acquisitions by a consolidated group.

Introducing separate rules for taxpayers who could track deductible liabilities would add further complexity to the existing rules and could create opportunities for taxpayers to maximise benefits. Applying the alternative approach on a mandatory basis would minimise tax risk and reduce complexity and compliance costs.

1.45 In addition, at footnote 36 of the April 2013 Report, the Board stated that:

The 48 month period represents a reasonable compromise for bringing deductible non-current liabilities included in step 2 of the entry tax cost setting amount to account into assessable income over a reasonable period of time and is consistent with the period for recognising certain amounts relating to financial arrangements held by a joining entity in certain circumstances (section 701-61 ITAA 1997). The Board

acknowledges that, like any arbitrary compliance cost savings rule, the 48 month period may result in distortionary outcomes in some circumstances. However, this approach could be adopted if desired using a longer or shorter period.

Example 1.4

Head Co, from Example 1.2, acquires all of the membership interests in Joining Co on 30 September 2016. Joining Co becomes a subsidiary member of Head Co's consolidated group on that day.

The acquired part of deductible non-current liabilities included in step 2 of the entry allocable cost amount for Joining Co is \$150,000. This amount will be included in Head Co's assessable income as follows:

- as there are 274 days between 30 September 2016 and 30 June 2017, \$28,151 (that is, $(25\% \times \$150,000) \times 274/365$) will be included in assessable income for the 2016-17 income year;
- \$37,500 (that is, $25\% \times \$150,000$) will be included in assessable income in each of the 2017-18, 2018-19 and 2019-20 income years; and
- the balance of \$9,249 (that is, $\$150,000 - \$140,651$) will be included in assessable income for the 2020-21 income year.

Liabilities related to joining time unrealised forex gains — step 2 amount deductible

1.46 The Board of Taxation also raised concerns that a double benefit or a double detriment can arise for the forex gain or loss component of a liability held by a joining entity that is an obligation to pay foreign currency. In this regard:

- if there is an unrealised forex gain in respect of the liability at the joining time, double taxation arises for the consolidated group because a reduced amount is included at step 2 of the entry allocable cost amount and the head company is taxed on the forex gain; and
- if there is an unrealised forex loss in respect of the liability at the joining time, a double benefit arises for the consolidated group because an increased amount is included at step 2 of the entry allocable cost amount and the head company can deduct the forex loss.

1.47 The forex loss component of a liability held by a joining entity arising from an obligation to pay foreign currency gives rise to a

deductible liability. Therefore, the double benefit that arises is addressed by the deductible liability provisions.

1.48 If a joining entity has an unrealised forex gain on a deductible liability at the joining time, a double detriment arises for the consolidated group because:

- the amount of the liability included in the entry allocable cost amount for the joining entity is less than it otherwise would be; and
- the head company is liable to pay tax on the gain when a forex realisation event happens in relation to the gain.

1.49 To address this double detriment that arises in respect of the forex gain component of a liability held by a joining entity, the head company of a consolidated group will be able to deduct an amount where:

- an entity (the joining entity) becomes a member of a consolidated group (because the group acquires the membership interests in the joining entity);
- the joining entity holds an accounting liability (a joining liability) that is added to step 2 of the entry allocable cost amount;
- the head company of the group would have made a forex realisation gain (as defined in subsection 995-1(1)) (the joining time unrealised forex gain) under Division 775 if, just after the joining time:
 - the head company had made a payment to discharge the joining liability; and
 - forex realisation event 4 (section 775-55) happened in relation to the joining liability — forex realisation event 4 happens, broadly, if an obligation, or a part of an obligation, to pay foreign currency ceases; and
- the joining liability is not covered by subsection 705-75(1A) — that is, a liability that is covered by subsection 705-75(1A) is excluded from the scope of section 716-430.

[Schedule #, Part 1, item 12, subsection 716-430(1)]

1.50 Paragraphs 1.24 to 1.26 outline the liabilities that are covered by subsection 705-75(1A).

1.51 The head company will be able to deduct the amount of the joining time unrealised forex gain to the extent that it is attributable to the acquired part of a joining liability.

1.52 If the joining liability was a current liability of the joining entity for accounting purposes just before the joining time, the amount of the joining time unrealised forex gain will be deductible over the one year period following the joining time, as follows:

- the amount deductible in the income year in which the joining time occurs is worked out based on the number of days between the day on which the joining time occurs and the end of the income year; and
- the balance is deductible in the following income year.

[Schedule #, Part 1, item 12, subsections 716-430(2), (3) and (6)]

1.53 If the joining liability was a non-current liability of the joining entity for accounting purposes just before the joining time, the amount of the joining time unrealised forex gain will be deductible over the 4 year period following the joining time, as follows:

- the amount deductible in the income year in which the joining time occurs is worked out based on 25 per cent of the amount of the acquired part of the amount of the joining time unrealised forex gain and the number of days between the day on which the joining time occurs and the end of the income year;
- 25 per cent of the amount of the acquired part of the amount of the joining time unrealised forex gain will be deductible in each of the following three income years; and
- the balance is deductible in the following income year.

[Schedule #, Part 1, item 12, subsections 716-430(4), (5) and (6)]

Adjustments to the entry tax cost setting rules

1.54 As a consequence of the changes to the treatment of deductible liabilities, consequential changes are required to step 2 of the entry tax cost setting rules. In particular:

- as outlined in paragraphs 1.30 to 1.38, the owned component of deductible liabilities will be excluded from the step 2 amount;
- the adjustment in subsection 705-75(1) for accounting liabilities that give rise to a future tax deduction will not apply to deductible liabilities that are covered by new section 716-420; and
- the adjustment in section 705-80 for accounting liabilities that are recognised at a later time for income tax purposes will not apply to:
 - deductible liabilities that are covered by new sections 716-420 and 716-430; or
 - accounting liabilities that are, or are a part of, financial arrangements covered by the TOFA rules.

1.55 Subsection 705-75(1) applies to reduce the amount of a liability included in step 2 of the entry tax cost setting rules where that liability gives rise to a future tax deduction. As a consequence of the changes to the treatment of deductible liabilities, this adjustment will no longer apply to deductible liabilities that are covered by new sections 716-420 and 716-430.

1.56 As a result, subsection 705-75(1) is modified so that it applies only to deductible liabilities that are excluded from the scope of new section 716-420. That is, subsection 705-75(1) will continue to have potential application to the following liabilities:

- policy liabilities held by a life insurance company that joins or leaves a consolidated group (which are liabilities of the type referred to in section 713-520);
- policy liabilities and reserves held by a general insurance company that joins or leaves a consolidated group (which are liabilities of the type referred to in section 713-710);
- accounting liabilities that are, or are a part of, a financial arrangement that is covered by the TOFA rules held by an entity that joins or leaves a consolidated group (which are liabilities of the type referred to in section 715-375);
- liabilities that arise under a retirement village residence contract or a retirement village services contract held by an entity that joins or leaves a consolidated group; and

- liabilities that are covered by new section 716-435 — that is, broadly, deductible liabilities or liabilities related to a joining time unrealised forex gain that are taken out of a consolidated group by a leaving entity in the same income year as they come into the group with a joining entity.

[Schedule #, Part 1, items 5 and 6, subsection 705-75(1A)]

1.57 The sections listed in paragraph 705-75(1A)(a) usually have the effect of specifying the step 2 amount for the specific liabilities that they cover. Therefore, even though those liabilities are listed in subsection 705-75(1A), the reduction in the step 2 amount of the entry tax cost setting rules under subsection 705-75(1) may not apply to those liabilities. For example, subsection 705-75(1) would not be expected to apply to an accounting liability that is a financial arrangement covered by the TOFA rules and is subject to the Division 230 fair value elective method.

1.58 Section 705-80 operates to increase or decrease the value of liabilities included at step 2 of the entry tax cost setting rules in respect of accounting liabilities that are recognised at a later time for income tax purposes. This adjustment is being modified so that it applies only to a liability that is covered by subsection 705-75(1A), except for an accounting liability that is, or is a part of, a financial arrangement that is covered by the TOFA rules. *[Schedule #, Part 1, items 7 and 8, subsections 705-80(1A) and (2)]*

1.59 The sections listed in paragraph 705-75(1A)(a) usually have the effect of specifying the step 2 amount for the specific liabilities that they cover. Therefore, even though those liabilities are listed in subsection 705-75(1A), the reduction in the step 2 amount of the entry tax cost setting rules under section 705-80 may not apply to those liabilities.

Adjustments to the exit tax cost setting rules

1.60 As a consequence of the changes to the treatment of deductible liabilities, consequential changes are required to step 4 of the exit tax cost setting rules. In particular, the following adjustments to the step 4 amount will not apply to deductible liabilities that are covered by new section 716-420:

- the adjustment in subsection 711-45(3) for an accounting liability that gives rise to a future tax deduction; and
- the adjustment in subsections 711-45(8) to (10) for an accounting liability that was taken into account under the

entry tax cost setting rules, where the amount of the liability on entry differs to the amount of the liability on exit.

1.61 Subsection 711-45(3) applies to reduce the amount of a liability included in step 4 of the exit tax cost setting rules where that liability gives rise to a future tax deduction. As a consequence of the changes to the treatment of deductible liabilities, this adjustment will no longer apply to deductible liabilities that are covered by new sections 716-420 and 716-430.

1.62 As a result, subsection 711-45(3) is modified so that it applies only to deductible liabilities that are excluded from new sections 716-420 and 716-430. That is, subsection 711-45(3) will continue to have potential application to the following liabilities that are covered by subsection 711-45(3A):

- policy liabilities held by a life insurance company that joins or leaves a consolidated group (which are liabilities of the type referred to in section 713-520);
- policy liabilities and reserves held by a general insurance company that joins or leaves a consolidated group (which are liabilities of the type referred to in section 713-710);
- accounting liabilities that are, or are a part of, a financial arrangement that is covered by the TOFA rules held by an entity that joins or leaves a consolidated group (which are liabilities of the type referred to in section 715-375);
- liabilities that arise under a retirement village residence contract or a retirement village services contract held by an entity that joins or leaves a consolidated group; and
- liabilities that are covered by new section 716-435 — that is, broadly, deductible liabilities or liabilities related to a joining time unrealised forex gain that are taken out of a consolidated group by a leaving entity in the same income year as they come into the group with a joining entity.

[Schedule #, Part 1, items 9, and 10, subsection 711-45(3A)]

1.63 The sections listed in paragraph 711-45(3A)(a) usually have the effect of specifying the step 4 amount for the specific liabilities that they cover. Therefore, even though those liabilities are listed in subsection 711-45(3A), the reduction in the step 4 amount of the exit tax cost setting rules under subsection 711-45(3) may not apply to those liabilities.

1.64 Subsections 711-45(8) to (10) to increase or decrease the value of liabilities included at step 4 of the exit tax cost setting rules for an accounting liability held by a leaving entity where, broadly:

- subsection 711-45(5) applies to the liability — subsection 711-45(5) adjusts the step 4 amount in relation to unrealised gains and losses on the liability;
- the liability was taken into account under the entry tax cost setting rules; and
- the amount of the liability included at step 2 of the entry tax cost setting rules (less any payment made in respect of the liability after the joining time) differs to the subsection 711-45(5) amount.

1.65 This adjustment is being modified so that it applies only to an accounting liability that is covered by subsection 711-45(3A), except for an accounting liability that is, or is a part of, a financial arrangement that is covered by the TOFA rules. [*Schedule #, Part 1, item 11, subsection 711-45(7A)*]

1.66 The sections listed in paragraph 711-45(3A)(a) usually have the effect of specifying the step 4 amount for the specific liabilities that they cover. Therefore, even though those liabilities are listed in subsection 711-45(3A), the reduction in the step 4 amount of the exit tax cost setting rules under subsections 711-45(8) to (10) may not apply to those liabilities.

Consequential amendments

1.67 Consequential amendments are made to:

- update the checklist relating to particular kinds of assessable income so that it refers to deductible liabilities; and
- update the checklist relating to particular kinds of deductions so that it refers to joining time unrealised forex gains.

[*Schedule #, Part 1, items 1 and 2, sections 10-5 and 12-5*]

Application

1.68 The acquired liabilities measure applies in relation to:

- an entity that becomes a subsidiary member of the group under an arrangement that commences on or after the 2013 Budget time — that is, at or after 7.30 pm, by legal time

in the Australian Capital Territory, on 14 May 2013 (the date of announcement of the measure by the former Government); and

- an entity that ceases to be a subsidiary member of the group under an arrangement that commences on or after the 2013 Budget time.

[Schedule #, Part 1, item 13]

1.69 The time that an arrangement commences depends on the nature of the arrangement, as outlined in paragraph #.198. *[Schedule #, Part 6, item 31]*

Part 2 — The securitised assets measure

1.70 The securitised assets measure in Part 2 of Schedule # to the Bill removes anomalies that arise when an entity that has securitised assets joins or leaves a tax consolidated group by modifying the tax cost setting rules to disregard liabilities relating to the securitised assets.

1.71 The Board of Taxation considered issues that arise where an asset is not recognised for tax consolidation purposes but a related accounting liability is recognised (or vice versa) in Chapter 5 of its April 2013 Report. In practice, the main scenario where this issue arises is when an entity joins or leaves a tax consolidated group holding assets that are subject to a securitisation arrangement.

1.72 In this regard, at paragraphs 5.13 to 5.15 of its April 2013 Report, the Board stated that:

For example, in the case of a mortgage loan securitisation arrangement, where a financial institution's interest in mortgages is equitably assigned:

- the consideration received for the assignment is recognised as an accounting liability and therefore is taken into account under the entry and exit tax cost setting rules; and
- the mortgage loan asset (being the assigned mortgage loan), which is recognised as an asset for accounting purposes, may not be recognised as an asset for tax purposes and therefore may have no tax cost allocated to it under the entry or exit tax cost setting rules.

As a result, in the case of a securitised asset held by an entity that joins a consolidated group, a mismatch that is beneficial to the group may arise because the accounting liability increases the entry tax cost setting amount but no tax cost is allocated to the securitised asset (the

value of the accounting liability is instead allocated to other reset cost base assets held by the joining entity).

However, in the case of a securitised asset held by an entity that leaves a consolidated group, a mismatch that is detrimental to the group may arise because the accounting liability reduces the exit tax cost setting amount, so that the tax cost allocated to the leaving entity's shares is understated (with the result that the group makes a higher capital gain on the disposal of those shares).

1.73 Securitisation is a financing arrangement that, so far as is relevant, typically involves the interest held by an authorised deposit-taking institution (ADI) or financial entity in certain financial assets (such as residential mortgages) being equitably assigned to a special purpose vehicle.

1.74 Typically, the special purpose vehicle raises the funds to purchase the assets from the ADI or financial entity by issuing debt securities to investors.

1.75 The ADI or financial entity holds the residual income rights in the special purpose vehicle and gets a return equal to, broadly, the difference between the payments due on the notes and the amounts receivable on the assets, net of fees associated with the securitisation arrangement. This has the advantage of allowing the ADI or financial entity to diversify its funding.

1.76 A problem arises under the consolidation tax cost setting rules when an entity that holds securitised assets joins or leaves a consolidated group. In certain circumstances, the relevant Australian accounting standard (AASB 139) requires an entity to continue to recognise the underlying securitised assets on its balance sheet despite the equitable assignment of those assets to the special purpose vehicle for valuable consideration. In addition, the entity is required to recognise an accounting liability for the consideration received from the special purpose vehicle.

1.77 In these circumstances a mismatch can arise because the consolidation tax cost setting rules recognise the value of the associated accounting liability, but the underlying securitised assets may not be recognised as assets. This is because the assets do not have economic value in the hands of the joining entity as a result of being equitably assigned to the special purpose vehicle.

1.78 As a result of this mismatch, when an entity that has securitised assets joins a tax consolidated group, the value of the accounting liability is allocated to other assets held by the joining entity. This outcome arises

because the underlying securitised assets have no or little value. As a result:

- the tax costs of those other assets are overstated; and
- to the extent that there are insufficient assets to absorb the increased tax value, the head company may realise an artificial capital loss.

1.79 When an entity that has securitised assets leaves a tax consolidated group, the accounting liability reduces the tax value that is allocated to the membership interests held by the group in the leaving entity. As a result, the group will make a higher capital gain on the disposal of the membership interests in the leaving entity because:

- the tax costs of membership interests are understated; and
- to the extent that the accounting liabilities exceed the value of the leaving entity's assets, the tax costs of the membership interests will be nil and the head company will make a capital gain equal to the amount of the excess.

1.80 To overcome this anomaly, an accounting liability arising from the transfer or equitable assignment of the securitised assets is effectively disregarded for entry and exit tax cost setting purposes where a member of the group is an ADI or a financial entity. This outcome is consistent with Recommendation 5.1 of the Board's April 2013 Report.

1.81 Securitisation arrangements typically involve ancillary agreements, such as agreements that relate to swap arrangements, liquidity facilities and other standby facilities. Any accounting liabilities arising from ancillary agreements do not arise from the transfer or equitable assignment of the underlying securitised assets and therefore are not securitisation liabilities covered by these amendments.

Securitisation liabilities disregarded under entry tax cost setting rules

1.82 When an entity joins a tax consolidated group, the value of the joining entity's accounting liabilities increase the entry allocable cost amount (step 2 of the entry allocable cost amount worked out under section 705-70). However, no amount is added at step 2 for the liability if the accounting liability is a securitisation liability (as defined in section 705-76). [*Schedule #, Part 2, item 14, subsection 705-70(4)*]

1.83 An accounting liability is a securitisation liability if:

- at the joining time, a member of the joined group is an *ADI* or a *financial entity* (as defined in subsection 995-1(1)) — this requirement recognises that securitisation arrangements are primarily undertaken by these types of entities;
- the liability:
 - arose from the transfer or equitable assignment of one or more assets (the underlying securitised assets) by the joining entity to another entity before the joining time; and
 - is a liability of the joining entity at the joining time according to the accounting principles that the joining entity would use if it were to prepare financial statements just before the joining time;
- the other entity was established for the purpose of securitising assets — this will be determined by applying ordinary commercial principles;
- the underlying securitised assets were securitised in accordance with that purpose before the joining time; and
- at the joining time, the market value of the joining entity's interest in the underlying securitised assets was nil (so that the interest in underlying securitised assets is not recognised as an asset for tax consolidation purposes), or was substantially less than the amount of the securitisation liability — this requirement ensures that, regardless of what the entity recognised, at law there is a mismatch between the value of the joining entity's interest in the securitised assets recognised for tax consolidation purposes and the value of the securitisation liability.

[Schedule #, Part 2, item 15, section 705-76]

1.84 The underlying securitised assets will be transferred or equitably assigned for these purposes if those assets are taken to be transferred or equitably assigned for the purposes of the relevant Australian accounting standards. This ensures that the full range of circumstances that can give rise to the current anomaly in the law are covered by these amendments.

1.85 In addition, if the joining entity was a member of another tax consolidated group (the old group) prior to the joining time, the single entity rule (section 701-1) applied to the joining entity when it was a member of the old group. However, that rule has no effect for the purpose

of determining whether the joining entity transferred or equitably assigned the underlying securitised assets to another entity before the joining time.

In this regard:

- the single entity rule applies to the old group only for the purpose of determining the old group's income tax liability or loss for an income year; and
- the single entity rule does not affect the joined group's ability to determine whether, in fact, a transfer or assignment took place while the joining entity was a member of the old group.

Securitisation liabilities disregarded under exit tax cost setting rules

1.86 When an entity leaves a tax consolidated group, the value of the joining entity's accounting liabilities decrease the exit allocable cost amount (step 4 of the exit allocable cost amount worked out under section 711-45). However, no amount is added at step 4 for the liability if the accounting liability is a securitisation liability (as defined in section 711-46). [*Schedule #, Part 2, item 16, subsection 711-45(11)*]:

1.87 An accounting liability is a securitisation liability if:

- just before the leaving time, a member of the old group is an *ADI* or *financial entity* (as defined in subsection 995-1(1));
- the liability:
 - arose from the transfer or equitable assignment of one or more assets (the underlying securitised assets) by the member of the old group to another entity before the leaving time; and
 - is a liability of the leaving entity at the leaving time according to the accounting principles that the leaving entity would use if it were to prepare financial statements just before the leaving time;
- the other entity was established for the purpose of securitising assets — this will be determined by applying ordinary commercial principles;
- the underlying securitised assets were securitised in accordance with that purpose before the leaving time; and
- at the leaving time, the market value of the leaving entity's interest in the underlying securitised assets was nil (so that

the interest in the underlying securitised asset is not recognised as an asset for tax consolidation purposes), or was substantially less than the amount of the securitisation liability — this requirement ensures that, regardless of what the entity recognised, at law there is a mismatch between the value of the leaving entity's interest in the securitised assets recognised for tax consolidation purposes and the value of the securitisation liability.

[Schedule #, Part 2, item 17, section 711-46]

1.88 The underlying securitised assets will be transferred or equitably assigned for these purposes if those assets are taken to be transferred or equitably assigned for the purposes of the relevant Australian accounting standards. This ensures that the full range of circumstances that can give rise to the current anomaly in the law are covered by these amendments.

Application

1.89 The securitised assets measure applies in relation to an entity that joins or leaves a tax consolidated group under an arrangement that commences after the 2014 Budget time. The 2014 Budget time is 7.30 pm, by legal time in the Australian Capital Territory, on 13 May 2014 (the time of announcement of the measure). *[Schedule #, Part 2, subitems 18(1) and (7), 19(1) and (6)]*

1.90 The time that an arrangement commences depends on the nature of the arrangement, as outlined in paragraph #.198. *[Schedule #, Part 6, item 31]*

1.91 Under the transitional rules, the securitised assets measure also applies in relation to an entity that:

- became a member of a tax consolidated group under an arrangement that commenced before the 2014 Budget time in certain circumstances; or
- ceased to be a member of a tax consolidated group under an arrangement that commenced before the 2014 Budget time in certain circumstances.

[Schedule #, Part 2, subitems 18(2) to (7) and 19(2) to (6)]

1.92 The transitional rules are consistent with observations made by the Board of Taxation directed at ensuring equitable outcomes for tax consolidated groups affected by anomalies that arise under the current law in relation to securitised assets and have been developed in consultation with key stakeholders to ensure that taxpayers are not disadvantaged by

the amendments. However, the transitional rules are also designed to prevent taxpayers from obtaining unexpected windfall gains.

Transitional rules when an entity became a member of a tax consolidated group under an arrangement that commenced before the 2014 Budget time

1.93 Under the joining case transitional rules, the securitised assets measure applies in relation to an entity that became a member of a tax consolidated group under an arrangement that commenced before the 2014 Budget time in certain circumstances. [*Schedule #, Part 2, subitems 18(2) to (7)*]

1.94 The joining case transitional rules ensure that the position taken by the head company of a tax consolidated group under the entry tax cost setting rules in relation to an arrangement entered into before the 2014 Budget time is maintained.

1.95 In addition, the joining case transitional rules ensure that the current law will apply to an arrangement entered into before the 2014 Budget time where the head company of the group first works out the entry allocable cost amount for a joining entity between the 2014 Budget time and the commencement of this measure.

1.96 The outcome that arises under the joining case transitional rules depends on whether or not, under the entry tax cost setting rules, the head company recognised:

- the securitisation liability held by the joining entity; or
- the securitised asset held by the joining entity.

Securitisation liability recognised under the entry tax cost setting rules

1.97 Where, under an arrangement that was entered into before the 2014 Budget time, the head company of a tax consolidated group recognised the full securitisation liability held by the joining entity under the entry tax cost setting rules, the joining case transitional rules confirm this position.

1.98 Consequently, the securitisation liability is not removed from the entry allocable cost amount for a joining entity under an arrangement that was entered into before the 2014 Budget time if the Commissioner of Taxation considers that it is reasonable to conclude that:

- the circumstances in section 705-76 existed — that is, broadly:

- at the joining time, a member of the joined group is an ADI or financial entity;
 - the joining entity was holding an accounting liability that is a securitisation liability; and
 - the market value of the joining entity’s interest in the underlying securitised asset was nil, or was substantially less than the amount of the securitisation liability;
- the head company of the group worked out the group’s allocable cost amount for the joining entity before the 2014 Budget time; and
 - for the purpose of working out the step 2 amount, the head company added the full amount for the securitisation liability.

[Schedule #, Part 2, subitem 18(3)]

1.99 If the Commissioner is not satisfied that the circumstances in subitem 18(3) exist, the joining case transitional rules apply to ensure that the securitisation liability is not included in the entry allocable cost amount for the joining entity. *[Schedule #, Part 2, subitem 18(2)]*

Securitised asset recognised under the entry tax cost setting rules

1.100 In some cases, under an arrangement that was entered into before the 2014 Budget time, the head company of a tax consolidated group that recognised a securitisation liability for the purpose of working out the step 2 amount for a joining entity may have worked out a tax cost setting amount for the interest in the securitised asset in order to eliminate or reduce the mismatch that would otherwise arise.

1.101 As the interest in the securitised asset is not recognised as an asset under the tax consolidation regime, the joining case transitional rules apply to reduce the tax consolidated group’s allocable cost amount for the joining entity by the tax cost setting amount allocated to the interest in the underlying securitised assets. *[Schedule #, Part 2, items 18(4) and (5)]*

1.102 This transitional rule applies only if the Commissioner considers that it is reasonable to conclude that, before the 2014 Budget time, the head company of the group worked out a tax cost setting amount for that interest. *[Schedule #, Part 2, items 18(4) and (5)]*

1.103 The purpose of this transitional rule is to prevent affected tax consolidated groups from obtaining an unintended benefit by revising the

tax cost setting calculations for a joining entity and allocating the value of the securitisation liability to the tax cost setting amounts of other assets.

1.104 However, the transitional rule minimises compliance costs for affected tax consolidated groups as it ensures that the tax cost setting amounts for assets other than the interest in the securitised asset remain the same.

Securitisation liability not recognised under the entry tax cost setting rules

1.105 In some cases, under an arrangement that was entered into before the 2014 Budget time, the head company of a tax consolidated group may not have recognised a securitisation liability under the entry allocable cost amount for a joining entity in order to eliminate or reduce the mismatch that would otherwise arise.

1.106 The joining case transitional rules apply to protect affected tax consolidated groups that took this position. In addition, these tax consolidated groups are prevented from obtaining an unintended benefit by revising the tax cost setting calculations for a joining entity to change the position that they took — that is, these groups are unable to revise the tax cost setting calculations for a joining entity by recognising a securitisation liability under the entry allocable cost amount for the joining entity. *[Schedule #, Part 2, items 18(2) and (3)]*

No position taken prior to the 2014 Budget time

1.107 The joining case transitional rules ensure that the current law will apply to an arrangement entered into before the 2014 Budget time where the head company of the tax consolidated group first works out the entry allocable cost amount for a joining entity between the 2014 Budget time and the commencement of this measure. This will protect taxpayers that relied on the current law when they entered into a commercial transaction before the 2014 Budget time.

1.108 Consequently, the amendments will not apply where an entity entered into an arrangement before the 2014 Budget time and the Commissioner considers that it is reasonable to conclude that:

- the circumstances in section 705-76 existed — that is, broadly:
 - at the joining time, a member of the joined group is an ADI or financial entity;
 - the joining entity was holding an accounting liability that is a securitisation liability; and

- the market value of the joining entity’s interest in the underlying securitised asset was nil, or was substantially less than the amount of the securitisation liability; and
- the head company of the group first worked out the group's allocable cost amount for the joining entity:
 - after the 2014 Budget time; and
 - before the date of Royal Assent for this Bill.

[Schedule #, Part 2, item 18(6)]

1.109 If the Commissioner is not satisfied that the circumstances in subitem 18(6) exist, the joining case transitional rules apply to ensure that the securitisation liability is not included in the entry allocable cost amount for the joining entity. *[Schedule #, Part 2, subitem 18(2)]*

Transitional rules when an entity ceased to be a member of a consolidated group under an arrangement that commenced before the 2014 Budget time

1.110 Under the leaving case transitional rules, the securitised assets measure applies in relation to an entity that ceased to be a member of a tax consolidated group under an arrangement that commenced before the 2014 Budget time in certain circumstances. *[Schedule #, Part 2, subitems 19(2) to (6)]*

1.111 The leaving case transitional rules ensure that the position taken by the head company of a tax consolidated group under the exit tax cost setting rules in relation to an arrangement entered into before the 2014 Budget time is maintained.

1.112 However, under these transitional rules, the securitised assets measure will apply to disregard a securitisation liability when working out the exit allocable cost amount for a leaving entity if the head company:

- entered into an arrangement before the 2014 Budget time; and
- has not taken a position in relation to the treatment of the securitisation liability prior to that time.

1.113 Therefore, the outcome that arises under the leaving case transitional rules depends on whether or not, under the exit tax cost setting rules, the head company of the old group recognised:

- the securitisation liability that leaves the old group with a leaving entity; or
- the securitised asset that leaves the old group with a leaving entity.

Securitisation liability recognised under the exit tax cost setting rules

1.114 Where, under an arrangement that was entered into before the 2014 Budget time, the head company of a tax consolidated group recognised a securitisation liability held by the leaving entity under the exit tax cost setting rules, the leaving case transitional rules confirm this position.

1.115 Consequently, the securitisation liability is not removed from the exit allocable cost amount for a leaving entity under an arrangement that was entered into before the 2014 Budget time if the Commissioner of Taxation considers that it is reasonable to conclude that:

- the circumstances in section 711-46 existed — that is, broadly:
 - just before the leaving time, a member of the old group is an ADI or financial entity;
 - the leaving entity was holding an accounting liability that is a securitisation liability; and
 - the market value of the leaving entity’s interest in the underlying securitised asset was nil, or was substantially less than the amount of the securitisation liability;
- the head company of the group worked out the old group’s allocable cost amount for the leaving entity before the 2014 Budget time; and
- for the purpose of working out the step 4 amount, the head company added an amount for the securitisation liability.

[Schedule #, Part 2, item 19(3)]

1.116 If the Commissioner is not satisfied that the circumstances in subitem 19(3) exist, the leaving case transitional rules apply to ensure that the securitisation liability is not included in the exit allocable cost amount for the leaving entity. *[Schedule #, Part 2, subitem 19(2)]*

Securitised asset recognised under the exit tax cost setting rules

1.117 In some cases, under an arrangement that was entered into before the 2014 Budget time, the head company of a tax consolidated group that recognised a securitisation liability under the exit allocable cost amount for a leaving entity may have also recognised the tax cost setting amount for the interest in the securitised asset in order to eliminate or reduce the mismatch that would otherwise arise.

1.118 In these circumstances, the leaving case transitional rules apply so that the old group's allocable cost amount for the leaving entity is increased by the amount included for the interest in the securitised asset at step 1 of the exit allocable cost amount. [*Schedule #, Part 2, items 19(4) and (5)*]

1.119 However, the transitional rule applies only if the Commissioner considers that it is reasonable to conclude that, before the 2014 Budget time, the head company of the old group worked out a tax cost setting amount for the leaving entity's interest in the underlying securitised assets and included an amount at step 1. [*Schedule #, Part 2, items 19(4) and (5)*]

1.120 As a result of this transitional rule, the tax cost setting amounts for the membership interests held by the old group in the leaving entity will remain unchanged. Therefore, affected tax consolidated groups will not incur additional compliance costs that would be required to recalculate the tax cost setting amounts for those membership interests if the interest in the securitised asset ceased to be recognised as an asset for the purposes of applying step 1 of the exit allocable cost amount.

No position taken prior to the 2014 Budget time

1.121 The leaving case transitional rules ensure that the securitisation measure will apply to an arrangement entered into before the 2014 Budget time where the head company of the old tax consolidated group first works out the entry allocable cost amount for a leaving entity after the 2014 Budget time. [*Schedule #, Part 2, subitem 19(2)*]

1.122 This will ensure that affected tax consolidated groups are protected from adverse outcomes that arise under the existing law.

Transitional rules — When is the allocable cost amount worked out?

1.123 The joining case and leaving case transitional rules are largely intended to ensure that affected tax consolidated groups do not have to change what they actually did under the current law. Therefore, some of the transitional rules apply based on way that a tax consolidated group worked out the allocable cost amount for a joining entity or a leaving entity.

1.124 When an entity joins a tax consolidated group, the tax costs of each asset of the joining entity is set at the joining time at an amount equal to the asset's tax cost setting amount (subsection 701-10(4)).

1.125 Similarly, when an entity leaves a tax consolidated group, the tax costs of each membership interest held by old group in the leaving entity is set at the leaving time at an amount equal to the interest's tax cost setting amount (subsection 701-15(3)).

1.126 Subsections 701-10(4) and 701-15(3) set the tax costs of assets and membership interests at a particular time. However, the application of the transitional rules depends on the time when the head company of a tax consolidated group actually calculated the tax cost setting amounts.

1.127 The head company of a tax consolidated group may calculate multiple draft permutations of an allocable cost amount. Although these calculations may be based on the entry and exit allocable cost amount rules, they are merely draft calculations.

1.128 Only the amount used to determine the tax costs of the joining entity's assets, or to calculate the tax costs of the old group's membership interests in the leaving entity, constitute the allocable cost amount. None of the other draft calculations constitute an allocable cost amount and therefore are insufficient alone to evidence the time at which a tax consolidated group has 'worked out' its allocable cost amount.

1.129 To determine if an allocable cost amount is 'worked out' before a particular time, for the purpose of applying the transitional rules, the Commissioner of Taxation will assess each situation according to the facts of each case. However, it is expected that the Commissioner will have regard to the following factors:

- information supplied by the affected tax consolidated group — the group may need to supply the Commissioner with electronic copies of its allocable cost amount calculations, with an electronic timestamp showing the time of the calculation;
- information available in the affected tax consolidated group's income tax return — it is expected that the Commissioner will cross-check an allocable cost amount calculation with, for example, capital allowance deductions, or a net capital gain or loss, claimed in the group's income tax return to determine the authenticity of their allocable cost amount calculation; and

- any other information that the Commissioner considers to be relevant.

Part 3 — The churning measure

1.130 The churning measure in Part 3 of Schedule # to the Bill prevents the tax costs of a joining entity's assets from being uplifted in certain circumstances where no tax is payable by a foreign resident owner when it ceases to hold membership interests in the joining entity by switching off the entry tax cost setting rules when there has been no change in the majority economic ownership of the joining entity for a period of at least 12 months before the joining time.

1.131 The churning measure is consistent with Recommendation 5.6 of the Board of Taxation's June 2012 Report.

When do the modifications to the tax cost setting rules apply?

1.132 The operation of the tax cost setting rules will be modified when:

- an entity (the joining entity) becomes a subsidiary member of a consolidated group;
- another entity (the gain entity) ceased to hold membership interests in the joining entity during the period (the test period) that:
 - started 12 months before the joining time; and
 - ended immediately after the joining time;
- a CGT event happened because the gain entity ceased to hold the membership interests;
- a capital gain of the gain entity from the CGT event was disregarded because of the operation of Division 855;
- the tax costs of the joining entity's assets would ordinarily be set at their tax cost setting amounts because the joining entity becomes a subsidiary member of the group — that is, section 701-10 would ordinarily apply to the joining entity's assets;
- it is reasonable to conclude that, throughout the test period, an entity (the control entity) had a *total participation interest*

(as defined in section 960-180) in the joining entity of 50 per cent or more; and

- if the control entity is not the gain entity, it is reasonable to conclude that the control entity had a *total participation interest* in the gain entity of 50 per cent or more at the time the CGT event happened.

[Schedule #, Part 3, item 20, subsection 716-440(1)]

1.133 Paragraph 716-440(1)(d) is satisfied if a capital gain of the gain entity from a CGT event was disregarded because of the operation of Division 855. This requirement can be satisfied even if, under a double tax agreement, Australia does not have a right to tax the capital gain of the gain entity.

1.134 Paragraph 716-440(1)(f) is satisfied if it is reasonable to conclude that, throughout the test period, an entity (the control entity) had a total participation interest in the joining entity of 50 per cent or more. Broadly, this test ensures that the churning measure will apply in respect of a joining entity only where that joining entity has been majority owned (directly or indirectly) by the control entity for a period of at least 12 months ending immediately after the joining time.

1.135 Paragraph 716-440(1)(g) is satisfied if, where the control entity is not the gain entity, it is reasonable to conclude that the control entity had a total participation interest in the gain entity of 50 per cent or more at the time of the CGT event which gave rise to the capital gain that was disregarded because of Division 855. This test requires the control entity and the gain entity to be the same or to be related at the time of the CGT event. This ensures that the churning measure applies only where the entity that ultimately benefits from the application of Division 855 would also ultimately benefit from the uplift in the tax cost of the joining entity's assets at the joining time if the churning measure did not apply.

1.136 An entity's *total participation interest* in another entity, as defined in section 960-180, at a particular time is the sum of:

- the entity's *direct participation interest* in the other entity at that time; and
- the entity's *indirect participation interest* in the other entity at that time.

1.137 An entity's *direct participation interest* is the total interest that an entity directly holds in another entity and is worked out under section 960-190.

1.138 An entity's *indirect participation interest* is the participation interest held by an entity in another entity through intermediate entities and is worked out in the way set out in section 960-185.

Which tax cost setting rules do not apply?

1.139 If the modifications apply to the head company of a consolidated group, the tax cost setting rules do not apply to reset the tax costs of the joining entity's assets. That is, the following provisions do not apply:

- section 701-10 (which is about the cost to the head company of the joining entity's assets);
- subsection 701-35(4) (which is about setting the value of trading stock at a tax-neutral amount); and
- subsection 701-35(5) (which is about setting the value of registered emissions units at a tax-neutral amount).

[Schedule #, Part 3, item 20, subsection 716-440(2)]

1.140 The consequence of switching off these tax cost setting rules is that, broadly, the tax costs of the joining entity's assets are retained.

Example 1.5

On 1 July 2013, FP Co (a foreign resident company) beneficially owns all of the membership interests in Target Co and Head Co respectively. Head Co, in turn, beneficially owns all of the membership interests in Acquirer Co.

- Target Co, Head Co and Acquirer Co are all Australian resident companies.
- Head Co and Acquirer Co are members of a consolidated group (the Head Co consolidated group).

On 1 September 2014, FP Co disposed of all of its membership interests in Target Co to Acquirer Co. As a result, CGT event A1 happened and FP Co makes a capital gain which is disregarded under Division 855 of the ITAA 1997.

Upon Acquirer Co becoming the beneficial owner of all of the membership interests in Target Co, Target Co became a subsidiary member of the Head Co consolidated group.

The churning conditions in subsection 716-440(1) are satisfied in this example. That is:

- paragraph 716-440(1)(a) is satisfied as Target Co became a subsidiary member of a consolidated group (the Head Co consolidated group) at a time (1 September 2014);
- paragraph 716-440(1)(b) is satisfied as FP Co ceased to hold membership interests in Target Co on 1 September 2014, which is during the test period — the test period is a period of 12 months ending just after the joining time (1 September 2014);
- paragraphs 716-440(1)(c) and (d) are satisfied as CGT event A1 happened as a result of FP Co ceasing to hold membership interests in Target Co and the resulting capital gain was disregarded under Division 855;
- paragraph 716-440(1)(e) is satisfied because, if the churning measure did not apply, the tax cost of Target Co's assets would be reset under the consolidation entry tax cost setting rules;
- paragraph 716-440(1)(f) is satisfied as, throughout the test period, FP Co (the control entity) maintained a total participation interest of at least 50 per cent in Target Co — that is, FP Co maintained a total participation interest of 100 per cent in Target Co throughout the test period, taking the following factors into account:
 - at the beginning of the test period, FP Co had a direct participation interest, and consequently a total participation interest, of 100 per cent in Target Co; and
 - at the end of the test period, FP Co had an indirect participation interest; and consequently a total participation interest, of 100 per cent in Target Co (FP's indirect participation interest in Target Co represents the total interest held in Target Co by FP through intermediary entities Head Co and Acquirer Co); and
- paragraph 716-440(1)(g) is not relevant in this example as FP Co is the gain entity.

All of the relevant churning conditions in subsection 716-440(1) are met in this example. Therefore, subsection 716-440(1) applies, with the effect that the existing tax values of Target Co's assets are retained when Target Co joins the Head Co consolidated group.

Example 1.6

On 1 July 2014, the Head Co consolidated group consists of two Australian resident companies, Head Co and Acquirer Co. Acquirer Co beneficially owns all of the membership interests in Foreign Co (a foreign resident company) who, in turn, beneficially owns all of the membership interests in Target Co (an Australian resident company).

Target Co is not a subsidiary member of the Head Co consolidated group as it does not qualify as a transitional foreign held subsidiary under Division 701C of the *Income Tax (Transitional Provisions) Act 1997*.

On 1 December 2015, Foreign Co disposes of all of its membership interests in Target Co to Acquirer Co. As a result, CGT event A1 happens and Foreign Co makes a capital gain which is disregarded under Division 855 of the ITAA 1997.

At the time Acquirer Co became the beneficial owner of all of the membership interests in Target Co, Target Co became a subsidiary member of the Head Co consolidated group.

The churning conditions in subsection 716-440(1) are satisfied in this example. That is:

- paragraph 716-440(1)(a) is satisfied as Target Co became a subsidiary member of a consolidated group (the Head Co consolidated group) at a time (1 December 2015);
- paragraph 716-440(1)(b) is satisfied as Foreign Co ceased to hold membership interests in Target Co on 1 December 2015, which is during the test period — the test period is a period of 12 months ending just after the joining time of 1 December 2015;
- paragraphs 716-440(1)(c) and (d) are satisfied as CGT event A1 happened as a result of Foreign Co ceasing to hold membership interests in Target Co and the resulting capital gain was disregarded under Division 855;
- paragraph 716-440(1)(e) is satisfied as, if the churning measure did not apply, the tax cost of Target Co's assets would be reset under the consolidation entry tax cost setting rules;
- paragraph 716-440(1)(f) is satisfied as, throughout the test period, Head Co (a control entity) maintained a total participation interest of at least 50 per cent in Target Co — that is, Head Co's maintained a total participation interest of 100 per cent in Target Co throughout the test period, taking the following factors into account:
 - at the beginning of the test period, Head Co had an indirect participation interest, and consequently a total participation interest, of 100 per cent in Target Co — Head Co's indirect participation interest in Target Co represents the total interest held in Target Co by Head Co through intermediary entities Acquirer Co and Foreign Co; and
 - at the end of the test period Head Co had an indirect participation interest, and consequently a total participation

interest, of 100 per cent in Target Co — Head Co's indirect participation interest in Target Co represents the total interest held in Target Co by Head Co through intermediary entity Acquirer Co; and

- paragraph 716-440(1)(g) is satisfied as Head Co (a control entity) had a total participation interest in Foreign Co (the gain entity) of at least 50 per cent at the time of the CGT event which gave rise to the disregarded capital gain — this is because Head Co had an indirect participation interest in Foreign Co of 100 per cent at this time.

All of the relevant churning conditions in subsection 716-440(1) are met in this example. Therefore, subsection 716-440(1) applies, with the effect that the existing tax values of Target Co's assets are retained when Target Co joins the Head Co consolidated group.

Example 1.7

On 1 July 2013, the Head Co consolidated group consists of two Australian resident companies, Head Co and Acquirer Co. Acquirer Co beneficially owns 70 per cent of the membership interests in Target Co. The remaining 30 per cent of the membership in Target Co are beneficially owned by X Co, a foreign resident entity which is unrelated to the two members of the consolidated group.

On 1 June 2015, X Co disposes of its membership interests in Target Co to Acquirer Co. As a result CGT event A1 happens and X Co makes a capital gain which is disregarded under Division 855 of the ITAA 1997.

At the time Acquirer Co became the beneficial owner of all of the membership interests in Target Co, Target Co became a subsidiary member of the Head Co consolidated group.

The churning conditions in paragraph 716-440(1)(a) to (f) are satisfied in this example. That is:

- paragraph 716-440(1)(a) is satisfied as Target Co became a subsidiary member of a consolidated group (the Head Co consolidated group) at a time (1 June 2015);
- paragraph 716-440(1)(b) is satisfied as X Co ceased to hold membership interests in Target Co on 1 June 2015, which is during the test period — the test period is a period of 12 months ending just after the joining time of 1 June 2015;
- paragraphs 716-440(1)(c) and (d) are satisfied as CGT event A1 happened as a result of X Co ceasing to hold membership interests in Target Co and the resulting capital gain was disregarded under Division 855;

- paragraph 716-440(1)(e) is satisfied because, if the churning measure did not apply, the tax cost of Target Co's assets would be reset under the consolidation entry tax cost setting rules; and
- paragraph 716-440(1)(f) is satisfied as, throughout the test period, Head Co (a control entity) maintained a total participation interest of at least 50 per cent in Target Co — that is, Head Co maintained a total participation interest of at least 70 per cent in Target Co throughout the test period (which exceeds the minimum 50 per cent requirement in paragraph 716-440(1)(f)), taking the following factors into account:
 - at the beginning of the test period, Head Co has an indirect participation interest, and consequently a total participation interest, of 70 per cent in Target Co — Head Co's indirect participation interest in Target Co represents the total interest held in Target Co by Head Co through Acquirer Co; and
 - at the end of the test period, Head Co had an indirect participation interest, and consequently a total participation interest, of 100 per cent in Target Co — Head Co's indirect participation interest in Target Co at that time represents the total interest held in Target Co by Head Co through Acquirer Co.

However, the conditions in paragraph 716-440(1)(g) are not met because, at the time of the CGT event which gave rise to the disregarded capital gain, Head Co (a control entity) had a total participation interest of nil in X Co. Therefore, the minimum requirement of 50 per cent is not satisfied.

As all of the relevant churning conditions in subsection 716-440(1) are not met, the churning measure does not apply in the circumstances set out in this example. Therefore, the consolidation entry tax cost setting rules will apply to reset the tax cost of Target Co's assets when it joins the Head Co consolidated group.

Application

1.141 The churning measure applies in relation to an entity that joins a consolidated group under an arrangement that commences on or after the 2013 Budget time. The 2013 Budget time is 7.30 pm, by legal time in the Australian Capital Territory, on 14 May 2013 (the date of announcement of the measure by the former Government). [*Schedule #, Part 3, item 21*]

1.142 The time that an arrangement commences depends on the nature of the arrangement, as outlined in paragraph #.198. [*Schedule #, Part 6, item 31*]

Part 4 — The TOFA measure

1.143 The TOFA measure in Part 4 of Schedule # to the Bill clarifies the operation of the TOFA provisions by setting a tax value for an intra-group asset or liability that is, or is part of, a Division 230 financial arrangement when the asset or liability emerges from a consolidated group because a subsidiary member leaves the group.

1.144 This will, for example, ensure that:

- a lender is not assessed on a return of the principal of a loan; and
- a borrower cannot claim deduction for the repayment of that principal.

1.145 The broad objective of the TOFA measure is to make the tax treatment of intra-group TOFA financial arrangements consistent with the economic substance of the transactions.

1.146 Similar rules currently exist for TOFA financial arrangements that are not intra-group financial arrangements (sections 715-375 and 715-378).

Setting a tax cost for intra-group liabilities that are Division 230 financial arrangements

1.147 New section 715-379 sets a tax cost for an intra-group liability that is, or is part of, a Division 230 financial arrangement. This is necessary for the operation of the TOFA provisions so that the entity that holds the Division 230 financial arrangement after the leaving time can determine gains and losses relating to the arrangement.

1.148 The tax cost for an accounting liability that is, or is part of, a Division 230 financial arrangement is set for an entity (the leaving entity) that ceases to be a member of a consolidated group at a time (the leaving time) if:

- a thing (the accounting liability) is, in accordance with accounting standards or statements of accounting concepts made by the Australian Accounting Standards Board, a liability of the leaving entity just before the leaving time that can or must be recognised in its statement of financial position;
- because the single entity rule (subsection 701-1(1)) ceases to apply to the leaving entity at the leaving time:

- the accounting liability becomes a liability of the leaving entity; and
- an asset (the corresponding asset) that consists of the liability becomes an asset of the head company; and
- the corresponding asset's tax cost is set under section 701-20.

[Schedule #, Part 4, item 24, paragraph 715-379(1)(a), subparagraphs 715-379(1)(b)(i), (c)(i) and (d)(i), and paragraph 715-379(1)(e)]

1.149 In these circumstances, for the purposes of Division 230 and Schedule 1 to the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009*, the leaving entity is taken to have started to have the accounting liability at the leaving time for receiving a payment equal to the tax cost setting amount of the corresponding asset. *[Schedule #, Part 4, item 24, paragraph 715-379(2)(a)]*

1.150 Similarly, the tax cost for an accounting liability that is, or is part of, a Division 230 financial arrangement is set for the head company of a consolidated group when an entity (the leaving entity) ceases to be a member of a consolidated group at a time (the leaving time) if:

- a thing (the accounting liability) is, in accordance with accounting standards or statements of accounting concepts made by the Australian Accounting Standards Board, a liability of the head company of the group at the leaving time that can or must be recognised in its statement of financial position;
- because the single entity rule (subsection 701-1(1)) ceases to apply to the leaving entity at the leaving time:
 - the accounting liability becomes a liability of the head company; and
 - an asset (the corresponding asset) that consists of the liability becomes an asset of the leaving entity; and
- the corresponding asset's tax cost is set under section 701-45.

[Schedule #, Part 4, item 24, paragraph 715-379(1)(a), subparagraphs 715-379(1)(b)(ii), (c)(ii) and (d)(ii), and paragraph 715-379(1)(e)]

1.151 In these circumstances, for the purposes of Division 230 and Schedule 1 to the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009*, the head company is taken to have started to have the accounting liability at the leaving time for receiving a payment

equal to the tax cost setting amount of the corresponding asset. [*Schedule #, Part 4, item 24, paragraph 715-379(2)(b)*]

1.152 The tax cost setting amount of the corresponding asset is worked out under sections 701-60 and 701-60A — the operation of these sections is outlined in the explanation relating to the value shifting amendments in Part 5 of Schedule # to this Bill.

Application of Division 230 to intra-group financial arrangements when an entity leaves a consolidated group

1.153 Under TOFA provisions, a taxpayer has a financial arrangement if, broadly, the taxpayer has a right to receive or an obligation to provide financial benefits under an arrangement (section 230-45).

1.154 Section 230-60 deems a taxpayer to have a right to receive or an obligation to provide a financial benefit under an arrangement if the financial benefit plays an integral role in determining whether there is a gain or loss from the arrangement or the amount of such a gain or loss.

1.155 New section 715-379A ensures that section 230-60 operates appropriately when an entity starts to have an asset or liability that is, or is part of, a Division 230 financial arrangement which emerges from a consolidated group when an entity leaves the group. This ensures that the TOFA provisions apply after the leaving time to gains and losses on the financial arrangement.

1.156 An entity (the leaving entity) that ceases to be a member of a consolidated group at a time (the leaving time) will be taken to have an obligation to provide or a right to receive a financial benefit under an arrangement in relation to an asset or liability if:

- because the single entity rule (subsection 701-1(1)) ceases to apply to the leaving entity after the leaving time, the asset or liability emerges from the group and becomes an asset or liability of the leaving entity;
- in the case of an asset, subsection 701-55(5A) applies in relation to the asset at the leaving time because of section 701-45 — that is, the tax cost of the asset is set at the leaving time;
- in the case of a liability, subsection 715-379(2) applies in relation to the liability at the leaving time — that is, the tax cost of the liability is set at the leaving time; and

- the asset or liability is, or is part of, a Division 230 financial arrangement.

[Schedule #, Part 4, item 24, paragraph 715-379A(1)(a), subparagraph 715-379A(1)(b)(i), paragraph 715-379A(1)(c) and paragraph 715-379A(1)(e)]

1.157 In these circumstances, in the case of an asset that is, or is part of, a Division 230 financial arrangement held by the leaving entity after the leaving time, for the purpose of section 230-60, the leaving entity is taken to have acquired the asset at the leaving time (as mentioned in subsection 701-55(5A)) in return for it starting to have an obligation to provide the payment mentioned in that subsection. *[Schedule #, Part 4, item 24, paragraph 715-379A(2)(a)]*

1.158 In this regard, the payment mentioned in subsection 701-55(5A) is the tax cost setting amount for the asset (paragraph 701-55(5A)(a)). Paragraph 701-55(5A)(b) has no operation in this context as that paragraph applies only when an entity becomes a member of a consolidated group.

1.159 If a liability is, or is part of, a Division 230 financial arrangement held by the leaving entity after the leaving time, then, for the purposes of section 230-60, the leaving entity is taken to have started to have the liability at the leaving time in return for it starting to have a right to receive the payment mentioned in subsection 715-379(2). *[Schedule #, Part 4, item 24, paragraph 715-379A(2)(b)]*

1.160 The tax cost setting amount of the corresponding asset is worked out under sections 701-60 and 701-60A — the operation of these sections is outlined in the explanation relating to the value shifting amendments in Part 5 of Schedule # to this Bill

1.161 Similarly, the head company of a consolidated group will be taken to have an obligation to provide or a right to receive a financial benefit under an arrangement in relation to an asset or liability where an entity (the leaving entity) ceases to be a member of a consolidated group at a time (the leaving time) if:

- because the single entity rule (subsection 701-1(1)) ceases to apply to the leaving entity after the leaving time, the asset or liability emerges from the group and becomes an asset or liability of the head company;
- in the case of an asset, subsection 701-55(5A) applies in relation to the asset at the leaving time because of section 701-20 — that is, the tax cost of the asset is set at the leaving time;

- in the case of a liability, subsection 715-379(2) applies in relation to the liability at the leaving time — that is, the tax cost of the liability is set at the leaving time; and
- the asset or liability is, or is part of, a Division 230 financial arrangement.

[Schedule #, Part 4, item 24, paragraph 715-379A(1)(a), subparagraph 715-379A(1)(b)(ii), paragraph 715-379A(1)(c) and paragraph 715-379A(1)(e)]

1.162 In these circumstances, in the case of an asset that is, or is part of, a Division 230 financial arrangement, held by the head company after the leaving time, for the purpose of section 230-60, the head company is taken to have acquired the asset at the leaving time (as mentioned in subsection 701-55(5A)) in return for it starting to have an obligation to provide the payment mentioned in that subsection. *[Schedule #, Part 4, item 24, paragraph 715-379A(3)(a)]*

1.163 If a liability that is, or is part of, a Division 230 financial arrangement held by the head company after the leaving time, then, for the purpose of section 230-60, the head company is taken to have started to have the liability at the leaving time in return for it starting to have a right to receive the payment mentioned in subsection 715-379(2). *[Schedule #, Part 4, item 24, paragraph 715-379A(3)(b)]*

1.164 In this regard, the payment mentioned in subsection 701-55(5A) is the tax cost setting amount for the asset (paragraph 701-55(5A)(a)). Paragraph 701-55(5A)(b) has no operation in this context as it applies only when an entity becomes a member of a consolidated group.

1.165 The tax cost setting amount of the corresponding asset is worked out under sections 701-60 and 701-60A — the operation of these sections is outlined in the explanation relating to the value shifting amendments in Part 5 of Schedule # to this Bill.

1.166 Examples #.8 and #.9 illustrate the operation of the TOFA amendments.

Example 1.8

Head Co is the head company of a consolidated group and is subject to the TOFA provisions in Division 230. Company A and Company B are subsidiary members of the group.

On 1 July 2015, Company A enters into an Australian dollar denominated loan arrangement with Company B. Under the arrangement, Company B lends an amount of \$100,000 to Company A on interest free terms. The term of the loan is 4 years.

On 1 December 2015, Company A repays \$20,000 of the loan.

On 1 July 2016, another entity (which is not a member of a consolidated group) acquires all of the membership interests in Company A. As a result, Company A leaves the consolidated group.

At the leaving time, the market value of the corresponding loan asset held by Company B is \$80,000.

Prior to the leaving time, the intra-group loan arrangement between Company A and Company B was not recognised for income tax purposes (due to the operation of the single entity rule).

At the leaving time, the single entity rule ceases to apply to the loan arrangement. Therefore, Division 230 starts to apply to the loan arrangement. As a result, for the purposes of applying Division 230:

- Head Co is taken to have acquired the loan asset at the leaving time in return for it starting to have an obligation to provide a payment of \$80,000 (section 701-20, item 3 of the table in section 701-60, paragraphs 701-55(5A)(a) and 715-379A(3)(a)); and
- Company A is taken to have the loan liability at the leaving time in return for it starting to have a right to receive the payment of \$80,000 (paragraphs 715-379(2)(a) and 715-379A(2)(b)).

Therefore, for the purposes of working out any gain or loss on the loan arrangement under Division 230:

- Head Co will take into account the payment of \$80,000; and
- Company A will take into account the receipt of \$80,000.

Example 1.9

Head Co is the head company of a consolidated group and is subject to the TOFA provisions in Division 230. Company A and Company B are subsidiary members of the group.

On 1 July 2015, Company A enters into a cash-settlable swap transaction with Company B for \$0. The term of the swap is 4 years.

On 1 July 2016, another entity (which is not a member of a consolidated group) acquires all of the membership interests in Company A. As a result, Company A leaves the consolidated group.

At the leaving time, both the swap asset held by Company A and the corresponding swap liability held by Company B have a fair value of \$100.

Prior to the leaving time, the intra-group swap arrangement between Company A and Company B was not recognised for income tax purposes (due to the operation of the single entity rule).

At the leaving time, the single entity rule ceases to apply to the swap arrangement. Therefore, Division 230 starts to apply to the swap arrangement. As a result, for the purposes of applying Division 230:

- Company A is taken to have acquired the swap asset at the leaving time in return for it starting to have an obligation to provide a payment of \$0 (section 701-45, item 3A of the table in section 701-60, paragraphs 701-55(5A)(a) and 715-379A(2)(a)); and
- Head Co is taken to have the swap liability at the leaving time in return for it starting to have a right to receive the payment of \$0 (paragraphs 715-379(2)(b) and 715-379A(3)(b)).

Therefore, for the purposes of working out any gain or loss on the swap arrangement under Division 230:

- Company A will take into account the payment of \$0; and
- Head Co will take into account the receipt of \$0.

Consequential amendments

1.167 Consequential amendments are made to clarify the headings to sections 715-375 and 715-378. [*Schedule #, Part 4, items 22 and 23, sections 715-375 and 715-378*]

Application

1.168 The TOFA measure applies in the same way as Part 2 of Schedule 1 to the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* applies — that is, from the commencement of the TOFA regime. [*Schedule #, Part 4, subitem 25(1)*]

1.169 However, as a transitional rule, the Commissioner of Taxation is prevented from amending an assessment of an entity for an income year in a particular way if:

- the entity lodged its income tax return for the income year before the 2013 Budget time — that is, before 7.30 pm, by legal time in the Australian Capital Territory, on 14 May 2013 (the date of announcement of the measure);
- the Commissioner could not amend the assessment in that way if these amendments were disregarded; and

- the entity has not requested the Commissioner to amend the assessment in that way.

[Schedule #, Part 4, subitems 25(2) and (3)]

1.170 This transitional rule ensures that taxpayers who took a position under the current law will not be disadvantaged by the amendments. However, it also prevents taxpayers from obtaining a windfall gain by amending prior year assessments in a way that takes advantage of a deficiency in the law.

Part 5 — The value shifting measure

1.171 The value shifting measure in Part 5 of Schedule # to the Bill removes anomalies that arise when an entity leaves a consolidated group holding an asset that corresponds to a liability owed to it by the old group by ensuring that the amount taken into account under the exit tax cost setting rules for the asset is aligned with the tax cost setting amount for the corresponding asset of the leaving entity.

1.172 Step 3 of the exit tax cost setting rules (section 711-40) increases the old group's allocable cost amount by the value of intra-group liabilities owed to the leaving entity.

1.173 Generally, the step 3 amount is the market value of the corresponding asset of the leaving entity (subsection 711-40(1)). However, this amount is reduced if, ignoring the single entity rule, a member of the group would have made a capital gain or capital loss when the liability arose. In these circumstances, the step 3 amount is, broadly, what would have been the cost base of the asset if that cost is less than the market value (subsections 711-40(2) and (3)).

1.174 When a leaving entity holds an asset that consists of a liability owed to it by a member of the old group, the asset's tax cost is set at the leaving time at the asset's tax cost setting amount (section 701-45). The tax cost setting amount is the market value of the asset (table item 3 in section 701-60).

1.175 The value shifting problem arises because:

- subsections 711-40(2) and (3) do not appropriately identify all of the circumstances in which the step 3 amount should be less than the market value of the corresponding asset; and
- in some cases, the tax cost setting amount for the corresponding asset should be less than the market value of that asset.

1.176 To overcome the value shifting problem:

- the exit tax cost setting rules will be modified so that the step 3 amount included for an intra-group liability owed to the leaving entity by the old group is equal to the tax cost setting amount for the corresponding asset; and
- the tax cost setting amount for the corresponding asset is set at:
 - in the case of an asset that corresponds to a debt owed to the leaving entity by the old group, the market value of the asset;
 - otherwise, an amount that reflects the cost of the asset.

Modification to step 3 of the exit tax cost setting rules

1.177 Under the exit tax cost setting rules that apply when an entity leaves a consolidated group, step 3 increases the old group's allocable cost amount when an intra-group liability is owed to the leaving entity by the old group.

1.178 The amendments modify section 711-40 so that the amount that is included at step 3 of the exit tax cost setting rules in relation to an intra-group liability that is owed to the leaving entity by the old group is the tax cost setting amount for the corresponding asset. *[Schedule #, Part 5, item 28, section 711-40]*

Modification to the tax cost setting amount

1.179 If an entity leaves a consolidated group holding an asset that consists of a liability owed to it by a member of the old group, the asset's tax cost is set at the leaving time at the asset's tax cost setting amount (section 701-45).

1.180 The asset's tax cost setting amount is set out in the Table #.1 and depends on whether the asset is a right to recover an intra-group liability that:

- is a debt owed to the leaving entity — that is, broadly, because money has been borrowed, or credit obtained, by a member of the old group from the leaving entity;
- arose in the old group or was acquired by the group and is not a debt owed to the leaving entity; or

- was brought into the group by a joining entity and is not a debt owed to the leaving entity.

[Schedule #, Part 5, items 26 and 27, table item 3A in sections 701-60 and 701-60A]

Table 1.1: Tax cost setting amount for an asset that is a right to recover an intra-group liability

<i>Nature of asset</i>	<i>Tax cost setting amount</i>
Right to recover an intra-group liability that is a debt owed to the leaving entity	Market value of the asset at the leaving time.
Right to recover a liability that is not a debt owed to the leaving entity where: <ul style="list-style-type: none"> • at the time the liability arose, the entity to whom the liability was owed and the entity owing the liability were both members of the old group; or • after the time the liability arose, a member of the old group acquired the corresponding asset. 	Nil.
Right to recover a liability that is not a debt owed to the leaving entity where: <ul style="list-style-type: none"> • at the time the liability arose, the entity to whom the liability was owed and the entity owing the liability were not both members of the old group; and • the tax cost of the corresponding asset was set under section 701-10 at the time an entity became a subsidiary member of the old group (whether or not the asset became an intra-group asset at the joining time or at a later time). 	The lesser of: <ul style="list-style-type: none"> • the tax cost setting amount of the asset; and • the market value of the asset at the leaving time.

[Schedule #, Part 5, item 27, subsections 701-60A(2), (3) and (4)]

1.181 If the asset is a right to recover a liability that is not a debt owed to the leaving entity and, at the time the liability arose, the entity to whom the liability was owed and the entity owing the liability were both members of the old group, the tax cost setting amount of the asset is nil. As a result, any incidental costs incurred by a consolidated group on the creation of the intra-group asset will not be prevented from being deducted as business capital expenditure under section 40-880.

1.182 If the asset is a right to recover a liability that is not a debt owed to the leaving entity and, after the time the liability arose, a member of the old group acquired the corresponding asset, the tax cost setting amount of the asset is also nil. As a result, the cost incurred by a consolidated group

to acquire the intra-group asset may also be deductible as business capital expenditure under section 40-880.

1.183 If the asset is a right to recover a liability that is not a debt owed to the leaving entity and, after the time the liability arose, the asset's tax cost was set because it was held by an entity that became a subsidiary member of the old group, the tax cost setting amount of the asset the lesser of:

- the tax cost setting amount for the asset — that is, the cost to the old group of acquiring the asset; and
- the market value of the asset at the leaving time.

1.184 Example #.10 illustrates the operation of the value shifting amendments.

Example 1.10

In 2005, a company granted a right over one of its assets to a subsidiary member of its wholly owned group. The market value of the right at that time was \$5,000.

In 2006, the company formed a consolidated group (Group A). As a result, the subsidiary member became a member of Group A. The tax cost setting amount for the right was set at \$5,000 (reflecting the market value of the right at that time). However, this tax cost setting amount was disregarded due to the operation of section 701-58.

During the time that the right was held by Group A, the value of the right increased. As a result, there was a corresponding decrease in the value of the asset over which the right was created. This decrease in the value of the asset was not recognised for tax purposes.

In 2015, Group A sold the subsidiary member to Group B (another consolidated group) for \$1 million. The right was the subsidiary member's only asset.

Under the current law, the step 3 amount is the market value of the right — that is \$1 million. In this regard, subsection 711-40(3) does not apply to reduce the step 3 amount because the right was created before the formation of the consolidated group. Therefore, Group A will not make a capital gain on the disposal of the subsidiary member.

The amendments change this outcome so that the step 3 amount is \$5,000 — that is, the lesser of:

- the tax cost setting amount for the right that was disregarded at the joining time (\$5,000); and

- the market value of the right (\$1 million).

Therefore, Group A will make a capital gain on the disposal of the subsidiary member which reflects the economic gain made by the group (being the difference between the amount the group receives on the disposal of the right (\$1 million) and the cost of acquiring the right (\$5,000)).

The tax cost setting amount of the right for the leaving subsidiary member will be \$5,000. However, under the entry tax cost setting rules, the tax cost of the right will be reset at its market value (\$1 million) when the subsidiary becomes a member of Group B.

Modification to step 4 of the exit tax cost setting rules

1.185 Step 4 of the exit tax cost setting rules (section 711-45) reduces the old group's allocable cost amount by the value of liabilities that the leaving entity takes with it. In the case of intra-group liabilities owed by the leaving entity to a member of the old group, the step 4 amount is the market value of the corresponding asset (subsection 711-45(4)).

1.186 To improve the structure of the current law, the amendments modify the step 4 amount in relation to an intra-group liability that is owed to the old group by the leaving entity so that it refers to the tax cost setting amount for the corresponding asset (rather than the market value of the corresponding asset). [*Schedule #, Part 5, item 29, subsection 711-45(4)*]

1.187 In this regard, when the head company of a consolidated group holds an asset that consists of a liability owed to it by the leaving entity, the asset's tax cost is set at the leaving time at the asset's tax cost setting amount (section 701-20). The tax cost setting amount for the asset is the market value of the asset (table item 3 in section 701-60). [*Schedule #, Part 5, item 26, table item 3 in section 701-60*]

1.188 The amendment to subsection 711-45(4) does not change the outcomes that arise under the current law but make it clear that there is alignment between:

- the amount that is included at step 4 of the exit tax cost setting rules for intra-group liabilities owed by the leaving entity to the old group; and
- the tax cost of the corresponding asset of the old group.

Application

1.189 The value shifting measure applies if an entity ceases to be a subsidiary member of a consolidated group under an arrangement that

commences on or after the 2013 Budget time — that is, at or after 7.30 pm, by legal time in the Australian Capital Territory, on 14 May 2013 (the date of announcement of the measure by the former Government). *[Schedule #, Part 5, subitems 30(1) and (5)]*

1.190 In this regard, the time that an arrangement commences depends on the nature of the arrangement, as outlined in paragraph #.198. *[Schedule #, Part 6, item 31]*

1.191 The changes to section 701-61A in the value shifting measure amendments to determine the tax cost setting amount of an asset are relevant for the operation of the TOFA measure.

1.192 Therefore, as the TOFA measure applies from the commencement of the TOFA regime, the changes to section 701-61A also apply from the commencement of the TOFA regime (as outlined in the paragraphs #.168 to #.170). *[Schedule #, Part 4, subitems 30(2), (3) and (4)]*

Application and transitional provisions

1.193 The amendments in Part 1 (the acquired liabilities measure), Part 3 (the churning measure) and Part 5 (the value shifting measure) of Schedule # to the Bill will improve the integrity of the consolidation regime and generally apply to arrangements that commence on or after the 2013 Budget time. The 2013 Budget time is 7.30 pm, by legal time in the Australian Capital Territory, on 14 May 2013 (the date of announcement of the measure by the former Government). *[Schedule #, Part 1, item 13; Part 3, item 21 and Part 5, item 30]*

1.194 The amendments in Part 2 (the securitised assets measure) of Schedule # to the Bill apply in relation to an entity that joins or leaves a consolidated group under an arrangement that commences either before or after the 2014 Budget time. The 2014 Budget time is 7.30 pm, by legal time in the Australian Capital Territory, on 13 May 2014 (the time of announcement of the measure). Transitional rules ensure that taxpayers are not disadvantaged or do not have to change the position taken under the current law. *[Schedule #, Part 2, items 18 and 19]*

1.195 These amendments ensure that the tax cost setting rules that apply to securitisation liabilities and securitised assets are symmetrical and produce an outcome that is consistent with the accounting outcome. The application of these amendments to arrangements entered into before the 2014 Budget time, together with the transitional rules, are consistent with observations made by the Board of Taxation directed at ensuring equitable outcomes for consolidated groups affected by anomalies that arise under the current law in relation to securitised assets.

1.196 The amendments in Part 4 (the TOFA measure) of Schedule # to the Bill apply in the same way as Part 2 of Schedule 1 to the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* applies — that is, from the commencement of the TOFA regime. Transitional rules prevent the Commissioner of Taxation from amending an assessment of an entity for an income year that is issued prior to the 2013 Budget time to ensure that taxpayers are not disadvantaged by the amendments and cannot obtain a windfall gain. [*Schedule #, Part 4, item 25*]

1.197 The application of the amendments for each measure is explained in more detail in the explanation of each Part of Schedule # to the Bill.

Commencement of an arrangement

1.198 The time that an arrangement commences depends on the nature of the arrangement, as outlined Table #.2.

Table 1.2: Commencement of an arrangement

<i>Type of arrangement</i>	<i>Time that the arrangement commences</i>
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 of the table in subsection 633(1) of the <i>Corporations Act 2001</i> is completed)
On-market takeover bid	The day on which the bidder announces a bid to the relevant financial market (that is, step 2 of the table in subsection 635(1) of the <i>Corporations Act 2001</i> is completed)
Scheme of arrangement	The day on which a court orders, under subsection 411(1) of the <i>Corporations Act 2001</i> , 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

[*Schedule #, Part 6, item 31*]

