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New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002

New Business Tax System (Venture Capital Deficit Tax) Bill 2002

EXPLANATORY MEMORANDUM

(Circulated by authority of the
Treasurer, the Hon Peter Costello, MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
A Platform for Consultation	Review of Business Taxation: *A Platform for Consultation*
A Tax System Redesigned	Review of Business Taxation: *A Tax System Redesigned*
AASB	Australian Accounting Standards Board
ACA	allocable cost amount
CFC	controlled foreign company
CGT	capital gains tax
Commissioner	Commissioner of Taxation
COT	continuity of ownership test
CTE	chosen transition entity

DWT	dividend withholding tax
FC(TAL) Act	*Financial Corporations (Transfer of Assets and Liabilities) Act 1993*
FDA	foreign dividend account
FIF	foreign investment fund
FLP	foreign life assurance policy
GDP	gross domestic product
GIC	general interest charge
GST	goods and services tax
GVSR	general value shifting regime
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
IT(TP) Act 1997	*Income Tax (Transitional Provisions) Act 1997*
June Consolidation Act	*New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002*

Abbreviation	***Definition***
LDPs	loss denial pools
LIM	loss integrity measure
LRM	loss reduction method
May Consolidation Act	*New Business Tax System (Consolidation) Act (No. 1) 2002*
MEC	multiple entry consolidated
NCS	non-chosen subsidary
OB	offshore banking
OBU	offshore banking unit
PAYG	pay as you go
PDF	pooled development fund

PST	pooled superannuation trust
R&D	research and development
RSA	retirement savings account
RUNL	residual unrealised net loss
SAP	substituted accounting period
SBT	same business test
September Consolidation Act	*New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002*
September Consolidation Bill	New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002
SIS	simplified imputation system
Solvency Standard	Actuarial Standard 2.02
TAA 1953	*Taxation Administration Act 1953*
TSA	tax sharing agreement
Valuation Standard	Actuarial Standard 1.02

General outline and financial impact

Consolidated groups

The key elements to the consolidation measure were introduced in the May Consolidation Act, the June Consolidation Act and the September Consolidation Act.

Schedules 1 to 24 to the New Business Tax System (Consolidation and Other Measures) (No. 2) Bill 2002 contain residual measures relating to discrete and specialist areas of the consolidation regime (e.g. life insurance companies) as well as various other consequential and technical amendments.

Date of effect: The consolidation measure will allow wholly-owned entity groups to choose to consolidate from 1 July 2002.

Proposal announced: The proposals were announced in Treasurers Press Release No. 58 of 21 September 1999. The consolidation elements in this bill were foreshadowed in Minister for Revenue and Assistant Treasurers Press Release No. C104/02 of 27 September 2002.

Financial impact: None.

Compliance cost impact: A number of the measures included in this bill are aimed at reducing compliance costs, particularly in relation to the cost setting rules. These changes will remove the need to re-calculate the tax values of all assets when a mistake is discovered and broaden access to an existing transitional concession.

Simplified imputation system

Schedule 27 to 30 to this bill will amend Part 3-6 of the ITAA 1997 to insert rules for the following aspects of the SIS:

- venture capital franking;
- cum dividend sales and securities lending arrangements; and
- machinery provisions, including those for franking returns, assessments and amendments.
- These rules complement the core SIS rules set out in the *New Business Tax System (Imputation) Act 2002*, which apply from 1 July 2002.
- In addition, consequential amendments will be made to the ITAA 1936 to:
- section 177EA, the general anti-avoidance provision dealing with franking credit trading and dividend streaming; and
- certain dividend withholding tax provisions dealing with the interaction between the imputation and dividend withholding tax regimes.

Date of effect: These amendments apply to events arising on or after 1 July 2002, when the SIS rules commenced.
Proposal announced: These rules are part of the SIS, which was announced as part of the Governments business tax reform package. The proposal was announced in Treasurers Press Release No. 58 of 21 September 1999 as a component of the unified entity regime. On 14 May 2002, the Minister for Revenue and Assistant Treasurer announced in Press Release No. C57/02, the Governments program for delivering the next stage of business tax reform measures. In that press release, the Minister confirmed that the simplified imputation system will commence on 1 July 2002.
Financial impact: None.
Compliance cost impact: The SIS is designed to reduce compliance costs incurred by business by providing for simpler processes and increased flexibility.

Chapter 1
Consolidation: life insurance companies

Outline of chapter

1.1 This chapter explains amendments to ensure that the provisions in the income tax law that apply to life insurance companies apply to the head company of a consolidated group that has one or more subsidiary members that are life insurance companies.
1.2 This chapter also explains:

- modifications to the membership rules for consolidated groups that have life insurance company members;
- modifications to the tax cost setting rules for life insurance companies that join or leave a consolidated group;
- circumstances where virtual PST losses can be transferred from the head company to a life insurance company that leaves a consolidated group; and
- transitional arrangements that will allow life insurance companies to rearrange assets of the group so that wholly-owned subsidiary entities can become a member of the same

consolidated group as the life insurance company without attracting any immediate taxation consequences.

Context of reform

1.3 The income tax law contains special provisions for taxing life insurance companies. Those provisions need to apply appropriately to the head companies of consolidated groups that have life insurance company members.

1.4 In particular, under Division 320 of the ITAA 1997 a life insurance company can segregate assets into:

- virtual PST assets which are broadly used to support liabilities relating to complying superannuation policies; and
- segregated exempt assets which are broadly used to support liabilities relating to immediate annuity and current pension policies.

1.5 The segregation of assets ensures that income relating to the different types of business of life insurance companies is identified and taxed at the appropriate rate:

- the ordinary class of taxable income is taxed at the company tax rate;
- the complying superannuation class of taxable income is taxed at the 15% complying superannuation rate; and
- income relating to segregated exempt assets is exempt from tax.

1.6 Division 320, which is complemented by special provisions in other parts of the income tax law, ensures that the different types of business of life insurance companies is taxed consistently with income derived on similar types of business carried on by other entities.

Summary of new law

1.7 The amendments will ensure that the provisions in the income tax law that apply to life insurance companies apply appropriately to the head companies of consolidated groups that have life insurance company members.

1.8 The amendments will also:

- modify the membership rules for consolidated groups that have life insurance company members to exclude certain wholly-owned entities from a consolidated group;
- modify the tax cost setting rules for life insurance companies that join or leave a consolidated group so that certain assets are treated as retained cost base assets and to specify the basis of valuing certain life insurance policy liabilities;
- in certain circumstances, allow virtual PST losses to be transferred from the head company to a life insurance company that leaves a consolidated group; and
- as a transitional arrangement, allow life insurance companies to rearrange assets of the group so that wholly-owned subsidiary entities can become members of the same consolidated group as the life insurance company without attracting any immediate taxation consequences.

Comparison of key features of new law and current law

New law	*Current law*
The special rules in the income tax law that apply to tax life insurance companies will apply to the head company of a consolidated group if that consolidated group has one or more members that are life insurance companies.	The special rules in the income tax law that apply to tax life insurance companies would not apply to the head company of a consolidated group that has one or more members that are life insurance companies unless that head company is a life insurance company.
Wholly-owned subsidiaries of a life insurance	Under the consolidation membership rules, all

company that have membership interests that are a mixture of virtual PST assets, segregated exempt assets and/or ordinary assets will be precluded from being a subsidiary member of the same consolidatable group as the life insurance company.	wholly-owned subsidiaries of a life insurance company would be subsidiary members of the same consolidatable group as the life insurance company.
The tax cost setting rules will be modified to specify certain assets of life insurance companies to be retained cost base assets and to specify the basis of valuing certain life insurance policy liabilities for the purposes of working out the allocable cost amount.	Under the tax cost setting rules assets of life insurance companies would generally be reset cost base assets and life insurance policy liabilities would be valued on an accounting basis for the purposes of working out the allocable cost amount.
As a transitional arrangement, life insurance companies will be able to rearrange assets of the group so that wholly-owned subsidiary entities can become members of the same consolidated group as the life insurance company without attracting any immediate taxation consequences.	Any rearrangement by life insurance companies of the assets of the group to allow subsidiary entities to become a member of the same consolidated group as the life insurance company would attract immediate taxation consequences.

Detailed explanation of new law

1.9 The amendments insert new Subdivision 713-L into the ITAA 1997. Subdivision 713-L sets out special rules for:

- a life insurance company that becomes, or ceases to be, a member of a consolidated group; and
- the head company of a consolidated group where a life insurance company is a subsidiary member of the group.

[Schedule 6, item 1, section 713-500]

Consolidated groups with members that are life insurance companies

Head company taken to be a life insurance company

1.10 A life insurance company is defined under section 995-1 of the ITAA 1997 to mean a company registered under the *Life Insurance Act 1995*. Therefore, if the head company of a consolidated group is a life insurance company, the special provisions in the income tax law that apply to life insurance companies will continue to apply to the consolidated group.

1.11 The head company of a consolidated group that has one or more subsidiary members that are life insurance companies at any time during the income year will also be taken to be a life insurance company for the purposes of applying the income tax law. ***[Schedule 6, item 1, section 713-505]***

1.12 This will ensure that the special provisions in the income tax law that apply to life insurance companies apply appropriately to the head company of a consolidated group that has subsidiary members that are life insurance companies.

1.13 That is, for example:

- the provisions in Division 320 of the ITAA 1997 will apply to the head company to, among other things:
- identify statutory income, exempt income (including management fees that qualify for transitional relief under section 320-40) and specific deductions;
- allocate taxable income into two classes the complying superannuation class and the ordinary class;
- establish and maintain virtual PST assets;
- allocate assessable income and allowable deductions to the virtual PST component of the complying superannuation class of taxable income; and

- establish and maintain segregated exempt assets;
- the dividend imputation rules that apply to life insurance companies will apply appropriately to the head company; and
- the provisions of the *Income Tax Rates Act 1986* that apply to life insurance companies will apply to the head company:
- this will ensure that the head company will be taxed at a rate of 15% on the complying superannuation class of its taxable income.

Application of the single entity rule

1.14 The income tax treatment of a consolidated group flows from the single entity rule in section 701-1 of the ITAA 1997. Under that rule an entity is treated as part of the head company while it is a subsidiary member of a consolidated group. Actions of the subsidiaries are treated as actions of the head company, as this is the only entity that the income tax law recognises for the purposes of working out the income tax liability or losses of a consolidated group.

1.15 A consolidated group may have two or more members that are life insurance companies each of which has their own virtual PST and segregated exempt assets. In these circumstances, the single entity rule will ensure that the head company has a single virtual PST and a single pool of segregated exempt assets.

1.16 In addition, assets and liabilities of a subsidiary member are treated for income tax purposes as if they were owned by the head company. Therefore, a consequence of the single entity rule is that:

- the virtual PST assets of the head company will include assets held by subsidiary entities where all the membership interests are virtual PST assets; and
- the segregated exempt assets of the head company will include assets held by subsidiary entities where all the membership interests are segregated exempt assets.

Modification of the membership rules

1.17 Under the consolidation membership rules, all of a resident holding companys eligible resident wholly-owned subsidiaries (whether companies, partnerships or trusts) must be included in the consolidated group that is, an all in principle applies. A significant difficulty arises with the application of the all in principle if a life insurance company becomes a member of a consolidated group.

1.18 Life insurance companies are required to segregate assets relating to complying superannuation business (virtual PST assets) and immediate annuity business (segregated exempt assets). Income (including capital gains) derived on the segregated assets is then taxed at the appropriate rate. Transactions between the segregated assets are taxing events.

1.19 To manage these requirements, life insurance companies often hold assets in wholly-owned unit trusts or wholly-owned companies. Consequently, the virtual PST assets and segregated exempt assets are the membership interests in those wholly-owned unit trusts or companies.

1.20 The application of the all in principle would cause the membership interests in wholly-owned unit trusts or companies to cease to be recognised for tax purposes. That is, the practical mechanism that is used to determine income (including capital gains) that should be taxed at 15% or that should be exempt from tax will no longer be effective.

1.21 Therefore, the all in principle will not apply to a consolidated group that has a member that is a life insurance company. Rather, a wholly-owned subsidiary of a life insurance company that has membership interests that, directly or indirectly, are a mixture of virtual PST assets, segregated

exempt assets and/or ordinary assets will be precluded from being a member of a consolidated group. ***[Schedule 6, items 1 and 5, subsection 713-510(1); note to section 703-20]***

1.22 Transitional measures, which are discussed later in this chapter, will allow a life insurance company that is joining a consolidated group to rearrange assets of the group so that subsidiary entities can become a member of the same consolidated group as the life insurance company without attracting any immediate taxation consequences.

1.23 If an entity is a subsidiary member of a consolidated group that has a life insurance company as a member, the entity will cease to be a member of the group if, after joining the group, its membership interests change and become, directly or indirectly, a mixture of virtual PST assets, segregated exempt assets and/or ordinary assets of a life insurance company. ***[Schedule 6, item 1, subsection 713-510(2)]***

1.24 However, if a wholly-owned subsidiary entity of a life insurance company is excluded from being a member of a consolidated group under section 713-510, that entity can be the member of another consolidated group provided that all the membership requirements in section 703-15 are satisfied.

Example 1.1

Head company is an ordinary Australian resident company that beneficially owns 100% of the membership interests in Life company (another ordinary Australian resident company).

Life company, in turn, beneficially owns 100% of the membership interests in A Co. and B Co. (each of which are ordinary Australian resident companies) and in A Trust, B Trust and C Trust (each of which are Australian resident fixed trusts).

In addition:

- B Trust beneficially owns 100% of the membership interests in C Co. (which is an ordinary Australian resident company); and
- B Co. owns 100% of the membership interests in D Co. (which is also an ordinary Australian resident company).

  Head company chooses to consolidate. Under the modified membership rules that apply to consolidated groups that have life insurance company members, the following entities will be subsidiary members of the consolidated group:
- Life company (which is 100% beneficially owned by Head company);
- A Co. (which is 100% beneficially owned by Life company and all its membership interests are assets supporting ordinary business);
- B Trust (which is 100% beneficially owned by Life company and all its membership interests are virtual PST assets);
- C Trust (which is 100% beneficially owned by Life company and all its membership interests are segregated exempt assets); and
- C Co. (which is 100% beneficially owned by B Trust so that all its membership interests are indirectly virtual PST assets).

Although Life company beneficially owns 100% of the membership interests in A Trust, A Trust is not a subsidiary member of the consolidated group because those membership interests are a mixture of assets supporting ordinary business and virtual PST assets.

Similarly, although Life company beneficially owns 100% of the membership interests in B Co., B Co. is not a subsidiary member of the consolidated group because those membership interests are a

mixture of virtual PST assets and segregated exempt assets. However, B Co. can be the head company of another consolidated group with D Co. as a subsidiary member.

Modification of the tax cost setting rules

1.25 When an existing consolidated group completes the acquisition of an entity that is eligible to become a member of a consolidated group, the acquired entity becomes a subsidiary member of the consolidated group and the cost of acquiring the entity (the ACA) is treated as the cost to the group of the entitys assets. The groups cost for each of the assets is worked out by allocating the ACA for the acquired entity among the entitys assets. This provides the basis for determining the cost of the asset to the group for CGT, trading stock and capital allowance purposes.

1.26 A consolidated groups ACA for a joining entity consists of the groups cost of acquiring the membership interests in the joining entity and the liabilities of the joining entity at the joining time. The ACA also reflects certain retained earnings, distributions, losses and entitlements to future deductions of the joining entity.

1.27 The tax cost setting rules will be modified to:

- specify certain assets of life insurance companies to be retained cost base assets; and
- specify the basis of valuing life insurance policy liabilities for the purposes of working out the ACA.

[Schedule 6, items 4, 6, 7 and 9, definition of retained cost base asset in subsection 995-1(1), notes to section 701-60 and subsections 705-25(5) and 705-70(1)]

Virtual PST assets and segregated exempt assets

1.28 Under Division 320 of the ITAA 1997 life insurance companies are required to segregate assets that support certain policy liabilities:

- assets segregated to support virtual PST life insurance policy liabilities (i.e. broadly, complying superannuation policies) are known as virtual PST assets; and
- assets segregated to support exempt life insurance policy liabilities (i.e. broadly, immediate annuity policies) are known as segregated exempt assets.

1.29 The assets segregated must be valued annually. If the transfer value of segregated assets exceeds the value of relevant liabilities, the company must transfer the excess assets out of the segregated assets. Similarly, if the transfer value of segregated assets is less than the value of relevant liabilities, the company may transfer additional assets to the segregated assets. This mechanism ensures that the correct amount of income is taxed at the 15% rate or is exempt from tax.

1.30 The transfer value of an asset is the amount that could be expected to be received from the disposal of the asset in an open market after deducting any costs expected to be incurred in respect of the disposal (see subsection 995-1(1)).

1.31 If a life insurance company joins or leaves a consolidated group, the joining time or leaving time, as the case may be, will also be taken to be a valuation time for the purposes of Division 320. ***[Schedule 6, items 1 to 3, section 713-525; notes to subsections 320-175(1) and 320-230(1)]***

1.32 Consequently, life insurance companies will need to value both virtual PST assets and associated liabilities and segregated exempt assets and associated liabilities immediately prior to joining or leaving a consolidated group to ensure that the transfer value of those assets at the joining time or leaving time, as the case may be, is equal to the value of relevant liabilities:

- if the transfer value of virtual PST assets or segregated exempt assets exceeds the value of relevant liabilities, assets having a transfer value equal to the excess must be transferred from the virtual PST or from the segregated exempt assets (as the case may be) within 30 days of the date of valuation; and

- if the transfer value of virtual PST assets or segregated exempt assets is less than the value of relevant liabilities, assets having a transfer value equal to the shortfall can be transferred to the virtual PST or the segregated exempt assets (as the case may be) within 30 days of the date of valuation.

1.33 In practice, this valuation may be done on the day before the life insurance company joins or leaves a consolidated group. Such a valuation would satisfy the requirements of section 713-525 provided that value of the assets and associated liabilities was substantially the same on both the day of valuation and the day the life insurance company joins or leaves a consolidated group.
1.34 To ensure that the value of virtual PST assets and segregated exempt assets are not affected by cost base adjustments, those assets will be retained cost base assets. ***[Schedule 6, item 1, paragraph 713-515(1)(a)]***
1.35 For the purposes of working out the ACA:

- the value of the virtual PST liabilities of a life insurance company that joins a consolidated group will be the amount worked out under section 320-190 at the joining time; and
- the value of the exempt life insurance policy liabilities of a life insurance company that joins a consolidated group will be the amount worked out under section 320-245 at the joining time.

[Schedule 6, item 1, subsections 713-520(2) and (3)]
1.36 In addition, for the purpose of working out the tax cost setting amounts of reset cost base assets under section 705-35, the tax cost setting amounts for virtual PST assets and segregated exempt assets will be the transfer value of the assets just before the joining time. This will ensure that the value of virtual PST assets and segregated exempt assets will be offset by the value of virtual PST liabilities and exempt life insurance policy liabilities. ***[Schedule 6, item 1, paragraph 713-515(2)(a)]***
1.37 For all other purposes, the tax cost setting amounts for virtual PST assets and segregated exempt assets will be the terminating value of the assets. The terminating value for an asset is set out in section 705-30. This will ensure that virtual PST assets and segregated exempt assets will, for example, retain their original cost base for CGT purposes on subsequent disposal. ***[Schedule 6, item 1, paragraph 713-515(2)(b)]***
Assets held to support the net investment component of ordinary life insurance policies
1.38 The net investment component of ordinary life insurance policies is the component of ordinary life insurance policies that has not been reinsured or is not the net risk component (as defined in subsection 995-1(1) of the ITAA 1997) of those policies. Ordinary life insurance policies are life insurance policies that are not exempt life insurance policies or virtual PST life insurance policies (as defined in subsection 995-1(1) of the ITAA 1997). ***[Schedule 6, items 1 and 8, subsection 713-515(4) and the definition of net investment component of ordinary non-participating life insurance policies in subsection 995-1(1)]***
1.39 To ensure that the value of assets held on behalf of ordinary policyholders is not affected by cost base adjustments, assets held by life insurance companies to support the net investment component of ordinary life insurance policies (other than policies that provide for participating benefits or discretionary benefits (as defined in subsection 995-1(1) of the ITAA 1997) under life insurance business carried on in Australia) will be retained cost base assets. ***[Schedule 6, item 1, paragraph 713-515(1)(b)]***
1.40 For the purposes of working out the ACA, the value of liabilities under the net investment component of ordinary life insurance policies will be the amount worked out for those liabilities under subsection 320-190(2) as if those liabilities were virtual PST liabilities. ***[Schedule 6, item 1, subsection 713-520(6)]***
1.41 That is, the value of liabilities under the net investment component of ordinary life insurance policies (other than policies that provide for participating benefits or discretionary benefits under life insurance business carried on in Australia) for the purposes of working out the sum of the joining life insurance companys liabilities will be:

- for policies that provide for participating benefits or discretionary benefits under life insurance business carried on overseas, the value of supporting assets (as defined in the Valuation Standard) and the policy owners retained profits in respect of the net investment component of those policies; and
- for all other policies, the current termination value (as defined in the Solvency Standard) of the net investment component of those policies.

1.42 The joining life insurance company may also have a deferred tax liability in relation to unrealised gains on assets held to support the net investment component of ordinary life insurance policies. That deferred tax liability is included in the joining life insurance companys liabilities under step 2 of the table in section 705-60 for the purpose of working out its ACA. Therefore, the joining life insurance companys ACA will be the sum of the current termination value of the net investment component of those policies plus the deferred tax liability in relation to unrealised gains on assets held to support those policies.
1.43 In addition, for the purpose of working out the tax cost setting amounts for reset cost base assets under section 705-35, the tax cost setting amounts for assets held to support the net investment component of ordinary life insurance policies (other than policies that provide for participating benefits or discretionary benefits under life insurance business carried on in Australia) will be the transfer value of the assets just before the joining time. This will ensure that the value of assets held to support the net investment component of ordinary life insurance policies (other than policies that provide for participating benefits or discretionary benefits under life insurance business carried on in Australia) will be offset by the value of liabilities for those policies plus the value of any deferred tax liabilities in relation to those policies. ***[Schedule 6, item 1, paragraph 713-515(2)(a)]***
1.44 For all other purposes, the tax cost setting amounts for assets held to support the net investment component of ordinary life insurance policies (other than policies that provide for participating benefits or discretionary benefits under life insurance business carried on in Australia) will be the terminating value of the assets. The terminating value for an asset is set out in section 705-30. This will ensure that these assets will, for example, retain their original cost base for CGT purposes on subsequent disposal. ***[Schedule 6, item 1, paragraph 713-515(2)(b)]***
1.45 Assets supporting policies that provide participating or discretionary benefits under life insurance business carried on in Australia are not retained cost base assets because they are owned jointly by policyholders and shareholders. However, for the purposes of working out the ACA, the value of liabilities under the net investment component of those policies will be the amount worked out for those liabilities under subsection 320-190(2) as if those liabilities were virtual PST liabilities that is, the value of supporting assets (as defined in the Valuation Standard) and the policy owners retained profits in respect of the net investment component of those policies. ***[Schedule 6, item 1, subsection 713-520(6)]***
Goodwill of life insurance companies that have demutualised
1.46 Goodwill accruing to the group as a consequence of its ownership and control of the joining entity is generally a reset cost base asset that is deemed to have been purchased by the head company at the joining time. Consequently, the tax cost setting provisions will generally result in goodwill having a cost base broadly equal to its market value.
1.47 In the case of a life insurance company that has demutualised, Division 9AA of the ITAA 1936 sets the cost base of demutualisation shares based on the embedded value of the company rather than the appraisal value (or broadly, the market value). Therefore, the income tax law has effectively established a cost base for goodwill in relation to a life insurance company that has demutualised.
1.48 Consequently, the goodwill asset of a joining entity that is a life insurance company that has demutualised will be a retained cost base asset provided that the ownership of the company has not changed between the time immediately after the company demutualised and the time of joining a consolidated group. ***[Schedule 6, item 1, paragraph 713-515(1)(c)]***

1.49 The tax cost setting amount of a goodwill asset of a life insurance company that has demutualised will be the embedded value (as defined in subsection 121AM(1) of the ITAA 1936) at the time of demutualisation of the life insurance company concerned reduced by the net value of shareholders assets held by the company on that day. This amount represents the goodwill component of the embedded value (as defined in AASB Accounting Standard 1038) of a life insurance company at the time of demutualisation. ***[Schedule 6, item 1, subsection 713-515(3)]***

Net risk component of life insurance policies

1.50 Section 320-85 of the ITAA 1997 prescribes a basis that must be used by life insurance companies for valuing the liabilities under the net risk component of life insurance policies. The net risk component of a life insurance policy is defined in subsection 995-1(1) to mean the risk component in respect of that part of the policy that has not been reinsured under a contract of reinsurance.

1.51 The amendments will ensure that the value of liabilities under the net risk components of life insurance policies for consolidation purposes is the current termination value (as defined in the Solvency Standard) of that component at the joining time as calculated by an actuary. ***[Schedule 6, item 1, subsections 713-520(4) and (5)]***

Transfer of virtual PST losses on leaving a consolidated group

1.52 The taxable income of a life insurance company is divided into 2 classes:

- the complying superannuation class which is taxed at a 15% rate; and
- the ordinary class which is taxed at the company tax rate.

1.53 The complying superannuation class of taxable income is made up of 3 components the virtual PST component, the RSA component and the specified roll-over component.

1.54 In practice, the only component that can be negative is the virtual PST component. If the virtual PST component is negative, the life insurance company effectively makes a virtual PST loss. In these circumstances, the income tax law operates to ensure that these losses can only be applied to reduce future virtual PST income.

1.55 In addition, life insurance companies can have a net capital loss from virtual PST assets. These losses can only be offset against future capital gains from virtual PST assets.

1.56 These loss quarantining rules will continue to apply when a life insurance company joins a consolidated group. That is, the head company will only be able to apply virtual PST losses and net capital losses on virtual PST assets against future virtual PST income or future capital gains from virtual PST assets. However, if a life insurance company subsequently leaves the group (and no other member of the group is a life insurance company that has a virtual PST), the head company will not have any future virtual PST income or capital gains that can be used to absorb the virtual PST losses. That is, the losses will be unable to be used.

1.57 Therefore, if a life insurance company leaves a consolidated group and no other member of the group is a life insurance company that has a virtual PST at the leaving time, any virtual PST losses and net capital losses on virtual PST assets of the head company will be transferred from the head company to the leaving life insurance company. ***[Schedule 6, item 1, section 713-530]***

Application and transitional provisions

1.58 In general, these amendments will apply to groups that consolidate on or after 1 July 2002.

1.59 As a transitional rule, a group of entities that includes a life insurance company will be given an opportunity to rearrange assets of the group for the purpose of allowing one or more of them to become members of a consolidated group in a way that does not attract any immediate taxation consequences. ***[Schedule 6, item 10, section 713-500 of the IT(TP) Act 1997]***

1.60 The purpose of the transitional relief is to allow consolidatable groups with life insurance company members to maximise the number of wholly-owned subsidiary entities that can be members of the consolidated group despite the departure from the all in principle. The transitional relief is available for a limited period of time (see paragraphs 1.70 and 1.87).

1.61 The transitional relief will apply where:

- an asset is transferred from one entity to another within the wholly-owned company group the section 713-505 case; and
- an asset is transferred between the segregated pools of assets of a life insurance company the section 713-510 case.

Assets transferred between entities the section 713-505 case

1.62 Transitional relief will apply where an event (the deferral event) involving an entity (the originating entity) and another entity (the recipient entity) happens in connection with a life insurance company becoming a member of a consolidated group. The transitional relief will defer the taxation consequences that would occur as a result of the deferral event.

[Schedule 6, item 10, subsection 713-505(1) of the IT(TP) Act 1997]

1.63 To qualify for transitional relief in a section 713-505 case, the originating entity must be:

- a life insurance company that has virtual PST assets or segregated exempt assets and that is a member of a consolidatable group;
- an entity that is unable to be a member of the same consolidatable group as a life insurance company because its membership interests consist partly, directly or indirectly, of virtual PST assets or segregated exempt assets of the life insurance company; or
- an entity that is, directly or indirectly, a subsidiary of a life insurance company and is a member of the same consolidated group as the life insurance company.

[Schedule 6, item 10, paragraph 713-520(1)(a) of the IT(TP) Act 1997]

1.64 In addition, the transitional relief will apply only if:

- the originating entity and the recipient entity are members of the same consolidatable group, or would be members of the same consolidatable group if the all in principle applied;
- any asset transferred by the originating entity to the recipient entity is transferred at its transfer value that is, the amount that could be expected to be received from the disposal of the asset in an open market after deducting any costs expected to be incurred in respect of the disposal (see subsection 995-1(1));
- the total transfer value of virtual PST assets of the member life insurance company immediately before the transfer is the same as the total transfer values of those assets just after the transfer; and
- the total transfer value of segregated exempt assets of the member life insurance company immediately before the transfer is the same as the total transfer values of those assets just after the transfer.

[Schedule 6, item 10, subsections 713-520(1) and (2) of the IT(TP) Act 1997]

The deferral event

1.65 In a section 713-505 case, if the originating entity is a company, the deferral event will be a CGT event that happens to an asset where, if the transitional relief did not apply, the CGT event would cause:

- an amount (other than a capital gain) to be included in the assessable income of the originating entity this would arise, for example, because the asset is held on revenue account or is a traditional security taxed under section 26BB of the ITAA 1936; or
- the originating entity to make a capital gain.

[Schedule 6, item 10, subsection 713-505(2) of the IT(TP) Act 1997]

1.66 If the originating entity is a trust, the deferral event will be a CGT event that happens to an asset where, if the transitional relief did not apply, the CGT event would cause:

- an amount (other than a capital gain) to be included in the net income of the trust; or

- the trust to make a capital gain.

[Schedule 6, item 10, subsection 713-505(3) of the IT(TP) Act 1997]
1.67 Section 104-5 lists the various CGT events. Transitional relief will apply to the following CGT events:

- CGT events A1, B1, D1, D2, D3, E2, F1 and F2; and
- CGT event C2 provided that the asset that ends is a unit in a unit trust that is replaced by an equivalent membership interest in a company or in another trust that is, a membership interest that is of equivalent value to the units in the unit trust.

[Schedule 6, item 10, subsection 713-505(4) of the IT(TP) Act 1997]
When transitional relief applies
1.68 The transitional relief will apply only if the originating entity chooses to apply the relief. The choice must be made:

- by the day the originating entity, or the head company of the consolidated group of which it is a member, lodges its income tax return for the income year in which the deferral event happened; or
- within a further time allowed by the Commissioner.

[Schedule 6, item 10, section 713-515 of the IT(TP) Act 1997]
1.69 If both the originating entity and the recipient are companies, they can choose roll-over relief for the assets transferred under Division 126-B of the ITAA 1936. If the originating entity chooses Division 126-B roll-over relief, it cannot also choose to obtain the transitional relief.
1.70 In addition, the transitional relief will apply only if the deferral event happens on or before the later of:

- 30 June 2004; and
- if the head company of the consolidated group of which the member life insurance company is a member, the end of the head companys income year in which 30 June 2004 occurs.

[Schedule 6, item 10, subsection 713-520(3) of the IT(TP) Act 1997]
1.71 However, assets to which the transitional relief applies will be taken to have been transferred immediately prior to the member life insurance company becoming a member of the consolidated group. ***[Schedule 6, item 10, section 713-525 of the IT(TP) Act 1997]***
Nature of the transitional relief
1.72 The nature of the transitional relief in a section 713-505 case will depend upon whether the originating entity is a company or a trust.
1.73 If the originating entity is a company, any amount that would have been included in the originating entitys assessable income (either as a gain on revenue account or as a capital gain) as a result of the deferral event is deferred until a new event happens to the asset.
[Schedule 6, item 10, paragraph 713-530(1)(a) of the IT(TP) Act 1997]
1.74 When a new event happens to the asset, the originating entity (or, because of the single entity rule, the head company if the originating entity is a member of a consolidated group) must include the deferred amount in its assessable income for the income year in which the new event happens or is taken to have made a capital gain equal to the deferred gain.
[Schedule 6, item 10, subsection 713-535(2) of the IT(TP) Act 1997]
1.75 If the originating entity is a trust, any amount that would have been included in the member life insurance companys assessable income (either as a gain on revenue account or as a capital gain) as a result of the deferral event is deferred until a new event happens to the asset. ***[Schedule 6, item 10, paragraph 713-530(1)(b) of the IT(TP) Act 1997]***
1.76 When a new event happens to the asset (see paragraph 1.79), the member life insurance company (or, because of the single entity rule, the head company if the member life insurance company is a member of a consolidated group) must include the deferred amount in its assessable income for the income year in which the new event happens or is taken to have

made a capital gain equal to the deferred gain. ***[Schedule 6, item 10, subsection 713-535(3) of the IT(TP) Act 1997]***

1.77 In addition, if the originating entity is a life insurance company or a trust and the deferred amount relates to an asset that was a virtual PST asset at the time of the deferral event, that amount will be included in the virtual PST component of the complying superannuation class of assessable income for the income year in which the new event occurs. ***[Schedule 6, item 10, subsection 713-535(4) of the IT(TP) Act 1997]***

1.78 The deferred amount will be a discount capital gain (provided it is a CGT event that qualifies as a discount capital gain) if:

- the deferred amount is a capital gain;
- the deferral event happens to a virtual PST asset of a life insurance company within 12 months of the date of acquisition of the asset; and
- the new event occurs at least 12 months after the asset was acquired.

[Schedule 6, item 10, section 713-545 of the IT(TP) Act 1997]

A new event

1.79 A new event will occur when a subsequent taxing event happens to the asset. That is, a new event will occur if:

- a CGT event happens to the asset or, if the deferral event was CGT event C2, the replacement asset;
- the recipient entity ceases to be a member of the consolidated group of which the life insurance company is a member;
- if the recipient entity is a life insurance company, the asset is transferred to or from the recipient entitys virtual PST or segregated exempt assets; or
- if the originating entity is a company, the originating entity ceases to exist.

[Schedule 6, item 10, subsection 713-535(1) of the IT(TP) Act 1997]

1.80 In addition, in a section 713-505 case, if the recipient entity is not a member of the same consolidated group as the originating entity when the new event happens, the recipient entity must notify the originating entity when a new event occurs to the asset. Notification is not required if the new event is the originating entity ceasing to exist. The notification must be within 60 days after the new event happens. The notification will be a trigger for the originating entity to include the deferral amount or deferred CGT amount in its assessable income or capital gains. ***[Schedule 6, item 10, section 713-540 of the IT(TP) Act 1997]***

1.81 An administrative penalty will apply if the recipient entity fails to notify the originating entity when a new event occurs to the asset within the specified time period. ***[Schedule 6, item 11, subsection 286-75(4) of Schedule 1 to the TAA 1953]***

1.82 The amount of the administrative penalty is one penalty unit (currently $110), for each period of 28 days or part of a period of 28 days starting on the day when notification is due and ending when notification is made of the happening of the event (up to a maximum of 5 penalty units). However, under subsections 286-80(3) and (4) of Schedule 1 to the TAA 1953, that penalty is multiplied by 2 for medium size taxpayers and by 5 for large taxpayers. ***[Schedule 6, item 11, paragraph 286-80(2)(c) of Schedule 1 to the TAA 1953]***

1.83 Notification of the new event is not required if the recipient entity is a member of the same consolidated group as the originating entity due to the operation of the single entity principle.

Assets transferred within a life insurance company the section 713-510 case

1.84 Transitional relief will also apply to defer the taxation consequences that would occur because of an event (the deferral event) happening involving the transfer of an asset by a life insurance company:

- to or from its virtual PST where, if the transitional relief did not apply, section 320-200 of the ITAA 1997 would apply to the transfer; or
- to or from its segregated exempt assets where, if the transitional relief did not apply, section 320-255 of the ITAA 1997 would apply to the transfer.

[Schedule 6, item 10, subsection 713-510(1) of the IT(TP) Act 1997]
1.85 To qualify for transitional relief in a section 713-510 case:

- the total transfer value of virtual PST assets of the member life insurance company immediately before the transfer must be the same as the total transfer values of those assets just after the transfer; and
- the total transfer value of segregated exempt assets of the member life insurance company immediately before the transfer must be the same as the total transfer values of those assets just after the transfer.

[Schedule 6, item 10, subsection 713-520(2) of the IT(TP) Act 1997]
When transitional relief applies
1.86 The transitional relief will apply only if the life insurance company chooses to apply the relief. The choice must be made:

- by the day the life insurance company, or the head company of the consolidated group of which it is a member, lodges its income tax return for the income year in which the deferral event happened; or
- within a further time allowed by the Commissioner.

[Schedule 6, item 10, section 713-515 of the IT(TP) Act 1997]
1.87 In addition, the transitional relief will apply only if the deferral event happens on or before the later of:

- 30 June 2004; and
- if the head company of the consolidated group of which the member life insurance company is a member, the end of the head companys income year in which 30 June 2004 occurs.

[Schedule 6, item 10, subsection 713-520(3) of the IT(TP) Act 1997]
1.88 However, assets to which the transitional relief applies will be taken to have been transferred immediately prior to the member life insurance company becoming a member of the consolidated group. ***[Schedule 6, item 10, section 713-525 of the IT(TP) Act 1997]***
Nature of the transitional relief
1.89 The nature of the transitional relief in a section 713-510 case is that:

- any amount that would have been included in the life insurance companys assessable income under paragraph 320-15(e) or (g) of the ITAA 1997 and allocated to the companys virtual PST under section 320-205 as a result of the deferral event is deferred until a new event happens to the asset; and
- any capital gain that the life insurance company would have made as a result of the deferral event is deferred until a new event happens to the asset.

[Schedule 6, item 10, subsection 713-530(2) of the IT(TP) Act 1997]
1.90 An amount is included in a life insurance companys assessable income under paragraph 320-15(e) or (g) of the ITAA 1997 when an asset is transferred to or from the companys virtual PST or segregated exempt assets in certain circumstances. Certain amounts included in the companys assessable income under paragraph 320-15(e) are allocated to the companys virtual PST under section 320-205.
1.91 When a new event happens to the asset (see paragraph 1.93), the member life insurance company (or, because of the single entity rule, the head company if the member life insurance company is a member of a consolidated group) must include the deferred amount in its

assessable income for the income year in which the new event happens or is taken to have made a capital gain equal to the deferred gain. ***[Schedule 6, item 10, subsection 713-535(5) of the IT(TP) Act 1997]***

1.92 The deferred amount will be a discount capital gain (provided it is a CGT event that qualifies as a discount capital gain) if:

- the deferred amount is a capital gain;
- the deferral event happens to a virtual PST asset of a life insurance company within 12 months of the date of acquisition of the asset; and
- the new event occurs at least 12 months after the asset was acquired.

[Schedule 6, item 10, section 713-545 of the IT(TP) Act 1997]

A new event

1.93 A new event will occur when a subsequent taxing event happens to the asset. That is, a new event will occur if:

- a CGT event happens to the asset or, if the deferral event was CGT event C2, the replacement asset;
- the life insurance company ceases to be a member of the consolidated group;
- the asset is transferred to or from the life insurance companys virtual PST or segregated exempt assets; or
- the life insurance company ceases to exist.

[Schedule 6, item 10, subsection 713-535(1) of the IT(TP) Act 1997]

Chapter 2

Additional rules for MEC groups

Outline of chapter

2.1 This chapter explains amendments of a technical nature that will effectively treat MEC groups like consolidated groups. It also explains modifications that are required to the MEC cost setting rules so that they are aligned with certain other cost setting rules found within Part 3-90.

Context of reform

2.2 Subdivision 719-A contains the provisions that allow MEC groups to work out their income tax liabilities as though they are a single entity. Amendments in this bill link MEC groups with the consolidated group operational provisions.

2.3 Also, modifications have been made to the MEC cost setting rules found in Subdivision 719-C (contained in the September Consolidation Act) so that they are aligned with the cost setting rules found in Subdivision 705-C (where a consolidated group is acquired by another consolidated group). The provisions introduced in this bill build on the cost setting rules introduced in previous consolidation legislation.

2.4 Further, for clarification purposes, the interaction between Subdivisions 719-C and 705-D is explained when a MEC group acquires linked entities which comprise an eligible tier-1 company and its wholly-owned subsidiary(s).

Summary of new law

Operational rules for MEC groups

2.5 Subdivision 719-A provides that other than Division 703 (the membership rules for consolidated groups) and Division 719 (the MEC grouping rules) Part 3-90 has effect in relation to a MEC group in the same way in which it has effect in relation to a consolidated group. This rule is, however, subject to any modifications that are required where it is not practicable to use the operational rules for consolidated groups. This means that the rules relating to the tax treatment of consolidated groups will also apply, as far as practicable, to MEC groups. A similar rule applies to the transitional provisions found in the IT(TP) Act 1997.

Modifications to the cost setting rules for MEC groups

2.6 The modifications made to the cost setting rules in Subdivision 719-C ensure that:

- where the acquiring group is a MEC group and the head company of the acquired group *becomes* an eligible tier-1 company of the acquiring group, the assets of the members of the acquired group do not have their tax cost reset at the acquisition time; and
- where either:
- the acquiring group is a MEC group but the head company of the acquired group *does not become* an eligible tier-1 company of the acquiring group; or
- the acquired group is a MEC group and the acquiring group is a consolidated group;

the assets of the members of the acquired group have their tax cost reset at the acquisition time.

Comparison of key features of new law and current law

New law	***Current law***
The operational provisions that apply to consolidated groups will apply to MEC groups, subject to any specific modifications.	While the tax treatment of MEC groups are described in Division 719 there are no operational provisions that allow MEC groups to work out their income tax liabilities.
1. Where the acquiring group is a MEC group and the head company of the acquired group *becomes* an eligible tier-1 company of the acquiring group, the assets of the members of the acquired group do not have their tax cost reset at the acquisition time. 2. Where either: • the acquiring group is a MEC group but the head company of the acquired group does not become an eligible tier-1 company of the acquiring group; or • the acquired group is a MEC group and the acquiring group is a consolidated group; the assets of the members of the acquired group have their tax cost reset at the acquisition time.	There is some non-alignment with the MEC cost setting rules found in Subdivision 719-C and the cost setting rules found in Subdivision 705-C.

Detailed explanation of new law

Operational rules for MEC groups

2.7 Subdivision 719-A contains the provisions that allow MEC groups to work out their income tax liabilities as though they are a single entity. Without these provisions MEC groups cannot effectively operate so as to obtain the benefits of consolidation. This is because as it currently stands MEC groups have merely been defined in Division 719 of the ITAA 1997; there are no operational provisions.

2.8 Subdivision 719-A provides that other than Division 703 (the membership rules for consolidated groups) and Division 719 (the MEC grouping rules) Part 3-90 (consolidated groups) has effect in relation to a MEC group in the same way in which it has effect in relation to a consolidated group ***[Schedule 11, item 1, subsection 719-2(1)]***. Further, where reference is made in Part 3-90 (other than Division 703 or 719) to a provision in Division 703 it applies as if it referred instead to that provision or the corresponding provision in Subdivision 719-B (as appropriate) ***[Schedule 11, item 1, subsection 719-2(3)]***. For example, paragraph 709-80(1)(c) of the ITAA 1997 and the note accompanying paragraph 709-80(1)(e) makes reference to subsection 703-35(4). There is no mention of a MEC group equivalent. In brief, subsection 719-2(3) ensures that where such a reference is made it will be treated as if it referred to the corresponding provision in Subdivision 719-B (in this example it is section 719-30).

2.9 The abovementioned rule is, however, subject to any modifications that are required where it is not practicable to use the operational rules for consolidated groups ***[Schedule 11, item 1, subsection 719-2(2)]***. This means that the rules relating to the tax treatment of consolidated groups will also apply, as far as practicable, to MEC groups.

2.10 A note to this effect is also found in the dictionary definitions of consolidated group and MEC group. ***[Schedule 11, items 2 and 3, subsection 995-1(1), note 1 to definitions consolidated group and MEC group]***

2.11 A similar rule applies to the transitional provisions found in the IT(TP) Act 1997. Subdivision 719-A of the IT(TP) Act 1997 provides that other than Division 703 (the membership rules for consolidated groups) and Division 719 (the MEC grouping rules) Part 3-90 (consolidated groups) has effect in relation to a MEC group in the same way in which it has effect in relation to a consolidated group. This rule is, however, subject to any modifications that are required where it is not practicable to use the operational rules for consolidated groups. ***[Schedule 11, item 4, section 719-2]***

2.12 One modification that is required is to ensure that section 703-30 of the IT(TP) Act 1997 (debt interests that are not membership interests) has effect in relation to a MEC group in the same way in which it has effect in relation to a consolidated group. ***[Schedule 11, item 4, section 719-5]***

Nomenclature of consolidated group and MEC group

2.13 While the terms consolidated group and MEC group are defined in section 995-1 of the ITAA 1997 it is important to note that the practical effect of Subdivision 719-A is that when the term consolidated group is used:

- within Part 3-90 it will, except for Divisions 703 and 719, include MEC groups; and
- outside Part 3-90 it will not include MEC groups. Therefore for a provision to apply to a MEC group it must specifically mention them.

[Schedule 11, items 2 and 3, subsection 995-1(1), note 2 to definitions consolidated group and MEC group]

Modifications to the cost setting rules for MEC groups

2.14 Modifications have been made to the MEC cost setting rules found in Subdivision 719-C (contained in the September Consolidation Act) so that they are aligned with the cost setting rules found in Subdivision 705-C (where a consolidated group is acquired by another consolidated group). Thus, eligible tier-1 companies are treated in a similar manner as head companies of a consolidated group.

2.15 These modifications ensure that:

- where the acquiring group is a MEC group and the head company of the acquired group *becomes* an eligible tier-1 company of the acquiring group, the assets of the members of the acquired group do not have their tax cost reset at the acquisition time; and
- where either:

- the acquiring group is a MEC group but the head company of the acquired group *does not become* an eligible tier-1 company of the acquiring group; or
- the acquired group is a MEC group and the acquiring group is a consolidated group;

the assets of the members of the acquired group have their tax cost reset at the acquisition time. ***[Schedule 12, item 4, section 719-170]***

The acquiring group is a MEC group and the head company of the acquired group becomes an eligible tier-1 company of the acquiring group

2.16 Where the acquiring group is a MEC group and the head company of the acquired group becomes an eligible tier-1 company of the acquiring group, the assets of the members of the acquired group do not have their tax cost reset at the acquisition time. Where the acquired group is a consolidated group this outcome is obtained under the law as it currently stands. However, modifications are required to sections 705-175 and 705-185 of the September Consolidation Act where the acquired group is a MEC group.

2.17 With regards to MEC groups, modifications are required because as it currently stands the application provision of Subdivision 705-C (i.e. subsection 705-175(1)) cannot be satisfied where more than one eligible tier-1 company joins a MEC group. This is because the criterion requiring that the acquisition be as a result of the acquisition of membership interests in the head company of the acquired group cannot be satisfied. Without satisfying the criteria in subsection 705-175(1) the operative provisions of Subdivision 705-C cannot be utilised. This issue has been resolved by ensuring that where the entities of the acquired group, other than the head company, have been acquired they are treated as if they are the membership interests in the head company of the acquired group. ***[Schedule 12, item 4, subsection 719-170(2)]***

2.18 A similarly worded modification is needed for subsection 705-185(1) to ensure that the subsidiary members (which includes non-head company eligible tier-1 companies) of the acquired group are treated as part of the head company of the acquired group. As a consequence of this, where all members of a MEC group, for example, are acquired at the same time by another MEC group and the head company of the acquired group becomes an eligible tier-1 company of the acquiring MEC group, the tax cost of the assets of the acquiring group will not be reset. ***[Schedule 12, item 4, subsection 719-170(2)]***

Example 2.1: Top company of mec group 1 acquires all the members of mec group 2

If Top Company 1 of MEC group 1 acquires all the eligible tier-1 companies of MEC group 2 at the same time, the head company of MEC group 1 can decide that, *inter alia*, the members of MEC group 2 can join MEC group 1. If this occurs, the members of MEC group 2 will not have their tax cost of their assets reset when they become members of MEC group 1.

This outcome is achieved by first, applying section 719-160 (the MEC group general modifying rule) so that an entity becoming an eligible tier-1 company of MEC group 1 (i.e. Company C) will be treated as if it were a part of the head company of MEC group 1 (i.e. Company A). And second, by applying section 705-185 so that the subsidiary members of MEC group 2 (including any non head company eligible tier-1 companies see section 719-25 of the ITAA 1997) are treated as if they were part of the head company of MEC group 2.

When the members of MEC group 2 join MEC group 1 the rules for setting the head companys cost of membership interests in subsidiary entities when they leave MEC group 2 (i.e. Division 711 of the ITAA 1997) will not be triggered. This is pursuant to subsection 705-180(1) of the September Consolidation Act. Further, the tax cost of the acquired groups assets will not be reset due to the

application of section 719-160 which, in brief, ensures that where a MEC joining entity is an eligible tier-1 company, the assets of the entity do not have their tax cost reset at the MEC joining time.

The acquiring groups is a MEC group but the head company of the acquired group does not become an eligible tier-1 company of the acquiring group

2.19 Where the acquiring group is a MEC group and the head company of the acquired group does not become an eligible tier-1 company of the acquiring group the assets of the members of the acquired group have their tax cost reset at the acquisition time. This is achieved by applying sections 705-175 and 705-185 for the purposes of the MEC cost setting rules, discussed in paragraphs 2.17 and 2.18.

Example 2.2: A subsidiary member of a MEC group acquires the members of another MEC group

Where a subsidiary member of MEC group 1 acquires all the members of MEC group 2, the members of MEC group 2 will become non-eligible tier-1 company subsidiary members of MEC group 1 (i.e. there will not be any members becoming eligible tier-1 companies of MEC group 1). Where this occurs, the members of MEC group 1 will have the tax cost of their assets reset at the acquisition time.

Because the criteria in subsection 705-175(1) have been satisfied section 705-185 can be utilised so that the subsidiary members of MEC group 2 are treated as if they were part of the head company (of MEC group 2). Thus Subdivision 705-A can apply (subject to any modifications contained in Subdivision 705-C) to reset the tax cost of the assets of the acquired entity (i.e. the head company of MEC group 2, which is becoming a subsidiary member of MEC group 1).

The MEC group general modifying rule in section 719-160 does not have any relevant operation here because the MEC joining entity is not an eligible tier-1 company.

The acquired group is a MEC group and the acquiring group is a consolidated group

2.20 Where the acquired group is a MEC group and the acquiring group is a consolidated group the assets of the members of the acquired group have their tax cost reset at the acqiuisition time. This is achieved by applying modified sections 705-175 and 705-185 for the purposes of the MEC cost setting rules, discussed in paragraphs 2.17 and 2.18.

Example 2.3 A subsidiary member of a consolidated group acquires all eligible tier-1 companies of a MEC group

Where a subsidiary member of a consolidated group acquires all the eligible tier-1 companies of a MEC group (i.e. companies A, B and C) the members of the acquired group will become subsidiary members of the consolidated group.

The MEC group general modifying rule does not apply because this rule does not apply when an entity leaves a MEC group. The general modifying rule only applies where an entity *becomes* a subsidiary member of a MEC group (see section 719-155 of the September Consolidation Act).

Because the criteria in subsection 705-175(1) have been satisfied section 705-185 can be utilised so that the subsidiary members of the MEC group are treated as if they were part of the head company (of the MEC group). Thus Subdivision 705-A can apply (subject to any modifications in Subdivision 705-C) to reset the tax cost of the assets of the acquired entity.

Other amendments made to Subdivision 719-C

2.21 Necessary consequential amendments have also been made to sections 719-155, 719-160 and 719-165, but these are purely structural in nature so as to provide a better framework to the Subdivision. ***[Schedule 12, items 1, 2 and 3, subsection 719-155(1), section 719-155, subsection 719-160(1) and section 719-165]***

Subdivision 705-D application to MEC groups

2.22 For clarification purposes only, Subdivision 705-D will apply (as modified by section 719-160) where the linked entities comprise an eligible tier-1 company and its wholly-owned subsidiary(s) join a MEC group. In such a situation the eligible tier-1 companys tax cost of its assets will not be reset at the joining time. This is pursuant to the MEC group general modifying rule. However, the linked subsidiary members will have the tax cost of their assets reset at the joining time pursuant to Subdivision 705-A (subject to any modifications in Subdivision 705-D).

Chapter 3

MEC groups: losses

Outline of chapter

3.1 This chapter explains modifications to the losses consolidation rules for MEC groups. The modifications are in Subdivision 719-F and:

- explain how the COT applies to a MEC group; and
- ensure the COT and SBT apply appropriately if the identity of a MEC groups head company changes.

3.2 References in this chapter are to the ITAA 1997, unless otherwise indicated.

Context of reform

3.3 Generally, the rules in Part 3-90 apply to a MEC group and its members in the same manner in which they apply to a consolidated group and its members. This is subject to the modifications in Division 719. This bill contains further modifications. Modifications are needed because a MEC group is structured differently to a consolidated group.

Applying the COT to MEC groups

3.4 The fact that a MEC group has multiple entry points (represented by each of its eligible tier-1 companies) rather than a single entry point (represented by a single Australian resident head company) presents difficulties in applying the COT to the group.

3.5 The COT is applied in determining whether a company, including the head company of a group, can use its losses. Broadly, a company satisfies the COT if it maintains substantially the same ownership from the start of the loss year until the end of the loss claim year.

3.6 For a consolidated group, the COT is applied by reference to the groups head company. But the head company of a MEC group is whichever of the groups eligible tier-1 companies is chosen by them as head company. Therefore, it is not appropriate to apply the COT to a MEC group by reference to its head company. That would mean a MEC groups tax position could change depending on which eligible tier-1 company was chosen as head company.

3.7 Also, applying the COT by reference to all of a MEC groups eligible tier-1 companies collectively is unworkable. The COT works to trace the ownership of a single loss entity. It cannot trace the ownership of a group of entities.

3.8 Therefore, the COT will be applied to a MEC group by reference to the groups top company the groups foreign resident parent company. That is, a MEC groups top company will be treated in the same manner as the head company of a consolidated group. This means ownership changes that occur post-consolidation below the top company of a MEC group (i.e.

in respect of interests held directly or indirectly by the top company) will be ignored in determining whether the head company of the MEC group has passed the COT in respect of any of its transferred or group losses.

3.9 However, consistent with the rules for consolidated groups, pre-consolidation ownership changes will continue to count in respect of a company from which a loss is transferred to the MEC group because the COT is passed.

Losses denied on dealings in membership interests below top company

3.10 Ownership changes below the top company level can only be ignored if such changes cannot be used as a means of duplicating the loss held by the group.

3.11 For changes in intra-group interests (broadly, interests below the eligible tier-1 level) this is achieved by the single entity rule which ignores such changes for income tax purposes and so dealings in them cannot give rise to a loss.

3.12 For interests in the groups eligible tier-1 companies, this will be achieved by adjusting the pooled cost bases of those interests on dealings in those interests. For interests in entities interposed between the eligible tier-1 companies and the groups top company, this will be achieved by rules which deny losses on dealings in those interests (unless the loss can be said to relate to an asset outside the MEC group). These rules are discussed in Chapter 11.

Deemed COT failure

3.13 Applying the COT by reference to a MEC groups top company makes it necessary to deem a COT failure if the groups structure changes in a manner that makes continued testing through the top company inappropriate.

3.14 One example is when there is a change in the MEC groups top company as a result of a new top company acquiring relevant membership interests below the original top company. In this case the new top company could only have come about as a result of a 100% change in interests. Therefore, the deemed COT failure simply reflects what has actually occurred. The deeming is necessary because the approach of ignoring changes below the original top company means changes below that level would otherwise not be detected.

3.15 Another example is when the MEC group ceases to exist (e.g. because it converts to a consolidated group or because of some other event that breaks the group). In that case there will no longer be a top company. The losses will remain with the entity that was the head company of the MEC group when it ceased to exist. It is appropriate then that the focus of the COT test move back on-shore to the entity that still has the losses. But it is impossible to shift the focus from the top company down to an on-shore entity and continue COT testing. For that reason, a COT failure will generally be deemed when a MEC group ceases to exist.

Ensuring the change in head company rules apply appropriately

3.16 Section 719-90 ensures that a change in a MEC groups head company does not affect the groups tax position. It does this by transferring the old head companys history to the new head company. This bill includes rules to ensure that section 719-90 interacts appropriately with the COT rules discussed in this chapter and with the SBT.

Summary of new law

Applying the COT to MEC groups

3.17 Ownership changes that occur post-consolidation below the top company of a MEC group will be ignored in determining whether the head company of the MEC group has passed the COT in respect of any of its transferred or group losses. That is, the groups top company will be treated in the same manner as the head company of a consolidated group.

3.18 Generally, in determining whether the head company of a MEC group has passed the COT in respect of a loss, the COT is applied to the groups top company from the transfer time (if the loss is a transferred loss) or the beginning of the income year in which the head company made the loss (if the loss was generated by the group itself).

3.19 There is an exception if the loss was transferred to the group because the COT was passed by the transferor (called a *COT transfer*). In that case the COT is applied to the transferor from the beginning of the income year in which it made the loss, but on the assumption that post-consolidation changes below the top company are ignored. This is consistent with the rules for consolidated groups contained in section 707-210.

3.20 The test company (i.e. the top company or transferor to which the COT is applied) will be deemed to have failed the COT if:

- the potential MEC group ceases to exist;
- the potential MEC group continues, but there is a change in its top company because something happens to membership interests below the top company; or
- there ceases to be a provisional head company for the group.

3.21 Satisfaction or failure of the COT by the test company is attributed to the head company of the MEC group.

3.22 Other rules relevant to determining whether the head company can use the loss (e.g. the SBT and control test) are applied directly to the head company.

Ensuring the change in head company rules apply appropriately

3.23 The transfer of history under section 719-90 from an old head company to a new head company will not affect the application of the COT to the old head company. Also, in applying the SBT, a new head company takes into account the groups relevant business history and not things that happened to the new head company before it joined the group.

Comparison of key features of new law and current law

New law	*Current law*
In determining whether the head company of a MEC group has passed the COT in respect of a group loss or a transferred loss (other than a transferred COT loss) the ownership of the groups foreign resident holding company (top company) is tested. The test is applied from the transfer time or the beginning of the income year for which the group loss was made.	In determining whether the head company of a consolidated group has passed the COT in respect of a group loss or a transferred loss (other than a transferred COT loss) the ownership of the groups head company is tested. The test is applied from the transfer time or the beginning of the income year for which the group loss was made.
In determining whether the head company of a MEC group has passed the COT in respect of a transferred COT loss, the ownership of the transferor is tested, subject to certain assumptions. The test is applied from the start of the transferors loss year.	In determining whether the head company of a consolidated group has passed the COT in respect of a transferred COT loss, the ownership of the transferor is tested, subject to certain assumptions. **The test is applied from the start of the transferors loss year.**
The application of the COT is not affected by the transfer of history from an old head company to a new head company under section 719-90.	**It may be argued that the old head company no longer has an ownership history because it was transferred to the new head company.**
In applying the SBT to the new head company of a MEC group, the new head company takes into account the groups business history and not things that happened to the new head company as a single entity before it joined the group.	**It may be argued that a new head company must take into account its own business history accrued prior to it joining the group.**

Detailed explanation of new law

Applying the COT to MEC groups: the broad approach

3.24 Broadly, the COT is applied to the relevant test company on the basis of certain assumptions and the result is attributed to the groups head company. ***[Schedule 13, item 1, subsections 719-260(1) and (2)]***

The steps in applying the COT to a MEC group

3.25 The steps in applying the COT to a MEC group are:

- step 1: identify the test company for the loss:
- this is the company to which the COT is applied;
- step 2: assume the test company made the loss:
- this allows the COT to be applied to the test company;
- step 3: identify the start of the income year for which the test company is taken to have made the loss:
- this marks the start of the test companys ownership test period (i.e. the time from which it commences to apply the COT); and
- step 4: apply the COT to the test company ignoring ownership and voting changes up to the top company level while the loss is held by a MEC group:
- also, the test company may be deemed to have failed the COT on the happening of certain events during the test companys ownership test period.

3.26 Examples 3.1 and 3.2 illustrate the application of the steps.

Commonly used terms

3.27 The terms test company, focal company and COT transfer are central to the rules. The expressions changes above top company and changes below top company are used in explaining the effect of the rules.

Focal company

3.28 The company seeking to use the loss is called the *focal company*.

3.29 The focal company will generally be the head company of a MEC group. However, it may be the ex-head company of a MEC group that has ceased to exist or the head company of a consolidated group that has converted from a MEC group. This is discussed further in paragraphs 3.44 to 3.50.

3.30 The focal company will have made the loss because:

- the loss was transferred to it under Subdivision 707-A (transferred loss); or
- the loss was generated by a consolidated or MEC group of which it was the head company (group loss).

  Test company

  3.31 The company that is tested to determine whether the focal company has passed the COT in respect of the loss is called the *test company*.

  3.32 The test company for the focal company will generally be the MEC groups top company. However, if the loss was transferred to the groups head company because the transferor passed the COT (a *COT transfer*) the test company will be the transferor (or the earliest company transferor if there has been a series of COT transfers).

  3.33 The focal company and the test company may be the same entity, though that will generally not be the case.

  COT transfer

  3.34 The transfer of a loss under Subdivision 707-A because the COT is passed is called a *COT transfer*. That is, the loss is transferred because the transferor meets the conditions in section 165-12. *[Schedule 13, item 2, definition of COT transfer in paragraph 707-210(1A)(a)]*

  3.35 However, the transfer is *not* a COT transfer if both the section 165-12 ownership test and the SBT in subsections 165-15(2) and (3) are passed (the control SBT). The control SBT

applies if the control test is failed. If the control SBT is passed then the loss is more properly categorised as an SBT loss, because in the end an SBT was the reason the loss was transferred, even though the ownership test was also passed. ***[Schedule 13, item 2, definition of COT transfer in paragraph 707-210(1A)(b)]***

Changes above and below top company

3.36 The expressions changes above top company and changes below top company, while not used in the legislation, are used in this explanation for brevity. They are illustrated in Diagram 3.1.

3.37 Changes above a MEC groups top company are taken into account in determining whether the groups head company has passed the COT. Broadly, this is a reference to changes in (direct or indirect) membership interests *in* a top company.

3.38 Changes below a MEC groups top company are not taken into account. This is a reference to changes in membership interests held directly or indirectly *by* a top company in group members, or in entities interposed between group members and a top company.

Diagram 3.1

Comparison with the rules for consolidated groups

3.39 The approach to COT testing MEC groups is modelled on the rules for consolidated groups contained in section 707-210.

3.40 However, the rules for MEC groups are broader than those in section 707-210 in 2 respects:

- first, they apply to *all* losses (whereas section 707-210 only applies to transferred COT losses):
- this ensures that a MEC groups top company is tested in respect of SBT losses, trust losses and group losses. There is no equivalent rule for consolidated groups because under the single entity rule the COT is automatically applied to the groups head company in respect of such losses; and
- second, they provide for interactions between the rules for consolidated groups and those for MEC groups in the event that a loss has passed from a consolidated group to a MEC group or from a MEC group to a consolidated group. Broadly:
- the rules in section 707-210 apply if the loss has only ever been held by a consolidated group;
- the rules discussed in this chapter apply if the loss has only ever been held by a MEC group;
- the rules discussed in this chapter apply to ensure continuous COT testing of a loss that moves from a consolidated group to a MEC group as a COT loss; and
- the rules discussed in this chapter apply to deem a COT failure of a loss if it is sought to be moved from a MEC group to a consolidated group.

3.41 Therefore, in determining whether a head company (or an ex-head company that is still holding the groups losses) has passed the COT the starting point is determining which set of rules apply those for consolidated groups in section 707-210 or those discussed in this chapter.

Examples illustrating the application of the COT testing steps

3.42 Examples 3.1 and 3.2 illustrate the application of the 4 steps used to determine whether the head company of a MEC group has passed the COT. Example 3.1 is a theoretical application of the 4 steps to a set of facts. Example 3.2 is a practical application of the steps (using actual figures) to the same set of facts.

Example 3.1

Year 1 Sub co makes a loss.

Year 2 Sub co joins a MEC group on the first day of year 2. At the joining time there is a COT transfer of Sub cos loss to the groups head company.

Year 3 there is a change in the MEC groups top company.

Year 4 the MEC groups head company seeks to recoup the loss.

The MEC groups head company is the focal company. It can use the loss provided the test company could have used the loss.

Step 1: identify the test company

The test company is Sub co:

- first, item 2 in the table in subsection 719-265(2) applies because the focal company made the loss as a result of a COT transfer and the focal company and the transferor are different companies. Item 2 identifies the test company as the entity that is the test company for the transferor. The transferor is Sub co ***[Schedule 13, item 1, subsection 719-265(2), item 2 in the table]***; and

- the rules for identifying the test company are applied again, this time assuming that Sub co is the focal company. Item 3 in the table in subsection 719-265(4) applies. It identifies the test company as the focal company (i.e. Sub co) ***[Schedule 13, item 1, subsection 719-265(4), item 3 in the table]***.

  Step 2: assume the test company made the loss
  Sub co is taken to have made the loss even though it has been transferred to the head company.
  Step 3: identify the start of the test companys loss year
  Sub cos loss year starts at the start of year 1:

- item 1 in the table in subsection 719-270(4) applies because Sub co made the loss other than by way of a transfer under Subdivision 707-A (i.e. it is Sub cos own loss). Therefore, Sub co is taken to have made the loss from the start of the income year in which it actually made it (i.e. the start of year 1). ***[Schedule 13, item 1, subsection 719-270(4), item 1 in the table]***

  Step 4: ignore ownership changes below top company
  First, after the transfer, assume nothing happens to membership interests or voting power in Sub co or in any entity interposed between Sub co and the groups first top company.
  Second, after the change in Top co, assume nothing happens to membership interests or voting power in the original Top co or in any entity interposed between it and the new Top co.
  Example 3.2
  This example continues Example 3.1. It shows whether the COT is passed in respect of the loss using actual figures.
  The diagram shows Sub cos ownership structure at the start of its loss year (i.e. year 1) 30% of it is owned by X co and 70% by Y co.
  During that year, Y co acquires the remaining 30% interest in Sub co from X co.

  Event Sub co transfers its loss to a MEC group
  The MEC group forms at the beginning of year 2, comprising Y co, Z co and Sub co. On formation, Sub co transferred its loss to Y co, the groups head company.
  Event change in the groups top company
  During year 3, T2 acquires Roses 10% interest in T1. This results in T2 replacing T1 as the groups top company:

- also, in year 3, B co acquires some of A cos shares in Y co so that B co owns 15% of Y co and A co owns 85%.

Is the COT passed?
The head company (i.e. Y co) passes the COT when it seeks to use the loss in year 4 if Sub co would have passed it.
The COT is applied to Sub co on the basis of the assumptions identified in Example 3.1.
Sub co takes these ownership changes into account:

- its pre-consolidation changes (i.e. Y cos acquisition of X cos interest in Sub co); and
- post-consolidation changes in T1 up until, and including, T2s acquisition of Roses 10% interest.

The post-consolidation changes in Y co (i.e. B cos acquisition of some of A cos interests) are ignored in determining whether the COT is passed. However, these changes will require adjustments to the pooled cost bases of interests in Y co and Z co. This is discussed in Chapter 11.
For the purpose of this example, assume that all shares carry equal voting, dividend and capital rights.
Sub co (and therefore head company) passes the COT because 63% of Sub cos ultimate ownership has continued from the start of its loss year to the end of the head companys claim year.

Shareholder	***Shareholdings that can be counted to pass the COT***	***Percentage held***
Joe	50% 90% 70%	31.5%
Greg	50% 90% 70%	31.5%
Total		63%

Applying the COT to MEC groups: the detailed rules
3.43 The next part of this chapter provides a more detailed explanation of each of the rules.
When do the rules apply?
3.44 The rules apply to a company seeking to utilise a loss (the focal company). That is, to a focal company seeking to recoup a loss or transfer it to another group. The rules apply in determining whether the focal company has passed the COT in section 165-12 in respect of the loss. They apply if the focal company was the head company of a MEC group at *any* time during its ownership test period for the loss. ***[Schedule 13, item 1, subsection 719-255(1)]***
What is the focal companys ownership test period?
3.45 Generally, a focal companys ownership test period is the period from the start of the income year for which the focal company made the loss to the end of the income year for which it is seeking to use the loss (see subsection 165-12(1)). For a transferred loss, the period starts at the transfer time (see section 707-205).
3.46 For both transferred and group losses, the period ends at the end of the trial year if the focal company is seeking to transfer the loss to another group (see section 707-120).
Loss may previously have been held by a consolidated group
3.47 The focal company may not have been the head company of a MEC group at the start of its ownership test period. At the start of the period it may have been the head company of a consolidated group that, before the end of the period, converts to a MEC group under a special conversion event in section 719-40.
3.48 Because the loss may previously have been held by a consolidated group it is specifically stated that in such cases the rules discussed in this chapter apply instead of the COT testing rules for consolidated groups contained in section 707-210. ***[Schedule 13, item 1, subsection 719-255(2)]***
3.49 Another example of the rules applying when the loss had previously been held by a consolidated group is a loss transferred to the focal company by the head company of a

consolidated group that is acquired by the focal companys MEC group. However, in that case the focal company will have been a head company of a MEC group at the start of its ownership test period.

Loss may no longer be held by a MEC group

3.50 The focal company need not be the head company of a MEC group at the end of its ownership test period. The rules continue to apply in determining the focal companys ability to use the loss even if the MEC group has ceased to exist (e.g. the MEC group has deconsolidated or converted to a consolidated group). In these cases, the rules will apply to deem a COT failure in respect of the loss. This is discussed further in paragraphs 3.114 to 3.118.

Step 1: identify the test company

3.51 The identity of the test company depends on how the loss was made by the focal company. Broadly, the test company will be the top company of the MEC group, unless the loss is a transferred COT loss in which case the test company will be the transferor. ***[Schedule 13, item 1, paragraph 719-265(1)(a)]***

3.52 There is no requirement that the test company still be a member of the group that is seeking to use the loss.

Example 3.3

A MEC group forms, comprising X co, Y co and Loss co.

On formation, Loss co transfers its loss to the groups head company. The transfer is a COT transfer. Therefore, Loss co is the test company.

Before the group has used the loss, Loss co leaves. However, the loss stays with the group and the group can use it, despite Loss cos exit.

Also, Loss co continues to be the test company, but on the assumption that its ownership structure is frozen to that which existed immediately after formation. That is, the fact that Loss co has left is ignored. This matches the rules for consolidated groups in section 707-210 and is explained further in paragraphs 3.87 to 3.113.

3.53 The rules for identifying the test company also accommodate the possibility that, at the transfer time or the beginning of the income year in which a group loss was made, the focal company was the head company of a consolidated group. In that case, the test company is identified by reference to the consolidated group.

Loss transferred to focal company because the SBT was passed

3.54 For a loss transferred to the focal company as the head company of a MEC group because the SBT is passed, the test company will be the top company of the MEC group at the transfer time. ***[Schedule 13, item 1, subsection 719-265(3), item 1 in the table]***

Example 3.4

The test company is the top company of the MEC group at the transfer time.

3.55 However, the test company will be the focal company if the focal company was the head company of a consolidated group at the transfer time. [Schedule 13, item 1, subsection 719-265(3), item 2 in the table]

Example 3.5

The loss was first transferred to the head company of a consolidated group. Subsequently the group converts to a MEC group under section 719-40. This means the head company of the consolidated group becomes the head company of the MEC group.

The test company is the focal company. That is, the head company of the MEC group (previously the head company of the consolidated group).

Loss transferred to the focal company by a trust

3.56 For a trust loss transferred to the focal company as the head company of a MEC group, the test company will be the top company of the MEC group at the transfer time. ***[Schedule 13, item 1, subsection 719-265(4), item 2 in the table]***

Example 3.6

The test company is the top company of the MEC group at the transfer time.

3.57 However, the test company will be the focal company if the focal company was the head company of a consolidated group at the transfer time. ***[Schedule 13, item 1, subsection 719-265(4), item 3 in the table]***

Loss made by the focal company as a group loss

3.58 For a group loss, the test company will be the top company of the MEC group at the start of the income year for which the loss was made. ***[Schedule 13, item 1, subsection 719-265(4), item 1 in the table]***

3.59 However, the test company will be the focal company if the focal company was *not* the head company of a MEC group at the start of the loss year. ***[Schedule 13, item 1, subsection 719-265(4), item 3 in the table]***

3.60 One example of this is a loss made by the head company of a MEC group in the income year in which the group formed where the group formed part way through the year. There is no formal transfer of such a loss to the group under Subdivision 707-A it is essentially a group loss. In this case, the head company (i.e. the focal company) would not have been the head company of the MEC group at the beginning of the income year. Therefore, the head company will be the test company.

Example 3.7

The head company of the MEC group makes a loss for the 2003-2004 income year. For the first part of that year, the head company was a single entity. For the second part, it was the head company of a MEC group.

It seeks to use the loss in a later income year. It is therefore the focal company. It is also the test company.

3.61 In the scenario outlined in Example 3.7, it would not be appropriate for the groups top company to be the test company because the group did not form (and therefore there was no top company) until part way through the loss year. The step 4 rules discussed in paragraphs 3.87 to 3.113 ensure that, *after* formation, changes in interests held by the top company in the test company (or in any entities interposed between the test company and the top company) will be ignored.

3.62 Another example is a loss made by the head company of a consolidated group that later converts to a MEC group. Again, there is no formal transfer of the loss to the MEC group.

Example 3.8

The head company of the MEC group makes a loss for the 2003-2004 income year. For the first part of that year, it was the head company of a consolidated group. As a result of that group converting to a MEC group during the year, it becomes the head company of a MEC group.

It seeks to use the loss in a later income year. It is therefore the focal company. It is also the test company.

3.63 The term group loss is not used in the law. Instead, the law refers to a loss made apart from **Subdivision 707-A. A loss made by a company in its capacity as a single entity and later transferred to itself in its capacity as the head company of a MEC or consolidated group could also be described as a loss made by that entity apart from Subdivision 707-A. Therefore, it is made clear that the test company for such a loss is to be identified by reference to the rules for transferred SBT or COT losses rather than the rules for group losses.** ***[Schedule 13, item 1, subsection 719-265(5)]***

Loss transferred to the focal company as a COT loss

3.64 For a loss transferred to the focal company as a COT loss, the test company will be the transferor (regardless of whether the focal company was the head company of a MEC or consolidated group at the transfer time). ***[Schedule 13, item 1, paragraph 719-265(1)(b), subsection 719-265(2), item 2 in the table and subsection 719-265(4), item 3 in the table]***

3.65 The transferor and the focal company will be the same entity if the loss was made by the focal company outside the group and transferred to itself in its capacity as the head company of a MEC or consolidated group. In that case, the focal company is identified as the test company. ***[Schedule 13, item 1, subsection 719-265(2), item 1 in the table]***
3.66 Also, the rules are drafted so as to identify the *earliest* transferor company as the test company if there has been a series of COT transfers. That is, the test company may be traced back through one or more COT transfers. Therefore, more than one application of the rules may be needed in order to identify the test company. ***[Schedule 13, item 1, paragraph 719-265(1)(b), item 1 in the table]***
3.67 A repeat application of the rules is needed if there is a COT transfer of the loss to the focal company and the transferor and the focal company are different entities. (If they are the same entity, then that entity is the test company and no further testing is needed.)
3.68 In applying the rules again, the transferor is treated as though it is the focal company. That is, as if the transferor still had the loss and was seeking to use it. The aim this time is to identify the test company for the transferor. This process is repeated until the first COT transferor is identified. That entity will be the test company.
Example 3.9

The loss is transferred from the original loss-making company to the head company of the MEC group when the original loss-maker joins the group. The transfer is a COT transfer. The focal company is the head company of the MEC group. The test company is identified using the tables in subsections 719-265(2) and (4). ***[Schedule 13, item 1, subsections 719-265(2) and (4)]***
First, item 2 in the table in subsection 719-265(2) applies because the focal company made the loss as a result of a COT transfer and the focal company and the transferor are different companies. It identifies the test company as the entity that is the test company for the transferor in this case, the original loss company. ***[Schedule 13, item 1, subsection 719-265(2), item 2 in the table]***
To work out the test company for the original loss company, the rules for identifying the test company are applied again, this time assuming that the original loss company is the focal company. Item 3 in the table in subsection 719-265(4) applies because, on the basis of that assumption, none of the other provisions apply. It identifies the test company as the focal company (i.e. the original loss company). ***[Schedule 13, item 1, subsection 719-265(4), item 3 in the table]***
Example 3.10

The facts are the same as Example 3.9 except there has been a COT transfer of the loss to the head company of MEC group 2.
The focal company is the head company of MEC group 2. The test company is identified using the tables in subsections 719-265(2) and (4). [Schedule 13, item 1, subsections 719-265(2) and (4)]
First, item 2 in the table in subsection 719-265(2) applies because the focal company made the loss as a result of a COT transfer and the focal company and the transferor are different companies. It identifies the test company as the entity that is the test company for the transferor in this case, the head company of MEC group 1. ***[Schedule 13, item 1, subsection 719-265(2), item 2 in the table]***
To work out the test company for the head company of MEC group 1, the rules for identifying the test company are applied again, this time assuming that the head company of MEC group 1 is the focal company. The process from this point is the same as that explained in Example 3.9 resulting in the original loss company being the test company. ***[Schedule 13, item 1, subsection 719-265(4), item 3 in the table]***
Example 3.11

The loss is transferred from the original loss-making company to the head company of MEC group 1 because the SBT was passed. There is then a COT transfer of the loss to the head company of MEC group 2.
The focal company is the head company of MEC group 2. The test company is identified using the tables in subsections 719-265(2) and (3). [Schedule 13, item 1, subsections 719-265(2) and (3)]
First, item 2 in the table in subsection 719-265(2) applies. It identifies the test company as the entity that is the test company for the transferor. The transferor is the head company of MEC group 1. ***[Schedule 13, item 1, subsection 719-265(2), item 2 in the table]***
To work out the test company for the head company of MEC group 1, the rules for identifying the test company are applied again, but on the assumption that the head company of MEC group 1 is the focal company. The table in subsection 719-265(3) applies because the loss was transferred to the head company of MEC group 1 because the SBT was passed. Item 1 in the table identifies the test company as the top company of MEC group 1 when the loss was transferred to MEC group 1. ***[Schedule 13, item 1, subsection 719-265(3), item 1 in the table]***

Example 3.12

A group loss is made by the head company of MEC group 1. It was the head company of MEC group 1 for the whole of the loss year. Subsequently, there was a COT transfer of the loss to the head company of MEC group 2.
The focal company is the head company of MEC group 2. The test company is identified using the tables in subsections 719-265(2) and (4). ***[Schedule 13, item 1, subsections 719-265(2) and (4)]***
First, item 2 in the table in subsection 719-265(2) applies. It identifies the test company as the entity that is the test company for the transferor. The transferor is the head company of MEC group 1. ***[Schedule 13, item 1, subsection 719-265(2), item 2 in the table]***
To work out the test company for the head company of MEC group 1, the rules for identifying the test company are applied again, but on the assumption that the head company of MEC group 1 is the focal company. Item 1 in the table in subsection 719-265(4) applies because the head company of MEC group 1 made the loss apart from Subdivision 707-A (and it was the head company of the group at the start of the loss year). It identifies the test company as the top company of MEC group 1 at the start of the loss year. ***[Schedule 13, item 1, subsection 719-265(4), item 1 in the table]***
Step 2: assume the test company made the loss
3.69 This allows the COT to be applied to the test company. ***[Schedule 13, item 1, subsections 719-270(1), (2) and (4)]***
3.70 It means that a test company that has never made the loss (i.e. a top company) can nonetheless apply the COT.
3.71 The assumption also applies where the test company has at some stage made the loss but has since transferred it to itself or another company. In those cases, the assumption reinstates the test company as the loss-maker. The fact that the test company has since transferred the loss does not disturb the assumption. ***[Schedule 13, item 1, subsection 719-270(6)]***
Step 3: identify the start of the test companys loss year
3.72 The COT is applied to the test company for its ownership test period. This is the period from the start of the test companys loss year until the end of the income year in which the head company seeks to use the loss.
3.73 The start of the test companys loss year depends on the identity of the test company and the nature of the loss.
3.74 Again, the fact that the test company may have since transferred the loss either to itself or to another company does not disturb the time that is pinpointed as the start of its loss year. [Schedule 13, item 1, subsection 719-270(6)]
The test company is the top company of the focal companys MEC group

3.75 If the test company is the top company for the focal companys MEC group, the start of the test companys loss year matches the start of the focal companys ownership of the loss.
3.76 The test companys loss year will start at the start of the income year for which the focal company made the loss if the focal company made the loss as a group loss.
[Schedule 13, item 1, subsection 719-270(1), item 1 in the table]
3.77 The test companys loss year will start at the transfer time if the loss was transferred to the focal company. ***[Schedule 13, item 1, subsection 719-270(1), item 2 in the table]***
The test company was the top company of an earlier MEC group
3.78 If the test company was the top company for an earlier MEC group, the start of the test companys loss year matches the start of the period of loss ownership for the focal company of that earlier MEC group. ***[Schedule 13, item 1, subsection 719-270(4), item 3 in the table]***
3.79 In Example 3.11, the top company for MEC group 1 was identified as the test company. The start of its loss year is set by reference to the focal company for MEC group 1. It will therefore be the time the loss was transferred to the focal company for MEC group 1.
The test company is the first loss-making company
3.80 If the test company is the first loss-making company of a loss that has been transferred on one or more occasions as a COT loss, the start of the test companys loss year matches the start of its original ownership period for the loss.
3.81 The test companys ownership period for the loss depends on how it made the loss. The test company may have generated the loss itself. Alternatively, the loss may have been transferred to it other than as a COT loss (e.g. because the SBT was passed).
3.82 The test companys loss year will begin at the start of the income year for which the test company originally made the loss if it generated the loss itself. [Schedule 13, item 1, subsection 719-270(4), item 1 in the table]
3.83 However, if the test company made the loss because the loss was transferred to it, then its loss year will start at the transfer time. ***[Schedule 13, item 1, subsection 719-270(4), item 2 in the table]***
The test company and the focal company are the same entity
3.84 The test company may be both the original loss-making company and the focal company. That is, the test company and the focal company are the same entity. Again, the start of the test companys loss year matches the start of its original ownership period for the loss.
3.85 That is, the test companys loss year will begin at the start of the income year for which the test company originally made the loss. [Schedule 13, item 1, subsection 719-270(2), item 1 in the table]
3.86 However, if the test company originally made the loss because it was transferred to it by another entity or it transferred it to itself because the SBT was passed, then its loss year will start at the transfer time. ***[Schedule 13, item 1, subsection 719-270(2), item 2 in the table]***
Step 4: ignore ownership changes below top company
3.87 Post-consolidation ownership changes below a MEC groups top company are ignored.
3.88 No special rules are needed to achieve this outcome if the test entity is the top company of the focal companys MEC group. That is, applying the COT to the top company naturally means that only changes in the top company (i.e. above it) are taken into account. This applies, for example, to losses generated by the MEC group itself and to losses transferred to the group because the SBT was passed.
3.89 However, special rules are needed if the test company is a company other than the top company for the focal companys MEC group. Special rules apply, for example, to losses transferred to a MEC group where the transfer was a COT transfer.
3.90 Broadly, each time there is a COT transfer of a loss to a MEC group (or the group gets a new top company) it is assumed that nothing happened *after* that time to membership interests or voting power in entities below the groups top company (or new top company) that would affect whether the test company met the conditions in section 165-12. This achieves 3 things:

- first, it ensures that changes that occur before the transfer (or the new top company) are counted;

- second, it freezes the ownership structure below the groups top company to that which exists immediately after the transfer (or new top company) time; and
- third, it ignores the test companys exit from the group, including ownership changes that trigger the exit.

[Schedule 13, item 1, subsection 719-275(2)]
3.91 Ignoring a test companys exit from the group is consistent with the general consolidation model which provides that tax attributes transferred to a group remain with the group for use by it even if the entity that transferred the attributes leaves the group. It is also matches the approach taken in section 707-210.
3.92 The rules are drafted to incorporate an assumption that freezes the relevant ownership structure. The assumption must be made whenever any one of 5 listed events occurs during the test companys ownership test period. That is, whenever one of the events occur between the start of the test companys loss year and the end of the head companys claim year. More than one event may occur during the period. Also, the same event may occur more than once during the period. ***[Schedule 13, item 1, subsection 719-275(1)]***
Event 1: COT transfer to a MEC group (from a single entity or the head company of a consolidated group)
3.93 This event occurs if there is a COT transfer of the loss to a MEC group from a single entity or from the head company of a consolidated group. (A transfer from the head company of a MEC group is covered by event 2. Transfers that are *not* COT transfers are not covered at all because there is no need that is, the top company of the MEC group will be the test company.)
3.94 The COT is applied to the test company on the assumption that, after* the transfer, nothing happens to the membership interests or voting power in the transferor (i.e. the single entity or the head company of the consolidated group). It is also assumed that nothing happens to any entity interposed between the transferor and the MEC groups top company. *[Schedule 13, item 1, subsection 719-275(2), item 1 in the table]
3.95 This ensures that ownership changes in the transferor up to the transfer time continue to be relevant. After the transfer time, only ownership changes in the top company are relevant.
Example 3.13

A MEC group forms comprising: X co, Y co, Z co, S1, S2 and S3.
On formation there is a COT transfer of a loss from S1 to the groups head company which is Z co. S1 is the test company.
The COT is applied to S1 on the basis of its ownership structure that existed at the formation time and which is within the diagram square.
Therefore, in applying the COT to S1, the subsequent exit of S1 from the group would be ignored. If the top company rolled down some or all of the interests it held in X co so, for example, they were held by Y co, that would be ignored for COT purposes. If the top company sold all of its interests in X co to an entity outside the group, resulting in X co and S1 leaving the group, that would be ignored.
Event 2: COT transfer to a MEC group (from the head company of another MEC group)
3.96 This event occurs if there is a COT transfer of the loss to a MEC group from the head company of another MEC group.
3.97 The COT is applied to the test company on the assumption that, *after* the transfer, nothing happens to the membership interests or voting power in the top company of the transferors MEC group or in any entity interposed between it and the top company of the transferees MEC group. ***[Schedule 13, item 1, subsection 719-275(2), item 2 in the table]***
3.98 This ensures that ownership changes in the top company of the transferors MEC group up to the transfer time continue to be relevant. After the transfer time, only ownership changes in the top company of the transferees MEC group are relevant.

3.99 Changes below the top company of the transferors MEC group will already be ignored either because that top company is the test company or because of a previous application of event 1.
3.100 Event 2 will only apply if the top company of one MEC group (the first group) acquires all of the membership interests in the top company of another MEC group (the second group). If the first group acquired the second group in any other manner (e.g. the first group acquired all of the second groups eligible tier-1 companies) the second group will be deemed to have failed the COT. Therefore, while losses held by the second group could still be transferred to the first group, the transfer could not be a COT transfer and so event 2 could not apply. The circumstances in which the COT is deemed to be failed are discussed in paragraphs 3.114 to 3.118.
Event 3: change in identity of a MEC groups top company
3.101 This event occurs if there is a change in identity of a MEC groups top company but the MEC group continues in existence (so the groups losses are retained by the group and are not transferred to any other company).
3.102 The COT is applied to the test company on the assumption that, *after* the change in top company, nothing happens to the membership interests or voting power in the former top company or in any entity interposed between it and the new top company. ***[Schedule 13, item 1, subsection 719-275(2), item 3 in the table]***
3.103 This event applies, for example, if the groups top company becomes a wholly-owned subsidiary of another foreign resident. That other foreign resident would become the new top company. Changes in the former top company leading to the change are relevant. After that, only changes in the new top company are relevant. See Examples 3.1 and 3.2.
3.104 This event only applies to a loss held by the MEC group at the event time. Because the test company is taken to have made the loss, it is necessary to reinstate the groups head company as the loss-maker in order to ensure this link between the loss and the event. ***[Schedule 13, item 1, subsection 719-275(3)]***
Event 4: company becomes the head company of a MEC group
3.105 This event occurs if a company makes a loss and becomes the head company of a MEC group and the companys losses are *not* transferred to itself as head company at that time.
3.106 The COT is applied to the test company on the assumption that, *after* the company became the head company of the MEC group, nothing happens to membership interests or voting power in the head company or in any entity interposed between it and the new top company. ***[Schedule 13, item 1, subsection 719-275(2), item 4 in the table]***
3.107 All changes in the entity up until it becomes the head company of a MEC group will be relevant. But after that only changes above the MEC groups top company are relevant.
3.108 This event applies in respect of:

- prior year losses held by the head company of a consolidated group when the group converts to a MEC group:
- losses are not transferred when a group converts from one group type to another; and
- losses made by an entity for the income year in which the MEC group formed (either from scratch or as a result of a conversion):
- such losses are not transferred because a head company that forms a consolidated group part way through its income year does not work out its taxable income or loss up to the joining time.

3.109 This event also only applies to a loss held by the MEC group at the event time. Because the test company is taken to have made the loss, it is necessary to reinstate the groups head company as the loss-maker in order to ensure this link between the loss and the event. ***[Schedule 13, item 1, subsection 719-275(3)]***

Event 5: COT transfer to the head company of a consolidated group

3.110 This event occurs if there is a COT transfer of a loss to the head company of a consolidated group from another company.

3.111 The COT is applied to the test company on the assumption that, *after* the transfer, nothing happens to membership interests or voting power in the other company or in any entity interposed between it and the head company. ***[Schedule 13, item 1, subsection 719-275(2), item 5 in the table]***

3.112 This event will apply if the test company was previously a member of a consolidated group. It matches the outcome for consolidated groups under section 707-210. It ensures that freezes to the ownership structure of a consolidated group continue after the loss has been transferred from the consolidated group to a MEC group. It is needed because section 707-210 no longer applies once a loss has been transferred to a MEC group. ***[Schedule 13, item 1, subsection 719-255(2)]***

3.113 This event does not apply if the test company made the loss in its capacity as a single entity and transferred it to itself in its capacity as the head company of a consolidated group. There is no need for the event to apply in that case. That is, there is no need to freeze the ownership structure of the consolidated group in respect of pre-consolidation losses made by the groups head company because for such losses only changes above the head company are relevant.

Deemed COT failure

3.114 The test company will be taken to have failed the COT in respect of a loss if any of these things happen to the focal companys MEC group or potential MEC group after the start of the focal companys ownership test period for the loss:

- the potential MEC group ceases to exist;
- the potential MEC group continues to exist but there is a change in its top company because something happens to membership interests in the MEC groups eligible tier-1companies or an entity interposed between the eligible tier-1 companies and the groups top company; or
- there ceases to be a provisional head company for the group.

[Schedule 13, item 1, subsections 719-280(1) to (4)]

3.115 These are of course not the only circumstances in which the test company may fail the COT. It will also fail the COT if it fails to meet the conditions in section 165-12 on the basis of the assumptions discussed in paragraphs 3.51 to 3.113 ***[Schedule 13, item 1, subsection 719-280(5)]***. If that happens before the deemed COT failure time, then the COT failure time is taken to be the earlier time ***[Schedule 13, item 1, subsection 719-260(2)]***.

The potential MEC group ceases to exist

3.116 A potential MEC group would cease to exist, for example, if the groups top company no longer satisfied the conditions for being a top company because it became an Australian resident or a wholly-owned subsidiary of an Australian resident (see subsection 719-10(7)). A potential MEC group would also cease to exist if the relevant MEC group converted to a consolidated group (see section 703-55 and subsection 719-10(7)).

Example 3.14

The MEC group comprises X co and Y co. The groups head company is X co. The groups top company is acquired by the head company of a consolidated group. As a result, the potential MEC group ceases to exist. Therefore, the COT will be deemed to have been failed in respect of any losses held by X co.

There is a change in the top company for a potential MEC group

3.117 A potential MEC group will continue to exist despite a change in its top company if all of the eligible tier-1 companies that were members of the group before the change are still members of the group after the change (see subsection 719-10(8)). But the test company will be deemed to have failed the COT where this happens as a result of an acquisition of interests

below the groups top company (i.e. in the groups eligible tier-1 companies or in an entity or entities interposed between the eligible tier-1 companies and the original top company).

Example 3.15

The MEC group comprises X co and Y co. The groups head company is X co. The groups top company changes as a result of the new top co acquiring all of the interests in X co and Y co. The COT will be deemed to have been failed in respect of any losses held by X co. However, there would be no deemed COT failure if the new top co acquired all of the interests in the original top company (though that may bring about an actual COT failure).

There ceases to be a provisional head company

3.118 A MEC group ceases to exist if it ceases to have a provisional head company (see paragraph 719-5(7)(c)).

Attributing a test companys COT results to the focal company

3.119 The result of applying the COT to the test company is attributed to the focal company.

Test company passes

3.120 If the test company passes the COT (i.e. it meets the conditions in section 165-12) on the basis of the rules discussed in paragraphs 3.51 to 3.118, then the focal company is taken to meet the conditions in section 165-12. ***[Schedule 13, item 1, subsection 719-260(1)]***

Test company fails

3.121 If the test company would have failed the COT on the basis of the rules discussed in paragraphs 3.51 to 3.118, then the focal company is taken to fail the COT. ***[Schedule 13, item 1, subsection 719-260(2)]***

3.122 The time at which the focal company is taken to fail is relevant in applying the SBT to the focal company. Generally, the focal company is taken to have failed the COT at the time the test company fails it. ***[Schedule 13, item 1, paragraph 719-260(2)(a)]***

3.123 However, if the *test company* is a listed public company (or 100% subsidiary) to which Division 166 applies, then the focal company is taken to have failed at the test companys test time that triggered the failure. ***[Schedule 13, item 1, paragraph 719-260(2)(b)]***

3.124 Because there are 2 ways the test company can fail a failure of section 165-12 or a deemed failure it is specified that the focal company will be taken to fail the COT at the time the test company *first* failed under either test. For example, if the test company failed as a result of applying section 165-12 (on the basis of the assumptions discussed in paragraphs 3.51 to 3.113) and later is deemed to have failed (because one of the events described in paragraphs 3.114 to 3.118 occurs), the focal company is taken to fail at the earlier failure time. ***[Schedule 13, item 1, paragraph 719-260(2)(a) and subparagraph 719-260(2)(b)(ii)]***

3.125 Regardless of how the test company failed, a further rule is needed to ensure that the SBT can be applied if the *focal company* is a listed public company (or 100% subsidiary) to which Division 166 applies. In that case, the focal companys test time, for the purpose of applying the SBT in subsection 166-5(5), is taken to be the focal companys failure time worked out under the rules discussed in paragraphs 3.122 to 3.124. ***[Schedule 13, item 1, subsection 719-260(3)]***

Test company fails: interaction with the modified transfer SBT

3.126 If the COT is being applied for the purpose of determining whether the focal company can transfer the loss to a new group, then the rules that determine the timing of the COT failure must interact correctly with the modified SBT that applies on transfer: see subsection 707-125(4).

3.127 First, the timing of the head companys COT failure is relevant for the modified SBT. This ensures that in applying the modified SBT the focal company will be required to test its business for the whole of the income year in which it is taken to have failed the COT. ***[Schedule 13, item 1, paragraph 719-260(4)(a)]***

3.128 Second, the modification to subsection 166-5(5) discussed in paragraph 3.125 has no application to the modified SBT which makes its own (and different) modifications to the SBT test time for listed public companies. ***[Schedule 13, item 1, paragraph 719-260(4)(b)]***

Ensuring the change in head company rules apply appropriately

3.129 Further rules ensure that the COT rules (discussed in this chapter) and the SBT interact appropriately with section 719-90.
3.130 When the head company of a MEC group becomes ineligible to continue as head company, the remaining eligible tier-1 companies can appoint a replacement. This does not affect the groups tax position section 719-90 provides for the transfer of the old head companys history to the new head company. That is, everything that happened before the change in relation to the old head company is instead taken to have happened to the new head company.
COT: modifications if there has been a change of head company
3.131 Some of the COT rules discussed in this chapter are modified if there has been a change of the head company of the MEC group seeking to use the loss (or of a MEC group that had previously held the loss if there has been a series of COT transfers).
Identify the test company
3.132 If the head company of a MEC group changes and the rules discussed in paragraphs 3.51 to 3.68 would otherwise have identified the latest head company as the focal company, then effectively the MEC groups first head company will instead be taken to be the focal company. That is, the test company is identified by reference to the groups first head company. ***[Schedule 13, item 1, subsections 719-265(6) and (7)]***
3.133 This is so even though, as a result of an application of section 719-90, the first head company is no longer taken to have made the loss. ***[Schedule 13, item 1, subsection 719-265(7)]***
3.134 This will generally only be an issue if the latest head company would otherwise have been identified as the test company (on the basis that it is also the focal company).

Example 3.16

The loss is transferred to the head company of the consolidated group because the SBT was passed.
Subsequently that group converts to a MEC group which results in the head company of the consolidated group becoming the head company of the MEC group (Head co 1).
Subsequently Head co 1 is replaced by a new head company (Head co 2) that seeks to use the loss.
In the absence of the rule discussed in paragraph 3.132, Head co 2 would be the test company. That is not the correct outcome. For example, it may not have been in existence at the time the loss was transferred to Head co 1. Also, its ownership history may be quite different to Head co 1s.
Rather, Head co 1 is the test company and the COT is applied to it from the transfer time. After the conversion, only ownership changes above the groups top company are taken into account.
Identify the start of the test companys loss year
3.135 Section 719-90 is disregarded in determining the start of the test companys loss year if the test company is the first head company. ***[Schedule 13, item 1, subsections 719-270(3) and (5)]***
3.136 The start of the test companys loss year depends in part on the manner in which the test company originally made the loss. These rules do not work correctly if the test company is considered no longer to have made the loss because it transferred this aspect of its history to the new head company. Therefore, section 719-90 is essentially overridden in determining the start of the first head companys loss year.
Ignore ownership changes below the top company
3.137 Section 719-90 is also disregarded if the first head company is the test company in respect of a loss it made in its capacity as a single entity and transferred to itself in its capacity as the first head company of a MEC group. ***[Schedule 13, item 1, subsection 719-275(4)]***
3.138 Event 1 (discussed in paragraphs 3.93 to 3.95) basically freezes the test companys ownership structure up to the level of the groups top company after transfer. If the test

company is replaced as head company it may be argued that the history it transfers to the new head company includes its ownership structure. Therefore, section 719-90 is disregarded in applying event 1.

SBT: only the groups business history is relevant

3.139 In applying the SBT, a new head company takes into account the groups relevant business history and *not* things that happened to the new head company before it joined the group. ***[Schedule 13, item 1, section 719-285]***

3.140 Broadly, an entity passes the SBT if the business it carried on just before the COT failure time (i.e. the test time) is the same as the business it carried on in the loss claim year. The test time is modified when applying the SBT in determining whether a loss is transferred to a consolidated or MEC group (see section 707-125).

3.141 If a MEC groups head company changes after the test time, it is possible that the new head company was not a member of the group at the test time and therefore has its own business history in respect of this time. This rule ensures that the new head company is not required to take into account its own business history accrued prior to it joining the group.

Application and transitional provisions

3.142 These measures will take effect on 1 July 2002, along with other aspects of the consolidation measures.

Consequential amendments

3.143 A consequential amendment is made to the Dictionary in subsection 995-1(1) to include a reference to the definition of COT transfer. ***[Schedule 13, items 4 and 5]***

3.144 Consequential amendments are made to section 707-210 to include references to the new definition of COT transfer. ***[Schedule 13, item 2, subsection 707-210(1); item 3, paragraph 707-210(3)(b)]***

Chapter 4

Subsidiary members held through interposed non-resident entities

Outline of chapter

4.1 This chapter explains:

- modifications to the consolidation membership rules contained in Division 703 of the ITAA 1997 which relate to when an entity is eligible to be a subsidiary member of a consolidatable or consolidated group, where there are one or more non-resident entities interposed between that entity and the head company of the group; and
- the cost setting rules for the assets of those subsidiary members on joining and on leaving a consolidated group.

Context of reform

4.2 Under the membership rules contained in Division 703 of the ITAA 1997, a consolidated or a consolidatable group consists of a single resident head company and all of the eligible resident wholly-owned subsidiaries of the head company. The rules allow certain resident wholly-owned subsidiaries of the head company to be subsidiary members of a consolidatable or consolidated group despite one or more non-resident entities being interposed between the head company and the resident subsidiaries.

4.3 This measure will make modifications to those rules to allow non-resident entities to be interposed between group members as a transitional measure only. These modifications will maintain the integrity of the consolidation cost setting rules without adding unnecessary complexity to the ongoing rules.

Summary of new law

Membership rules for subsidiary members held through interposed non-resident entities

4.4 This bill amends the membership rules contained in Division 703 of the ITAA 1997 to limit the circumstances within which non-resident entities can be interposed between members of a consolidated or consolidatable group.

4.5 Broadly, only those consolidated groups that consolidate with effect before 1 July 2004 are eligible to have non-resident entities interposed between members of the group. Further,

in general, subsidiary members of such consolidated groups may only be held by interposed non-resident entities where those non-resident holdings were in place at the time of formation of those consolidated groups. Such a subsidiary member is referred to as a transitional foreign-held subsidiary.

Cost setting rules for subsidiary members held through interposed non-resident entities

4.6 Modifications are made to the cost setting rules contained in Divisions 701, 705 and 711 to set tax costs of assets of entities that become members of a consolidated group, where there are interposed non-residents between that member and the group.

Comparison of key features of new law and current law

New law	***Current law***
Only those consolidated groups that consolidate in the transitional period may have non-resident entities interposed between the members of the group. Further, in general, subsidiary members of such groups may only be held by interposed non-resident entities where such holdings were in place at the time of formation of such groups.	Generally, an entity may qualify as a subsidiary member of a consolidated group where there are one or more non-resident entities interposed between it and the head company of the group irrespective of the date that the group consolidates.
Modifications to the cost setting rules are made to set the tax costs of transitional foreign-held entities.	No equivalent.

Detailed explanation of new law

Changes to the consolidation membership rules regarding interposed entities

4.7 Section 703-45 of the ITAA 1997 outlines certain ownership tests that need to be satisfied before an entity that is a wholly-owned subsidiary can qualify as a subsidiary member of a consolidatable or consolidated group where there are one or more entities interposed between it and the head company of the group. Those tests are discussed in Chapter 3 of the explanatory memorandum to the May Consolidation Act.

4.8 The ownership tests in section 703-45 have now been replaced with a test that requires any entities that are interposed between the entity being tested (the test entity) and the head company of a consolidatable or consolidated group at a particular time (the test time (see paragraphs 4.13 to 4.14)) to be either:

- a subsidiary member of the group; or
- an entity that holds membership interests in the test entity or a subsidiary member of the group (that is interposed between the head company and the test entity) only as a nominee of one or more entities that are members of the group.

[Schedule 16, item 2, section 703-45]

Circumstances in which non-resident entities can be interposed between members of a consolidatable or consolidated group

4.9 As a transitional measure, the rule in paragraph 4.8 is relaxed in limited circumstances to allow certain resident companies, trusts and partnerships to be subsidiary members of a consolidatable or consolidated group despite one or more (non-member) non-resident entities being interposed between the resident entities and the head company of the group.

4.10 The transitional rules replicate those rules in section 703-45 of the ITAA 1997 which allowed certain non-resident entities to be interposed between members of a consolidatable or consolidated group. However, supplementary rules will now apply so that those rules will now operate in a transitional manner. This limitation is necessary to maintain the integrity of the cost setting rules without adding unnecessary complexity to the ongoing rules.

4.11 Under the transitional rules, the ownership tests to establish whether a resident wholly-owned subsidiary that is held through one or more non-resident entities can be a subsidiary member of a consolidatable or consolidated group will be determined by the nature of the entity being tested. There are slightly different tests that are applied for consolidatable groups and consolidated groups. This is because once a group is consoldiated, the group must meet further tests for foreign held entities to continue to be subsidiary members of the consolidated

group. This requirement is not relevant for a consolidatable group. The relevant tests, referred to in this explanatory memorandum as the interposed foreign residency tests, are outlined in paragraphs 4.12 to 4.27.

Interposed foreign residency tests

The tests that apply when the test entity is a company

4.12 When the test entity is a company, it will qualify as a subsidiary member of a consolidatable or consolidated group at a particular time (the test time) if at the test time:

- there is at least one entity interposed between the test entity and the head company that is either:
- a foreign resident company (referred to as a non-resident company); or
- a trust that does not meet the residency tests set out in the consolidation membership rules (referred to as
- a non-resident trust. These tests, located in section 703-25 of the ITAA 1997, are discussed in paragraphs 3.60 and 3.61 of the explanatory memorandum to the May Consolidation Act);
- each entity interposed between the test entity and the head company of the group is one of the following:
- an entity that is a subsidiary member of the group;
- a non-resident company;
- a non-resident trust;
- an entity that holds membership interests in an entity interposed between it and the test entity, or in the test entity, only as a nominee of one or more entities each of which is a member of the group, a non-resident trust or a non-resident company; or
- a partnership, where each partner is a non-resident company or a non-resident trust; and
- the test entity would be a subsidiary member of the group if it was assumed that each of the following interposed entities was a subsidiary member of the group:
- each interposed entity that is a non-resident company; and
- each interposed entity that is a non-resident trust.

[Schedule 16, item 5, subsections 701C-10(1) to (5)]

4.13 In addition to the requirements in paragraph 4.12, the requirements in paragraphs 4.15 to 4.20 must be met for an entity, that is a company, to be a subsidiary member of a consolidatable or consolidated group at a particular time. The test in paragraph 4.15 is only applicable if, at the test time, the group is a consolidatable group. The test in paragraph 4.17 is relevant if the test time is the formation time and the group is a consolidated group. The requirements in paragraphs 4.19 and 4.20 will apply if the test time is after the formation time and the group is a consolidated group.

4.14 It is these additional requirements that distinguish the interposed foreign residency tests set out in this explanatory memorandum to the interposed foreign residency tests set out in the explanatory memorandum that accompanied the May Consolidation Act.

Additional requirement for consolidatable groups

4.15 If the group is a consolidatable group, the test time must be before 1 July 2004. ***[Schedule 16, item 5, subsection 701C-10(6)]***

4.16 This test effectively ensures that on or after 1 July 2004 there will be no consolidatable groups in existence that have non-resident entities interposed between members of the group. This effectively prevents consolidated groups that form after 1 July 2004 from being able to form with non-resident entities interposed between members of the group.

Additional requirement for consolidated groups at formation

4.17 If the group is a consolidated group and the test time is at the time at which the group forms a consolidated group, the test time must be before 1 July 2004. ***[Schedule 16, item 5, subsection 701C-10(7)]***

4.18 This test effectively ensures that only those consolidated groups that form before 1 July 2004 are permitted to have non-resident entities interposed between members of the group at the formation time.

Additional requirement for consolidated groups after formation

4.19 This additional requirement applies if:

- the group is a consolidated group; and
- the test time is after the consolidated group comes into existence; and
- one or more membership interests in the test entity are held at the test time by:
- a non-resident company; or
- a non-resident trust; or
- an entity that holds the membership interests only as a nominee of one or more entities each of which is a non-resident company or a non-resident trust; or
- a partnership, each of the partners in which is a non-resident company or a non-resident trust.

[Schedule 16, item 5, paragraphs 701C-10(8)(a) to (c)]

4.20 In this case, the test entity will only be a subsidiary member of the consolidated group where:

- the entity had been a subsidiary member of the consolidated group at all times from the time the consolidated group came into existence until the test time; and
- at the time that the group came into existence as a consolidated group, one or more membership interests in the test entity had been held by a non-resident entity or a nominee of a non-resident entity (of a kind set out in the third dot point of paragraph 4.19).

[Schedule 16, item 5, paragraphs 701C-10(8)(d) and (e)]

4.21 One implication of this rule operating in conjunction with the rule in paragraph 4.17 is that only certain consolidated groups that form before 1 July 2004 will be eligible, after the group forms, to have subsidiary members that are held through interposed non-resident entities.

4.22 This rule effectively prevents an entity from becoming a subsidiary member of any *existing* consolidated group where membership interests in that entity are held at the test time by a non-resident entity that is interposed between it and the head company of the group. For example, where a non-resident entity that is a wholly-owned subsidiary of the head company (of a consolidated group) acquires all of the membership interests in an Australian resident entity subsequent to that group forming, that resident entity will be ineligible to become a subsidiary member of the group.

4.23 Also, this rule will generally cause an entity whose membership interests are not held by a non-resident entity(s) to cease being a subsidiary member of a consolidated group where

some or all of its membership interests are transferred to a non-resident wholly-owned subsidiary of the head company. An exception applies where the entity had been a subsidiary member of the consolidated group at all times since the group came into existence, and at the time that the group formed some or all of the membership interests in that entity were held by an interposed non-resident entity.

4.24 Generally, an entity will continue to qualify as a subsidiary member of a consolidated group where membership interests in that entity were held by an interposed non-resident entity at the time that the group formed and some or all of the membership interests in the entity are subsequently transferred to other subsidiary members of the group, certain non-resident entities or certain nominees.

The test that applies where the test entity is a trust or partnership

4.25 If the test entity is a trust or partnership, it will be a subsidiary member of a consolidatable or consolidated group at a particular time (the test time) provided that one or more of the interposed companies are subsidiary members of the group because the relevant requirements in paragraphs 4.12 to 4.20 are met. ***[Schedule 16, item 5, subsections 701C-15(1) to (3)]***

4.26 In addition, it must be the case that, at the test time, the entity would be a subsidiary member of the group had the head company beneficially owned all of the membership interests that are beneficially owned by each company that qualifies as a subsidiary member because the applicable requirements in paragraphs 4.12 to 4.20 are satisfied. ***[Schedule 16, item 5, subsection 701C-15(4)]***

4.27 The interposed foreign residency tests effectively allow the interposed non-resident entities to be disregarded for the purposes of determining who is a subsidiary member of a consolidatable or consolidated group. The non-resident entities will not themselves become subsidiary members of the consolidatable or consolidated group.

Classification of certain subsidiary members that satisfy the interposed foreign residency tests

4.28 Entities that are subsidiary members of a consolidated group in a case where the interposed foreign residency tests (in paragraphs 4.12 to 4.26) are met are classified as either transitional foreign-held subsidiaries or transitional foreign-held indirect subsidiaries.

4.29 The classification of an entity as either a transitional foreign-held subsidiary or a transitional foreign-held indirect subsidiary is dependent on the nature of the entity(s) that holds membership interests in that entity.

What is a transitional foreign-held subsidiary?

4.30 An entity is a transitional foreign-held subsidiary if:

- it is a company that qualifies as a subsidiary member of a consolidated group in a case where the relevant interposed foreign residency tests in paragraphs 4.12 to 4.20 are met; and
- one or more membership interests in the entity are held by:
- a non-resident company (this is a foreign resident company); or
- a non-resident trust (this is a trust that does not satisfy the residency tests set out in section 703-25 of the ITAA 1997. See paragraphs 3.60 and 3.61 of the explanatory memorandum to the May Consolidation Act for further details of these tests); or
- an entity that holds the membership interests in that entity only as a nominee of one or more entities each of which is a non-resident company or a non-resident trust; or
- ***a partnership, each of the partners in which is a non-resident company or a non-resident trust.***

[Schedule 16, item 5, paragraphs 701C-20(a) to (c)]

What is a transitional foreign-held indirect subsidiary?

4.31 An entity is a transitional foreign-held indirect subsidiary if:

- the entity, being either a company, trust or partnership, is a subsidiary member of a consolidated group in a case where the relevant interposed foreign residency tests in paragraphs 4.12 to 4.20 (applicable where the test entity is a company) or paragraphs 4.25 and 4.26 (applicable where the test entity is a trust or partnership) are satisfied; and
- the entity is not a transitional foreign-held subsidiary; and
- one or more membership interests are held in it by:
- an entity that is a transitional foreign-held subsidiary; or
- an entity that is a transitional foreign-held indirect subsidiary.

[Schedule 16, item 5, paragraph 701C-20(d)]

4.32 One implication of the requirement in the third dot point in paragraph 4.31, as illustrated by Example 4.2, is that an entity will be classified as a transitional foreign-held subsidiary (rather than a transitional foreign-held indirect subsidiary) where membership interests in that entity are held by entities that include the following:

- an entity that is a non-resident entity or a nominee of a non-resident entity (of a kind set out in the second dot point of paragraph 4.30); and
- an entity that is a transitional foreign-held subsidiary.

4.33 Examples 4.1 and 4.2 illustrate the differences between transitional foreign-held subsidiaries and transitional foreign-held indirect subsidiaries.

Example 4.1

Assume that all of the entities in this example are companies.

In this example, a consolidated group exists consisting of a head company, Head Co, and subsidiary members Y Co, X Co, A Co and Z Co.

Head Co holds all of the membership interests in a non-resident entity, which in turn holds all of the membership interests in A Co. A Co holds all of the membership interests in Z Co.

Assume that A Co and Z Co qualify as subsidiary members of the consolidated group in a case where the relevant interposed foreign residency tests in paragraphs 4.12 to 4.20 are satisfied.

Which entities are transitional foreign-held subsidiaries?

A Co is a transitional foreign-held subsidiary. This is because:

- it is a company that qualifies as a subsidiary member of a consolidated group in a case where the relevant interposed foreign residency tests in paragraphs 4.12 to 4.20 are satisfied; and
- its membership interests are held by a non-resident company.

Z Co is not a transitional foreign-held subsidiary as its membership interests are not directly held by a non-resident entity (or a nominee of a non-resident entity).

Which entities are transitional foreign-held indirect subsidiaries?

Z Co is a transitional foreign-held indirect subsidiary. This is because:

- it is a company that qualifies as a subsidiary member of a consolidated group in a case where the relevant interposed foreign residency tests in paragraphs 4.12 to 4.20 are satisfied; and
- it is not a transitional foreign-held subsidiary; and
- its membership interests are held by A Co, a transitional foreign-held subsidiary.

Example 4.2

This example modifies Example 4.1, the differences being:

- A Co holds 50% of the membership interests in Z Co, with the non-resident entity holding the remaining 50% of the membership interests in Z Co.

In this example, a consolidated group consists of the head company, Head Co and subsidiary members Y Co, X Co, A Co and Z Co.
Assume that A Co and Z Co qualify as subsidiary members of the consolidated group in a case where the relevant interposed foreign residency tests in paragraph 4.12 to 4.20 are met.
Which entities are transitional foreign-held subsidiaries?
A Co is a transitional foreign-held subsidiary, for the reasons stated in Example 4.1.
Z Co is also a transitional foreign-held subsidiary. This is because:

- it is company that is a subsidiary member of a consolidated group in a case where the relevant interposed foreign residency tests in paragraphs 4.12 to 4.20 are satisfied; and
- some of its membership interests are directly held by a non-resident company (unlike in Example 4.1).

An entity that is a transitional foreign-held subsidiary cannot be a transitional foreign-held indirect subsidiary (see paragraph 4.31). Therefore, Z Co (and A Co) is not a transitional foreign-held indirect subsidiary.
Why cant certain entities that are owned through interposed non-resident entities become subsidiary members in other circumstances?
4.34 The key policy principle in relation to cost setting is to align the cost of acquiring an entity with the tax cost of the assets within that entity. An exception to this rule is where a consolidated or MEC group forms during the transition period and the choice is made to retain the costs of the assets of the group.
4.35 It is not possible to reset the cost bases of assets of a transitional foreign-held subsidiary. This is because the cost setting rules cannot be applied to that subsidiary through an interposed non-resident entity. Any modifications that are made to apply the cost setting rules to a non-resident entity would be both complex and affect the integrity of the cost setting rules.
4.36 This means that the tax cost of assets in a foreign-held entity cannot be reset. If foreign-entities were to be accommodated on an on-going basis further complexity will be added to the cost setting rules. Without further rules that take into account the fact that foreign-held entities do not have their tax cost reset there would be an unintended harsh result where the majority of the cost bases of the assets in the transitional foreign-held entities are less than their market values. In the reverse situation, where the cost bases of the assets of the transitional foreign-held entities are more than their market values, there may be a duplication of losses.
4.37 Additionally, such an ongoing rule would present tax arbitrage opportunities. More specifically, such a rule would effectively extend the transitional option to retain the costs of assets on an ongoing basis, which would weaken the integrity of the cost setting rules. For example, in situations where a head company wishes to acquire a resident entity, the head company could avoid the requirement to reset the costs of the assets held by the resident entity by interposing a wholly-owned non-resident between itself and the acquired entity. This would have the effect of turning the acquired entity into a transitional foreign-held subsidiary, which would then not have its costs reset. Such a feature would be in direct conflict with the original policy principle of aligning the costs of acquiring the membership interests in an entity with the cost of the assets of that entity.
Cost setting rules for transitional foreign-held entities
4.38 Where a group first comes into existence, the general tax cost setting rules are modified so that each entity that becomes a subsidiary member of the group is treated in the same way as an entity joining an existing consolidated group (see Subdivision 705-B of the ITAA 1997).

4.39 These amendments will further modify the cost setting rules contained in Subdivision 705-B to accommodate transitional foreign-held subsidiaries and transitional foreign-held indirect subsidiaries that become members of a consolidated group when the group forms ***[Schedule 16, item 5, subsection 701C-25(2)]***.Some or all of the membership interest in the transitional foreign-held subsidiary are owned by non-resident entities. Membership interests in transitional foreign-held indirect subsidiary are owned entirely by members of the consolidated group. It is due to this difference in circumstance that the cost setting rules differ for transitional foreign-held subsidiaries and transitional foreign-held indirect subsidiaries. There are modifications in relation to the transitional foreign-held subsidiary (see paragraphs 4.40 to 4.42 and 4.51 and 4.52) for when that subsidiary becomes a member and leaves a consolidated group. The cost setting rules for transitional foreign-held indirect subsidiaries do not need to be modified (see paragraphs 4.43 to 4.44 and 4.50).

Cost setting modifications when a consolidated group comes into existence

4.40 A general modifying rule is required to set the tax costs of assets of a transitional foreign-held subsidiary because the cost setting rules cannot be applied through an interposed non-resident entity. Setting the tax costs of assets of a transitional foreign-held subsidiary through the interposed non-resident would add complexity to the law and impinges on the integrity of the cost setting rules (see paragraphs 4.34 to 4.37).

4.41 Under the general modifying rule the transitional foreign-held subsidiary is treated as if it were a part of the head company of the group, rather than a separate entity ***[Schedule 16, item 5, section 701C-30]***. This has the effect of retaining the existing tax costs of the assets of that subsidiary. This is because the rules that set the tax costs of assets only applies to *subsidiary* members of a group. The head company of a group does not have its costs reset.

4.42 Other important effects of the general modifying rule are:

- the cost setting provisions that operate if the head company of the group holds membership interests in another entity operate if the transitional foreign-held subsidiary holds membership interests in another entity ***[Schedule 16, item 5, section 701C-30, note 1(a)]***;
- the cost setting provisions that operate if the head company owns or controls another entity operate if the transitional foreign-held subsidiary own or control another entity ***[Schedule 16, item 5, section 701-C-30, note 1(b)]***; and
- references within the cost setting provisions to an entity interposed between the head company and another entity will apply to an entity interposed between a transitional foreign-held subsidiary and another entity ***[Schedule 16, item 5, section 701C-30, note 1(c)]***.

4.43 The cost of assets of transitional foreign-held indirect subsidiaries are reset using the cost setting rules contained in Subdivision 705-B. The retained cost base of the direct membership interests that the transitional foreign-held subsidiary holds in the transitional foreign-held indirect subsidiary is used when determining the joined groups ACA in relation to the transitional foreign-held indirect subsidiary.

4.44 Where the consolidated group that has transitional foreign-held members satisfies the conditions for transitional groups, the head company will be able to choose to apply the transitional cost setting rules to retain the tax costs of assets held by transitional foreign-held indirect subsidiaries.

Trading stock of a transitional foreign-held subsidiary

4.45 As the cost assets (including trading stock) of a transitional foreign-held subsidiary are not reset when the consolidated group comes into existence, there is no need to set a tax neutral amount for its trading stock. ***[Schedule 16, item 5, section 701C-35]***

Application of other cost setting rules

4.46 The membership rules dictate which set of cost setting rules contained in Division 705 that will apply. Transitional foreign-held entities can only become members of a consolidated group when the group comes into existence in the transitional period (see paragraphs 4.9 to 4.18).

4.47 As a result, if a transitional foreign-held subsidiary is a member of a consolidated group (the acquired group), and that group is acquired by another consolidated group (the acquiring group), the cost setting rules in Subdivision 705-C cannot apply. This is because the membership rules require the transitional foreign-held subsidiary to be a member of the *acquiring group* at the formation time of the acquiring group. In this case, the acquired group would be broken up at the joining time, with those resident subsidiaries that are still eligible to join the acquiring group having their costs reset under the linked entities provisions in Subdivision 705-D.

4.48 An entity is precluded from joining a consolidated group when it is acquired after a consolidated group is formed, and there is a non-resident interposed between the entity and the head company of the group. In these circumstances, the group will only be able to bring the entity into the group by transferring the interposed non-residents interests to members of the group. Existing roll-over relief can be used to effect the restructure. The rolled over cost base, calculated using existing provisions, of the non-residents membership interests in the transitional foreign-held subsidiary is used in working out the groups ACA for that subsidiary.

Cost setting rules for when a transitional foreign-held subsidiary or transitional foreign-held indirect subsidiary leaves a consolidated group

4.49 Where a subsidiary leaves a consolidated group, just before the time the entity leaves, the head company recognises the membership interests in the leaving entity. The cost for membership interests is set at a cost equal to the head companys cost for the net assets that the leaving entity takes with it. The rules for setting the cost of membership interests held by a head company in a leaving entity are contained in Division 711 of the ITAA 1997. These cost setting rules preserves the alignment between the cost for membership interests in the leaving entity and its assets.

4.50 Where a transitional foreign-held indirect subsidiary leaves a consolidated group, Division 711 will apply. No modification is required to the Division 711 rules because the transitional foreign-held indirect subsidiary has all of its membership interests held, directly or indirectly, by the head company.

4.51 A modification is made to the operation of Division 711 in relation to a transitional foreign-held subsidiary that leaves the group. This is because, in contrast to transitional foreign-held indirect subsidiaries, some or all of the membership interests in a transitional foreign-held subsidiary are held by entities that are not members of the group. Without the modification, Division 711 would only recognise membership interests in the leaving transitional foreign-held subsidiary held by members of the group.

4.52 Division 711 is applied to the non-residents membership interests in the transitional foreign-held subsidiary as if those membership interests were held by the head company ***[Schedule 16, item 5, section 701C-40]***. As there is an ability to transfer assets and businesses within a consolidated group, a transitional foreign-held subsidiary may leave the group with different assets from those that it bought into the group. Without the modification that applies Division 711 to transitional foreign-held subsidiaries, value shifting opportunities would arise in relation to membership interest held in those subsidiaries.

Application and transitional provisions

4.53 The interposed foreign residency tests will be relevant to certain consolidatable groups before 1 July 2004 and to certain consolidated groups that come into existence before 1 July 2004.

4.54 The joining cost setting rules apply to transitional foreign-held subsidiaries and transitional foreign-held indirect subsidiaries that become members on formation of consolidated groups, where those groups come into existence before 1 July 2004.

4.55 The leaving cost setting rules apply to transitional foreign-held subsidiaries and transitional foreign-held indirect subsidiaries when those members leave a consolidated group.

Consequential amendments

4.56 Minor consequential amendments have been made to Division 703 of the ITAA 1997 as a result of the changes to that Division discussed in this chapter.

4.57 Amendments to section 703-45 and subsection 703-15(2), item 2, column 4 in the table reflect the fact that the consolidation membership rules now only allow non-resident entities to be interposed between members of a consolidatable or consolidated group as a transitional measure. ***[Schedule 16, item 1, item 2, column 4 in the table in subsection 703-15(2); item 2, section 703-45]***

4.58 Section 705-15 of the ITAA 1997 and the title to Division 701B of the IT (TP) Act 1997 are amended as a result of the insertion of the transitional foreign-held entity rules. ***[Schedule 16, items 3 and 4]***

4.59 A note is added to section 711-5 (tax cost setting amount for membership interests where entities leave a consolidated group) to provide a cross-reference to the modifications made to Division 711. ***[Schedule 16, item 5, section 701C-50]***

Chapter 5
Cost setting rules additional rules

Outline of chapter

5.1 This chapter explains amendments to the consolidation cost setting rules. The amendments explained in this chapter are contained in Schedules 1, 4, 17 and 21 to this bill.

5.2 This chapter explains the rules for:

- what happens if there is an error in working out, or in distributing, an entitys ACA when it joins a consolidated group;
- what happens if the ACA is based on a liability that changes after the joining time; and
- refinements and enhancements (including technical corrections) to existing cost setting rules.

5.3 This chapter also explains certain consequential amendments to other areas of the income tax law as a result of the cost setting rules.

5.4 All references to sections and divisions are references to sections and Divisions of the ITAA 1997 unless otherwise stated.

Context of reform

5.5 The treatment of assets held by entities that join a consolidated group is based on the asset-based model discussed in *A Platform for Consultation* and recommended by *A Tax System Redesigned*.

5.6 This model dispenses entirely with the income tax recognition of separate entities within a consolidated group. It treats a consolidated groups cost of acquiring an entity that becomes a subsidiary member as the cost to the group of acquiring the assets of that entity.

5.7 The majority of the cost setting rules are contained in previous bills and Acts. The following table contains details of the cost setting rules and cross references to the legislative provisions and explanatory memorandum chapters.

Table 5.1: Summary of already introduced cost setting rules

Measures	***Legislation***	***Explanatory memorandum***
Cost setting core rules	Division 701 May Consolidation Act	Chapter 2 of explanatory memorandum to May Consolidation Act
Cost setting rules single entity joining	Subdivision 705-A May Consolidation Act	Chapter 5 of explanatory memorandum to May Consolidation Act
Cost setting rules single and multiple entities leaving	Division 711 May Consolidation Act	Chapter 5 of explanatory memorandum to May Consolidation Act
Cost setting rules formation	Subdivision 705-B June Consolidation Act	Chapter 1 of explanatory memorandum to June Consolidation Act

Cost setting rules transitional provisions	Divisions 701 and 702 of the transitional provisions - June Consolidation Act	Chapter 1 of explanatory memorandum to June Consolidation Act
Cost setting rules consolidated group joining	Subdivision 705-C September Consolidation Act	Chapter 1 of explanatory memorandum to September Consolidation Bill
Cost setting rules linked entities joining	Subdivision 705-D September Consolidation Act	Chapter 1 of explanatory memorandum to September Consolidation Bill
Cost setting rules trusts	Subdivision 713-A September Consolidation Act	Chapter 1 of explanatory memorandum to September Consolidation Bill
Cost setting rules measures to address unintended tax benefits	Sections 705-57, 705-163 and 705-240; and Divisions 701A and 701B of the transitional provisions September Consolidation Act	Chapter 1 of explanatory memorandum to September Consolidation Bill

Summary of new law

Errors in tax cost setting amounts and changes in liabilities

5.8 The ACA is worked out when an entity joins a consolidated group. It is distributed among the entitys assets to give them a tax value in the groups hands. An error made in working out the ACA would be reflected in each reset cost base asset, so may require extensive re-calculation. To reduce compliance costs, the amendments aim to avoid those re-calculations.

5.9 The ACA is increased by an amount for the joining entitys liabilities. Because some liabilities are estimates of future debts, their amount could change after the entity has joined a consolidated group. If the entity had not joined the group, such a change would be reflected in the capital value of the membership interests in the entity and so affect the owners taxable income or loss when it disposed of those interests. That does not happen if a *consolidated group* disposes of the entity because of the way that the cost setting rules apply. Therefore, the amendments ensure that a change in a liability after the joining time is properly brought to account.

5.10 If there is a mistake in working out the tax cost setting amounts for the assets of an entity joining a consolidated group, but it would be unreasonable to have to recalculate the amounts, the incorrect amounts are taken to be correct. The difference is brought to account as a single capital gain or loss when the mistake is discovered.

5.11 If a liability is taken into account in working out the ACA of an entity that joins a consolidated group, and that liability is discharged for a different amount, any difference it would have made to the ACA is a capital gain or loss at the time of discharge.

Refinements and enhancements to cost setting rules

5.12 Refinements and enhancements, some of which have arisen from consultation, are made to the cost setting rules. The amendments relate to the following areas:

- adjusting the ACA for pre-joining time roll-overs from a foreign resident company to a resident company;
- adjusting the ACA for distributions of profits that did not accrue to the head company;
- allocating the ACA in a manner that accounts for direct and indirect membership interests in subsidiary entities;
- working out the ACA on formation of a consolidated group for subsidiary members other than those electing to retain existing tax values for their assets;

- allowing certain roll-overs connected with the restructure of a foreign owned group to be excluded from the application of section 701-35 of the IT(TP) Act 1997; and
- extending a transitional rule for consolidated groups with a SAP and for those groups with an income year ended 30 June.

5.13 A number of technical corrections are also made to the cost setting rules.

Consequential amendments

5.14 The new SIS, introduced following the consolidation rules, changed the basis for recording a corporate tax entitys franking account from a taxed income basis to a tax-paid basis. Broadly speaking, the SIS commenced on 1 July 2002. The cost setting rules currently refer to the old imputation provisions contained in the ITAA 1936. The amendments contained in this bill amend the ACA calculation to reflect appropriate interactions with the SIS.

5.15 The cost setting rules in certain circumstances give rise to a capital gain or a capital loss for the head company of a consolidated or MEC group. Amendments are made to allow the head company to recognise that capital gain or a capital loss.

Comparison of key features of new law and current law

New law	***Current law***
When reasonable, errors made in working out the tax cost setting amounts for assets of an entity joining a consolidated group will be corrected by a lump sum capital gain or loss instead of amending assessments.	Errors are fixed by re-calculating all the tax cost setting amounts and amending assessments to give effect to those re-calculations.
If a liability taken into account in working out the ACA for a joining entity changes after the joining time, any effect the change would have had on the ACA is brought to account as a capital gain or loss.	No adjustment is required to reflect a change in a liability.
An adjustment to the ACA calculation is made for the effect of certain pre-joining time roll-overs from a foreign resident company to a resident company.	No equivalent.
Amendments are made to the rules which prevent duplicating reductions in the ACA where the same profits have been distributed through a chain of entities. The amendments ensure that the ACA is only reduced for distributions that are effectively made to the head company.	The rules which prevent a duplication of the reduction of the ACA calculation works inappropriately in cases where a distribution has not effectively been made to the head company.
Amendments are made to the rule which corrects for distortions in the allocation of ACA to assets where a subsidiary holds *direct or indirect* membership interests in an entity that has certain *profits* or losses.	Corrections to the allocation of ACA only apply where a subsidiary member holds membership interests *directly* in an entity with certain losses.
The rule for calculating ACA on transition is amended to clarify its operation where a group has subsidiary entities which retain existing tax values for their assets.	Some uncertainty arose over the operation of the current rule.

All CGT events that happen after 16 May 2002 and for which there is a roll-over under Subdivision 126-B, apart from roll-overs relating to the transfer of a membership interest from a foreign resident company to an Australian resident company, are ignored for the purposes of applying the consolidation cost setting rules.	All CGT events that happen after 16 May 2002 and for which there is a roll-over under Subdivision 126-B are ignored for the purposes of applying the consolidation cost setting rules.
The application of the transitional rule which allows for certain undistributed, untaxed profits to be added when working out the ACA is extended to allow groups that consolidate: • on 1 July 2003; or • on the first day of its SAP that commences after 30 June 2003 and before 1 July 2004; to receive an increase in ACA for undistributed, untaxed profits.	Groups can only receive an increase in ACA for undistributed, untaxed profits if they consolidate before 1 July 2003.
Provisions in the ACA calculation are amended so that they interact appropriately with the new SIS.	Provisions in the ACA calculation refer to imputation provisions contained in the ITAA 1936, which have since been repealed.
CGT events happen in certain situations when the head company applies the ACA calculation.	No equivalent.

Detailed explanation of new law

5.16 The amendments explained in this chapter are discussed under the following topics:

- adjusting for tax cost setting errors (see paragraphs 5.17 to 5.34);
- what if the amount of a liability changes when realised (see paragraphs 5.35 to 5.42); and
- refinements and enhancements (including technical corrections) to existing cost setting rules (see paragraphs 5.43 to 5.102)

Errors in tax cost setting amounts and changes in liabilities

Adjusting for tax cost setting errors

5.17 When an entity joins a consolidated group, it has to work out its ACA. That is, a global amount that is distributed among the entitys assets to set their value for tax purposes (their tax cost setting amount) in the hands of the group. Occasionally, a mistake will be made in working out, or distributing, the ACA. In some of those cases, it would not be reasonable to have to go back and work out the correct tax cost setting amounts. The amendments ensure that, in those cases, the incorrect amounts are taken to be correct and the differences in ACA caused by the error are instead brought to account as a single capital gain or loss.

5.18 This outcome is intended to reduce the compliance costs involved in re-calculating the correct tax cost setting amounts ***[Schedule 4, item 2, section 705-305]***. In achieving that purpose, it accepts that there may be differences in the nature of the amounts and in the times at which they are brought to account for tax purposes.

When are incorrect tax cost setting amounts preserved?

5.19 Incorrect tax cost setting amounts will be preserved if these 4 conditions are satisfied:

- the head company took into account a tax cost setting amount for a reset cost base asset of the joining entity ***[Schedule 4, item 2, subsection 705-315(2)]***;

- the tax cost setting amount was wrong because the head company made an error in working it out ***[Schedule 4, item 2, subsection 705-315(3)]***;
- the error was *not* due to fraud or evasion ***[Schedule 4, item 2, subsection 705-315(5)]***; and
- it would be unreasonable to require the amounts to be re-calculated having regard to the total size of the net errors relative to the ACA, the number of tax cost setting amounts that would have to be re-calculated, the number of amendments needed to correct the error and the difficulty of getting any necessary information ***[Schedule 4, item 2, subsection 705-315(4)]***.

5.20 The last of those conditions asks whether requiring the taxpayer to re-calculate the correct cost setting amounts would be reasonable *in the circumstances*. It does not specify exactly when it would, and when it would not, be reasonable; it merely sets out what are the relevant circumstances and requires a judgment to be made. This allows for some flexibility to accommodate differences in the relative importance of those circumstances from case to case.

5.21 In general though, it would become *less* reasonable to require the tax cost setting amounts to be re-calculated as:

- the proportion, of the ACA represented by the total error in the amounts, got smaller;
- the number of tax cost setting amounts that would have to be re-calculated gets larger;
- the number of adjustments in existing assessments or future tax returns in order to correct the errors gets larger; and
- it becomes more difficult to obtain the information necessary to perform the re-calculations or make the adjustments.

5.22 The judgment about whether or not it is reasonable to require the correct tax cost setting amounts to be re-calculated may be influenced by the measures stated object of avoiding the time and expense that would be involved in correcting errors ***[Schedule 4, item 2, section 705-305]***. For example, if there would be little time or expense involved in correcting the errors, it is more likely that it would be reasonable in the circumstances to require the tax cost setting amounts to be re-calculated.

What happens when an error is preserved?

The error is taken to have been correct

5.23 If the 4 conditions mentioned in paragraph 5.19 are satisfied, the erroneous tax cost setting amounts are taken to have been correct for most purposes of the ITAA 1936, the ITAA 1997 and the TAA 1953. ***[Schedule 4, item 2, subsections 705-315(1) and 705-320(1)]***

5.24 That means, for example, that:

- any change in the gain or loss because of the incorrect tax cost on disposal of those assets will not be adjusted;
- any change in depreciation of those assets because of the incorrect tax cost will not be adjusted; and
- the Commissioner cannot amend an assessment to correct those figures or anything else that depended on them.

Example 5.1: ACA error taken to be correct

Satrune Pty Ltd joins the Squalley Group. The ACA was worked out as $6.2 million but, in fact, it should have been $6.5 million. The error was not discovered for some years, at which time the group notified the Commissioner. There was no fraud or evasion, the error was only a small fraction of the ACA and Satrune had a large number of assets when it joined the group, so it is not reasonable to re-calculate the figures or to amend the assessments. Therefore, the tax cost setting amounts based on the incorrect ACA are taken to be correct.

5.25 There are some exceptions to the rule about taking the erroneous figures to be correct. The error is still recognised for these provisions of the TAA 1953:

- section 8N (offence for making a false or misleading statement);
- section 284-75 of Schedule 1 (administrative penalty for making a false or misleading statement); and
- section 284-145 of Schedule 1 (administrative penalty for entering into a scheme to get a tax benefit);

in relation to statements made before the Commissioner became aware of the errors. ***[Schedule 4, item 2, subsection 705-320(2)]***

5.26 The policy behind the penalties for making false or misleading statements is to encourage taxpayers to be truthful and accurate in the statements they make to the Commissioner. The policy behind the penalty for entering into a scheme to obtain a tax benefits is to discourage taxpayers from entering into such schemes. These exceptions to the rule about taking the erroneous figures to be correct are necessary to preserve those policies.

5.27 The rule about taking the erroneous figures to be correct also does not limit the operation of Part IVA of the ITAA 1936 ***[Schedule 4, item 2, section 705-310]***. That means that a tax benefit from a scheme that alters the tax cost setting amounts could be cancelled by the Commissioner and action taken to give effect to that cancellation.

<u>There is a capital gain or loss</u>

5.28 If the 4 conditions are satisfied, there is also a new CGT event (CGT event L6) for the head company of the consolidated group. ***[Schedule 4, item 4, subsection 104-525(1)]***

5.29 The CGT event happens at the start of the income year that the Commissioner becomes aware of the error. ***[Schedule 4, item 4, subsection 104-525(2)]***

5.30 So long as the Commissioner could otherwise amend *all* the assessments affected by the error (see paragraphs 5.32 and 5.33 if only some assessments can be amended), there will be:

- a *capital gain* equal to the net amount by which all the tax cost setting amounts were overstated (called the ***net overstated amount***); or
- a *capital loss* equal to the net amount by which all the tax cost setting amounts were understated (called the ***net understated amount***).

[Schedule 4, item 4, subsections 104-525(3) and (4)]

Example 5.2: Capital gain replaces ACA correction

Continuing the previous example, the ACA for Satrune Pty Ltd was understated by $300,000. That led to a net understatement of $300,000 in the tax cost setting amounts of Satrunes reset cost base assets. This might have been made up only of tax cost setting amounts that were understated, or there might have been some overstatements and some understatements. In either case, the result must have been a net understatement of $300,000.

Therefore, the head company in the Squalley Group, Squalley Holdings Pty Ltd, would have a capital loss of $300,000 in the income year that the Commissioner was notified.

5.31 This capital gain or loss aims to bring the total amount of the error to account as a single amount rather than as a series of adjustments to the tax values of the joining entitys assets. The same amount will be brought to account in total but its character and the timing could be different. For example, if the error increases the cost of an item of trading stock, it will be balanced by a *capital* gain, not a revenue gain. Similarly, an error that decreases the cost of a depreciating asset will be balanced by an *immediate* capital loss, not one loss each time a deduction is claimed for depreciation. Changes to the character and timing of the balancing amount are inevitable consequences of reducing compliance costs by substituting a single amount for a series of effects on a diverse range of assets.

5.32 If the mistake was only discovered after time limits made it impossible to amend any of the assessments that had been affected by it, then some part of the mistake would become permanent. The amendments do not count these permanent parts of mistakes when working out what lump sum amount is needed to correct them. That is consistent with this measures

policy of achieving the same broad outcome as would be achieved anyway but with reduced compliance costs.

5.33 To prevent counting the permanent parts of the error, only this fraction of the full capital gain or loss is brought to account:

The total tax cost setting amount for reset cost base assets that the head company held from the joining time to the earliest year whose assessment could still be amended when the Commissioner became aware of the error

The total tax cost setting amount for all reset cost base assets held by the joining entity at the joining time

[Schedule 4, item 4, subsections 104-525(5) and (6)]

Example 5.3: When only part of the error is correctable

Suppose in the previous example that Satrune joined the Squalley Group in year 1 and that the Commissioner was notified of the $300,000 error in year 7. In year 2 Satrune had sold for $700,000 a block of land that had been allocated $500,000 of the ACA. All the other assets (all of which were reset cost base assets) were still held into year 3. When he became aware of the error, the Commissioner was still able to amend all assessments from year 3 onwards but not the assessment for year 2. In these circumstances, the $300,000 capital loss for the error will be reduced like this:

The $6.2 million is the total ACA and the $5.7 million is the ACA distributed to the assets held into year 3 (i.e. excluding the $500,000 allocated to the land sold in year 2). The $275,806 result is the amount of the error that could still be corrected if the correct figures had been calculated and all possible amendments made to assessments. Rather than making all the re-calculations, the Squalley Group will have a $275,806 capital loss in year 7.

Does a head company have to do anything when it discovers the error?

5.34 The head company of a consolidated group must notify the Commissioner in the approved form of an error it made in working out a tax cost setting amount as soon practicable after discovering it. ***[Schedule 4, item 2, subsection 705-315(6)]***

What if the amount of a liability changes when realised?

5.35 In some cases, the ACA will be correct but the actual amount of a liability will turn out to be different from the amount used to work out the ACA at the joining time. This could be for many reasons. Some liabilities (e.g. provisions for insurance claims) are no more than estimates of future payments. Those estimates will seldom be completely accurate. Some liabilities might be wholly or partly forgiven by the creditor after the joining time. Some liabilities will be denominated in a foreign currency and the exchange rate might move after the joining time.

5.36 If the liability figures used at the joining time were wrong (e.g. because the amount was not in accordance with accounting standards), the error rules would apply. But many changes in a liability will not be because the joining time figure was wrong (e.g. the cases mentioned in paragraph 5.35). The error rules will not apply in those cases but the change in the liability can produce a similar effect to an error in the ACA. Therefore, the amendments account for any difference that using the eventual amount of the liability would have made to the ACA.

5.37 They do so by creating a new CGT event (CGT event L7) that will generate a capital gain or loss. ***[Schedule 4, item 4, subsection 104-530(1)]***

5.38 CGT event L7 happens if:

- a liability that was taken into account in working out the ACA is discharged for a different amount; and
- had that amount been used at the joining time, the ACA would have been different.

[Schedule 4, item 4, subsection 104-530(3)]

5.39 There is a capital *gain* if the ACA would have been smaller had the amount for which the liability was discharged been used at the joining time. There is a capital *loss* if the ACA would have been larger. The amount of the capital gain or loss is equal to the difference that would have been made in the ACA. ***[Schedule 4, item 4, subsections 104-530(4) and (5)]***

5.40 CGT event L7 happens at the start of the income year in which the liability is discharged. ***[Schedule 4, item 4, subsection 104-530(2)]***

Example 5.4: Capital gain on a change in a liability

The Stuhrer Group acquired Trister Insurance Pty Ltd for $130 million in year 2. In year 1, Trister had deducted $100 million, which it had estimated to be the amount it would have to pay out on insurance claims for that year and carried that amount forward as a tax loss.

In year 3, the Stuhrer group consolidated and Trister joined. At that time, Trister had increased its provision for year 1s insurance claims to $150 million because of higher than expected claim lodgments. This produced an ACA of $200 million.

The insurance claims for year 1 were finally satisfied in year 4 for only $80 million. If that figure had been used to work out the ACA at the joining time, the ACA would have been $186 million.

Because the ACA would have been lower, there will be a capital gain in year 4 equal to the $14 million difference
(i.e. $200 million $186 million).

5.41 Not every change in the amount of a liability between the joining time and its discharge will affect the ACA. That is because the ACA calculation factors in future tax effects for the liability and, taking those into account, there may be no net change in the ACA.

Example 5.5: Liability changes but the ACA does not

In the previous example, suppose that the year 1 insurance claims had instead been satisfied for $120 million. If that figure had been used at the joining time, the ACA would have been $200 million (i.e. unchanged from what it was at the joining time). There is no change because the decline in the liability would have been matched by the decline in the tax losses that accrued to the Stuhrer group, resulting in no change to the figure taken into account at step 2 of the ACA calculation.

5.42 The *full* capital gain or loss for CGT event L7 is brought to account in the income year that the liability is discharged. That is different to the CGT event L6 case (when some of the capital gain or loss might not be brought to account). That different treatment is explained by the different nature of the cases. In the CGT event L6 case (errors in tax cost setting amounts), a mistake was made that might not be fixable because of time limits on amending assessments. In the CGT event L7 case, no error was made in the past; an amount is simply being brought to account in the year the liability was discharged because the amount of the liability has changed. This continues the tax laws usual approach of bringing an amount to account to correct the effect of an estimate when the amount of that correction can be ascertained (e.g. see subsection 170(9) of the ITAA 1936).

Refinements and enhancements to existing cost setting rules

5.43 The changes to the cost setting rules relate to amendments to the following areas:

- adjusting the ACA for a pre-joining time roll-over from a foreign resident company to a resident company (see paragraphs 5.45 to 5.52);
- adjusting the ACA for distributions of profits that did not accrue to the head company (see paragraphs 5.53 to 5.60);
- adjusting the allocation of ACA where subsidiary entities have certain profits or losses (see paragraphs 5.61 to 5.71);
- working out the ACA on formation of a consolidated group for subsidiary members other than chosen transitional entities (see paragraphs 5.72 to 5.74);
- allowing certain roll-overs connected with the restructure of a foreign owned group to be excluded from the application of section 701-35 of the IT(TP) Act 1997 (see paragraphs 5.75 to 5.88); and

- extending the operation of step 3 of working out the ACA on transition for consolidated groups with a SAP and for those groups with an income year ended 30 June (see paragraphs 5.89 to 5.94).

5.44 A number of technical corrections are also made to the cost setting rules (see paragraphs 5.95 to 5.102).

Adjustment to ACA for pre-joining time roll-over from a foreign resident company to a resident company

5.45 One effect of a roll-over of an asset within a wholly-owned group is a deferral of any gain that would otherwise be brought to account as a result of the disposal. The taxation of this gain is deferred until the asset leaves the group because either it is disposed of directly or it leaves with the disposal of an entity. The deferral takes place by allowing the recipient company to retain the originating companys cost base for the asset. An effect that can occur where the originating company in a roll-over is a foreign resident company is that the groups aggregate cost for its assets following consolidation would be different from what it would have been if the roll-over had not occurred. The purpose of this provision is to offset any effect that a roll-over would otherwise have in altering a groups aggregate cost for its assets.

5.46 An additional step, step 3A, is included in determining the joined groups ACA for a joining entity ***[Schedule 1, item 11, section 705-60, item 3A in the table]***. This step applies in limited circumstances where:

- before the joining time there was a roll-over of a CGT asset under Subdivision 126-B, or section 160ZZO of the ITAA 1936;
- the originating company of the roll-over was a foreign resident and the recipient company was an Australian resident that did not become the head company of the joined group;
- there was not a CGT event, other than another roll-over, in relation to the asset between the roll-over time and the joining time;
- the CGT asset is not a pre-CGT asset at the joining time; and
- the entity that holds the asset subsequently becomes a member of the joined group where that entity was the recipient of the asset or received the asset as a result of a further roll-over.

[Schedule 1, item 14, subsection 705-93(1)]

5.47 Where step 3A applies the ACA for the joining entity is:

- increased by the amount of the capital loss that was disregarded as a result of the roll-over (the increase amount); or
- reduced by the amount of the capital gain that was disregarded as a result of the roll-over (the reduction amount).

[Schedule 1, item 14, subsection 705-93(2)]

5.48 Where section 705-93 applies to one or more roll-over assets the result after step 3 in working out the ACA is increased or reduced by the net result taking into account all reduction amounts and increase amounts. If the result after step 3A is negative the head company makes a capital gain equal to the negative amount and the ACA for the entity is nil. New CGT even L2 gives rise to the capital gain.

5.49 When a group comes into existence and an asset has been rolled over to the entity from the head company prior to the formation time section 705-150 applies. That section operates in conjunction with step 3A and the net result after the operation of both provisions applies to determine whether the result after step 3A is negative.

5.50 Sections 705-147 and 705-227 ensure that section 705-93 applies correctly when a consolidated group is formed and where linked entities join a consolidated group. These sections modify the operation of section 705-93 so that it also applies to a roll-over asset held by an entity being a membership interest in another entity that becomes a subsidiary member of the consolidated group at the same time. Where a membership interest is a pre-CGT asset it

is not excluded from the operation of these sections. The pre-CGT status of membership interest is retained by the pre-CGT factor attached to the underlying assets of the entity. ***[Schedule 1, items 15 and 22, subsections 705-147(3) and 705-227(3)]***

5.51 Sections 705-147 and 705-227 also require that the step 3A adjustment be made to the ACA for the entity that the head company holds direct membership interests in (the first level entity) where that entity holds direct or indirect membership interests in the entity with the roll-over asset (the subject entity). Where a number of first level entities hold direct or indirect membership interests in the subject entity the step 3A adjustment is apportioned between the first level entities on the basis of the respective market values of their direct and indirect membership interests in the subject entity. ***[Schedule 1, items 15 and 22, subsections 705-147(2) and (5) and 705-227(2) and (5)]***

5.52 As a result of the inclusion of step 3A a number of consequential amendments are necessary to ensure that:

- step 4 follows step 3A ***[Schedule 1, item 12]***; and
- section 705-150 applies to the result of step 3A ***[Schedule 1, items 16 to 20, section 705-150]***.

Adjusting the ACA for distribution of profits not accruing to the head company

5.53 Existing sections 705-155 and 705-230 modify step 4 of the ACA calculation to prevent a duplication of reductions in the ACA for distributions that are effectively a return of the costs of acquiring membership interests. This duplication can occur if reductions are made separately for the distribution of the same profits through a chain of 2 or more entities.

5.54 The existing provisions prevent the duplication by only deducting at step 4 the distribution made by the lowest entity in a chain of companies and not deducting at step 4 distributions made by entities that have successively passed on the distribution. This does not achieve the correct outcome as the distribution may not have been received by the head company.

5.55 Under the cost setting rules for the formation of a consolidated group and where linked entities join an existing consolidated group it is only the cost of the direct interests in a subsidiary member that is pushed down to assets of the subsidiary member (including an asset consisting of membership interests in a lower level subsidiary member). Accordingly, it is only where some of the cost of acquiring the direct membership interests held by the head company in subsidiary members has been returned that the reduction should be made at step 4.

Reduction under step 4 only for distributions that have been made to the head company in respect of direct membership interests

5.56 Existing sections 705-155 and 705-160 have been replaced with amended provisions which ensure that the step 4 reduction in the ACA calculation is only made if the distribution is made in respect of the direct membership interests held by the head company. That is, notwithstanding that the profits may have been distributed to the head company through a chain of entities the reduction in step 4 of the ACA calculation is only made in working out the ACA for the entity that distributes the profits to the head company. ***[Schedule 1, items 1 and 2, subsections 705-155(2) and (3) and section 705-230]***

Reduction under step 4 for effective distribution to the head company

5.57 The amended section 705-155 also ensures that there is a reduction under step 4 in particular circumstances where profits have *effectively* been returned to the head company. This could occur where:

- a distribution (called the subject distribution) is made by an entity (called the subject entity) that becomes a member of a consolidated group;
- the head company of the consolidated group has a direct membership interest in the subject entity at the joining time;

- the head company acquired the interest in the subject entity, either directly or indirectly, as a result of one or more acquisitions from other entities for which roll-over relief was obtained; and
- while the head company held the interest, the entity from which it acquired the interest received a distribution (called a further distribution) of some of the subject distribution from the subject entity.

[Schedule 1, item 1, subsection 705-155(4)]

5.58 Where the conditions in paragraph 5.57 are satisfied then there are 2 potential consequences. Firstly, if the following conditions are satisfied:

- by the formation time, any of the further distribution (called the eligible reduction amount) had *not* been passed on by the recipient of the further distribution and that recipient does not become a member of the consolidated group;
- by the formation time, any of the further distribution (called the eligible reduction amount) had been subsequently distributed by the recipient of the further distribution to another entity (including successive distributions) and that other entity does not become a member of the consolidated group; or
- both the above situations apply,

then in working out the ACA for the subject entity, the reduction under step 4 for the subject distribution only occurs to the extent of the sum of the eligible reduction amounts.

[Schedule 1, item 1, subsection 705-155(5)]

5.59 However, if subsection 160ZK(5) of the ITAA 1936 or subsection 110-55(7) have applied to reduce the reduced cost base of the membership interests in the subject entity, then for the purposes of step 1 of the ACA calculation (i.e. working out the cost of membership interests) for the subject entity the reduced cost base of the membership interests is increased by the reduction previously made. ***[Schedule 1, item 1, subsection 705-155(6)]***

5.60 An amendment is not required to section 705-230 to deal with *effective* distributions to the head company as the necessary roll-over relief (for the special case to arise) would not be available in the case of linked entities joining an existing consolidated group.

Adjusting the allocation of ACA where subsidiary entities have certain profits or losses

5.61 Sections 705-160 and 705-235, which adjust the market values of interests in entities that have step 5 amounts (i.e. losses that accrued to the joined group before joining time) on formation or when linked entities join an existing consolidated group, are amended to also adjust the market values of:

- indirect interests in entities that have step 5 amounts; and
- direct and indirect interests in entities that have step 3 amounts (i.e. undistributed, taxed profits that accrued to the joined group before joining time).

5.62 Extending the scope of these sections in this manner leaves their purpose unchanged as they continue to prevent a distortion in the allocation of ACA under section 705-35. However, these amendments recognise that a distortion occurs when an entity has direct or indirect membership interests in another entity and that entity has certain losses or profits. ***[Schedule 1, items 9 and 10, subsections 705-160(1) and 705-235(1)]***

5.63 As noted in paragraph 1.71 of the explanatory memorandum to the June Consolidation Act, the market value of an entitys membership interests in another entity is increased where the other entity has certain losses in order to avoid the unintended double counting of those losses. Similarly, the market value of those membership interests should be reduced where the other entity has certain profits in order to avoid the unintended double counting of those profits.

5.64 Sections 705-160 and 705-235 operate to adjust the market values of the membership interests in entities that have a profit/loss adjustment amount, being step 3 and/or step 5 amounts (as per section 705-60) that are reflected in that entitys ACA calculation. The need

for this adjustment only arises when more than one entity becomes a subsidiary member of a consolidated group at the one time.

5.65 Working out an entitys interest in the profit/loss adjustment amount and how it affects the market value of that entity for ACA allocation purposes is dealt with separately depending on whether those interests are:

- directly held in the entity with the profit/loss adjustment amount; or
- indirectly held in that entity.

Directly held interests in an entity with step 3 profits or step 5 losses

5.66 This rule applies where there are directly held interests in an entity and those directly held interests are held by a subsidiary of the head company. Accordingly, the rule directs its focus to 2 tiers of entities a subsidiary that holds membership interests in another subsidiary with step 3 profits or step 5 losses (the first entity) and the subsidiary with those profits or losses (the second entity). ***[Schedule 1, items 9 and 10, paragraphs 705-160(2)(a) and (b) and 705-235(2)(a)]***

5.67 The tax cost setting amount for assets held by the first entity is worked out as if the market value of its membership interests in the second entity is:

- reduced by the first entitys interest in the amount that is added at step 3 when calculating the groups ACA for the second entity that amount being the second entitys profit/loss adjustment amount; or
- increased by the first entitys interest in the amount that is subtracted at step 5 when calculating the groups ACA for the second entity that amount also being the second entitys profit/loss adjustment amount.

[Schedule 1, items 9 and 10, subsections 705-160(2) and 705-235(2)]

5.68 The first entitys interest in the second entitys profit/loss adjustment amount is worked out as follows:

[Schedule 1, items 9 and 10, subsections 705-160(3) and 705-235(3)]

Indirectly held interests in an entity with step 3 profits or step 5 losses

5.69 The same principle applies where there are indirectly held interests, except that 3 tiers of subsidiary entities are recognised:

- a subsidiary that has step 3 profits or step 5 losses (the third entity);
- a subsidiary that holds indirectly, through one or more interposed entities, membership interests in the third entity (the first entity); and
- a subsidiary of the first entity that either directly, or indirectly through a chain of one or more subsidiaries, holds membership interests in the third entity (the second entity).

[Schedule 1, items 9 and 10, paragraphs 705-160(4)(a), (b) and (c) and 705-235(4)(a) and (b)]

5.70 When this rule applies, the tax cost setting amount for assets held by the first entity is worked out as if the market value of its membership interests in the second entity is:

- reduced by the first entitys interest in the amount that is added at step 3 when calculating the groups ACA for the third entity that amount being the third entitys profit/loss adjustment amount; or
- increased by the first entitys interest in the amount that is subtracted at step 5 when calculating the groups ACA for the third entity that amount also being the third entitys profit/loss adjustment amount.

[Schedule 1, items 9 and 10, subsections 705-160(4) and 705-235(4)]

5.71 The first entitys interest in the third entitys profit/loss adjustment amount is worked out as follows:

The numerator above refers to the market value of all of the membership interests that the first entity indirectly holds in the third entity as a consequence of holding membership interests in the second entity. [Schedule 1, items 9 and 10, subsections 705-160(5) and 705-235(5)]

Example 5.6: Accounting for direct and indirect interests in subsidiaries with step 3 profits and step 5 losses in a formation case

Scenario

At the formation time

SubOne has 2 assets: land with a market value of $500 and 100% of the interests in SubTwo. An ACA of $2,500 is assumed to be available to be allocated.

SubTwo has 3 assets: cash of $70 (a dividend from ProfitSub), 50% of the interests in LossSub and 100% of the interests in ProfitSub. SubTwo has a step 3 amount of $70.

LossSub has only one asset, a depreciating asset with a terminating value and market value of $1,800. It has no liabilities and the market value of the future tax benefit is, in this example, considered to be nil. LossSub has a step 5 amount of $200.

ProfitSub holds land with a terminating value and market value of $1,000. Prior to the formation of the HeadCo consolidated group, ProfitSub earned accounting profit of $140 being rental revenue of $200 cash less income tax expense of $60. ProfitSub distributed $70 of this profit (franked to 100%) to SubTwo. ProfitSub has a step 3 amount of $70.

Working out the tax cost setting amounts for SubOne

To apply section 705-35, the market value of SubOnes shareholding in SubTwo is $2,040, which is adjusted to $2,000 and calculated as follows:

- $2,040;
- *less* $70, which is SubOnes 100% interest in the second entitys profit/loss adjustment amount for the step 3 profit amount (as per subsections 705-160(2) and (3));
- *less* $70, which is SubOnes 100% interest in the third entitys profit/loss adjustment amount for the step 3 profit amount (as per subsections 705-160(4) and (5));
- *plus* $100, which is SubOnes 50% interest in the third entitys profit/loss adjustment amount for the step 5 loss amount (as per subsections 705-160(4) and (5)).

SubOnes assets have the following tax cost setting amounts:

Asset	Tax cost setting amount	Workings (under section 705-35)
Land	$ 500	Market value of $500 total market values of $2,500 ACA of $2,500
Membership interest in SubTwo	$ 2,000	Market value of $2,000 total market values of $2,500 ACA of $2,500
Total ACA	**$ 2,500**	

Working out the tax cost setting amounts for SubTwo

The ACA for SubTwo is $2,070; SubOnes tax cost setting amount for membership interests in SubTwo ($2,000, as per step 1) *plus* SubTwos undistributed, taxed profits ($70, as per step 3).

To apply section 705-35, the market value of SubTwos shareholding in ProfitSub is $1,070 and LossSub is $900.

The shareholding in ProfitSub would have an adjusted market value of $1,000 calculated as follows:

- $1,070;

- *less* $70, which is SubOnes 100% interest in the second entitys profit/loss adjustment amount for the step 3 profit amount (as per subsections 705-160(2) and (3)).

  The shareholding in LossSub would have an adjusted market value of $1,000 calculated as follows:

- $900;
- *plus* $100, which is SubOnes 50% interest in the second entitys profit/loss adjustment amount for the step 5 loss amount (as per subsections 705-160(2) and (3)).

SubTwos assets have the following tax cost setting amounts:

Asset	**Tax cost setting amount**	**Workings (under section 705-35)**
Cash	$ 70	After allocating ACA to cash, only $2,000 remains available
Membership interest in ProfitSub	$ 1,000	Market value of $1,000 total market values of $2,000 ACA of $2,000
Membership interest in LossSub	$ 1,000	Market value of $1,000 total market values of $2,000 ACA of $2,000
Total ACA	**$ 2,070**	

Working out the tax cost setting amounts for ProfitSub

The ACA for ProfitSub is $1,130; SubTwos tax cost setting amount for membership interests in ProfitSub ($1,000, as per step 1) *plus* ProfitSubs income tax liability ($60, as per step 2) *plus* ProfitSubs undistributed, taxed profits ($70, as per step 3).

ProfitSubs assets have the following tax cost setting amounts:

Asset	**Tax cost setting amount**	**Workings (under section 705-35)**
Cash	$ 130	After allocating ACA to cash, only $1,000 remains available
Land	$ 1,000	ProfitSubs only other asset
Total ACA	**$ 1,130**	

Working out the tax cost setting amounts for LossSub

The ACA for LossSub is $1,800; SubTwos tax cost setting amount for membership interests in LossSub ($1,000, as per step 1) *plus* HeadCos cost base of membership interests in LossSub ($1,000, as per step 1) *less* LossSubs accrued losses ($200, as per step 3).

LossSubs depreciating asset has a tax cost setting amount of $1,800.

Working out the ACA on formation of a consolidated group for subsidiary members other than chosen transitional entities

5.72 Existing section 701-20 of the IT(TP) Act 1997 sets out how the ACA is worked out when the head company of a transitional group elects for a transitional entity to be a chosen transitional entity (i.e. to retain existing tax values for the entitys assets). These rules treat the chosen transitional entity as a head company in relation to the membership interests it holds in other entities.

5.73 Paragraph 701-20(5)(c) is amended to make it clear that in applying section 701-20 the membership interests held by each sub-group entity at the formation time were the only membership interests held in any other sub-group member and the membership interests actually held by a sub-group in another sub-group entity prior to that time were the membership interests actually held. ***[Schedule 1, items 28 and 29, paragraph 701-20(5)(c)]***

5.74 The following example demonstrates how the ACA is worked out for a non-chosen subsidiary member.

Example 5.7

Scenario

On 1 July 1999 A Co acquires 60 of the 100 shares in B Co for $60 and B Co accrues undistributed taxed profits of $50 during the year ended 30 June 2000.

On 1 July 2000 A Co acquires a further 30 shares in B Co from the previous holder for $45 (30% of $150) and in that income year B Co accrues a further $100 of undistributed taxed profits.

During the year ended 30 June 2002 HeadCo acquires all of the shares in A Co and the remaining 10 shares in B Co for $25 (10% of $250) and B Co earns no profits.

HeadCo consolidates on 1 July 2002 and chooses that A Co be a chosen transitional entity.

Calculating the ACA for B Co

Step 1 (applying section 705-65 and subsection 705-140(1))

HeadCos membership interests in B Co 105

A Cos membership interests in B Co 25 130

Head companys adjusted allocable amount (applying subsection 701 20(4))

There are no step 2 to step 7 amounts nil

Sub-groups notional ACA

Applying paragraph 701-20(5)(c)

As the only membership interests that any entity held in B Co at any time were the sub-groups membership interests then the amount of the profit that accrued to the sub-group during the year ended 30 June 2000 is the $50 profit multiplied by 60 and divided by 90 which equals $33.33 and for the year ended 30 June 2001 is the $100 times 90 divided by 90 which equals $100.

Applying paragraph 701-20(5)(d)

The formula is applied as follows:

Steps 2-7 sub-groups notional ACA 120

Total ACA 250

Exclusion from section 701-35 of the IT(TP) Act 1997

5.75 Where a consolidated group is formed, the cost setting rules apply to set the head companys cost of acquiring the assets of each entity that becomes a subsidiary member of the group at the formation time. Where the group came into existence prior to 1 July 2004, special rules apply in some instances under section 701-35 of the IT(TP) Act 1997 to alter the amount that would otherwise have been the head companys cost of acquiring the assets of a formation member.

5.76 Section 701-35 of the IT(TP) Act 1997 is intended to ensure the revenue is not adversely impacted by groups seeking to maximise choices available under the cost setting rules upon the formation of a group by rolling over assets prior to consolidating. Where the section applies, the cost setting rules operate as if the transfer of the asset had not occurred.

5.77 Broadly, the rules in section 701-35 can be triggered if a CGT event has happened in relation to an asset for which there has been a roll-over under either Subdivision 126-B or section 40-340 prior to a group consolidating and the amount that would be the cost of that asset, or any other asset, to the head company differs as a result of that roll-over.

5.78 The rules contained in section 701-35 of the IT(TP) Act 1997 currently give rise to unintended consequences when applied to foreign owned group restructures as they may prevent the cost of assets in a restructured entity from being reset under the cost setting rules. A foreign owned group may wish to restructure an entity, such as an eligible tier-1 company or a transitional foreign-held subsidiary, prior to consolidating in order to allow the cost of the assets in the entity to be reset.

5.79 A failure to reset the cost of assets in these circumstances could result in the group being taxed on non-existent gains upon a subsequent exit of an entity from the group. A similar problem does not arise for Australian owned groups as it is not necessary for those groups to restructure entities prior to consolidating in order to allow the cost of assets in a restructured entity to be reset.

5.80 To prevent these unintended consequences arising, Schedule 17 to this bill contains rules which are designed to allow certain roll-overs connected with the restructure of a foreign owned group to be excluded from the application of section 701-35 ***[Schedule 17, item 2, subsection 701-35(3)]***. Excluding these roll-overs will allow foreign owned groups to reset the cost of assets in a restructured entity under the cost setting rules upon the formation of a consolidated group or MEC group.

When will the exclusion apply?

5.81 The exclusion from section 701-35 of the IT(TP) Act 1997 will apply where the 4 tests discussed in paragraphs 5.82 to 5.88 are satisfied.

The roll-over asset

5.82 The exclusion will only apply in relation to a roll-over of an asset that is a membership interest in an entity (for ease called the *test entity*). ***[Schedule 17, item 2, paragraph 701-35(3)(a)]***

The originating company and the recipient company in the roll-over

5.83 The exclusion will only apply where the originating company in the roll-over is a foreign resident company and the recipient company is an Australian resident company. This requirement is consistent with the objective of the exclusion, which is to allow the cost of assets in the test entity to be reset. As the cost of assets can only be reset where an entity becomes wholly-owned by Australian resident entities, the exclusion will be limited to transfers from a foreign resident company to an Australian resident company. ***[Schedule 17, item 2, paragraph 701-35(3)(b)]***

Test entity must become a subsidiary member upon formation of the group

5.84 The exclusion will only apply where the test entity becomes a subsidiary member, at the time of formation, of a consolidated group or MEC group that qualifies as a transitional group ***[Schedule 17, item 2, paragraph 701-35(3)(c)]***.

5.85 What constitutes a transitional group is defined in section 701-1 of the IT(TP) Act 1997. Broadly, a transitional group is a consolidated group or MEC group that forms during the period beginning on 1 July 2002 and ending on 30 June 2004 and which contains at least one entity that qualifies as a transitional entity. An entity will broadly qualify as a transitional entity if it became wholly-owned by the head company prior to 1 July 2003 and remained owned in that manner until the time of the formation of the group.

Type of subsidiary member

5.86 The exclusion will only apply if, at the time the consolidated group or MEC group is formed, the test entity is not a subsidiary member that:

- has some of its membership interests held by a foreign resident company or a non-resident trust called a transitional foreign-held subsidiary; or
- is an eligible tier-1 company of a MEC group.

[Schedule 17, items 2 and 3, paragraph 701-35(3)(c) and section 719-163]

5.87 If the test entity was one of those subsidiary members, the cost setting rules would not apply to reset the cost of the assets in the test entity at the time of the formation of the group. This requirement therefore ensures that the exclusion will only apply in circumstances where the cost setting rules can apply to reset the cost of the assets in the test entity.

5.88 Without this requirement, the exclusion would be too wide as it would allow the effect of the provision to be circumvented in cases where the cost of the assets in the test entity are not being reset. This would occur, for instance, where the test entity, and one or more entities who hold the rolled-over membership interests in the test entity, are not members of the same transitional group.

Example 5.8

Assume the following structure existed at 16 May 2002:

Assume the group wishes to form a MEC group with effect from 1 December 2002. However, rather than form the group in the structure illustrated with A Co, B Co and C Co as eligible tier-1 companies, the group wishes to restructure prior to the formation of the group to allow

the cost setting rules to apply to reset the cost of the assets in C Co. To achieve this, the group undertake the following restructure in relation to C Co:

- B Co transfers its 80% interest in C Co to D Co with roll-over under Subdivision 126-B applying in relation to the transfer; and
- Top Co subsequently transfers its 20% interest in C Co to D Co with roll-over under Subdivision 126-B again applying in relation to the transfer.

Section 701-35 of the IT(TP) Act 1997 will not apply in relation to the roll-over of the 20% interest Top Co held in C Co, the test entity, as the 4 tests discussed in paragraphs 5.82 to 5.88 have been satisfied in relation to that roll-over. Therefore, to determine whether section 701-35 applies to alter the amount that would otherwise have been the head companys cost of acquiring the assets in C Co, the comparison is to be made between:

- the amount that would be the head companys cost base for each asset in C Co worked out on the basis that D Co holds 100% of the membership interests in C Co; and
- the amount that would be the head companys cost base for each asset in C Co worked out on the basis that D Co holds 20% of the membership interests in C Co and B Co holds the other 80%.

If the cost bases for any of the assets are different, the head companys cost of acquiring the assets in C Co will be worked out on the basis that D Co holds 20% of the membership interests in C Co and B Co holds the other 80%.

Extending the operation of step 3 of working out the ACA on transition

5.89 Section 701-30 of the IT(TP) Act 1997, which allows groups to receive an increase in the ACA for undistributed, untaxed profits accrued to the group is now extended so that, in addition to applying to groups that consolidate before 1 July 2003, it applies:

- to a group if it consolidates on the first day of its income year commencing after 30 June 2003 and before 1 July 2004 where the head company of the consolidated group has a SAP; and
- to a group if it consolidates on 1 July 2003 where the head company of the consolidated group has an income year ending on 30 June.

[Schedule 1, item 27, subsections 701-30(1) and (2)]

5.90 The significance of consolidating at the start of the income year that commences on 1 July 2003 or after that date but before 1 July 2004 is that this concession is extended to undistributed, untaxed profits accruing to a consolidated group prior to the removal of the grouping rules for that group.

5.91 The transitional concession provides groups with an outcome that could be achieved through the payment of an unfranked dividend to the head company prior to the removal of the inter-corporate dividend rebate. As such, the concession reduces compliance costs by removing the need to distribute, prior to consolidating, profits that would be subject to the inter-corporate dividend rebate.

5.92 The change recognises that, in certain circumstances, consolidated groups with a SAP have access to the inter-corporate dividend rebate for untaxed dividends until the end of their SAP, not 30 June 2003.

5.93 In the case of consolidated groups with an ordinary income year (i.e. ending 30 June), the concession which provides recognition under the cost setting rules for undistributed, untaxed profits accruing prior to the removal of the grouping rules is extended to apply to groups that consolidate on or before 1 July 2003.

5.94 Without the amendment, the concession would only be available to consolidated groups with an ordinary balancing date of 30 June where they consolidate prior to 1 July 2003. This would have required the group to consolidate from 30 June with the additional compliance costs of not consolidating from the first day of their income year.

Technical corrections

5.95 The bill also contains a number of technical corrections.

Technical correction to section 701-45

5.96 The reference in the subsection 701-45(3) to head company is being deleted so that the provision (which sets the cost of the asset encompassing a liability that the head company owes to the leaving entity) instead refers to the income tax consequences of the entity. This will ensure that the objects clause is consistent with the section applying for entity core purposes. ***[Schedule 1, item 24, subsection 701-45(3)]***

Technical correction to section 705-150

5.97 As noted in paragraphs 1.56 to 1.66 in the explanatory memorandum to the June Consolidation Act, section 705-150 adjusts the ACA calculation for a subsidiary member where the head company rolled over an asset to that subsidiary and cost base of the consideration given by the subsidiary for that roll-over did not equal the cost base of the rolled over asset. To correct the effect that the head company roll-over adjustment amount has on the step 3 result, section 705-150 is being amended such that the step 3 result is:

- increased where the head company roll-over adjustment amount is an excess; and
- reduced where the head company roll-over adjustment amount is a shortfall.

[Schedule 1, item 26, subsections 705-150(3) and (4)]

Technical correction to section 701-35 of the IT(TP) Act 1997

5.98 Currently, where the conditions outlined in section 701-35 of the IT(TP) Act 1997 are satisfied in relation to a CGT event that happens after 16 May 2002, Part 3-90 applies as if the CGT event did not happen. It has been argued that applying all of Part 3-90 on this assumption may have a wider effect than intended. For instance, it has been argued that the provision may currently prevent an entity from becoming a member of a consolidated group where the asset that was the subject of the CGT event was a membership interest in the entity.

5.99 Section 701-35 of the IT(TP) Act 1997 is intended to ensure certain CGT events are disregarded for the purposes of applying the cost setting rules in Division 705 of the ITAA 1997. Where the conditions for applying the provision are satisfied, the cost setting rules are to apply as if the asset was still with the transferor, and not the transferee, and that any consideration given in relation to the event had not been given.

5.100 To clarify what is the effect of section 701-35 of the IT(TP) Act 1997 applying, a technical amendment is made to that section so that only Division 705 and the provisions of the IT(TP) Act 1997 that modify the effect of that Division, apply on the assumption that the CGT event had not happened ***[Schedule 17, items 1 and 2, subsections 701-35(1) and 701-35(2)]***. This amendment closes off arguments that other Divisions of Part 3-90, such as the membership rules, are to be applied on the assumption that the CGT event had not happened.

Other technical corrections

5.101 Other technical corrections are being made to the cost setting rules in the ITAA 1997. These corrections amend:

- subsection 701-25(4) (tax neutral consequences) by deleting the comma after the parentheses in order to improve the readability of the subsection ***[Schedule 1, item 23, subsection 701-25(4)]***; and
- subparagraph 701-75(3)(a)(ii) to correct the punctuation used and to ensure that the conditions in both paragraphs (a) and (b) are to be satisfied ***[Schedule 1, item 25, subparagraph 701-75(3)(a)(ii)]***.

5.102 Further technical corrections are being made to the IT(TP) Act 1997 to include words identifying that cross references to provisions of the ITAA 1997 are to provisions of that Act

and not the IT(TP) Act 1997. ***[Schedule 1, items 30 to 36, sections 701-5, 701-15, 701-20 and 701-25]***

Application and transitional provisions

5.103 These measures will take effect on 1 July 2002, along with other aspects of the consolidation measure.

Consequential amendments

5.104 Consequential amendments are made to the income tax law to account for:

- errors in tax cost setting amounts and changes in liabilities (see paragraphs 5.105 to 5.111);
- changes resulting from the SIS (see paragraphs 5.112 to 5.117); and
- CGT events relating to setting the cost of assets (see paragraphs 5.118 to 5.138).

Errors in tax cost setting amounts and changes in liabilities

Penalty provisions

5.105 Amendments to section 8W, and to sections 284-80 and 284-150 of Schedule 1 to the TAA 1953 are required as a consequence of the measure that preserves errors in tax cost setting amounts. Those sections allow additional penalties to be imposed when the amount of tax payable is reduced because a taxpayer either makes a false or misleading statement or enters into a scheme. The additional penalties are based on the reduction in tax.

5.106 The consequential amendments are needed to create a proxy for that reduction in tax. They start with the amount of the capital gain, so do not apply to cases where the error caused a capital loss. Also, using the capital gain as a starting point automatically excludes the part of the error that can no longer be corrected by amending an assessment (because the capital gain does not include those amounts (see paragraph 5.32)). ***[Schedule 4, items 8, 9 and 10, subsection 8W(1C) and subsections 284-80(2) and 284-150(3) of Schedule 1 to the TAA 1953]***

5.107 The capital gain is then reduced to exclude the part of it that represents future tax effects, on the basis that any future tax effect has not *yet* produced a reduction in tax. The future tax effects are excluded by removing the part of the capital gain that relates to reset cost base assets still on hand at the start of the income year that the error is discovered. However, any deductions for decline in value already claimed for those assets is added back because those deductions represent existing, not future, tax effects. ***[Schedule 4, items 8, 9 and 10, subsection 8W(1C) and subsections 284-80(2) and 284-150(3) of Schedule 1 to the TAA 1953]***

5.108 These calculations leave, as the proxy for the reduction in tax, the part of the capital gain that relates either:

- to reset cost base assets that were not still held in the year that the error was discovered but had been held long enough for relevant assessments to still be amendable; or
- to depreciation deductions for reset cost base assets that were still held in the year the error was discovered.

Example 5.9: Penalty for making a false or misleading statement

A company makes an error in working out the tax cost setting amount for its reset cost base assets when it joins a consolidated group. The error is discovered and a capital gain of $200,000 arises.

The tax cost setting amount for all its reset cost base assets was $5.6 million. Of that, $600,000 was for assets that were disposed of in years whose assessments can no longer be amended. Of the remaining $5 million, $3 million related to assets that were not held in the year that the error was discovered and $2 million to assets that were still held in that year. Depreciation deductions of $500,000 had been claimed on the assets that were still held by the group in that year.

The formula to work out the shortfall amount is:

which works out to be $140,000. That is the part of the $200,000 capital gain that relates to assets the company did not hold in the year the error was discovered and to depreciation deductions claimed on assets it did hold in that year.

Miscellaneous

5.109 Division 705 currently ends with a link note to point out that the next Division is Division 707. The amendments repeal that link note to insert rules about errors in tax cost setting amounts. ***[Schedule 4, item 1, section 705-245]***

5.110 There are some amendments that update CGT guide material to cover the new CGT events the amendments are adding for errors in tax cost setting amounts and changes in liabilities. ***[Schedule 4, items 3 and 5, sections 104-5 and 110-10]***

5.111 The dictionary is amended to include definitions of 2 new terms used by the amendments, net overstated amount and net understated amount. The dictionary entries direct readers to subsection 104-525(3) where the substantive definitions are located. ***[Schedule 4, items 6 and 7, subsection 995-1(1)]***

Simplified imputation system

5.112 Amendments are made to step 3 of the ACA calculation for a joining entity, to reflect appropriate interactions with the SIS. The SIS changed the basis for recording a corporate tax entitys franking account from a taxed income basis to a tax-paid basis. Broadly speaking, the SIS commenced on 1 July 2002.

5.113 The purpose of step 3 in the ACA calculation is to prevent double taxation of profits in a joining entity. Step 3 does this by allowing a consolidated group a cost for retained tax or taxable profits that accrued to membership interests that were held by the consolidated group. This can occur where there is an incremental acquisition of an entity.

5.114 The amount added to the ACA under step 3 is calculated by reference to a notional franking account balance at the joining time. The notional franking account balance takes into account the income tax that will be payable or refundable by the joining entity for the income year that ends immediately before the joining time (see subsection 705-90(4)).

5.115 In order to isolate that portion of the undistributed profits of the joining entity that represents taxed profits, the notional franking account is grossed up using the following formula:

where:

- the balance of the franking account takes into account those assumptions outlined in paragraph 5.114; and
- the corporate tax rate is the rate that is applicable to the joining entity at the joining time.

[Schedule 1, item 4, subsection 705-90(3)]

5.116 The amount of taxed profits worked out using this formula cannot exceed the amount of undistributed profits of the joining entity at the joining time.

5.117 Various amendments are made to reflect that the purpose of step 3 of the ACA calculation is to account for tax paid at the joining entity level. ***[Schedule 1, items 3, 5 to 8]***

CGT events relating to setting the cost of assets

5.118 The application of the ACA calculation when an entity joins or leaves a consolidated group may result in a capital gain or capital loss for the head company. The following CGT events prescribe the conditions under which the capital gain or the capital loss will arise.

Where a negative amount remains after step 3A of the ACA on joining: CGT event L2

5.119 Before a consolidated group forms or a subsidiary joins a group, an asset may have been rolled over to the subsidiary by either members of the group or a foreign entity. The effect of the roll-over is to defer a capital gain that would otherwise be bought to account as a result of disposing of the rolled over asset. Where that asset is brought into a group, the capital gain may be sheltered from tax as a result of the tax cost setting process.

5.120 Step 3A of the ACA calculation offsets any effect that a roll-over would otherwise have in altering a consolidated groups aggregate cost for its assets (see paragraphs 5.45 to 5.52). An additional adjustment, under section 705150, may be required where a group comes into

existence and before the formation time an asset had been rolled over from the head company to a subsidiary member of the group (see paragraphs 1.56 to 1.66 of the explanatory memorandum to the June Consolidation Act).

5.121 After applying step 3A, including any adjustments required under section 705-150, the result of the step may be to reduce the ACA below zero. CGT event L2 will happen in this circumstance ***[Schedule 21, item 3, subsection 104-505(1)]***. The head company will make a capital gain equal to the negative amount ***[Schedule 21, item 3, subsection 104-505(3)]***.

5.122 The time of CGT event L2 is just after the joining entity joins the consolidated group ***[Schedule 21, item 3, subsection 104-505(2)]***. This is to ensure that the capital gain that arises may be included in the head companys tax return.

Where the tax cost setting amount for retained cost base assets exceeds joining ACA amount: CGT event L3

5.123 The head companys costs for retained cost base assets is set equal to the joining entitys cost for those assets (see section 705-25).

5.124 Broadly, a retained cost base asset is:

- Australian currency;
- a right to receive a specified amount of Australian currency (other than a right that is marketable security within the meaning of section 70B of the ITAA 1936); or
- an entitlement that is subject to a prepayment.

5.125 If the total amount to be treated as a head companys cost for retained cost base assets of a joining entity exceeds the joined groups ACA for the joining entity, the head company of the consolidated group will make a capital gain equal to the excess. ***[Schedule 21, item 3, section 104-510]***

5.126 The time of CGT event L3 is just after the joining entity joins the consolidated group ***[Schedule 21, item 3, subsection 104-510(2)]***. This is to ensure that the capital gain that arises may be included in the head companys tax return.

Where there are no reset cost base assets and an excess of ACA on joining: CGT event L4

5.127 A reset cost base asset is any asset that is not a retained cost base asset. The ACA remaining after deducting an amount equal to a head companys set costs for the retained cost base assets of a joining entity is allocated among the reset cost base assets, other than excluded assets. There is a proportionate allocation of the remaining ACA to each of the joining entitys reset cost base assets.

5.128 It may be the case that a joining entity does not have any reset cost base assets. An example of this may be where the joining entity is a shelf company acquired by the group. A shelf company would not have been operating prior to acquisition by the group, so cannot allocate the remaining ACA to goodwill.

5.129 CGT event L4 happens when there is an excess of the ACA and there are no reset cost base assets of the joining entity ***[Schedule 21, item 3, subsection 104-515(1)]***. CGT event L4 will always result in a capital loss.

5.130 The amount of the capital loss is equal to the amount that results after the joined groups ACA is reduced by the total of the payments for the retained cost base assets. ***[Schedule 21, item 3, subsection 104-515(3)]***

5.131 The time of CGT event L4 is just after the entity joins the consolidated group ***[Schedule 21, item 3, subsection 104-515(2)]***. This is to ensure that the capital loss that arises may be included in the head companys tax return.

Where a negative amount remains after step 4 of the ACA for a leaving entity: CGT event L5

5.132 Just before an entity ceases to be a member of a consolidated group, the head company recognises the membership interests in that entity. These membership interests would not be recognised whilst the entity was a member of the group because of the single entity principle, which broadly treats that subsidiary member as part of the head company.

5.133 The cost of membership interests in the leaving entity is determined by working out the old groups ACA for the leaving entity. This amount is determined in 5 steps. Step 4 in determining the old groups ACA is to subtract the amount of the leaving entitys liabilities. CGT event L5 happens when the amount remaining after applying step 4 is negative. ***[Schedule 21, item 3, subsection 104-520(1)]***

5.134 The head company will make a capital gain equal to the negative amount ***[Schedule 21, item 3, subsection 104-520(3)]***. CGT event L5 will always result in a capital gain.

5.135 The time of CGT event L5 is when the entity ceases to be a subsidiary member of the group ***[Schedule 21, item 3, subsection 104-515(2)]***. This is to ensure that the capital gain that arises may be included in the head companys tax return.

Consequential amendments as a result of inserting CGT events

5.136 The note after section 100-15 (overview of steps 1 and 2 of calculating a capital gain or capital loss) is updated to reflect that the concepts of cost base and capital proceeds are not relevant for some CGT events, including the CGT events in Subdivision 104-L. ***[Schedule 21, item 1]***

5.137 The tables in section 104-5 (summary of CGT events) and section 110-10 (rules about cost base not relevant for some CGT events) are amended to highlight the special rules in relation to CGT events L2 to L5. ***[Schedule 21, items 2 and 4]***

5.138 Various notes within Division 705 (tax cost setting amounts for assets where entities join a consolidated group) and Division 711 (tax cost setting amounts for assets where entities leave a consolidated group) are amended to refer to the relevant CGT events. ***[Schedule 1, items 13 and 21 and Schedule 21, items 5 to 7]***

Chapter 6
Losses technical amendments

Outline of chapter

6.1 This chapter explains various amendments to the rules dealing with the transfer and utilisation of losses. They ensure that:

- ownership changes in an entity that result in it joining a consolidated group are taken into account in working out its taxable income for the period up to the joining time;
- non-membership period losses can be transferred and utilised;
- in some cases, the capital injection rules can be ignored in applying the value donor rules;
- losses continue to be transferable under the FC(TAL) Act; and
- a minor referencing error in the Dictionary amendments made by the May Consolidation Act is corrected.

6.2 Rules that modify the COT and SBT for MEC groups are discussed in Chapter 3.

6.3 References in this chapter are to the ITAA 1997, unless otherwise indicated.

Context of reform

6.4 The amendments refine the losses rules introduced previously. The value donor amendments are the result of consultation. The amendments to the FC(TAL) Act complete the rules needed to ensure that loss transfers involving a foreign bank branch can continue under Division 170 (despite the introduction of the consolidation regime).

Summary of new law

6.5 The first 2 amendments relate to a subsidiary members calculation of its taxable income or loss for a non-membership period. An entity may be a subsidiary member of a group for only part of an income year (e.g. because it joins or exits the group part way through the income year). A part of the year during which it is not a subsidiary member is called a non-membership period. The entity may have more than one non-membership period for an income year (see section 701-30).

Ownership changes at the joining time

6.6 In applying the COT for the purpose of determining whether an entity can recoup its losses for a non-membership period that ends just before it joins a consolidated group, the period is extended so it ends at the joining time.

Transfer and utilisation of non-membership period losses

6.7 A loss made by an entity in any non-membership period will be treated as a loss for the purpose of provisions dealing with the transfer and utilisation of losses. These include:

- loss transfers under Division 170 in the income year during which consolidation occurs;
- loss transfers involving an Australian branch of a foreign bank (which may continue under Division 170 despite the introduction of the consolidation regime); and
- loss transfers to a consolidated group under Division 707 and their subsequent utilisation by the group.

Amendments to the value donor rules

6.8 There are 2 amendments to the value donor rules contained in the IT(TP) Act 1997.

6.9 The first waives all intra-group capital injections and non-arms length transactions in applying the value donor rules. It is referred to in this explanation as the group waiver rule. It only applies if all parties to the injections and transactions were group members and broadly, if every loss transferred to the group on its formation by a joining member could have been transferred to every other group member under Division 170.

6.10 The second ignores an injection or transaction involving 2 group members (and is referred to as the single waiver rule). It applies if the 2 members satisfy the value donor conditions.

FC(TAL) Act loss transfers to foreign bank branch

6.11 A tax loss or net capital loss transferred to the head company of a consolidated group under Subdivision 707-A can be transferred by the head company under Schedule 1 or 2 to the FC(TAL) Act. The loss must be incurred by an entity (the real loss-maker) that would have satisfied the conditions for transfer had it not joined the consolidated group. Further, for the purposes of the FC(TAL) Act, the head company will be taken to have incurred the loss for the income year in which the real loss-maker incurred the loss.

6.12 The relaxed SBT in section 26C of the FC(TAL) Act that applies to a transferring corporation will also apply to a head company that satisfies the conditions for transfer of a Subdivision 707-A loss under that Act.

Comparison of key features of new law and current law

New law	*Current law*
Ownership changes that occur at the joining time will be taken into account in determining whether a loss can be utilised by an entity in working out its taxable income (if any) for the non-membership period.	Ownership changes that occur at the joining time may not be taken into account in determining whether a loss can be utilised by an entity in working out its taxable income (if any) for the non-membership period.
A loss incurred in a non-membership period prior to consolidation will be treated as a loss for the entire income year for some limited purposes.	Generally, only a non-membership period loss incurred in a period ending at the end of an income year can be treated as a loss for the entire income year.

In applying the value donor rules, the modified market value of a real loss-maker or value donor may, in some circumstances, reflect increases in that value from capital injections and non-arms length transactions.	In applying the value donor rules, the modified market value of a real loss-maker or value donor is worked out ignoring increases in that value from capital injections and non-arms length transactions.
A loss transferred to a consolidated group can be transferred by the head company under the FC(TAL) Act if: • the company that originally made the loss is a member of the group; and • **it could have transferred the loss under that Act had it not joined the group.**	**A loss transferred to a consolidated group is not transferable under the FC(TAL) Act.**

Detailed explanation of new law

Ownership changes at the joining time

6.13 An entitys non-membership period will be extended to include the time just after the end of that period for the purpose of determining whether a loss can be claimed by the entity for the period. This ensures that any ownership changes in the entity that occur at the time it becomes a subsidiary member of a consolidated group are taken into account in determining whether it can claim a loss for the non-membership period. ***[Schedule 19, item 1, subsection 701-30(3A)]***

Why is the period being extended?

6.14 Currently, the period ends just before the joining time. This means ownership changes in an entity at the time it joins a consolidated group as a subsidiary member may *not* be taken into account in determining whether the entity can use its losses in working out its taxable income up to the joining time. That is, those changes may not be taken into account in applying the COT as a recoupment test in working out the entitys final pre-consolidation taxable income.

6.15 However, such changes are specifically taken into account in applying the COT as a transfer test (as a result of the definition of trial year). That is, in determining whether a joining entitys losses can be transferred to the consolidated group. This means a loss may pass the COT when used as a recoupment test up to the joining time, but fail it when used as a transfer test.

6.16 Therefore, the amendment will synchronise the application of the COT as a recoupment test (for a pre-joining period) with its application as a transfer test.

Which losses does the rule apply to?

6.17 This rule applies to the entitys use of the following losses in working out its the pre-joining time taxable income:

- a loss made by the entity (without a transfer under Subdivision 707-A) for an earlier income year
- ***[Schedule 19, item 1, subparagraph 701-30(3A)(b)(i)]***:
- that is, a loss made by the entity as a single entity or as the head company of a consolidated group for an income year that ends before the start of the non-membership period;

- a loss transferred to the entity during an earlier income year ***[Schedule 19, item 1, subparagraph 701-30(3A)(b)(ii)]***:
- that is, a loss transferred to the entity under Subdivision 707-A in an income year that ends before the start of the non-membership period; and
- a loss transferred to the entity in the non-membership period ***[Schedule 19, item 1, paragraph 701-30(3A)(a)]***:
- that is, a loss transferred to the entity under Subdivision 707-A (because the entity was a head company) or under Division 170.

6.18 Therefore, the rules also apply to losses made by, or transferred to, the head company of a consolidated group that becomes a subsidiary member of another consolidated group.

Example 6.1

The head company of a consolidated group, acquires 100% of the membership interests of Sub Co on 1 September 2002 (the joining time). Sub Co has a prior year tax loss made in the year ended 30 June 2002 and will need to determine whether it can utilise this loss in working out its taxable income for the non-membership period 1 July 2002 to 31 August 2002.

Applying the rule in subsection 701-30(3A), the non-membership period of 1 July 2002 to 31 August 2002 will now include the time just after the end of that period as if it were the end of the income year ***[Schedule 19, item 1, subsection 710-30(3A)]***. The ownership test period under subsection 165-12(1) will therefore be the period 1 July 2001 to 1 September 2002.

In testing for ownership changes, the 100% change that occurred on 1 September 2002 will fall within the ownership test period and cause the COT to be failed. In order to utilise the loss for the non-membership period, Sub Co will need to pass the SBT.

The extension does not affect the application of the SBT

6.19 In applying the SBT to determine whether a company can use a loss for a non-membership period, the company is taken to have carried on at the time just after the end of the non-membership period the same business it carried on just before that time. ***[Schedule 19, item 1, subsection 701-30(3A)]***

6.20 In the absence of this rule, it may be argued that the extension of the non-membership period (so it ends at the joining time) means the business carried on by the entity for that period includes the business carried on by the group. The rule matches subsection 707-120(3) which applies in determining whether a loss can be transferred to a consolidated group.

6.21 A company that fails the COT may use its loss if the business it carries on during the income year (or non-membership period) in which it seeks to use the loss is the same as the one it carried on immediately before the COT failure.

Transfer and utilisation of non-membership period losses

6.22 Section 701-30 will be amended to ensure that for the purpose of provisions dealing with the transfer and utilisation of losses, any non-membership period loss is treated as a loss for an income year that started at the start of the period and ended at the end of the period. ***[Schedule 19, item 2, subsection 701-30(8)]***

6.23 For all other purposes (i.e. entity core purposes), only a non-membership period loss incurred in a non-membership period which ends at the end of an income year is a loss for the income year. This

means that a non-membership period loss generated by an entity in the last period in an income year (i.e. after it leaves a consolidated group) will be the only loss which is carried forward by the entity to the next income year. ***[Schedule 19, item 2, subsection 701-30(9)]***

6.24 The effect of these amendments on specific loss transfer and utilisation provisions is discussed in paragraphs 6.27 to 6.31.

Why is the amendment necessary?

6.25 A loss may be generated for any non-membership period. However, currently only a loss made for a non-membership period that ends at the end of the income year is an actual loss for the income

year see subsection 701-30(7).

6.26 There is currently a rule in section 707-405 which ensures that a non-membership period loss made for a period that ends just before the joining time is a loss that can be transferred to the group under Subdivision 707-A. However, there is, for example, no equivalent rule to allow such a loss to be transferred under Division 170. This is contrary to the policy that Division 170 continue to be available up to the end of the transitional period (and in an ongoing sense for transfers involving a foreign bank branch).

Non-membership period loss: Division 170 transfer

6.27 An earlier non-membership period loss will nevertheless be available for use under Division 170 in its previous form, or in its ongoing limited application to transfers involving Australian branches of foreign banks.

6.28 In the final year in which transfers are potentially available for use under Division 170 (before it commences operation in its limited form), and where consolidation occurs part way during the income year, a non-membership period loss may be generated in the earlier period prior to consolidation. This earlier loss is potentially available for transfer and in calculating the income tax liability of the transferee for the entire income year, regardless of the fact that the loss is not generated in a period which ends at the end of the income year. ***[Schedule 19, item 2, subsection 701-30(8); item 6, subitem 39(10) of the May Consolidation Act]***

Example 6.2

Head Co consolidates Walton Group from 1 July 2002. All the members of the group have a SAP of 1 January to 31 December.

Francis Co becomes a subsidiary member of Walton Group on 1 July 2002. It exits the group on 1 October 2002.

Taxable income or loss for each non-membership period must be calculated separately in determining the income tax position of Francis for its 2002-2003 income year.

In the period up to 30 June 2002, Francis makes a non-membership period loss of $100. This loss is transferred to another subsidiary of Walton Group, Crease Co, under Division 170. Because the loss has been transferred under Division 170, it is not available for transfer to the Walton Group under Subdivision 707-A.

Crease Co offsets the loss in determining its taxable income for the year 2002-2003 and in respect of its own non-membership period ending at 30 June 2002.

During the period of consolidation between 1 July 2002 and 30 September 2002, Francis has no taxable income or loss due to the operation of the single entity rule.

In the period between 1 October 2002 and 31 December 2002, Francis makes a further non-membership period loss. This loss is the actual tax loss for the income year 2002-2003. It can be carried forward by Francis to the next income year. It may subsequently be recouped by Francis or transferred to the head company of another consolidated group of which Francis becomes a member.

Non-membership period loss: Subdivision 707-A transfer and utilisation

6.29 This aspect was previously governed by section 707-405. That provision has been repealed and this aspect will now be governed by the new subsections 701-30(8) and (9). ***[Schedule 19, items 2 and 3]***

6.30 Section 707-405 ensured that:

- a non-membership period loss that was not a loss for an income year under subsection 701-30(7) could nonetheless be transferred to a consolidated group under Subdivision 707-A; and
- in determining whether any non-membership period loss could be transferred under Subdivision 707-A it was tested from the start of the non-membership period (rather than the start of the income year in which the non-membership period occurred):
- this test period was also relevant to determining whether the loss could be utilised by the group if the rules in section 707-210 apply.

6.31 The new rules in subsections 701-30(8) and (9) achieve the same outcome as section 707-405. However, because they are expressed as applying to *any* provisions relating to the transfer or utilisation of a loss, they are broader in 2 respects:

- first, they apply to all of the consolidation rules in Part 3-90, including the rules in Subdivision 719-F that modify the consolidation loss rules for MEC groups; and
- second, they apply to rules outside Part 3-90, including the loss recoupment rules in Division 165:
- this means, for example, that a company that makes a non-membership period loss after leaving a consolidated group tests its ability to later use that loss as though the loss year started at the start of the non-membership period.

[Schedule 19, item 2, subsections 701-30(8) and (9)]

Example 6.3

Sub Co is a member of a consolidated group from 1 July 2003 until it exits on 1 January 2004. Sub Cos non-membership period starts on 1 January 2004 and ends on 30 June 2004. Assume Sub Co makes a loss for this period.

Sub Cos ownership test period in respect of the loss starts on 1 January 2004 (and not 1 July 2003). Therefore, in determining whether Sub Co can claim the loss, say in its 2004-2005 income year, it tests its ownership from the time it exits the group.

In the absence of the increased coverage of the rules for non-membership period losses, Sub Cos ownership test period would start on 1 July 2003 (i.e. the actual start of the income year in which the loss was made). This is clearly inappropriate given that the loss did not commence to be generated until after that. In any event, it would not be clear which entity should be tested given that, for the period of its membership of the group, Sub Co is treated as a part of the groups head company.

Amendments to the value donor rules

6.32 There are 2 amendments to the value donor rules contained in the IT(TP) Act 1997. The amendments are referred to in this explanation as the group waiver rule and the single waiver rule.

6.33 The group waiver rule waives the effect of the capital injection rules in section 707-325 in respect of injections and transactions involving group members (provided no entities external to the group are also involved). The single waiver rule waives the effect of the capital injection rules in respect of injections and transactions involving 2 group members only. It may apply to groups unable to satisfy the conditions of the group waiver rule.

Why are the group and single waiver rules being introduced?

6.34 The rules are being introduced in response to submissions received in relation to the May Consolidation Act.

6.35 Broadly, the value donor rules allow the available fraction for losses transferred to a consolidated group by a company (the real loss-maker) to be increased by the value of another group member (the value donor) to which the real loss-maker could have transferred the losses under the previously applicable group loss rules in Division 170.

6.36 The integrity of the available fraction is maintained by excluding an increase in a loss entitys value resulting from an injection of capital into the entity or a non-arms length transaction involving the entity before the entity joins the group (see subsections 707-325 (2) to (5)).

6.37 However, it may be inconsistent to exclude an injection of value from another group member (under the capital injection rules) and yet recognise and facilitate a donation of value (under the value donor rules). The introduction of the rules will improve consistency between the capital injection and value donor rules.

6.38 The amendments apply in a limited set of circumstances. The complex nature of the value donor rules, which effectively overlay the operation of the existing loss transfer rules onto the consolidation losses rules, means the scope of the group and single waiver rules cannot be broadened without either undermining the integrity of the consolidation losses rules or adding an unworkable amount of complexity to the law.

Which losses do the rules apply to?

6.39 The value donor rules, and therefore the group and single waiver rules, only apply to tax losses (including film losses) and net capital losses. That is, the utilisation of an overall foreign loss (as defined in section 160AFD of the ITAA 1936) is not affected by these rules. ***[Schedule 19, item 4, paragraph 707-326(1)(b); item 5, subsection 707-328A(6)]***

Group waiver rule

6.40 The group waiver rule ignores the effect that the capital injection rules would otherwise have in respect of these events in working out an available fraction for the real loss-makers losses:

- a pre-consolidation injection of capital into a group member by another group member; and
- a non-arms length transaction involving only group members.

[Schedule 19, item 5, subsections 707-328A(1) and (3)]

6.41 That is, there is no need to reduce a group members modified market value by an increase in that value that flows from an event listed in paragraph 6.40. This means those increases continue to be reflected in a members modified market value. However, this rule essentially only applies if all other group members can in any event donate their value and losses to the real loss-maker under the value donor rules.

Group waiver rule: choice

6.42 The head company of a consolidated group can choose to apply the group waiver rule if all the conditions listed in paragraph 6.44 are satisfied at the group formation time. The choice cannot be amended or revoked and must be made by the day on which the head company lodges its income tax return for the first income year for which it utilises losses transferred to it. ***[Schedule 19, item 5, paragraph 707-328A(1)(d) and subsection 707-328A(4)]***
6.43 The choice is made in respect of a single group member that transferred its own losses to the head company on formation under Subdivision 707-A (i.e. the real loss-maker).
Group waiver rule: conditions
6.44 The conditions are:

- all members of the group at the formation time are companies ***[Schedule 19, item 5, paragraph 707-328A(1)(c)]***:
- none of the members can be trusts because the value donor rules do not apply to trust losses;
- the groups head company chooses (under the value donor rules) for the available fraction for the real loss-makers loss bundle to be worked out taking into account the modified market value of every other group member ***[Schedule 19, item 5, paragraph 707-328A(1)(a) and subsection 707-328A(2)]***:
- that is, all other group members can and do donate value to the real loss-maker under section 707-325 of the IT(TP) Act 1997;
- the head company chooses to treat any losses transferred to it on formation by the value donors as if they were included in the real loss-makers bundle ***[Schedule 19, item 5, paragraph 707-328A(1)(b)]***:
- that is, value donors donate all their losses to the real loss-makers bundle under section 707-327 of the IT(TP) Act 1997; and
- none of the group members have had a capital injection or a non-arms length transaction involving an entity that did not become a member of the group on formation ***[Schedule 19, item 5, paragraph 707-328A(1)(d)]***:
- in the absence of this rule, the real loss-makers available fraction could be inflated by moving value into the group from outside.

Group waiver rule: its effect

6.45 Essentially, if all the conditions are met, all of the groups tax losses and net capital losses will be used according to the real loss-makers available fraction. Further, that fraction will be worked out on the basis of the real loss-makers modified market value plus the modified market value of the other group members (up to the maximum extent permitted by the value donor rules).

6.46 However, to avoid doubt, it is specifically stated that the rule can operate only in relation to one bundle of losses transferred to the groups head company under Subdivision 707-A. That is, the rule cannot be used in working out an available fraction for a bundle of losses transferred by a value donor. ***[Schedule 19, item 5, subsection 707-328A(7)]***

Group waiver rule: working out an available fraction for a value donor

6.47 Generally no available fraction will be needed in respect of a value donors own losses. This is because they will have been donated to the real loss-makers bundle and so used by the group in accordance with the real loss-makers available fraction.

6.48 However, a value donor available fraction must be worked out in some limited circumstances:

- if the value donor transferred foreign losses (because the value donor and group waiver rules only apply to tax losses and net capital losses) ***[Schedule 19, item 5, subsection 707-328A(6)]***:
- the value donor available fraction is worked out on the basis of the value donors modified market value (which will include adjustments for capital injections and non-arms length transactions); and
- if the value donor transferred any losses that were used by the group in accordance with the COT concession in section 707-350 of the IT(TP) Act 1997 and for which the concession was lost as a result of them being transferred to a new group ***[Schedule 19, item 5, subsection 707-328A(5)]***:
- the value donor available fraction is worked out on the basis of the value donors modified market value (which will include adjustments for capital injections and non-arms length transactions) *less* any value it donated to the real loss-maker also see subsection 707-325(8) of the IT(TP) Act 1997.
-
- **Example 6.4: Group waiver rule**
-

On 1 July 2003, Head Co chooses to form a consolidated group that comprises Head Co, X Co and Y Co. On formation, X Co and Y Co transfer tax losses to Head Co.

Head Co and X Co satisfy the conditions for transferring their value to Y Co. Also, X Co meets the conditions for its transferred losses being treated as part of Y Cos bundle of transferred losses.

Prior to formation, Head Co injected capital into both X Co and Y Co. Also, X Co injected the capital it received from Head Co into Y Co.

Because the only injections are entirely intra-group, Head Co can choose to apply the group waiver rule. This means the modified market value of each group member is worked taking account of the effect of the capital injections.

Also, the available fraction for Y Cos loss bundle is worked out taking into account the modified market values of both Head Co and X Co. Also, X Cos bundle of losses is utilised as if it were in Y Cos bundle of losses.

Single waiver rule

6.49 The single waiver rule ignores the effect that the capital injection rules would otherwise have in respect of capital injections and non-arms length transactions as between a real loss-maker and a value donor. ***[Schedule 19, item 4, subsections 707-326(1) and (2)]***

6.50 The rule may apply more than once within a consolidated group because it looks individually at each real loss-maker and value donor relationship within the group.

Single waiver rule: condition

6.51 The rule applies if there is either:

- a injection of capital directly into the real loss-maker by the value donor ***[Schedule 19, item 4, subsection 707-326(3)]***; or

- a non-arms length transaction involving only the real loss-maker and the value donor ***[Schedule 19, item 4, subsection 707-326(4)]***.

6.52 Nonetheless, the rule does not apply if the capital injection rules have applied to the value donor in respect of events involving the value donor and an entity that is *not* the real loss-maker. That is, if capital has been injected into the value donor by an entity that is not the real loss-maker or there has been a non-arms length transaction involving the value donor and an entity that is not the real loss-maker. ***[Schedule 19, item 4, subsection 707-326(5)]***

6.53 In the absence of this exclusion, a value donor could be used as a vehicle to pass value to a real loss-maker from another entity that is not itself a value donor of the real loss-maker. For that reason, the exclusion applies to events involving the value donor and another entity, regardless of whether the other entity is a member of the group.

Single waiver rule: its effect

6.54 Where the conditions are met, the modified market value of the real loss-maker is not adjusted to exclude an increase in value caused by an event involving the value donor. The following example illustrates the application of the single waiver rule, including its interaction with the group waiver rule.

Example 6.5: Single waiver rule

Using the same facts as Example 6.4, assume an entity outside the group, Z Co, made an injection of capital into X Co prior to the formation time. As a result of this injection, the group is unable to meet the conditions for applying the group waiver rule.

However, the single waiver rule can be applied with respect to Y Co (the real loss-maker) and Head Co (the value donor). This means Y Cos modified market value is worked out taking into account the increase in that value as a result of the capital injection from Head Co.

As X Co received a capital injection from Z Co, the single waiver rule cannot be applied in respect of the capital injection from X Co into Y Co. That is, any increase in Y Cos modified market value arising from the injection from X Co will be excluded.

Further, as X Co is also a real loss-maker, it can apply the single waiver rule in respect of the injection of capital it received from its value donor, Head Co. However, the capital injection rules would continue to operate to exclude any increase in X Cos modified market value arising from the capital injection from Z Co.

Minor referencing correction

6.55 The reference in the amendments to the definition of test time in item 34 of Schedule 5 to the May Consolidation Act should be to section 166-85 and not 166-86. ***[Schedule 19, item 7]***

Application and transitional provisions

6.56 These measures will take effect on 1 July 2002, along with other aspects of the consolidation measure.

Consequential amendments

6.57 The FC(TAL) Act will be amended to ensure that losses that would have been transferable by a subsidiary of a foreign bank, will continue to be transferable by a consolidated group of which the subsidiary becomes a member.

Why are the amendments necessary?

6.58 Schedules 1 and 2 to the FC(TAL) Act allow tax losses and net capital losses to be transferred from a subsidiary of a foreign bank to an Australian branch of the bank. Only pre-commencement losses may be transferred. They are losses made for the income year in which the FC(TAL) Act commenced, or an earlier income year. The Act commenced on 22 December 1993.

6.59 When a bank subsidiary transfers such a loss to a consolidated group, the loss is taken to be made by the groups head company for the income year in which the *transfer* occurred. In the absence of further rules, this refreshing of the loss incurrence date would mean the loss no longer qualified as a pre-commencement loss. Also, the head company of the group may not satisfy the conditions for a transferring corporation under the FC(TAL) Act.

6.60 Therefore, the FC(TAL) Act will be amended to ensure that losses that would have been transferable by a subsidiary, will continue to be transferable by a consolidated group of which the subsidiary becomes a member. [Schedule 20, item 1, subsection 20(1A) and item 2, subsection 20(1A)]

Modifications to the Schedules to the FC(TAL) Act

6.61 The guide in section 170-5 of Schedule 1 to the FC(TAL) Act will make it clear that special rules apply to allow a head company of a consolidated group to transfer particular losses that it incurred because of a Subdivision 707-A transfer. This is achieved by way of modifications to the existing rules. ***[Schedule 20, item 4, subsection 170-5(5)]***

6.62 The modifications apply where a head company has incurred a tax or net capital loss because of a transfer under Subdivision 707-A and the real loss-maker is a member of the group at the end of the income year for which it is proposed to transfer the loss. ***[Schedule 20, item 5, subsection 170-75(1) and item 7, subsection 170-175(1)]***

6.63 For a loss to be transferred from a loss company to an income company the conditions in the FC(TAL) Act about transferring and receiving corporations having certain characteristics, must be satisfied. The head company will satisfy the conditions for a transferring corporation if the real loss-maker satisfies those conditions. To achieve this the single entity principle has to be ignored in applying the FC(TAL) Act to that real loss-maker at the end of the notional transfer year. ***[Schedule 20, item 5, subsection 170-75(3) and item 7, subsection 170-175(3)]***

6.64 Further, the head company will be taken to have incurred the loss (apart from Subdivision 707-A) for the income year in which the real loss-maker incurred the loss. This has the effect that, if the real loss-maker incurred the loss for the income year in which the FC(TAL) Act commenced (or an earlier income year) the loss is one that may be transferred. ***[Schedule 20, item 5, paragraph 170-75(2)(b) and item 7, paragraph 170-175(2)(b)]***

6.65 All other sections in the Subdivisions operate as if the head company were a transferring corporation within the meaning of the FC(TAL) Act. This ensures that the other sections in these Subdivisions are applied to the head company in the same way as to any other company that is not a head company of a consolidated group. Where those rules rely on provisions in the ITAA 1997 these provisions, as modified for a head company of a consolidated group if applicable, apply. ***[Schedule 20, item 5, subsection 170-75(2) and item 7, subsection 170-175(2)]***

Modifications to section 26C of the FC(TAL) Act

6.66 The relaxed SBT in section 26C of the FC(TAL) Act for a company that transfers a tax loss is modified so that it may apply where the loss is a Subdivision 707-A loss. Where the modified conditions for transfer in Subdivision 170-A in Schedule 1 to the FC(TAL) Act are satisfied, the relaxed SBT will apply as if the head company were the transferring corporation and made the loss for the income year for which the real loss-maker made that loss. ***[Schedule 20, item 3, subsections 26C(2) and (3)]***

6.67 Because the relaxed SBT only applies if the transferring corporation would otherwise fail the requirements of Subdivision 165-A (or Subdivision 175-A), a provision has been included to ensure that Subdivision 165-A applies appropriately to a Subdivision 707-A loss. That is, the head company should apply the COT as modified by Subdivision 707-B or Subdivision 719-F. ***[Schedule 20, item 3, paragraph 26C(3)(c)]***

Chapter 7
Foreign dividend accounts and other international rules

Outline of chapter

7.1 This chapter explains technical amendments that:

- provide for the transfer of an FDA balance from a company that becomes a member of a consolidated group to the head company of the group;
- phase out the transfer of an FDA surplus between members of a wholly-owned group by the payment of unfranked dividends consisting of an FDA declaration amount;

- extend the benefits of the OBU concessions contained in Division 9A of Part III to a consolidated or MEC group;
- deal with elections made under Parts X and XI where entities become subsidiary members of a consolidated or MEC group and where entities leave a group;
- ensure the calculation of FIF income in Subdivisions 717-D and 717-E of the ITAA 1997 is correctly determined for a consolidated or MEC group and for a leaving company;
- ensure that the payment of an amount of foreign tax is not counted twice in calculating foreign tax credits; and
- deal with the grouping of an Australian bank branch of a foreign bank (foreign bank branch) and a head company/single resident company for thin capitalisation purposes.

7.2 In this chapter, a reference to a consolidated group should be read as including a reference to a MEC group and references to provisions discussed in paragraphs are references to provisions contained in the ITAA 1936, unless otherwise stated.

Context of reform

7.3 With the introduction of the new consolidation regime, a number of technical amendments in the areas mentioned in paragraph 7.1 have to be made to ensure that those international provisions apply appropriately to consolidated groups. Amendments are also needed to remove a grouping rule contained in the FDA provisions.

Summary of new law

Foreign dividend accounts

7.4 The new law will enable a head company of a consolidated group to operate a single FDA by pooling the FDA balances transferred to it at the joining time. The head company can then utilise the FDA surplus of the group to pay non-resident shareholders of the group unfranked dividends free from DWT. In this chapter, the term FDA dividend is used to refer to an unfranked dividend that consists of a FDA declaration amount, unless otherwise stated.

7.5 The new law will also phase out the ability of members in a wholly-owned group to transfer a proportion of a FDA surplus by paying another member of the group a FDA dividend.

7.6 A company that ceases to be a subsidiary member of a consolidated group cannot take a FDA balance with it on exit.

7.7 The amendments also make clear that in the case of a MEC group it is the provisional head company of the group at any time that operates the FDA and makes FDA declarations for dividends. There is also a provision to transfer the FDA balance when there is a change in the provisional head company.

Offshore banking units

7.8 The law will deem the head company of a consolidated group to be an OBU where a subsidiary member of the group is a gazetted OBU. The head company will only be deemed to be an OBU, however, for the period in which there is at least one subsidiary member that is a gazetted OBU.

Technical amendments affecting Parts X and XI and FTCs

7.9 New rules ensure that the entry history rule in Part 3-90 of the ITAA 1997 does not adversely affect the head companys ability to make elections in relation to its interests in CFCs, FIFs and FLPs. Similarly, they ensure the exit history rule in Part 3-90 does not adversely affect the leaving entitys ability to make elections in relation to interests in CFCs, FIFs and FLPs that the leaving entity takes with it on exit.

7.10 The new rules ensure the interaction between the entry history rule and the calculation of FIF income under Part 3-90 of the ITAA 1997 does not result in double taxation of an amount of FIF income. There are similar rules to prevent the double taxation of an amount of FIF income because of the interaction between the exit history rule and the calculation of FIF income when a company leaves a consolidated group.

7.11 There will be no double counting of an amount of foreign tax paid when a group company transfers excess foreign tax credits to another member of the group when a period of an income year is treated as though it were an income year.

Thin capitalisation

7.12 Amendments to Subdivision 820-FB of the ITAA 1997 will:

- subject to certain conditions, allow a single company that is a potential member of a MEC group to join with a foreign bank branch for thin capitalisation purposes; and
- clarify the rules by which the same choice is available to a head company.

Comparison of key features of new law and current law

New law	*Current law*
The FDA balance of a company that joins a consolidated group will be transferred to the head company at the joining time.	Resident companies in a wholly-owned group can only transfer a proportion of the FDA surplus from one resident company to another with the payment of a FDA dividend.
A head company is able to use the FDA surplus of the group to pay non-resident shareholders FDA dividends free from DWT, including dividends to non-resident shareholders of a subsidiary member. The ability to pay FDA dividends within a wholly-owned group will be phased out from the introduction of the consolidation regime.	A resident company can pay FDA dividends to non-resident shareholders free from DWT. A resident company is also able to transfer a FDA surplus by paying FDA dividends to another resident company in the same wholly-owned group.
The provisional head company of a MEC group will be able to operate a single FDA for all members of the group.	There is no comparable provision.
The law will deem the head company of a consolidated group to be an OBU for any period in which there is at least one subsidiary member of the group that is an actual OBU.	There is no comparable provision.
A taxpayer can choose to change elections and choices that may have been made in relation to interests in CFCs, FIFs or FLPs held by entities that become subsidiary members of a consolidated group or that leave a consolidated group.	Once certain elections or choices are made in relation to interests in CFCs, FIFs or FLPs by a taxpayer, those choices or elections cannot be varied.
Only one entity will be taxed on the FIF income calculated at the time when an entity joins or leaves a consolidated group.	Both an entity that becomes a subsidiary member of a consolidated group or that leaves a consolidated group and the head company of the group may be taxed on the same amount of FIF income.
There will be no double counting of foreign tax paid when a prospective head company transfers	There is no comparable provision.

excess foreign tax credits to a group member just before a consolidated group is formed.	
Subject to certain conditions, a single resident company that is a member of a potential MEC group can include a foreign bank branch as part of itself for thin capitalisation purposes.	A foreign bank branch cannot be included as part of a single resident company for thin capitalisation purposes where that single company is a member of a potential MEC group.

Detailed explanation of new law

FDA measures

7.13 The current FDA measure in Subdivision B of Division 11A of Part III was introduced to enable certain foreign source dividends paid to a resident company to be paid to non-resident shareholders free from DWT. The exemption from DWT is provided where a resident company pays an unfranked dividend that consists of an FDA declaration amount. The FDA declaration amount is calculated by taking into account the FDA surplus available at the beginning of the day. The FDA surplus is essentially the balance in the FDA of a company after the debits in that account are offset against the credits.

7.14 The new rules for consolidation will modify the operation of the FDA measure so as to allow a head company of a consolidated group to credit and debit its FDA where those credits and debits would have otherwise arisen for a subsidiary member of the group. The head company will also be able to make FDA declarations in relation to the dividends paid by any member of the group if the FDA is in surplus. ***[Schedule 9, item 1, Subdivision 717-J]***

Transfer of the FDA balance

A company joining a consolidated group

7.15 A company that becomes a member of a consolidated group will have to determine the FDA balance to be transferred to the head company at the joining time. The FDA balance that will be transferred is either the FDA surplus or deficit (which is the excess of FDA debits over FDA credits) immediately before the joining time. ***[Schedule 9, item 1, section 717-510]***

7.16 The joining company will be required to determine the balance in its FDA just before the joining time (referred to as the balance time) so that all the necessary adjustments, including an adjustment for an FDA debit that arises at the end of the income year, are made to that account before that company transfers the balance to the head company. The transfer of the FDA balance will be effective for the head company at the joining time, rather than at the balance time, because the joining company will not be a subsidiary member of the group before the joining time. However, as the joining time immediately follows the balance time there will be no entries made to the joining companys FDA between the balance time and the joining time.

7.17 Where the joining companys FDA is in surplus immediately before the joining time, a debit equal to the FDA surplus will arise in the FDA of the joining company at the balance time ***[Schedule 9, item 1, paragraph 717-510(2)(a)]***. A corresponding credit equal to the FDA surplus of the joining company at the balance time will arise in the FDA of the head company at the joining time ***[Schedule 9, item 1, paragraph 717-510(2)(b)]***.

7.18 Where the joining companys FDA is in deficit immediately before the joining time, the FDA debit balance is transferred to the head company at the joining time. The transfer of the deficit balance is effected by crediting the joining companys FDA for that amount at the balance time and entering a corresponding debit in the head companys FDA at the joining time. ***[Schedule 9, item 1, subsection 717-510(3)]***

7.19 Once the joining company has transferred the FDA balance to the head company, the head company will operate a single FDA by pooling all the FDA balances of the subsidiary members with any it had itself.

FDA debit for an Australian taxable dividend amount

7.20 Under the current law, an FDA debit for an Australian taxable dividend amount can arise when a resident company receives non-portfolio dividends in respect of which it is entitled to a foreign tax credit (paragraph 128TB(1)(d)). The debit is because of any Australian tax paid on the dividend and to avoid a double benefit arising for the same income from the FDA system and imputation. The amount of the FDA debit is determined according to the formula in subsection 128TB(2) and will give rise to an FDA debit in that companys FDA at the end of its income year.

7.21 Where a company joins a consolidated group part-way through its income year and an FDA debit under paragraph 128TB(1)(d) would have arisen for that company at the end of its income year, the joining company is to make an FDA debit just before the balance time. The joining company can treat the period from the start of its income year in which it joins the group until immediately before the balance time as though that period were an income year. ***[Schedule 9, item 1, subsection 717-510(4)]***

7.22 Where a company ceased to be a subsidiary member of a consolidated group but subsequently rejoined the group or joined another consolidated group, any such FDA debit is calculated only for the last non-membership period ending immediately before the balance time. ***[Schedule 9, item 1, subparagraph 717-510(4)(a)(ii)]***

7.23 Any FDA debits that arise for the period treated as an income year are taken into account by the joining company in determining the FDA balance that is transferred to the head company at the joining time. The FDA debit that will be made immediately before the balance time will ensure that the FDA balance of the joining company is accurate when it is transferred to the head company.

Example 7.1

Assume:

- A Co, B Co and C Co formed a consolidated group on 1 July 2002. A Co is the head company of the group.
- D Co joins the group on 1 December 2003 and has an income year that starts on 1 July and ends on 30 June.
- D Co has an FDA surplus of $300 on 31 August 2003.
- On 1 September 2003 D Co is paid a non-portfolio dividend of $100 in respect of which $10 of foreign tax was paid.
- This dividend is not exempt under section 23AJ but is to be included in D Cos assessable income.
- D Co does not incur any expenses in relation to the non-portfolio dividend.
- An FDA debit for an Australian taxable dividend amount (under paragraph 128TB(1)(d)) will arise on 30 June 2004 for $67.
- There are no further FDA credits or FDA debits made to D Cos account. The applicable company tax rate is 30%.

The net non-portfolio dividend received by D Co is $90

(i.e. $100 $10). On 1 September 2003 an FDA credit of $90 arises in D Cos FDA. As the non-portfolio dividend received by D Co is not exempt under section 23AJ, D Co will be liable for Australian tax on it. The payment of Australian tax will also give rise to an imputation credit for D Co.

D Cos FDA balance before the joining time will be $390. However, this balance does not reflect the FDA debit for an Australian taxable dividend amount that would arise for D Co at the end of its income year. New subsection 717-510(4) of the ITAA 1997 will apply to ensure D Co debits the FDA for $67

[(0.3 ($100 $0)) $10) / 0.3] immediately before the balance time.

Once an FDA debit of $67 is made immediately before the balance time, the balance in the FDA is a surplus of $323. D Cos FDA surplus of $323 is transferred to A Co by debiting D Cos FDA for $323 at the balance time and crediting A Cos FDA for $323 at the joining time.

Treatment of a subsidiary members FDA during consolidation

7.24 The FDA of a subsidiary member will be inoperative during the time that company is a member of a consolidated group. That is, no credit or debit entries are made to the FDA of the subsidiary member from the time it joins the group until the time it leaves the group. Instead, the credit and debit entries will be made to the head companys FDA.

A company leaving the group not to take any FDA balance

7.25 A company that leaves a consolidated group is not able to take a proportion of the FDA balance on exit. The principle that the FDA balance remains with the group when a company ceases to be a subsidiary member is consistent with the consolidation treatment of most other tax attributes on exit (e.g. franking credits and foreign tax credits).

7.26 The leaving company can operate its own FDA from the leaving time onwards according to Subdivision B of Division 11A of Part III.

Treatment of a head companys FDA during consolidation

7.27 The FDA balances transferred to the head company will be pooled by the head company into a single FDA. The head company will be able to maintain a single account during consolidation by treating the companies that become subsidiary members of the group as being part of the head company, rather than separate entities, for this purpose. The single entity treatment will apply for the purposes of section 128TA (which deals with FDA credits) and section 128TB (which deals with FDA debits). ***[Schedule 9, item 1, section 717-515]***

7.28 The single entity rule for FDA credits and debits will permit the head company to credit the FDA when a member of the group is paid a non-portfolio dividend and to debit the FDA when, for example, an expense is incurred in relation to the non-portfolio dividend received by that member. Any FDA credits and debits that are taken to arise for a head company will not arise for a subsidiary member of the group during consolidation. ***[Schedule 9, item 1, section 717-515]***

7.29 New section 717-515 of the ITAA 1997 also enables a head company to aggregate the foreign investments of all its members to determine whether a dividend paid during consolidation qualifies as a non-portfolio dividend. The aggregation of the groups interests in foreign companies allows the head company to operate the FDA on the basis of the total dividends received and the total foreign tax paid. ***[Schedule 9, item 1, note 1(b) to section 717-515]***

Foreign tax taken to be paid by head company

7.30 Under the current law, a company can credit its FDA for a non-portfolio dividend if that company is taken to have paid and to have been personally liable for foreign tax on the dividend. In

consolidation, if a dividend is paid to a subsidiary member and that company paid and was personally liable for foreign tax in relation to that dividend, the head company will be able to credit its FDA for the dividend amount. The head company can do so because section 717-10 of the ITAA 1997 would deem the head company to have paid and to have been personally liable for the foreign tax (including any underlying foreign tax under section 160AFC) paid by a subsidiary member, where the foreign income is included in the assessable income of the head company.

7.31 Therefore, as the head company will be taken to have paid and to have been personally liable for foreign tax, then the head company will be able to credit the FDA for the dividend amount. Equally, where the total foreign tax paid needs to be calculated for an FDA debit for an Australian taxable dividend amount, then the head company will be able to do so because it will be taken to have paid and to have been personally liable for the tax. ***[Schedule 9, item 1, note 2 to section 717-515]***

FDA declaration for dividends paid by subsidiary members

7.32 The head company of a consolidated group is able to make FDA declarations in relation to dividends paid to its non-resident shareholders under the operation of the current FDA provisions. During consolidation, the head company will also be able to make FDA declarations in respect of dividends paid by the subsidiary members of the group. The head company can make the FDA declarations because it will be held for FDA purposes to have paid dividends that are paid to non-resident shareholders of the subsidiary members. ***[Schedule 9, item 1, subsection 717-520(2)]***

7.33 To enable the head company to make FDA declarations for dividends paid by its subsidiary members, subsection 128TC(2) will have a modified application. Under that modified operation, the head company will determine the FDA declaration percentages and the FDA declaration amounts for the dividends paid ***[Schedule 9, item 1, subsection 717-520(2)]***. The head company will do that calculation for all dividends paid to the shareholders in the subsidiary member on a particular day ***[Schedule 9, item 1, subsection 717-520(4)]***. Essentially, this means that the head company will be required to apply the formula in subsection 128TC(2) separately for each subsidiary member paying a dividend on a given day.

7.34 Once the FDA declaration is made, the head company will be required to make an FDA debit equal to the sum of the FDA declaration amounts for all of the dividends to which the declaration relates.

Multiple FDA declarations made on a particular day

7.35 Where the head company makes multiple FDA declarations on a particular day in relation to dividends paid by itself and/or one or more of its subsidiary members, the total FDA declarations made by the group on that day will need to be determined to ensure the FDA surplus at the beginning of the day is not exceeded by the total FDA declaration amounts. ***[Schedule 9, item 1, subsection 717-525(2)]***

7.36 If the sum of the FDA declaration amounts worked out under subsection 128TC(2) does not exceed the FDA surplus at the beginning of the day then the head company will debit its FDA for that sum immediately after the FDA dividends are paid. The FDA debit for the declarations made by the head company will arise under section 128TB for the sum of the declaration amounts for all of the dividends (to which the declarations relate) paid by all group members.

7.37 If the sum of the declaration amounts exceeds the FDA surplus at the beginning of the day, each FDA declaration will nevertheless, be treated as valid. The FDA dividends paid are not adjusted and new declarations are not required by the head company. However, all the declaration amounts will be proportionally reduced so as not to exceed the FDA surplus in total ***[Schedule 9, item 1, subsection 717-525(3)]***. This has the effect that only the adjusted FDA declaration percentages will be relevant for FDA purposes. The operation of this rule is consistent with the principles embodied in the equivalent provision in the existing law.

7.38 The proportional reduction of the FDA declaration percentages will ensure that the FDA debit made for the FDA declaration amounts (under paragraph 128TB(1)(a)) does not exceed the FDA surplus at the beginning of that day.

Example 7.2

Assume:

- F Co, a non-resident company, has 2 wholly-owned Australian subsidiaries: A Co and D Co. A Co has 2 wholly-owned Australian subsidiaries: B Co and C Co.
- A Co, B Co, C Co and D Co form a MEC group on 1 July 2002. A Co is the provisional head company of the group.
- On 1 September 2002, A Co and D Co both pay an unfranked dividend of $5,000 each to F Co.
- A Co sets the FDA declaration percentage at 60% for both dividends.
- A Co has an FDA surplus of $7,000 at the beginning of the day on which the FDA declarations are made.

  The FDA declaration percentage of 60% will permit A Co and D Co to pay their dividends exempt from DWT to the extent of the FDA declaration amounts. The FDA declaration amount is $3,000
  (i.e. 60% $5,000) for each dividend. That amount of each dividend is exempt from DWT. The total FDA declaration for A Co and D Co is $6,000
  ($3,000 $3,000) which does not exceed the available FDA surplus of $7,000 and a debit of $6,000 would be made to the FDA of A Co.

  Example 7.3
  Assume:

- The MEC group from Example 7.2 had an FDA surplus of $7,500 at the beginning of 1 September 2003.
- On that day, A Co and D Co pay dividends to F Co. A Co pays an unfranked dividend of $5,000 and D Co pays one of $4,000.
- A Co makes an FDA declaration in relation to both dividends. The FDA declaration percentage is set at 90% for both dividends.

  The FDA declaration percentage of 90% permits the dividends paid to be exempt from DWT to the extent of the declaration amounts. The FDA declaration amounts are $4,500 (i.e. 90% $5,000) for the dividend paid by A Co and $3,600 (i.e. 90% $4,000) for the dividend paid by D Co.
  The sum of the declaration amounts is $8,100 ($4,500 + $3,600), which exceeds the FDA surplus of $7,500. As such, the declaration amount is reduced by applying the formula in the new subsection 717-525(3) of the ITAA 1997. The result is an FDA declaration percentage of 83-% that is taken to have effect for FDA purposes [i.e. 90%   ($7,500 / $8,100)].
  The reduced FDA declaration percentage will in turn reduce the total declaration amount to $7,500. However, that amount does not reduce the declaration amounts already set by A Co in the dividend statements issued to F Co. Therefore, the failure by A Co and D Co to deduct sufficient withholding tax on dividends paid will result in A Co being liable for additional tax.

  An FDA debit of $7,500 is made to A Cos FDA to reflect the corrected total declarations made by the group on that day.
  Head company liable for penalty tax

7.39 An FDA declaration made by a head company that results in the FDA surplus being exceeded by the declaration amount will trigger the operation of the penalty provision in the existing law. Similarly, if a head company issues an incorrect dividend statement to a non-resident shareholder of a subsidiary member then the head company will be liable for additional tax ***[Schedule 9, item 1, subsection 717-520(6)]***. Section 128TE applies in relation to the declaration made by the head company even though the shareholders and dividends mentioned in that section may relate to a subsidiary member.

7.40 Therefore, a consequence of the head company issuing a dividend statement is that the head company will be held liable for any incorrect amounts set out in the statement, as provided by section 128TE. [Schedule 9, item 1, subsection 717-520(6)]

7.41 Similarly, where a head company makes multiple FDA declarations that exceed the available FDA surplus at the beginning of the day then the head company will be liable for additional tax by way of a penalty for an amount equal to the withholding tax shortfall on the dividends. The head company will be liable for the additional tax if the incorrect statement relates to the dividend paid to its shareholders or those paid to a shareholder of a subsidiary member. ***[Schedule 9, item 1, subsections 717-520(6) and 717-525(5) and (6)]***

Extended application of certain provisions

7.42 Section 128AAA applies Division 11A of Part III to a non-share equity interest and an equity holder in the same way as it applies to a dividend and a shareholder. That provision has an application in relation to new sections 717-520 and 717-525 of the ITAA 1997 in the same way it applies to the provisions in Division 11A. ***[Schedule 9, item 1, section 717-530]***

FDA balances and change in head company

7.43 The rule in section 703-75 of the ITAA 1997 deals with a situation where a company is an interposed head company. That rule provides that everything that happened to the original company (the old head company) before the completion time is taken instead to happen to the interposed company (the new head company) in relation to the head company and entity core purposes and for the franking account balance. The FDA measure does not fall within the head company or entity core purposes. Therefore, subsection 703-75(3) will be amended by this bill to allow the FDA balance to be transferred from the old head company to the new head company.

7.44 The amended subsection 703-75(3) of the ITAA 1997 will enable the new head company to operate the FDA rather than the old one by taking everything to have happened to the new head company instead. ***[Schedule 9, item 13, paragraph 703-75(3)(d)]***

FDA balances and MEC groups

7.45 The rules in the new Subdivision 717-J of the ITAA 1997 will operate for a provisional head company of a MEC group in the same way as they do for a head company of a consolidated group. ***[Schedule 9, item 2, section 719-900]***

7.46 The application of the new Subdivision 717-J to MEC groups will allow the provisional head company of a MEC group to operate a single FDA by debiting and crediting the account at various points in time according to the rules in the existing law. The provisional head company of a MEC group can also make the FDA declarations in relation to dividends paid to non-resident shareholders by a subsidiary member of the group.

7.47 A provisional head company of the group at a particular point in time will not be a subsidiary member of the group for FDA purposes. Similarly, a company that is a subsidiary member at a particular point in time will not be a provisional head company of a group for FDA purposes at that time. ***[Schedule 9, item 2, subsection 719-900(3)]***

Transfer of the FDA balance to a new provisional head company

7.48 Section 719-90 of the ITAA 1997 provides that a new head company is treated as substituting the old head company for all times before the transition time. Subsection 719-90(3) restricts the scope of that provision to head company and entity core purposes. Due to the fact that the FDA measure does not fall within the head company or entity core purposes, the FDA balance cannot be transferred from the old head company to the new head company by applying section 719-90.

7.49 The new law transfers the FDA balance held by the former provisional head company to the new provisional head company where one company ceases to be a provisional head

company and another company becomes the provisional head company. The transfer from one provisional head company to another is carried out in the same way as when a company joins a consolidated group. ***[Schedule 9, item 2, section 719-905]***

Repeal of the FDA grouping provisions

7.50 Under the current law, one resident company can pay an FDA dividend to another resident member of the same wholly-owned group. When the FDA dividend is paid to a resident company, an FDA debit arises for the paying company and an FDA credit arises for the receiving company. The transferred FDA surplus is then used by the receiving resident company to pay its non-resident shareholders unfranked dividends free from DWT.

7.51 The rule that allows an FDA dividend to be paid from one member of a wholly-owned group to another, and thereby to transfer FDA credits within the group, will be repealed. Repealing this rule is consistent with the removal of other grouping provisions. This means that members of a wholly-owned group operating outside the consolidation regime will be denied the opportunity to transfer an FDA surplus to another member with the payment of an FDA dividend. [Schedule 9, items 3 to 11]

The OBU regime

7.52 Under the current law certain entities can be gazetted by the Treasurer as OBUs. These entities are then entitled to reduce their income and expenses arising from OB activities so that such activities are effectively taxed at 10%.

7.53 With the introduction of the consolidation regime one or more members of a consolidated group may be an OBU. However, where the head company of the consolidated group is not itself an OBU but one or more subsidiary members are, it is necessary that Division 9A of Part III operates to extend the concession to the head company.

Definition of an OBU

7.54 OBU is defined in section 128AE to be a person that the Treasurer may, by notice published in the Gazette, declare to be an OBU. Broadly, subsection 128AE(2) provides that the following can be OBUs:

- a company that is an authorised deposit-taking institution;
- a public authority constituted under the law of an Australian State that carries on banking;
- a company wholly owned beneficially by an OBU (other than a dealer in foreign exchange);
- authorised foreign exchange dealers;
- life insurance companies;
- funds managers subject to certain eligibility criteria; and
- a company the Treasurer determines in writing to be an OBU.

7.55 Provided the membership criteria for inclusion in a consolidated group or MEC group are satisfied (see Division 703 and Division 719 of Part 3-90 of the ITAA 1997) any of these entities can join a consolidated group or a MEC group.

Head company an OBU

7.56 Where the head company of a consolidated group is an OBU, the single entity principle contained in section 701-1 of the ITAA 1997 will operate to treat subsidiary members of the consolidated group as parts of the head company. In these circumstances OB activities undertaken by subsidiary members will for the purposes of Division 9A be subject to the concessional OBU treatment provided for by that Division if the other requirements imposed by that Division are satisfied.

7.57 It is important to note that the single entity principle only applies for core purposes, that is, the calculation of the head companys income tax liability for a year of income (subsection 701-1(2) of the ITAA 1997). Division 11A of Part III provides for certain withholding tax exemptions on interest paid to non-residents by an OBU and excludes such interest from the assessable income of the non-resident. As Division 11A deals with the liability of the non-

resident lender to withholding tax this is not a core purpose. Accordingly, the requirement for the exemption that the interest be paid by an OBU will not be met where the loan contract is between a subsidiary member of the consolidated group and the non-resident lender.

Subsidiary member is an OBU

7.58 Where an entity that is an OBU is a subsidiary member of a consolidated group or joins such a group the head company will, if it is not itself an OBU, be treated as if it were an OBU. This treatment will persist for the period of time that at least one subsidiary member of the group is an OBU. ***[Schedule 10, item 2, section 717-710]***

7.59 As is the case outlined at paragraph 7.57, the head company will only be treated as if it were an OBU for the purposes of Division 9A, that is, the calculation of the amount to be included in the taxable income of the head company and taxed to give an effective tax rate on that amount of 10% ***[Schedule 10, item 2, subsection 717-710(1)]***. The deeming of the head company to be an OBU will not apply for the purposes of determining whether a non-resident lender to the group is entitled to a withholding tax exemption on interest paid on the loan under Division 11A.

7.60 Subsidiary members of a consolidated group continue to be persons as defined in section 6 and there is no requirement in section 128AE that the person be a taxpayer. In these circumstances the Treasurer will continue to be able to declare subsidiary members of a consolidated group to be OBUs if they satisfy the criteria set out in subsection 128AE(2). If this occurs and the head company is not an OBU the head company will be treated as if it were an OBU for Division 9A purposes. ***[Schedule 10, item 2, subsection 717-710(1)]***

Consequences of consolidation

7.61 A consequence of the head company either being an OBU or being treated as one is that OB activities undertaken outside the declared OBU member or members may be entitled to the OBU concession conferred by Division 9A. The concession will apply provided the requirements set out in that Division and the record keeping requirements specified in section 262A are met.

7.62 Where the OB activity as defined in section 121D can only be undertaken if the person meets certain criteria under legislation other than tax legislation the proposed law will not affect that external requirement or penalties to be imposed for breach of that requirement. An example would be the license required to be held by foreign exchange dealers.

7.63 It is worth noting that section 121EH which is aimed at preventing the excessive use of non-OB money to fund OB activities will apply to the consolidated group as a whole rather than only to actual OBUs within the group. The provisions of Division 9A that deal with OB resident-owner money will not apply to the equity interest in subsidiary members of the group.

7.64 Similarly, section 121EK deeming interest to be paid on OBU resident-owner money will not operate in respect of the internal shareholding arrangements within the consolidated group.

Elections in relation to CFCs, FIFs and FLPs

7.65 Within Part X and Part XI, a taxpayer can make decisions about how to calculate attributable income in relation to CFCs, and FIF income in relation to FIFs and FLPs. Some of these choices or elections are irrevocable and some decisions mean that other options cannot be taken.

7.66 With the ordinary application of the entry history rule (section 701-5 of the ITAA 1997), the decisions made by entities that become subsidiary members of a consolidated group may affect the ability of the head company to make different decisions when calculating its income tax liability. Similarly, with the application of the exit history rule (section 701-40 of the ITAA 1997), the decisions made by the head company may affect the ability of an entity that leaves the group to make different decisions when calculating its income tax liability.

Irrevocable elections

7.67 The irrevocable elections made under Part X or Part XI by entities that join a consolidated group will not become the elections of the head company under the entry history rule (section 701-5 of the ITAA 1997). Instead, the head company may decide whether or not to make the irrevocable elections according to its preferences rather than be bound by

decisions made by other taxpayers over which it may have had no control at the time those decisions were made. ***[Schedule 8, item 9, section 717-285]***

7.68 Irrevocable elections that a head company has made will continue to apply to the head company and will affect the interests in CFCs, FIFs and FLPs that the head company may hold under the single entity rule (section 701-1 of the ITAA 1997) when entities become subsidiary members of a consolidated group.

7.69 Similarly, where entities leave a consolidated group any irrevocable elections made by the head company will not become the elections of the entity that left the group under the exit history rule (contained in section 701-40 of the ITAA 1997). Instead, the leaving entity will be able to choose for itself whether or not to make an irrevocable election under Part X or XI. ***[Schedule 8, item 9, section 717-310]***

Calculating FIF income using the calculation method (entry/exit)

7.70 A taxpayer may use any one of 3 methods to calculate the attributable income from an interest in a FIF (section 534). The 3 methods for FIF interests are:

- the market value method;
- the deemed rate of return method; and
- the calculation method.

7.71 A taxpayer can only elect to calculate FIF income under the calculation method once (section 535). If the taxpayer changes to another method in a subsequent year, the taxpayer is not able to go back to the calculation method to calculate the FIF income of that particular FIF at any time in the future. This means the election to use the calculation method is not an irrevocable election. However, the taxpayer can only use the calculation method if it makes an irrevocable election under subsection 486(3) to change the notional accounting period of a FIF. Paragraph 7.67 discusses the consequence of such an irrevocable election if the taxpayer becomes a subsidiary member of a consolidated group.

7.72 Where an entity with an interest in a FIF becomes a subsidiary member of a consolidated group, the head company will be able to choose whether or not it wishes to apply the calculation method to calculate the FIF income. The head company can use the calculation method whether or not the joining entity would have been prevented from using that method. However, the head company could not make the election if it was precluded from using the calculation method because of past decisions made by the head company in relation to that FIF. ***[Schedule 8, item 9, section 717-290]***

7.73 Similarly, where an entity leaves a consolidated group with an interest in a FIF, the leaving company will be able to choose whether or not it wishes to use the calculation method to calculate the FIF income. The leaving entity can decide to use the calculation method whether or not the head company would have been precluded from using that method. ***[Schedule 8, item 9, section 717-315]***

Deferred attribution credits (entry/exit)

7.74 Part X has rules for maintaining an attribution account, including when credits and debits are made to this account. Briefly, a company maintains an attribution account to exempt dividends paid by a CFC out of income on which the taxpayer has already been taxed. At any time, an attribution account surplus arises when the credits exceed the debits.

7.75 Generally, an attribution credit arises when attributable income is included in the taxpayers assessable income. Where a CFC ceases to be a resident of an unlisted country and becomes a resident of a listed country, the CFCs attributable income includes the unrealised capital gains on the deemed disposal of the CFCs assets. Under subsection 371(8) an attributable taxpayer may elect to defer the timing of the attribution credit until the time of the CFCs payment of a dividend out of gains derived by it from the actual disposal of any of the assets.

Entry rules

7.76 If a company joining a consolidated group has an interest in a CFC, then the joining companys attribution account for the CFC will not reflect credits deferred as a result of

elections made under subsection 371(8). However, under section 717-210 of the ITAA 1997, the company joining the consolidated group transfers the surplus (if any) of the attribution account to the head company at the joining time.

7.77 The joining companys deferred attribution credits (because of elections it made under subsection 371(8)) will be available to the head company of a consolidated group when they would have been available to the joining company had it not joined the group. ***[Schedule 8, item 2, section 717-227]***

Exit rules

7.78 Where a company leaves a consolidated group with an interest in an attribution account entity, the attribution account held by the head company in respect of that entity will not reflect credits deferred as a result of elections under subsection 371(8). However, under section 717-245 of the ITAA 1997, the head company will transfer to the leaving company a proportion of the surplus (if any) of the attribution account at the leaving time. The proportion of the surplus that may be transferred is determined by applying the formula contained in section 717-245.

7.79 The leaving company will also be able to use the appropriate proportion of the deferred attribution credits the head company would have been entitled to as a result of elections under subsection 371(8). The credit will arise for the leaving company at the time it would have arisen for the head company if the leaving company had not left the group. ***[Schedule 8, item 7, section 717-262]***

7.80 The appropriate proportion of the deferred attribution credit that will be available to the leaving company will be determined by reference to the percentage of the groups interest in the attribution account entity that the leaving company takes with it at the leaving time. ***[Schedule 8, item 7, subsection 717-262(3)]***

7.81 The amount of the deferred attribution credit that the leaving company can use in the future reduces any entitlement that the head company may have had. ***[Schedule 8, item 7, subsection 717-262(4)]***

Ensuring FIF income is not taxed twice (entry/exit)

7.82 Where a company joins a consolidated group with an interest in a FIF, section 717-230 of the ITAA 1997 operates when the joining time is part-way through the notional accounting period of the FIF. The section allocates an amount of FIF income to the joining company for the period from the beginning of the notional accounting period of the FIF until the time the company joins the consolidated group.

7.83 To ensure the head company includes the appropriate amount of FIF income in its assessable income, the head company will be deemed to have acquired the interest in the FIF at the time the joining company joined the consolidated group. Deeming the head company to have acquired the FIF interest at the joining time will mean that the entry history rule will not apply for the purposes of calculating the FIF income. The ordinary operation of Part XI ensures the head company includes in its assessable income an amount of FIF income for so much of the notional accounting period of the FIF from the joining time until the usual end of the notional accounting period. ***[Schedule 8, item 3, subsection 717-230(4)]***

7.84 Similarly, section 717-265 of the ITAA 1997 operates when a company leaves a consolidated group with an interest in a FIF part-way through the notional accounting period of the FIF. The section allocates an amount of FIF income to the head company for the period from the beginning of the notional accounting period of the FIF until the time the leaving company left the consolidated group.

7.85 To ensure the leaving company includes the appropriate amount of FIF income in its assessable income the leaving company will be deemed to have acquired the interest in the FIF at the time the company leaves the consolidated group. Deeming the leaving company to have acquired the FIF interest at the leaving time will mean that the exit history rule will not apply for the purposes of calculating the FIF income for the leaving company. The ordinary operation of Part XI ensures the leaving company includes in its assessable income an amount of FIF income for so much of the notional accounting period from the leaving time until the normal end of the notional accounting period. [Schedule 8, item 8, subsection 717-265(5)]

7.86 The value of the interest in the FIF that the head company will be deemed to have acquired at the joining time or that the leaving company will be deemed to have acquired at the leaving time is determined under paragraph 538(2)(a). ***[Schedule 8, item 3, subsection 717-230(5) and item 8, subsection 717-265(6)]***

No double counting of foreign tax

7.87 New item 11 in the June Consolidation Act will apply to a taxpayer during the transitional period where the taxpayer chooses to apply the old section 160AFE to transfer excess foreign tax credits that relate to part of an income year to another group company ***[Schedule 18, item 1]***. This may occur when a consolidated group is formed part-way through the prospective head companys income year or simply where the old section 160AFE ceases to operate (on 1 July 2003) part-way though the transferring companys income year.

7.88 Where a taxpayer pays foreign tax in relation to foreign income that is included in its assessable income, that foreign tax will not give rise to a foreign tax credit under section 160AF to the extent the taxpayer has transferred to another taxpayer some of that foreign tax under the old section 160AFE. [Schedule 18, item 1, subitem 11(2) of Schedule 10 of the June Consolidation Act]

7.89 This is to avoid both the taxpayer making the transfer and the taxpayer receiving the additional credit claiming a foreign tax credit for the same amount of foreign tax.

Thin capitalisation

Expanding when a foreign bank branch is able to be treated as part of a single company

7.90 The thin capitalisation rules that permit a single company to group with a foreign bank branch are intended to be consistent with the loss transfer rules as amended following the introduction of the consolidation regime. Under the loss transfer rules, a single company that meets certain requirements can group with a foreign bank branch provided it is not a member of a potential or actual consolidated group.

7.91 The thin capitalisation provisions included in the September Consolidation Act, however, contain an additional condition at subparagraph 820-599(2)(c)(iv) of the ITAA 1997 whereby the single company cannot be a member of a potential MEC group. No such restriction applies for loss transfers.

7.92 The repeal of this provision will correct this anomaly and ensure that the circumstances when a single company can group with a foreign bank branch for thin capitalisation purposes are consistent with the general policy underlying the consolidation regime. ***[Schedule 22, item 1, subparagraph 820-599(2)(c)(iv)]***

7.93 This change will mean that grouping is permitted where:

- a single company (that is an eligible tier-1 company with no Australian resident subsidiaries) has not joined with another tier-1 company to form a MEC group; or
- the single company and the branch represent the foreign banks only presence in Australia.

Clarifying the choice available to a head company

7.94 The same thin capitalisation rules also permit, in certain circumstances, a head company to make a choice to group with an Australian bank branch under either the head company option or the single company option. This occurs where a consolidated group consists of only one member, that being the head company.

7.95 The intention of the legislation was, however, to distinguish between a choice made by the head company of a consolidated group or a MEC group (under subsection 820-597(1) of the ITAA 1997) and that made by a single company that is not a head company (under subsection 820-599(1) of the ITAA 1997).

7.96 The inclusion of the criteria that the single company cannot be a member of a consolidated group or MEC group will ensure that a company that is considered to be a head company is confined to making its choice under subsection 820-597(1) of the ITAA 1997. It will also ensure that a single company that is part of an actual MEC group cannot make a choice to group with a foreign bank branch. ***[Schedule 22, item 1, subparagraphs 820-599(2)(c)(iv) and (v)]***

7.97 This amendment will not affect the ability of a head company to group with a foreign bank branch for thin capitalisation purposes.

Application and transitional provisions

7.98 The rules dealing with FDAs for a consolidated group and amendments made to subsection 995-1(1) of the ITAA 1997 will apply from 1 July 2002 to accommodate consolidated groups formed from that date.

7.99 Subitem 12(1) in Schedule 9 provides the general rule that the current grouping provision in Subdivision B of Division 11A of Part III will apply until 30 June 2003 to allow members of a wholly-owned group to pay FDA dividends to another member of the group. ***[Schedule 9, item 12]***

7.100 Subitem 12(2) is an exception to the application of the general rule in subitem 12(1). It ensures that where a wholly-owned group consolidates before 1 July 2003 the amended Subdivision B will apply to dividends paid from the consolidation day. If a company joins the consolidated group after the consolidation day then subitem 12(1) will apply. While technically this means that the current Subdivision B applies to the joining company until 30 June 2003, this has no practical effect because of the operation of the single entity rule once it has joined the group. ***[Schedule 9, subitems 12(2) and 12(3)]***

7.101 However, if a wholly-owned group does not consolidate on or before 1 July 2003, the ability to pay an FDA dividend will be governed by the amended Subdivision B from 1 July 2003 onwards. The one exception to this rule is where the head company has a substituted accounting period and consolidates at the beginning of its first income year commencing after 1 July 2003 and before 1 July 2004. In that case, the amended Subdivision B will apply to dividends paid from the consolidation day. Subdivision B as it currently stands would apply to dividends paid by any group member up until the beginning of the head companys income year. ***[Schedule 9, subitems 12(2)(b) and 12(3)]***

7.102 The other technical amendments discussed in this chapter will apply from 1 July 2002. There are no transitional rules for these measures.

Consequential amendments

7.103 Consequential amendments made to subsection 995-1(1) of the ITAA 1997 will include new Dictionary terms relating to FDAs. ***[Schedule 9, items 15 to 20]***

7.104 Consequential amendments (if any) in relation to the other technical amendments discussed in this chapter will be included in subsequent legislation.

Chapter 8
Pay as you go instalments

Outline of chapter

8.1 This chapter explains consequential amendments that will be made to the PAYG instalments legislation to ensure the efficient collection of income tax payable by entities that are members of consolidated groups or MEC groups during an income year. These amendments are in addition to, or complement, refine or modify, consequential amendments to the PAYG instalments legislation contained in the May Consolidation Act.

8.2 Unless otherwise noted, the sections referred to in this chapter are sections of Schedule 1 to the TAA 1953.

Context of reform

8.3 As explained in chapter 12 of the explanatory memorandum to the May Consolidation Act, the PAYG instalments legislation was amended to ensure that the liabilities of members of consolidated groups to pay PAYG instalments reflect the assessment liabilities of the members of a mature consolidated group. Generally, the head company of a mature consolidated group will bear the liability to pay PAYG instalments. In broad terms, a head company of a mature consolidated group, or mature head company, is a head company to which the Commissioner has given an instalment rate worked out from an assessment of the head company for the income year in which the consolidated group is formed.

8.4 The amendments included in the May Consolidation Act ensure that a mature head company will pay its instalments in much the same way as any other company. It will pay quarterly instalments and will generally work out the amount payable by multiplying its

instalment income, as worked out according to the single entity rule, by its instalment rate. However, a head company with a base assessment instalment income of $1 million or less may pay an instalment worked out from its GDP-adjusted notional tax.

8.5 The May Consolidation Act also contains special rules that apply in relation to instalments payable before a head company becomes a mature head company. That is, these special rules apply in relation to instalments payable in the period before the Commissioner gives the head company an instalment rate worked out from an assessment of a head company of the group for the income year in which the consolidated group is formed. In that period, each member of the consolidated group remains liable to pay instalments as if it were not a member of a consolidated group. This is so even though each subsidiary member is treated as a part of the head company of the group for the purposes of determining the head companys income tax liability for that period.

8.6 Some of the PAYG instalments consequential amendments in this bill complement, refine or modify the way in which the May Consolidation Act amendments apply to members of consolidated groups. For example:

- the application rule (that explains when the Subdivision that contains the rules for mature groups applies to a head company of a consolidated group) will be modified to take account of all the ways in which a consolidated group can start, or cease, to exist;
- the exit rule (that applies when an entity ceases to be a subsidiary member of a consolidated group) will be modified to ensure it operates appropriately if an exiting entity immediately joins a mature MEC group; and
- the Commissioners power to issue a higher or lower instalment rate to the head company of a group where the membership of the group has changed will be amended to make it clear the power can be exercised more than once in relation to a particular membership change.

8.7 The amendments made to the PAYG instalments regime by the May Consolidation Act do not set out how the regime applies to the members of MEC groups. Nor do the mechanisms used to extend the primary rules of the consolidation regime to MEC groups contained in this bill apply for the purposes of the PAYG instalments regime. Therefore, this bill contains a number of consequential amendments that will extend the PAYG instalments rules for members of consolidated groups to the members of MEC groups.

8.8 There are also amendments that are consequential upon other measures contained in the September Consolidation Act or this bill. For example, there are rules that set out how the PAYG instalments regime applies when:

- an interposed company becomes the new head company of a mature consolidated group;
- a new provisional head company is appointed for a MEC group after an earlier provisional head company ceases to be eligible to be the provisional head company of the group; and
- a head company of a group is treated as a life insurance company because a subsidiary member is a life insurance company.

8.9 There are also new rules that are intended to minimise the costs incurred by members of groups in complying with the PAYG instalments regime. They will apply when:

- a mature head company is taken-over by a member of another group that is not yet mature; or
- an entity ceases to be a subsidiary member of a mature group, and it chooses to consolidate a consolidatable group consisting of itself, as head company, and its wholly-owned subsidiaries.

Summary of new law

New rules for members of consolidated groups

8.10 A head company of a consolidated group will start to be treated as a mature head company, at the start of the instalment quarter in which one of the following events occurs:

- the Commissioner gives the head company of the group an instalment rate worked out from an assessment of the head company of the group for the income year in which the consolidated group comes into existence as a result of a companys choice to form the consolidated group;
- the consolidated group is created from a mature MEC group; or
- a company is interposed between the head company of a mature consolidated group and that companys shareholders and the interposed company chooses to continue the consolidated group and becomes the head company of that group.

8.11 A head company of a consolidated group will stop being a mature head company at the earliest of the following times:

- at the end of the instalment quarter in which the group ceases to exist (but a MEC group is not created from it);
- at the end of the instalment quarter in which a MEC group is created from the consolidated group if the Commissioner is notified of the creation of the MEC group in that quarter;
- just before the instalment quarter in which the Commissioner is notified of the creation of a MEC group from the consolidated group if the MEC group was created in an earlier quarter; or
- just before the instalment quarter in which a company is interposed between the head company and its shareholders and the interposed company chooses to continue the consolidated group and becomes head company of that group.

8.12 When an interposed company chooses to continue a consolidated group, it will inherit, at the time the interposition occurs, the history of the company it replaces as head company of the group. The interposed company will become responsible for the PAYG instalments obligations as from the start of the instalment quarter in which the interposition occurs.
8.13 The Commissioner has the power to give a head company of a consolidated group a higher or lower instalment rate, or instalment amount, when the membership of the group changes. The Commissioner will be able to exercise that power in relation to:

- the most recent instalment rate or instalment amount given to the head company before the first exercise of the power; or
- a rate or amount that is worked out, after an exercise of the power, from an assessment of the income year in which the change occurred or an earlier income year.

Special rules for members of consolidated groups

8.14 A head company of a mature consolidated group may become a wholly-owned subsidiary of another entity that is a member of a group that is not yet mature. When that happens, the head company will be able to continue paying instalments as if it were still the head company of the mature group until the head company of the other group becomes mature or the head company ceases to be a member of the other group. Without this special rule, the PAYG instalments exit rule would apply and each member of the mature group would be required to pay separate instalments.
8.15 An entity may cease to be a subsidiary member of a mature consolidated group but, at that time, become the head company of a consolidatable group consisting of itself, as head company, and its wholly-owned subsidiaries. When that happens, and the entity chooses to consolidate the consolidatable group, that entity may be treated as if it immediately becomes the head company of a mature group as from the date of consolidation. If this were not the case, the PAYG instalments exit rule would apply and each member of the new group would be required to pay separate instalments until the entity is given an instalment rate worked out from its first assessment as the head company of that new group.

New rules for members of MEC groups

8.16 The PAYG instalments regime will apply to the members of a MEC group in much the same way as it applies to the members of a consolidated group. A rule that applies to a head company of a consolidated group will generally apply to the provisional head company of a MEC group. A rule that applies to a subsidiary member of a consolidated group will generally apply to a member (other than the provisional head company) of a MEC group.

8.17 For example, the provisional head company of a mature MEC group will bear the liability to pay PAYG instalments. It will pay PAYG instalments in much the same way as any other company. It will pay quarterly instalments and will generally work out the amount payable by multiplying its instalment income, as worked out according to the single entity rule, by its instalment rate. However, if a head company of a MEC group has a base assessment instalment income of $1 million or less, the provisional head company of the group may pay an instalment worked out from its GDP-adjusted notional tax.

8.18 A provisional head company of a MEC group will become a mature provisional head company for PAYG instalments purposes at the start of the instalment quarter in which one of the following events occurs:

- the Commissioner gives the provisional head company of the group an instalment rate worked out from an assessment of the head company of the group for the income year in which the MEC group comes into existence as a result of the choice of the eligible tier-1 companies to form the MEC group;
- the Commissioner is notified that a MEC group has been created from a mature consolidated group; or
- a new provisional head company is appointed after a cessation event happens to a former provisional head company that is a mature provisional head company.

8.19 A provisional head company of a MEC group will stop being a mature provisional head company at the earliest of the following:

- at the end of the instalment quarter in which the group ceases to exist (but a consolidated group is not created from it);
- at the end of the instalment quarter in which a consolidated group is created from the MEC group; or
- just before the instalment quarter in which another company is appointed as provisional head company of the MEC group.

8.20 When a provisional head company of a MEC group ceases to be eligible to be a provisional head company and a replacement provisional head company is appointed, the replacement provisional head company will inherit, at the time the replacement takes effect, the history of the company it replaces. The replacement provisional head company will become responsible for the PAYG instalments obligations of the group from the start of instalment quarter in which the replacement takes effect.

Instalment income of a life insurance company

8.21 All entities must include in their instalment income for an instalment period the ordinary income they derive in that period, to the extent to which it is assessable income of the income year that includes that period. The instalment income of a life insurance company for an instalment period will also include any part of its statutory income that is both reasonably attributable to that period and included in the complying superannuation class of its taxable income for the income year that includes that period. This will apply to an entity that is itself a life insurance company, and a head company of a consolidated group or provisional head company of a MEC group that is taken to be a life insurance company because a subsidiary member of the group is a life insurance company.

Comparison of key features of new law and current law

New law	*Current law*
A head company of a consolidated group will start being treated as a mature head company at the start of the instalment quarter during which: • the Commissioner gives the head company the initial head company instalment rate; • the head company becomes the head company of a consolidated group that is created from a mature MEC group or from a MEC group that would have become mature in that quarter had it remained a MEC group; or • the head company is interposed between the former head company of a mature consolidated group and the former head companys shareholders where the interposed head company chooses to continue the consolidated group and becomes the head company of the group.	A head company of a consolidated group will start being treated as a mature head company at the start of the instalment quarter during which the Commissioner gives the head company the initial head company instalment rate.
A head company of a consolidated group will stop being treated as a mature head company at the earliest of the following times: • at the end of the instalment quarter during which the consolidated group ceases to exist (but a MEC group is not created from it); • at the end of the instalment quarter during which the Commissioner is notified of the creation of a MEC group from the consolidated group if the MEC group is created during that quarter; • just before the instalment quarter during which the Commissioner is notified of the creation of a MEC group from a consolidated group if the MEC group was created during an earlier instalment quarter; or • just before the instalment quarter during which a company is interposed between the head company of a consolidated group and the head companys shareholders where the interposed company chooses to continue the consolidated group and becomes the	A head company of a consolidated group will stop being treated as a mature head company at the end of the instalment quarter during which the consolidated group ceases to exist.

head company of the group.	
A company will inherit, for PAYG instalments purposes, the history of the company it replaces as head company of a consolidated group if it is interposed between that head company and that companys shareholders and the interposed company chooses to continue the consolidated group and becomes the head company of the group.	No equivalent
The Commissioner may give a head company of a consolidated group a higher or lower instalment rate, or instalment amount, when the membership of a group changes. The power may be exercised in relation to: • the most recent instalment rate or instalment amount given to the head company before the exercise of the power, or • a rate or amount that is worked out, after an exercise of the power, from an assessment of either the income year in which the change occurred or an earlier income year.	The Commissioner may give a head company of a consolidated group a higher or lower instalment rate, or instalment amount, when the membership of a group changes. The power may only be exercised in relation to the most recent instalment rate or instalment amount given to the head company.
The head company of a mature consolidated group will continue to be treated as a head company of a mature consolidated group even if it is taken-over by a member of another group that is not mature. But this will only be so if the head company of that other group notifies the Commissioner, not later than 28 days (or such further period as the Commissioner allows) after the takeover, that it is taken to be consolidated from the date of the takeover or an earlier date. The head company continues as if it were a mature head company until the head company of the other group becomes a mature head company or it ceases to be a member of the other group.	The exit rule would apply to the subsidiary members of the mature group when the head company of the group is taken-over. That is because the consolidated group ceases to exist when the head company is no longer eligible to be a head company. The exit rule requires an entity that ceases to be a subsidiary member of a mature group to pay an instalment for the instalment quarter in which it ceases to be a subsidiary member of the mature group and does not immediately become a member of another mature group. The former subsidiary members would continue to pay instalments for each instalment quarter until the head company of the other group becomes a mature head company.
A company that ceases to be a subsidiary member of mature consolidated group may immediately be treated as becoming a mature head company. This will happen if, at the time the company ceases to be a subsidiary member, it is a head company of a consolidatable group and it notifies the Commissioner, within 28 days (or such further period as the Commissioner allows) of the day it ceases to be a subsidiary member of the original group, that the consolidatable group is consolidated as from that day.	The exit rule would apply to the entities that cease to be subsidiary members of the mature group. The exit rule requires an entity that ceases to be a subsidiary member a mature group to pay an instalment for the instalment quarter in which it ceases to be a subsidiary member of the mature group and does not immediately become a member of another mature group. The former subsidiary members would continue to pay instalments for each instalment quarter until the head company of the group becomes a

	mature head company.
The PAYG instalments regime generally applies to members of a MEC group in the same way as it applies to members of a consolidated group. Generally, a rule that applies to a head company of a consolidated group will apply to a provisional head company of a MEC group. Generally, a rule that applies to a subsidiary member of a consolidated group will apply to a member (other than the provisional head company) of a MEC group.	No equivalent
A provisional head company of a MEC group will become a mature provisional head company at the start of the instalment quarter during which: • the Commissioner gives the provisional head company the initial head company instalment rate; or • the Commissioner is notified of creation of a MEC group from a consolidated group and the consolidated group is already a mature group before that quarter or would have become mature in that quarter had it remained a consolidated group; or • the provisional head company is appointed as provisional head company of the MEC group in that quarter and the previous provisional head company is already a mature provisional head company before that quarter or would have become mature in that quarter had it remained as provisional head company of the group.	No equivalent
A provisional head company of a MEC group stops being a mature provisional head company at the earliest of the following times: • at the end of the instalment quarter during which the MEC group ceases to exist (but a consolidated group is not created from it); • at the end of the instalment quarter during which a consolidated group is created from the MEC group; or • just before the start of the instalment quarter during which it ceases to be a provisional head company and another company is appointed provisional head	No equivalent

company of the MEC group.	
A new provisional head company will inherit, for PAYG instalments purposes, the history of the previous provisional head company when it is appointed provisional head company after a cessation event happens to that previous company.	No equivalent
The instalment income of a life insurance company for an instalment period will include any part of its statutory income that is both reasonably attributable to that period and included in the complying superannuation class of its taxable income for the income year that includes that period. This will apply to an entity that is itself a life insurance company, and a head company of a consolidated group or provisional head company of a MEC group that is taken to be a life insurance company because a subsidiary member of the group is a life insurance company.	The instalment income of a life insurance company for an instalment period will include any part of its: • statutory income that is both reasonably attributable to that period and included in the complying superannuation class of its taxable income for the income year that includes that period; and • statutory income (other than net capital gains) that is included in the ordinary class of its taxable income for that income year. This applies to an entity that is itself a life insurance company.

Detailed explanation of new law

Amendments to the general rules for consolidated groups

8.22 The explanation of the amendments under this heading (paragraphs 8.22 to 8.87) will generally refer to consolidated groups and their members. Some of the provisions, but not all, will also apply to MEC groups and their members because of the rules discussed in paragraphs 8.111 to 8.182 under the heading *How the PAYG instalments regime applies to members of MEC groups*.

When Subdivision 45-Q applies to a head company of a consolidated group

Introduction

8.23 The May Consolidation Act contains consequential amendments enabling the PAYG instalments regime to apply to members of consolidated groups. It contains rules that apply before a head company of a consolidated group is given an instalment rate worked out from its first assessment as a head company. These rules are found in Subdivision 45-R. In this period, the PAYG instalments regime does *not* treat the members of a consolidated group as a single entity and each member of the group is required to pay separate instalments as if it were not a member of a consolidated group.

8.24 The May Consolidation Act also contains rules that apply once the head company of a consolidated group is given an instalment rate worked out from its first assessment as a head company. Those rules are found in Subdivision 45-Q. Once Subdivision 45-Q applies to a head company of a consolidated group, the PAYG instalments regime treats the members of the group as a single entity, and the head company pays a single instalment on the basis that its subsidiary members are parts of it.

Note: The explanatory memorandum to the May Consolidation Act referred to a head company that had been given an instalment rate worked out from its first assessment as a head company of a mature consolidated group or a mature head company. The terms mature consolidated group and mature head company are used in a similar way in this chapter.

8.25 More specifically, section 45-705 states that Subdivision 45-Q applies to the head company of a consolidated group for the period:

- beginning at the start of the instalment quarter during which the Commissioner gives the company its initial head company instalment rate; and
- ending at the end of the instalment quarter during which the company ceases to be the head company of the group.

Initial head company instalment rate is defined to be the instalment rate given to the head company by the Commissioner that is worked out on the basis of that companys first assessment as the head company of the consolidated group.

8.26 Section 45-705 is fundamental to the application of the PAYG instalments regime to members of consolidated groups. That is because the operation of each of the other provisions of Subdivision 45-Q requires Subdivision 45-Q to apply to the head company of the group. That is, those other sections can only be applied to a member of a consolidated group if Subdivision 45-Q applies to the groups head company.

8.27 However, section 45-705 currently only takes account of the ordinary case where a consolidated group:

- is formed by an entitys choice to consolidate a group under section 703-50 of the ITAA 1997; and
- ceases because the head company ceases to be a head company.

8.28 Section 45-705 will be repealed and a new section substituted ***[Schedule 24, item 5, section 45-705]***. The new section will take account of the fact that a consolidated group can come into existence because of an entitys choice to form a consolidated group under section 703-50 of the ITAA 1997 or can be created from a MEC group under section 703-55 of that Act. It will also take account of the fact that a consolidated group ceases to exist because the head company ceases to be a head company or because a MEC group is created from the consolidated group under section 719-40 of the ITAA 1997. It will also deal with the fact that the head company of a consolidated group changes when a company is interposed between the head company and its shareholders and that interposed company chooses to continue the group and becomes the head company of the group as provided for by Schedule 2 of the September Consolidation Act.

Period during which Subdivision 45-Q applies to a head company of a consolidated group

8.29 Subdivision 45-Q will apply to a head company for a period, the start of which will be determined under one of 3 mutually exclusive subsections. The period will end at the earliest of 4 different times. ***[Schedule 24, item 5, subsection 45-705(1)]***

Subdivision 45-Q usually starts applying to a head company when it is given the initial head company instalment rate

8.30 Subdivision 45-Q will usually start applying to a company as the head company of a consolidated group at the beginning of the instalment quarter in which the Commissioner gives the head company its initial head company instalment rate. [Schedule 24, item 5, subsection 45-705(2)]

8.31 The current definition of initial head company instalment rate will be repealed and replaced by a new definition. The amendment is necessary to take account of the fact that a consolidated group can come into existence through an entitys choice to form a consolidated group or can be created from a MEC group. The new definition will also define initial head company instalment rate for provisional head companies of MEC groups. ***[Schedule 24, item 22, subsection 995-1(1)]***

8.32 The ***initial head company instalment rate*** for a head company of a consolidated group, that comes into existence as a result of an entitys choice to consolidate a group under section 703-50 of the ITAA 1997, will be an instalment rate worked out from the first assessment of a head company of the consolidated group for the income year in which the group comes into existence. This is, effectively, a replica of the existing definition. ***[Schedule 24, item 22,***

subsection 995-1(1), paragraph (a) of the definition of initial head company instalment rate]

8.33 There are two ways of identifying the initial head company instalment rate for a head company of a consolidated group that is created from a MEC group.

8.34 The first applies where a consolidated group is created from a MEC group that comes into existence under section 719-50 of the ITAA 1997. The ***initial head company instalment rate*** for the head company of the consolidated group will be an instalment rate worked out from the first assessment of the head company of the MEC group for the income year in which the MEC group comes into existence. ***[Schedule 24, item 22, subsection 995-1(1), subparagraph (b)(i) of the definition of initial head company instalment rate]***

8.35 The second applies where a consolidated group is created from a MEC group that comes into existence under section 719-40 of the ITAA 1997. In that case, it is necessary to trace successively through the consolidated group (the later group) and any earlier MEC group or consolidated group, to determine which instalment rate is the initial head company instalment rate. The ***initial head company instalment rate*** for the head company of the later group will be the instalment rate worked out from the first assessment of an entity as head company of the earliest group for the income year in which the earliest group was formed. The earliest group may be formed as a consolidated group under section 703-50 of the ITAA 1997 or as a MEC group under section 719-50 of that Act. ***[Schedule 24, item 22, subsection 995-1(1), subparagraph (b)(ii) of the definition of initial head company instalment rate]***

8.36 A consolidated group is ***created*** from a MEC group if the consolidated group comes into existence under section 703-55 of the ITAA 1997 at the time that the MEC group ceases to exist as mentioned in that section. ***[Schedule 24, item 21, subsection 995-1(1), paragraph (a) of the definition of created]***

8.37 Subdivision 45-Q will only start to apply to a head company of a consolidated group when it is given the initial head company instalment rate if Subdivision 45-Q has not applied to:

- that company or a previous head company of the group; or
- a provisional head company of a MEC group if the consolidated group is created from that MEC group.

8.38 Diagram 8.1 shows how Subdivision 45-Q may start to apply to a head company of a consolidated group created from a MEC group when the head company of the consolidated group is given the initial head company instalment rate.

Diagram 8.1

When Subdivision 45-Q starts applying when a consolidated group is created from a mature MEC group

8.39 Subdivision 45-Q will start to apply to a company as head company of a consolidated group at the start of an instalment quarter (the starting quarter) if:

- the consolidated group is created from the MEC group (i.e. it comes into existence under section 703-55 of the ITAA 1997 at the time that the MEC group ceases to exist) during the starting quarter;
- the company is the head company of the consolidated group immediately after the consolidated group is created from the MEC group; and
- either:
- Subdivision 45-Q applied to the entity that was the provisional head company of the MEC group at the end of the previous quarter; or
- the Commissioner gives the initial head company instalment rate to the provisional head company of the MEC group in the starting quarter.

[Schedule 24, item 5, subsection 45-705(3)]

8.40 This subsection effectively ensures that a head company of a consolidated group is immediately treated as a mature head company under Subdivision 45-Q if the provisional head company of the MEC group from which the consolidated group is created:

- is a mature provisional head company at the end of the quarter before the starting quarter; or
- would have become a mature provisional head company during the starting quarter (because it is given the initial head company instalment rate before the conversion) if the consolidated group had not been created.

In those cases, the head company will not be treated as a head company of a group in transition to which Subdivision 45-R applies.

8.41 Diagrams 8.2 and 8.3 show how Subdivision 45-Q may start to apply to a head company of a consolidated group created from a MEC group.

Diagram 8.2

Diagram 8.3

8.42 A consolidated group may be created out of a MEC group before Subdivision 45-Q starts to apply to a provisional head company of the MEC group. If that happens, Subdivision 45-Q will start to apply to the head company of the consolidated group when the head company is given an instalment rate worked out from the first assessment of the head company of the MEC group for the income year in which the MEC group comes into existence see subsection 45-705(2) and paragraph (b) of the definition of initial head company instalment rate as discussed at paragraphs 8.30 to 8.38.

When Subdivision 45-Q starts applying when an interposed company becomes the head company of a group

8.43 The September Consolidation Act contains rules that ensure that a consolidated group can continue to exist even though a company (the interposed company) is interposed between the head company of the group (the original company) and its shareholders see subsection 124-380(5) and section 703-70 of the ITAA 1997. If the interposed company chooses to continue the consolidated group and becomes the head company of the group, it is treated as if it were the original company and the original company is treated as if it were the interposed company at all times before the interposition occurs see subsection 124-380(5) and section 703-75 of the ITAA 1997.

8.44 One practical effect of those sections is that the interposed company is assessed as if it were the head company of the consolidated group for all of the income year in which the interposition occurs (or at least so much of the year during which the consolidated group exists). A similar result to that arising under section 703-75 of the ITAA 1997 will apply for PAYG instalments see section 45-740 and the discussion at paragraphs 8.66 to 8.77.

8.45 Subdivision 45-Q will start to apply to a company as head company of a consolidated group at the start of an instalment quarter (the starting quarter) if:

- the company is an interposed company as mentioned in subsection 124-380(5) of the ITAA 1997, that is, the company is interposed between the head company of a consolidated group and the head companys shareholders;
- the company chooses, under subsection 124-380(5) of the ITAA 1997, to continue the consolidated group at and after the time it is interposed;
- the interposition is completed in the starting quarter; and
- one of the following applies:

- Subdivision 45-Q applied to the original company (i.e. the previous head company of the consolidated group) as head company of the consolidated group at the end of the previous quarter;
- the Commissioner gives the initial head company instalment rate to the original company during the starting quarter;
- the consolidated group is created from a MEC group during the starting quarter, and Subdivision 45-Q applied to the provisional head company at the end of the previous instalment quarter; or
- the consolidated group is created from a MEC group during the starting quarter, and the Commissioner gives the initial head company instalment rate to the provisional head company of the MEC group in that quarter.

[Schedule 24, item 5, subsection 45-705(4)]

8.46 This subsection effectively ensures that an interposed company is immediately treated as a mature head company under Subdivision 45-Q if the original company:

- is a company to which Subdivision 45-Q applies at the end of the instalment quarter before the quarter in which the interposed company becomes the head company of the consolidated group, whether the Subdivision applies to the original company in its capacity as a head company of the consolidated group or provisional head company of a MEC group from which the consolidated group is created; or
- would have become a company to which Subdivision 45-Q applies during the quarter in which the interposition is completed (whether that would be in its capacity as a head company of the consolidated group or provisional head company of a MEC group from which the consolidated group is created) if the interposition had not happened.

The interposed company will not be treated as a head company of a group in transition to which Subdivision 45-R applies in these circumstances.

8.47 Diagrams 8.4 and 8.5 show how Subdivision 45-Q may start to apply to an interposed company as head company of a consolidated group.

Diagram 8.4

Diagram 8.5

8.48 A company may be interposed before Subdivision 45-Q starts to apply to the original company. If that happens, Subdivision 45-Q will start to apply to the interposed company when it is given the initial head company instalment rate see subsection 45-705(2) and the discussion at paragraphs 8.30 to 8.38.

8.49 The exit rule in section 45-760 will apply to the subsidiary members of a consolidated group at the time an interposition is completed if the interposed company chooses not to continue the consolidated group under subsection 124-380(5) of the ITAA 1997. Further, Subdivision 45-Q will stop applying to the original company at the end of the instalment quarter in which the interposition is completed because the consolidated group will cease to exist see paragraph 45-705(5)(a) as discussed at paragraph 8.51.

When Subdivision 45-Q stops applying to a head company of a consolidated group

8.50 Subdivision 45-Q will stop applying to a head company of a consolidated group at the earliest of any of 4 different times. ***[Schedule 24, item 5, subsection 45-705(5)]***

8.51 First, Subdivision 45-Q will stop applying to a head company of a consolidated group at the end of the instalment quarter in which the consolidated group ceases to exist (but a MEC group is not created from it). ***[Schedule 24, item 5, paragraph 45-705(5)(a)]***

8.52 A MEC group is ***created*** from a consolidated group if:

- the MEC group comes into existence, under section 719-40 of the ITAA 1997, when a special conversion event happens to a potential MEC group derived from an eligible tier-1 company of a top company; and
- the eligible tier-1 company was the head company of the consolidated group (that is mentioned in paragraph 719-40(1)(b) of that Act) immediately before the special conversion event happened.

[Schedule 24, item 21, subsection 995-1(1), paragraph (b) of the definition of created]
8.53 Secondly, Subdivision 45-Q will stop applying to a head company of a consolidated group at the end of the instalment quarter during which the Commissioner is notified that a MEC group has been created from the consolidated group if the MEC group is created during that quarter ***[Schedule 24, item 5, paragraph 45-705(5)(b)]***. The Subdivision stops applying to the head company in its capacity as head company of a consolidated group at the end of the quarter in which the MEC group is created. However, when this happens, Subdivision 45-Q will generally start to apply to that entity in its capacity as provisional head company of the MEC group at the start of the instalment quarter in which the MEC group is created see subsection 45-915(3) and the discussion at paragraphs 8.132 to 8.136. This overlap in the application of Subdivision 45-Q ensures that the single entity rule applies appropriately.
8.54 Diagram 8.6 shows how Subdivision 45-Q may stop applying to a head company of a consolidated group when the Commissioner is notified that a MEC group is created from the consolidated group in the same instalment quarter that the group is created.
Diagram 8.6

8.55 The Commissioner is notified of the creation of a MEC group from a consolidated group when the Commissioner receives a written notice, from the entity that was head company of the consolidated group, stating that the MEC group is to come into existence. The notice must be in accordance with subsection 719-40(1) of the ITAA 1997. ***[Schedule 24, item 5, subsection 45-705(6)]***
8.56 Thirdly, Subdivision 45-Q will stop applying to the head company of the consolidated group just before the quarter during which the Commissioner is notified that a MEC group has been created from the consolidated group if the Commissioner is notified of the MEC groups creation after the instalment quarter in which the MEC group is created. ***[Schedule 24, item 5, paragraph 45-705(5)(c)]***
8.57 Diagram 8.7 shows how Subdivision 45-Q may stop applying to a head company of a consolidated group when the Commissioner is notified that a MEC group is created from the consolidated group in an instalment quarter later than the one in which the group is created.
Diagram 8.7

8.58 This means that Subdivision 45-Q continues to apply to the company as head company of the consolidated group, even though the consolidated group has ceased to exist. This is necessary because, under section 719-40 of the ITAA 1997, the head company does not need to notify the Commissioner of the creation of the MEC group until lodgment of the return for the income year in which the MEC group is created. The consequence is that Subdivision 45-Q must continue to apply to the head company of the consolidated group until just before the instalment quarter in which the Commissioner is notified of the creation of the MEC group.
8.59 A new subsection will provide for the application of Subdivision 45-Q in these circumstances. It will ensure that the PAYG instalments rules have effect for the head company of the consolidated group, and the other members of the consolidated group, as if:

- the consolidated group had continued to exist until just before the start of the quarter in which the Commissioner is notified of the creation of the MEC group; and
- the company were the head company of the group until just before the start of that quarter.

[Schedule 24, item 5, subsection 45-705(7)]

8.60 When the Commissioner receives notice of the creation of the MEC group in accordance with subsection 719-40(1) of the ITAA 1997, Subdivision 45-Q will start applying to the entity that is the provisional head company of the MEC group see subsection 45-915(3) and the discussion at paragraphs 8.132 to 8.136.
8.61 Fourthly, Subdivision 45-Q will stop applying to a head company of a consolidated group (the original company) that is replaced by an interposed company that chooses to continue the group. The Subdivision will stop applying to the original company just before the instalment quarter in which the interposed company becomes head company of the consolidated group ***[Schedule 24, item 5, paragraph 45-705(5)(d)]***. As explained in paragraphs 8.43 to 8.49, the Subdivision will generally start to apply to the interposed company at the start of the instalment quarter in which it becomes head company of the consolidated group.
8.62 If an interposed company does not choose to continue a consolidated group, Subdivision 45-Q will stop applying to the original company at the end of the instalment quarter in which the interposition occurs because the consolidated group ceases to exist see paragraph 45-705(5)(a) and paragraph 8.51.
Observations about the application of Subdivision 45-Q
8.63 As mentioned in paragraph 8.26, section 45-705 is fundamental to the application of the PAYG instalments regime to consolidated groups. That is because the operation of each of the other provisions of Subdivision 45-Q requires Subdivision 45-Q to apply to the head company of the group. That is, those other sections can only be applied to the members of a consolidated group if Subdivision 45-Q applies to the groups head company.
8.64 One consequence of using this approach is that Subdivision 45-Q can apply to an entity as head company of a consolidated group for all of a particular instalment quarter even though the entity is not a head company for all of that quarter. For example, if an interposed company becomes the head company of a consolidated group part-way through an instalment quarter, Subdivision 45-Q applies to the interposed company from the start of the instalment quarter in which the interposition happens. Subdivision 45-Q does not just apply for the period the interposed company is actually the head company. ***[Schedule 24, item 5, subsection 45-705(9)]***
8.65 In limited circumstances, the combined operation of section 45-705 and section 45-915 (about how Subdivision 45-Q applies to a provisional head company of a MEC group) may, at first, appear anomalous. One rule may state that Subdivision 45-Q *stops* applying to a particular entity just before a particular instalment quarter but another may state that it *starts* applying to the same entity at the beginning of that quarter. This will only happen if two or more events occur in the same quarter. For example, there may be both a conversion of a group from one kind to another and the interposition of a head company or change of provisional head company as a result of a cessation event in the same quarter. Subdivision 45-Q will not, and is not intended to, apply to an entity if the Subdivision stops applying to the entity before it starts applying to the entity. In these circumstances, there will be another entity to which the Subdivision applies for the relevant instalment quarter. ***[Schedule 24, item 5, subsection 45-705(8)]***
Interposed company treated as substituted for previous head company
8.66 The September Consolidation Act contains rules that will ensure that a consolidated group can continue to exist even though a company (an interposed company) is interposed between the head company of the group (the original company) and the original companys shareholders see subsection 124-380(5) and section 703-70 of the ITAA 1997. When the interposed company chooses to continue the consolidated group, it is treated as if it were the original company and the original company is treated as if it were the interposed company at all times before the interposition occurs see subsection 124-380(5) and section 703-75 of the ITAA 1997. However, those rules only apply for certain purposes, such as assessing the interposed company for income years ending after the interposition. The rules do not apply for PAYG instalments purposes.
8.67 A new section will be inserted in Subdivision 45-Q to ensure a similar outcome is achieved for the PAYG instalments regime. Its object will be to ensure that an interposed

company will inherit the history of the original company for the purposes of the PAYG instalments regime. Further, the interposed company will ignore its pre-interposition history when working out its instalments as head company of the consolidated group. ***[Schedule 24, item 7, subsection 45-740(1)]***

8.68 The new section will apply to a head company of a consolidated group if:

- it is an interposed company that chooses, under subsection 124-380(5) of the ITAA 1997, to continue the consolidated group at and after the time when it is interposed (which is called the completion time in that subsection); and
- Subdivision 45-Q applied to the original company at the end of the quarter prior to the one that includes the completion time, or would have started applying to the original company during the quarter that includes the completion time had the original company remained as head company.

[Schedule 24, item 7, subsection 45-740(2)]

8.69 The new section will not apply if the interposition occurs before Subdivision 45-Q starts to apply to the original company. In the period before Subdivision 45-Q starts to apply to the original company as head company of a consolidated group, each member of the group is liable to pay instalments separately. As the interposition of a new company will not alter the liabilities of the members of the group to pay their instalments there is no need for this rule to apply before the original company is a mature head company.

8.70 When the section applies, everything that happened in relation to the original company before the completion time will be taken to have happened instead to the interposed company. These things will be taken to have happened just as if, at all times before the completion time:

- the interposed company had been the original company; and
- the original company had been the interposed company.

That is, the interposed company is substituted for the original company for the purposes of the PAYG instalments regime. ***[Schedule 24, item 7, paragraphs 45-740(3)(a), (c) and (d)]***

8.71 Further, things that happened to the original company prior to the completion time because of the operation of either the consolidation regime or the PAYG instalments regime will be taken to have happened instead to the interposed company. ***[Schedule 24, item 7, subsections 45-740(3) and (4)]***

8.72 Subsections 45-740(3) and (4) will ensure, for example, that the interposed company will be taken to derive the instalment income that is derived, before the completion time, by the original company according to the single entity rule.

8.73 However, the history of the interposed company that relates to periods prior to the completion time is effectively ignored. ***[Schedule 24, item 7, paragraph 45-740(3)(b)]***

8.74 An original or amended assessment of the original company for an income year that ends before the income year that includes the completion time, will be taken to be something that happened to the interposed company regardless of when the assessment is made. This rule applies to ensure that such assessments can be used to calculate an instalment rate for the interposed company, if they would have been used to calculate an instalment rate for the original company had it remained the head company of the consolidated group. ***[Schedule 24, item 7, subsection 45-740(5)]***

8.75 The interposed company will be substituted for the original company when applying the PAYG instalments regime to the members of the consolidated group for any instalment quarter that ends after the completion time. This section and subsection 45-705(4) ensure the interposed company becomes liable to pay instalments as head company of the consolidated group from the instalment quarter in which the completion time occurs. It will remain so liable until Subdivision 45-Q stops applying to it. ***[Schedule 24, item 7, subsection 45-740(6)]***

8.76 To ensure that this section interacts appropriately with section 45-705 (which is about when Subdivision 45-Q applies to a head company of a consolidated group), subsections 45-740(1) to (6) will be disregarded in applying section 45-705. That means, the time when

Subdivision 45-Q starts to apply to the interposed company will be determined under subsection 45-705(4). It will not be determined under subsection 45-705(2) on the basis that the interposed company will be taken, by section 45-740, to have been given the initial head company instalment rate actually given to the original company. ***[Schedule 24, item 7, subsection 45-740(7)]***

8.77 The original company may become a subsidiary member of the consolidated group at the time the new head company is interposed see section 703-70 of the ITAA 1997. If that happens, a PAYG instalments provision that applies when an entity becomes a subsidiary member of a consolidated group, such as the section 45-755 entry rule, will not apply to the original company. ***[Schedule 24, item 7, subsection 45-740(8)]***

Extension of Commissioners power to work out different instalment rate or amount for membership change

8.78 Section 45-775 gives the Commissioner a power to work out a higher or lower instalment rate or GDP-adjusted notional tax amount where there is a change in the membership of a mature consolidated group. Currently, the Commissioner can exercise the power once in relation to the most recent instalment rate or GDP-adjusted notional tax given to the head company.

8.79 Two new subsections will be added to section 45-775 to provide that the Commissioner can exercise the power more than once in relation to a particular change of membership. ***[Schedule 24, item 9, subsections 45-775(4) and (5)]***

8.80 The new subsections will apply if the Commissioner:

- has already given the head company of a consolidated group a new instalment rate or instalment amount under section 45-775; and
- is subsequently required to work out an instalment rate (under section 45-320) or GDP-adjusted notional tax amount (under section 45-405) from an assessment of either the income year in which the membership change occurs or an earlier income year.

In these situations, the Commissioner may again determine whether it is reasonable to provide the head company with a higher or lower instalment rate or GDP-adjusted notional tax amount than the newly calculated rate or amount. In doing that, the Commissioner must still have regard to the membership change and the objects of the PAYG instalments regime. If the Commissioner does consider it is reasonable, he or she may again exercise the power to give a new rate or amount. ***[Schedule 24, item 9, subsection 45-775(4)]***

8.81 The Commissioner may use the power to give a new instalment rate, or instalment amount, in respect of more than one assessment. For example, the Commissioner could exercise the power in relation to an instalment rate worked out from the assessment of the income year that ends before the membership change. The Commissioner may then exercise the power again in relation to an assessment of the income year that included the membership change. However, for a particular change in membership, the Commissioner cannot exercise the power more than once in relation to a particular instalment rate worked out under section 45-320 or a particular GDP-adjusted notional tax amount worked out under section 45-405. ***[Schedule 24, item 9, subsection 45-775(5)]***

Example 8.1

There is a significant change in the membership of a mature consolidated group in the third quarter of the 2003-2004 income year. The Commissioner exercises the power to give the head company a new rate in the fourth quarter of that year. The head company continues to use the new rate in the 2004-2005 income year.

In the second quarter of the 2004-2005 income year, the head companys income tax return for the 2003-2004 income year is assessed. This assessment triggers the calculation of a new instalment rate for the head company. However, the Commissioner considers the instalment rate worked out from that assessment is inappropriate because the assessment covers periods both before and after the change in the groups membership.

The Commissioner considers that the new instalment rate previously worked out for the head company in the exercise of this power should continue to apply. The Commissioner may

make that determination and is not required to give the head company the instalment rate worked out from the 2003-2004 assessment.

Instalment income of a life insurance company

8.82 Subsection 45-120(1) requires all entities to include in their instalment income for a particular instalment period the ordinary income they derive during that period, to the extent to which it is assessable income of the income year that includes the period.

8.83 However, under subsection 45-120(2A), a life insurance company is also required to include in its instalment income for an instalment period any part of its:

- statutory income that is reasonably attributable to that period and is included in the complying superannuation class of its taxable income for the income year that includes that period; and
- statutory income (other than net capital gains) that is included in the ordinary class of its taxable income for the income year that includes that period.

Note: A life insurance company has two classes of taxable income. This enables the taxable income arising from the companys superannuation business to be taxed at 15%, that is, the same rate as applies to complying superannuation funds. The balance of the companys taxable income is taxed at the ordinary company rate of 30%.

8.84 Section 713-505 of the ITAA 1997, as contained in this bill, will treat a head company of a consolidated group as a life insurance company for an income year if a subsidiary member is a life insurance company at any time during the year.

8.85 As such, the head company of a mature consolidated group that includes a life insurance company would be required to work out its instalment income according to both subsections 45-120(1) and 45-120(2A). That would effectively require the head company of the group to include in its instalment income the statutory income arising from the activities of the non-life insurance company members of the group and this would increase a groups compliance costs.

8.86 In order to avoid any such increased compliance costs, and to ensure that all life insurance companies are treated equally, whether they are members of a consolidated group or not, subsection 45-120(2A) will be amended. As a result of that amendment, a life insurance company will be required to include in its instalment income for an instalment quarter the statutory income that is reasonably attributable to that period and is included in the complying superannuation class of its taxable income for the income year that includes that period. ***[Schedule 24, item 1, subsection 45-120(2A)]***

8.87 This amendment will apply in relation to an income year that begins on or after 1 July 2003. This will enable taxpayers to make the necessary adjustments to their instalment income recording systems and procedures and the Commissioner to adjust his or her instalment rate calculations procedures.

Amendments to the special rules for consolidated groups

Continued application of Subdivision 45-Q to the head company of an acquired group

8.88 A consolidated group will cease to exist if its head company becomes a wholly-owned subsidiary of an entity that is a member of another consolidated group or a MEC group see sections 703-5 and 703-15 of the ITAA 1997. When a mature consolidated group ceases to exist, the section 45-760 exit rule will make each entity that ceases to be a subsidiary member of the group liable to commence paying PAYG instalments unless it immediately becomes a member of another mature consolidated group or mature MEC group.

8.89 This could mean that additional administrative and compliance costs would be incurred by the members of a mature consolidated group if the head company of the group is acquired by a member of another consolidated group or a MEC group, that is not yet a mature group. A new section will ensure that the compliance costs incurred by members of a mature consolidated group are not unnecessarily increased when this occurs. ***[Schedule 24, item 18, section 45-880]***

8.90 The new section will apply to a company (the taken-over head company) if all of the following conditions are satisfied in relation to a particular time (the takeover time):

- just before the takeover time, the taken-over head company is a mature head company (i.e. Subdivision 45-Q applied to it as the head company of a consolidated group at that time);
- at the takeover time, the company becomes a wholly-owned subsidiary of a member of another consolidated group or MEC group (the new group);
- the new group is consolidated, under section 703-50 or 719-50 of the ITAA 1997, at or before the takeover time;
- not later than 28 days after the takeover time, or within such further period (if any) as the Commissioner allows, the Commissioner receives notice of the choice to consolidate the new group; and
- Subdivision 45-Q does not apply to the head company, or provisional head company, of the new group at the takeover time.

[Schedule 24, item 18, subsection 45-880(1)]
8.91 The conditions identified in the third and fourth dot points in the previous paragraph ensure the new group is one of the following:

- already a consolidated group or MEC group at the takeover time (in the sense that the head company of the consolidated group has, or all of the eligible tier-1 companies of the MEC group have, already decided to consolidate the group and the Commissioner has been notified of that decision);
- a consolidatable group, or potential MEC group, before the takeover, and the Commissioner is notified, not later than 28 days after the takeover time (or within such further period, if any, as the Commissioner allows), of the decision to consolidate the group from the takeover time or an earlier date; or
- a consolidatable group, or potential MEC group, that arises because of the takeover such that it can consolidate as from the takeover time and the Commissioner is notified, not later than 28 days after the takeover time (or within such further period, if any, as the Commissioner allows), of the decision to consolidate the group from the takeover time.

8.92 As indicated in the previous 2 paragraphs, the head company of the new group may apply to the Commissioner for an extension of the time in which the company must notify the Commissioner of its decision to consolidate the new group. The head company must apply for the extension not later than 28 days after the takeover time. The Commissioner may grant the extension if he or she considers it appropriate. ***[Schedule 24, item 18, subsection 45-880(6)]***
8.93 When the section applies, it will have effect in relation to the taken-over head company and the other members of the group (the preserved group) of which it was the head company as if:

- the preserved group had continued to exist as a consolidated group despite the fact that the head company is no longer eligible to be a head company and the group would otherwise be deconsolidated;
- the taken-over head company were still the head company of the preserved group;
- Subdivision 45-Q had continued to apply to the taken-over head company as head company of the preserved group; and
- an entity, while being a subsidiary member of the preserved group, were not a member of the new group.

[Schedule 24, item 18, subsection 45-880(2)]
8.94 The section will have effect for the period that:

- starts from the start of the instalment quarter that includes the takeover time; and

- ends at the earlier of the following:
- the end of the instalment quarter of the taken-over head company during which it ceases to be a member of the new group; or
- just before the instalment quarter of the taken-over head company during which Subdivision 45-Q starts to apply to the head company, or provisional head company, of the new group because that company is given the initial head company instalment rate.

[Schedule 24, item 18, subsections 45-880(2) and (5)]

8.95 The purpose of the rules discussed in the previous 2 paragraphs is to ensure that the compliance costs incurred by the entities that become members of the new group are not unnecessarily increased. They do this by allowing the taken-over head company to keep doing what it is required to do before it joins the new group, that is, to continue paying instalments as a single entity on the basis that its wholly-owned subsidiaries are a part of it.

8.96 However, subsection 45-880(2) does not stop the taken-over head company from being a member of the new group during the instalment quarters covered by subsection 45-880(5). This means the provisions of Subdivision 45-R can still be applied to it as a member of the new group until that group becomes a mature group, even while the provisions of Subdivision 45-Q are taken to apply to it as the head company of the preserved group. ***[Schedule 24, item 18, subsection 45-880(3)]***

8.97 In this regard, it is necessary to specify how the single entity rule in section 701-1 of the ITAA 1997 applies to the taken-over head company so that it can work out its instalment income. The taken-over head company must:

- assume that it will be assessed as head company of the preserved group under section 701-1 of that Act on the income derived by the members of the preserved group; and
- ignore the fact that the income of the members of the preserved group will actually be assessable to the head company of the new group under that section.

[Schedule 24, item 18, subsection 45-880(4)]
8.98 This will mean, for example, income arising from transactions between members of the preserved group is ignored in working out the instalment income of the taken-over head company. However, income derived by a member of the preserved group from a transaction between that member and a member of the new group will be included in the instalment income of the taken-over head company.
8.99 The entry and exit rules in sections 45-755 and 45-760 will continue to apply in relation to the subsidiary members of the preserved group while that group is taken to continue to exist. [Schedule 24, item 18, subsection 45-880(7)]
8.100 This section ensures that the single entity rule continues to apply to the members of the preserved group so that none of the members of the group are required to pay separate PAYG instalments. The section will apply automatically from the takeover time if the Commissioner has already been notified that the new group is consolidated.
8.101 If the Commissioner has not already been notified of the decision to consolidate the new group, the head company, or provisional head company, of the new group effectively has a choice as to what compliance costs it is prepared to bear in relation to the subsidiary members of the taken-over head company. It can ensure that the taken-over head company pays a single instalment for itself and its subsidiary members by notifying the Commissioner of its decision to consolidate the new group not later than 28 days after the takeover (or within such further period, if any, as the Commissioner allows).
8.102 If the head company, or provisional head company, of the new group does not notify the Commissioner of the consolidation of the new group within the required time, the section 45-760 exit rule will apply, at the takeover time, to the subsidiary members of the group that would have been the preserved group. Therefore, they will be required to pay an instalment

for the instalment quarter that includes the takeover time and each subsequent instalment quarter until the quarter in which Subdivision 45-Q starts to apply to the head company, or provisional head company of the new group.

Early application of Subdivision 45-Q to head company of a new group

8.103 A consolidated group may cease to exist or it may sell off a subsidiary member in circumstances where a former subsidiary member of the group or the member that is sold off has one or more wholly-owned subsidiaries. If the consolidated group is a mature group when either of these events occur, the exit rule contained in section 45-760, as amended by this bill, will make:

- all the subsidiary members of the group (if the group ceases to exist); or
- the particular entity that is sold off and each of its wholly-owned subsidiaries (in the other case),

liable to commence paying PAYG instalments unless they immediately become members of another mature consolidated group or mature MEC group. Each entity would be required to pay its instalments using the most recent instalment rate given to the head company of the group before the end of the instalment quarter in which it ceases to be a member of the group.

8.104 This could mean that additional administrative and compliance costs would be incurred by the former subsidiary members of a mature consolidated group if a former subsidiary member is eligible to form a new consolidated group. A new section will ensure that the compliance costs incurred by such entities are not unnecessarily increased when this occurs. ***[Schedule 24, item 18, section 45-885]***

8.105 The new section will apply to a company if all of the following conditions are satisfied in relation to a particular time (the starting time):

- just before the starting time, the company is a subsidiary member of a consolidated group or a member of a MEC group;
- just before the starting time, the consolidated group or MEC group was a mature group (that is, Subdivision 45-Q applies, at that time, to its head company or provisional head company);
- at the starting time, either:
- the company ceases to be a subsidiary member of the consolidated group or a member of the MEC group; or
- the consolidated group or MEC group ceases to exist (other than because the head company or provisional head company is acquired by a member of another mature group or because another group is created from it);
- at the starting time, the company is the head company of another consolidated group; and
- within 28 days after the starting time, or such further period (if any) as the Commissioner allows, the Commissioner receives the choice to consolidate that other consolidated group at and after the starting time under section 703-50 of the ITAA 1997.

[Schedule 24, item 18, subsections 45-885(1) and (4)]

8.106 As the last dot point of the previous paragraph indicates, the company that is making the choice to consolidate the other group may apply to the Commissioner for an extension of the time in which the company may notify the Commissioner of the decision to consolidate the group. It must apply for the extension within 28 days of the starting time. The Commissioner may grant the extension if he or she considers it appropriate. ***[Schedule 24, item 18, subsection 45-885(3)]***

8.107 When new section 45-885 applies to the company, the instalment rate that company is taken to have been given by the Commissioner under paragraph 45-760(2)(a) (the exit rule) will have effect as if it were the initial head company instalment rate of the company. That

will mean that Subdivision 45-Q will start to apply to the company, as the head company of the consolidated group, at the start of the instalment quarter in which the starting time occurs. ***[Schedule 24, item 18, paragraph 45-885(2)(a)]***

8.108 Further, an instalment rate that would otherwise be the initial head company instalment rate of the company will not be treated as the initial head company instalment rate. ***[Schedule 24, item 18, paragraph 45-885(2)(b)]***

8.109 This section effectively gives the former subsidiary member of the mature group a choice as to what compliance costs it is prepared to bear in relation to the members of its new consolidated group. It can ensure that it pays a single instalment for itself and its wholly-owned subsidiaries as a mature group by notifying the Commissioner of its decision to consolidate the new group not later than 28 days after the starting time (or within such further time as the Commissioner allows).

8.110 If the company does not notify the Commissioner of the consolidation of the new group within the required time, the section 45-760 exit rule will apply, at the starting time, to the entities that have ceased to be subsidiary members. Therefore, they will be required to pay an instalment for the instalment quarter that includes the starting time and each subsequent instalment quarter until the quarter in which Subdivision 45-Q starts to apply to the head company of the new group. Of course, the section 45-760 exit rule would also apply if the company chooses not to consolidate the group.

How the PAYG instalments regime applies to members of MEC groups

8.111 Currently, the PAYG instalments regime does not set out how it applies to the members of MEC groups. Nor do the mechanisms used to extend the provisions of Part 3-90 of the ITAA 1997 to MEC groups discussed elsewhere in this explanatory memorandum apply for the purposes of the PAYG instalments regime. Therefore, this bill will insert a new Subdivision into Part 2-10 (PAYG instalments) of Schedule 1 to the TAA 1953. The objects of the new Subdivision are to extend the existing rules of the PAYG instalments regime to members of MEC groups, and modify the PAYG instalments regime so that its extended operation takes account of the special characteristics of MEC groups. ***[Schedule 24, item 18, Subdivision 45-S and section 45-905]***

Extended operation of PAYG instalments to cover MEC groups

8.112 The PAYG instalments regime will have effect for the members of a MEC group in the same way as it has effect for members of a consolidated group. ***[Schedule 24, item 18, subsection 45-910(1)]***

8.113 However, that general rule is subject to certain modifications. ***[Schedule 24, item 18, subsection 45-910(2)]***

8.114 One modification is that a reference in Part 2-10 (PAYG instalments) to a consolidated group will be taken to be a reference to a MEC group. ***[Schedule 24, item 18, subsection 45-910(2), Table item 1]***

8.115 A second modification is that a reference to the head company of a consolidated group will be taken to be a reference to the provisional head company of a MEC group. This will ensure that the PAYG instalment obligations of a mature MEC group are borne by the provisional head company of the group. The modification is necessary because:

- the head company of a MEC group is defined to be the entity that is the provisional head company of the MEC group at the end of the income year (or when the group ceases to exist) see sections 719-25 and 719-75 of the ITAA 1997; and
- the PAYG instalments responsibilities arise from time to time during the income year when it is not possible to determine, with absolute certainty, which entity will be the head company of the MEC group at the end of the income year.

[Schedule 24, item 18, subsection 45-910(2), Table item 2]

8.116 The third modification is that a reference to a subsidiary member of a consolidated group will be taken to be a reference to a member (other than the provisional head company) of a MEC group. It will ensure that the rules that apply to a subsidiary member of a consolidated group can be applied through the course of the income year to members of MEC

groups. It is not possible to determine, with absolute certainty during the income year, which entities are the subsidiary members of a MEC group because a subsidiary member of a MEC group is defined to be all the members of the group other than the head company. The head company can only be determined at the end of the income year (or when the MEC group ceases to exist). ***[Schedule 24, item 18, subsection 45-910(2), Table item 3]***

8.117 However, there are a number of exceptions when one or another of those modifications does not apply. Generally, these exceptions are needed because particular provisions of the PAYG instalments regime will deal with the special characteristics of MEC groups and their members or do not apply to members of MEC groups. ***[Schedule 24, item 18, subsection 45-910(3)]***

8.118 For example, section 45-705, which specifies the period during which Subdivision 45-Q applies to a head company of a consolidated group will not apply to a provisional head company of a MEC group. A separate rule will specify the period during which Subdivision 45-Q applies to a provisional head company of a MEC group. Similarly, section 45-740 about an interposed company becoming head company of a consolidated group, will not apply to a provisional head company of a MEC group because the interposed company rules do not apply, for income tax assessment purposes, to MEC groups. However, there will be a special rule that deals with the appointment of a new provisional head company of a MEC group when a cessation event happens to an existing provisional head company. ***[Schedule 24, item 18, paragraph 45-910(3)(e) and section 45-913]***

When Subdivision 45-Q applies to a provisional head company of a MEC group

Introduction

8.119 The May Consolidation Act contains consequential amendments enabling the PAYG instalments regime to apply to members of consolidated groups. It contains rules that apply before a head company of a consolidated group is given an instalment rate worked out from its first assessment as a head company. These rules are found in Subdivision 45-R. In this period, the PAYG instalments regime does *not* treat the members of a consolidated group as a single entity and each member of the group is required to pay separate instalments as if it were not a member of a consolidated group.

8.120 The May Consolidation Act also contains rules that apply once the head company of a consolidated group is given an instalment rate worked out from its first assessment as a head company. Those rules are found in Subdivision 45-Q. Once Subdivision 45-Q applies to a head company of a consolidated group, the PAYG instalments regime treats the members of the group as a single entity, and the head company pays a single instalment on the basis that its subsidiary members are parts of it.

8.121 Section 45-705 specifies the period during which Subdivision 45-Q applies to a head company of a consolidated group. It is fundamental to the application of the PAYG instalments regime to consolidated groups. That is because the operation of each of the other provisions of Subdivision 45-Q requires Subdivision 45-Q to apply to the head company of the group. That is, those other sections can only be applied to a member of a consolidated group if Subdivision 45-Q applies to the groups head company.

8.122 However, section 45-705 does not take account of the special characteristics of MEC groups, either as currently enacted or as amended by this bill. Consequently, a new section (section 45-915) will explain when Subdivision 45-Q will apply to a provisional head company of a MEC group. Section 45-915 will perform the same function for MEC groups as section 45-705 does for consolidated groups and will be fundamental to the application of the PAYG instalments regime to the members of a MEC group.

Period during which Subdivision 45-Q applies to a provisional head company of a MEC group

8.123 Subdivision 45-Q will apply to a provisional head company for a period, the start of which will be determined under one of 3 mutually exclusive subsections. The period will end at the earliest of 3 different times. ***[Schedule 24, item 18, subsection 45-915(1)]***

Subdivision 45-Q usually starts applying to a provisional head company when it is given the initial head company instalment rate

8.124 Subdivision 45-Q will usually start to apply to a provisional head company of a MEC group at the beginning of the instalment quarter in which the Commissioner gives the company, as provisional head company of the group, the initial head company instalment rate. [Schedule 24, item 18, subsection 45-915(2)]

8.125 The ***initial head company instalment rate*** of a provisional head company of a MEC group will generally be an instalment rate that is worked out from the first assessment of a head company of the MEC group for the income year in which the MEC group comes into existence. However, this will only be the case if the MEC group is formed by the choice of the eligible tier-1 companies of a potential MEC group to consolidate the group under section 719-50 of the ITAA 1997. ***[Schedule 24, item 22, subsection 995-1(1), paragraph (a) of the definition of initial head company instalment rate]***

8.126 There are two ways of identifying the initial head company instalment rate for a provisional head company of a MEC group that is created from a consolidated group.

8.127 The first applies where a MEC group is created from a consolidated group that comes into existence under section 703-50 of the ITAA 1997, the ***initial head company instalment rate*** for the provisional head company of the MEC group will be an instalment rate worked out from the first assessment of the head company of the consolidated group for the income year in which the consolidated group comes into existence. ***[Schedule 24, item 22, subsection 995-1(1), subparagraph (b)(i) of the definition of initial head company instalment rate]***

8.128 The second applies where a MEC group is created from a consolidated group that comes into existence under section 703-55 of the ITAA 1997. In that case, it is necessary to trace successively through that MEC group (the later group)and any earlier consolidated group or MEC group, to determine which instalment rate is the initial head company instalment rate. The ***initial head company instalment rate*** for the provisional head company of the later group will be the instalment rate worked out from the first assessment of an entity as head company of the earliest group for the income year in which the earliest group was formed. The earliest group may be formed as a consolidated group under section 703-50 of the ITAA 1997 or as a MEC group under section 719-50 of that Act. ***[Schedule 24, item 22, subsection 995-1(1), subparagraph (b)(ii) of the definition of initial head company instalment rate]***

8.129 A MEC group is ***created*** from a consolidated group if:

- the MEC group comes into existence under section 719-40 of the ITAA 1997 when a special conversion event happens to a potential MEC group derived from an eligible tier-1 company of a top company; and
- that eligible tier-1 company was the head company of the consolidated group immediately before the special conversion event happened.

[Schedule 24, item 21, subsection 995-1(1), paragraph (b) of the definition of created]

8.130 Subdivision 45-Q will only start applying to a provisional head company of a MEC group when it is given the initial head company instalment rate if Subdivision 45-Q has not applied to a:

- previous provisional head company of the group; or
- head company of a consolidated group if the MEC group is created from a consolidated group.

8.131 Diagram 8.8 shows how Subdivision 45-Q may start to apply to a provisional head company of a MEC group created from a consolidated group when the provisional head company of the MEC group is given the initial head company instalment rate.

Diagram 8.8

When Subdivision 45-Q starts applying when a MEC group is created from a mature consolidated group

8.132 Subdivision 45-Q will start to apply to a company as provisional head company of a MEC group at the start of an instalment quarter (the starting quarter) if:

- during the starting quarter, the Commissioner receives a notice of the creation of the MEC group from a consolidated group under subsection 719-40(1) of the ITAA 1997; and
- the company is the provisional head company of the MEC group when the Commissioner is so notified; and
- either:
- Subdivision 45-Q applied to the head company of the consolidated group at the end of the previous quarter; or
- the Commissioner gives the initial head company instalment rate to the head company of the consolidated group during that quarter.

[Schedule 24, item 18, subsections 45-915(3) and (5)]

8.133 This subsection effectively ensures that once the Commissioner is notified of the creation of the MEC group, a provisional head company of a MEC group is treated as a mature provisional head company under Subdivision 45-Q if the head company of the consolidated group from which the MEC group is created:

- is a mature head company in the quarter before the Commissioner is notified of the creation of the MEC group; or
- would have become a mature head company during the quarter in which the Commissioner is notified of the creation of the MEC group (because it is given the initial head company instalment rate in that quarter) if the MEC group had not been created.

In those cases, the provisional head company will not be treated as a provisional head company of a group in transition to which Subdivision 45-R applies.

8.134 The Commissioner may be notified of the creation of a MEC group before Subdivision 45-Q starts to apply to a head company of the consolidated group. If that happens, Subdivision 45-Q will start to apply to the provisional head company of the MEC group when the provisional head company is given the initial head company instalment rate see subsection 45-915(2) and paragraphs 8.124 to 8.131.

8.135 Subdivision 45-Q may not start to apply to an entity as provisional head company of a MEC group until an instalment quarter that is after the instalment quarter in which the MEC group comes into existence under section 719-40 of the ITAA 1997. Subdivision 45-Q does not stop applying to the head company of the consolidated group as head company of the consolidated group from which the MEC group is created until the Commissioner is actually notified of the creation of the MEC group see paragraphs 8.53 to 8.60.

8.136 Diagrams 8.9 and 8.10 show how Subdivision 45-Q may start to apply to a provisional head company of a MEC group created from a consolidated group.

Diagram 8.9

Diagram 8.10

When Subdivision 45-Q starts applying when a new provisional head company is appointed

8.137 The September Consolidation Act contains rules that ensure that the tax position of a MEC group is not affected by the departure or change in membership status of a provisional head company of the MEC group. When a provisional head company of a MEC group stops being eligible to be a provisional head company (that is, a cessation event happens to the provisional head company), the MEC group membership rules require the remaining eligible

tier-1 companies to appoint a replacement provisional head company. That ensures the group continues in existence.
8.138 The September Consolidation Act rules ensure that the history of a head company of a MEC group is transferred to the new head company of the group by treating a new head company of a MEC group as if it were the former head company of the MEC group at all times before the cessation event occurs see section 719-90 of the ITAA 1997. However, that rule only applies for certain purposes, such as assessing the new head company, for income years ending after the cessation event happens. The rule does not apply for PAYG instalments purposes.
8.139 A similar result to that arising under section 719-90 of the ITAA 1997 will apply for the purposes of the PAYG instalments regime. However, the PAYG instalments rule will affect the respective provisional head companies before and after the cessation event happens see section 45-920 and paragraphs 8.154 to 8.167.
8.140 Subdivision 45-Q will start to apply to a company as provisional head company of a MEC group at the start of an instalment quarter (the starting quarter) if:

- the company is appointed as the provisional head company of the MEC group under subsection 719-60(3) of the ITAA 1997 following a cessation event that occurs during the starting quarter; and
- one of the following applies:
- Subdivision 45-Q applied to the former provisional head company of the MEC group (i.e., the provisional head company to which the cessation event happens) at the end of the previous quarter;
- the Commissioner gives the initial head company instalment rate to the former provisional head company of the MEC group during the starting quarter;
- the Commissioner receives notice of the creation of the MEC group from a consolidated group under subsection 719-40(1) of the ITAA 1997 during the starting quarter and Subdivision 45-Q applied to the head company of the consolidated group at the end of the previous instalment quarter; or
- the Commissioner receives notice of the creation of the MEC group from a consolidated group under subsection 719-40(1) of the ITAA 1997 during the starting quarter, and the Commissioner gives the initial head company instalment rate to the head company of the consolidated group during the starting quarter.

[Schedule 24, item 18, subsections 45-915(4) and (5)]

8.141 This subsection effectively ensures that a new provisional head company is immediately treated as a mature provisional head company under Subdivision 45-Q if a former provisional head company:

- is a company to which Subdivision 45-Q applies at the end of the instalment quarter before the starting quarter, whether the Subdivision applies to it in its capacity as provisional head company of a MEC group or as head company of a consolidated group from which the MEC group is created; or
- would have become a company to which Subdivision 45-Q applies during the starting quarter, whether that would be in its capacity as provisional head company of a MEC group or as head company of a consolidated group from which the MEC group is created, if the cessation event had not happened.

The new provisional head company will not be treated as a provisional head company of a group in transition to which Subdivision 45-R applies.
8.142 If the appointment of a new provisional head company occurs before Subdivision 45-Q starts to apply to the former provisional head company, Subdivision 45-Q will start applying

to the new provisional head company when it is given the initial head company instalment rate - see subsection 45-915(2) and paragraphs 8.124 to 8.131.

8.143 Diagrams 8.11 and 8.12 show how Subdivision 45-Q may start to apply to a new provisional head company of a MEC group.

Diagram 8.11

Diagram 8.12

When Subdivision 45-Q stops applying to a provisional head company of a MEC group

8.144 Subdivision 45-Q will stop applying to a provisional head company of a MEC group at the earliest of 3 different times. ***[Schedule 24, item 18, subsection 45-915(6)]***

8.145 First, Subdivision 45-Q will stop applying to a provisional head company of a MEC group at the end of the instalment quarter in which the MEC group ceases to exist (but a consolidated group is not created from it). ***[Schedule 24, item 18, paragraph 45-915(6)(a)]***

8.146 Secondly, Subdivision 45-Q will stop applying to a provisional head company of a MEC group at the end of the instalment quarter in which a consolidated group is created from the MEC group ***[Schedule 24, item 18, paragraph 45-915(6)(b)]***. In this case, the Subdivision stops applying to the company that is the provisional head company of the MEC group (in its capacity as provisional head company of the MEC group) at the end of the quarter in which the consolidated group is created. However, when this happens, Subdivision 45-Q will generally start to apply to the same company (in its capacity as head company of the consolidated group) at the start of the same instalment quarter see paragraph 8.39 to 8.42. This overlap in the application of Subdivision 45-Q ensures that the single entity rule applies appropriately.

8.147 Thirdly, Subdivision 45-Q will stop applying to a provisional head company of a MEC group just before the instalment quarter in which a cessation event happens to that company and the appointment of a new provisional head company takes effect. A cessation event happens when a provisional head company ceases to exist or ceases to satisfy the conditions for being a provisional head company see subsection 719-60(6) of the ITAA 1997. As explained in paragraphs 8.137 to 8.143, the Subdivision generally starts to apply to the new provisional head company at the start of the instalment quarter in which it becomes the provisional head company of the MEC group. ***[Schedule 24, item 18, paragraph 45-915(6)(c)]***

Observations about the application of Subdivision 45-Q

8.148 As mentioned in paragraph 8.122, section 45-915 is fundamental to the application of the PAYG instalments regime to members of a MEC group. That is because the operation of each of the provisions of Subdivision 45-Q for members of a MEC group requires Subdivision 45-Q to apply to the provisional head company of the group. That is, those other sections can only be applied to the members of a MEC group if Subdivision 45-Q applies to the groups provisional head company.

8.149 One consequence of using this approach is that Subdivision 45-Q can apply to an entity as provisional head company of a MEC group for all of a particular instalment quarter even though the entity is not a provisional head company for all of that quarter. For example, if a new provisional head company becomes the provisional head company of a MEC group part-way through an instalment quarter, Subdivision 45-Q applies to the new provisional head company for the whole quarter. Subdivision 45-Q does not just apply for the period it is actually the provisional head company. ***[Schedule 24, item 18, subsection 45-915(8)]***

8.150 In limited circumstances, the combined operation of section 45-915 and section 45-705 (about when Subdivision 45-Q applies to a head company of a consolidated group) may, at first, appear anomalous. One rule may state that Subdivision 45-Q *stops* applying to a particular entity just before a particular instalment quarter but another may state that it *starts* applying to the same entity at the beginning of that quarter. This will only happen if 2 or more events occur in the same quarter. For example, a conversion of a group from one kind to another and the interposition of a head company or change of provisional head company as a result of a cessation event may occur in the same quarter. Subdivision 45-Q will not, and is

not intended to, apply to an entity if the Subdivision stops applying to the entity before it starts applying to the entity. There will be another entity to which the Subdivision applies for the relevant instalment quarter. ***[Schedule 24, item 18, subsection 45-915(7)]***

Applying the single entity rule in relation to members of a MEC group

8.151 Section 45-710 states that an entity that is a subsidiary member of a consolidated group, and any other subsidiary member of the group, are taken to be parts of the head company of the group while they are subsidiary members. This ensures that the single entity rule applies for PAYG instalments purposes in the same way as section 701-1 of the ITAA 1997 applies for the core purposes covered by that section.

8.152 The operation of section 45-710 will be extended so that it also has effect for the members of a MEC group. That is, the other members of the MEC group will be taken to be parts of the provisional head company while they are members of the MEC group. ***[Schedule 24, item 18, subsections 45-910(1) and (2)]***

8.153 Further, in applying section 45-710 to the members of a MEC group at any time during an income year, the provisional head company will be assumed to be the head company of the MEC group for that part of the companys income year during which the group exists. As this means that a provisional head company of a MEC group must assume that the income derived by the other members of the group will be assessable to it, it will be able to properly work out its instalment income for a particular quarter. (In this regard, note that an entitys instalment income for an instalment quarter is defined to be the ordinary income derived by the entity in that quarter, to the extent to which that income is assessable income of the income year that includes that quarter.) ***[Schedule 24, item 18, section 45-917]***

New provisional head company treated as substituted for the former provisional head company

8.154 The September Consolidation Act contains rules that ensure that the tax position of a MEC group is not affected by the departure or change in membership status of a provisional head company of the MEC group. When a provisional head company of a MEC group stops being eligible to be a provisional head company (i.e. a cessation event happens to the provisional head company), the MEC group membership rules require the remaining eligible tier-1 companies to appoint a replacement provisional head company. That ensures the group continues in existence.

8.155 The September Consolidation Act rules ensure that the history of a head company of a MEC group is transferred to the new head company of the group by treating a new head company of a MEC group as if it were the former head company of the MEC group at all times before the cessation event happens see section 719-90 of the ITAA 1997. However, the rules only apply for certain purposes, such as assessing the new head company, for income years ending after the cessation event happens. The rules do not apply for PAYG instalments purposes.

8.156 A new section will deal with the PAYG instalments implications of a change in provisional head company of a MEC group. Its object will be to ensure that a new provisional head company will inherit the history of the former provisional head company for the purposes of the PAYG instalments regime. Further, the history of the new provisional head company will be ignored. ***[Schedule 24, item 18, subsection 45-920(1)]***

8.157 The new section will apply to a provisional head company of a MEC group (the new provisional head company) that is appointed as provisional head company under subsection 719-60(3) of the ITAA 1997 after a cessation event has happened to another provisional head company of the group (the former provisional head company). It will apply if:

- the former provisional head company is one to which Subdivision 45-Q applies at the end of the quarter before the quarter in which the cessation event happens, whether the Subdivision applies to it at that time in its capacity as a provisional head company of a MEC group or as the head company of a consolidated group from which the MEC group is created; or
- the former provisional head company would have become a company to which Subdivision 45-Q starts to apply during the quarter in which the cessation event happens, (whether as a

provisional head company of a MEC group or as the head company of a consolidated group from which the MEC group is created) if the cessation event had not happened and whether or not Subdivision 45-Q actually applied to it for any period of time.

[Schedule 24, item 18, paragraph 45-920(2)(a)]

8.158 The section will also apply where a new provisional head company is appointed in the same instalment quarter in which the MEC group is created from a consolidated group but the Commissioner is not notified of the creation of the MEC group until a subsequent quarter. For the section to apply in this situation, either of the following must be satisfied:

- the head company of the consolidated group from which the MEC group is created must be one to which Subdivision 45-Q applied at the end of the previous quarter; or
- the Commissioner must give that head company the initial head company instalment rate during the quarter in which the MEC group is created.

[Schedule 24, item 18, paragraph 45-920(2)(b)]

8.159 This is necessary because:

- until the Commissioner is notified of the creation of the MEC group in the later quarter, Subdivision 45-Q continues to apply to the head company of the consolidated group from which the MEC group is created; and
- the new provisional head company must still inherit the history of the former provisional head company even if Subdivision 45-Q does not immediately start to apply to it in the quarter in which it is appointed.

8.160 When the section applies, everything that happened in relation to the former provisional head company before the starting time (which is the time at which the cessation event occurs) will be taken to have happened instead to the new provisional head company. These things will be taken to have happened just as if, at all times before the starting time:

- the new provisional head company had been the former provisional head company; and
- the former provisional head company had been the new provisional head company.

That is, the new provisional head company is substituted for the former provisional head company. ***[Schedule 24, item 18, paragraphs 45-920(3)(a), (c) and (d) and subsection 45-920(4)]***

8.161 Further, things that happened to the former provisional head company prior to the starting time because of the operation of the consolidation regime or the PAYG instalments regime will be taken to have happened instead to the new provisional head company. ***[Schedule 24, item 18, subsections 45-920(3) and (5)]***

8.162 Subsections 45-920(3) and (5) will ensure, for example, that the new provisional head company will be taken to derive the instalment income that is derived by the former provisional head company, before the starting time, according to the single entity rule (in its extended operation for members of MEC groups).

8.163 However, the history of the new provisional head company that relates to periods prior to the starting time is effectively ignored. ***[Schedule 24, item 18, paragraph 45-920(3)(b)]***

8.164 An original or amended assessment of the former provisional head company, for an income year that ends before the income year that includes the starting time, will be taken to be something that happened to the new provisional head company regardless of when the assessment is made. This rule will apply to ensure that such assessments can be used to calculate an instalment rate for the new provisional head company, if they would have been used to calculate an instalment rate for the former provisional head company had it remained the provisional head company of the MEC group. ***[Schedule 24, item 18, subsection 45-920(6)]***

8.165 The new provisional head company will be substituted for the former provisional head company when applying the PAYG instalments regime to the members of the MEC group for any instalment quarter that ends after the starting time. This section and subsection 45-915(4)

ensure that the new provisional head company becomes liable to pay instalments as provisional head company of the MEC group from the instalment quarter in which the starting time occurs. It will remain so liable until Subdivision 45-Q stops applying to it. ***[Schedule 24, item 18, subsection 45-920(7)]***

8.166 To ensure that this section interacts appropriately with section 45-915 (which is about when Subdivision 45-Q applies to a provisional head company of a MEC group), subsections 45-920(1) to (7) will be disregarded in applying section 45-915. That means, the time when Subdivision 45-Q starts to apply to the new provisional head company will be determined under subsection 45-915(4). It will not be determined under section 45-920 on the basis that the new provisional head company will be taken, under section 45-920, to have been given the initial head company instalment rate actually given to the former provisional head company. ***[Schedule 24, item 18, subsection 45-920(8)]***

8.167 The former provisional head company may remain a member of the MEC group when a cessation event happens to it see subsection 719-60(6) and sections 719-65 and 719-75 of the ITAA 1997. If that happens, a PAYG instalments provision that, in its extended operation for members of MEC groups, applies when an entity becomes a member (other than the provisional head company) of a MEC group will not apply to the former provisional head company. For example, the section 45-755 entry rule will not apply if the former provisional head company remains a member of the MEC group. ***[Schedule 24, item 18, subsection 45-920(9)]***

Provisional head company taken to be a life company

8.168 Section 713-505 of the ITAA 1997, as contained in this bill, will treat a head company of a consolidated group or MEC group as a life insurance company for an income year if, during that year, the group contains a member that is a life insurance company.

8.169 A new section will ensure that this rule can be applied during an income year in relation to the members of a MEC group. A provisional head company of a mature MEC group will be taken to be a life insurance company for an instalment quarter if one or more life insurance companies are members of the group during that quarter or an earlier instalment quarter of the income year. ***[Schedule 24, item 18, section 45-922]***

8.170 A provisional head company of a mature MEC group that is taken to be a life insurance company will work out its instalment income according to subsection 45-120(1) and new subsection 45-120(2A), which is discussed at paragraphs 8.82 to 8.87.

Extended operation of Subdivision 45-R rules

Sections 45-855 and 45-860

8.171 Section 45-855 ensures that until a head company of a consolidated group is a mature head company, each member of the group works out its instalment income without regard to the single entity rule in section 701-1 of the ITAA 1997. That is, when each member of the group works out its instalments, it ignores the fact that the head company will be assessable on the income derived by the subsidiary members of the group.

8.172 Section 45-860 applies in the unusual case where the instalment quarter or income year of a subsidiary member of a consolidated group differs from that of the head company. It ensures that a subsidiary member pays an instalment for its instalment quarter or income year that includes the day on which the head company becomes a mature head company.

8.173 Sections 45-855 and 45-860 will be amended by this bill. The amendments will insert several references to the particular provisions of section 45-705 (about when Subdivision 45-Q applies to a head company of a consolidated group) because that section determines the day on which a head company becomes a mature head company. They are explained in more detail below at items 12 to 16 of Table 8.1.

8.174 As stated in paragraph 8.122, section 45-705 will not apply to a provisional head company of a MEC group. Instead, new section 45-915 will specify when Subdivision 45-Q applies to a provisional head company of a MEC group.

8.175 The operation of sections 45-855 and 45-860 will be extended to apply to the members of a MEC group under the general modification rules in new section 45-910 see paragraphs 8.112 to 8.118 for an explanation of that section. Further, a new section will effectively specify that the references, in sections 45-855 and 45-860, to provisions of section 45-705 are

to be read as references to the equivalent provisions of section 45-915, which states when Subdivision 45-Q will apply to a provisional head company of a MEC group. ***[Schedule 24, item 18, section 45-925]***

Sections 45-865 and 45-870 and subsection 45-30(4)

8.176 Section 45-865 makes the head company of a consolidated group entitled to a credit against its assessed income tax liability, for an income year that is a consolidation transitional year, for instalments payable by its subsidiary members. Subsection 45-30(4) is a related provision. It ensures that an amount credited to the head company cannot be taken into account again when working out a subsidiary members own entitlement to a PAYG instalments credit for any part of the income year in which it was not a member of the consolidated group.

8.177 Section 45-870 makes the head company of a consolidated group liable to pay the general interest charge in relation to certain PAYG instalments variations made by its subsidiary members.

8.178 The new section 45-910 modifications that extend the operation of the PAYG instalments regime to MEC group members are not appropriate for these 3 provisions. That is because these provisions are concerned with events following the assessment of the members of a MEC group after the end of the income year and not instalment liabilities arising during the income year. Therefore, those modifications will not apply in relation to sections 45-865 and 45-870. ***[Schedule 24, item 18, paragraph 45-910(3)(h)]***

8.179 Instead, a reference in those provisions to a consolidated group will be taken to be a reference to a MEC group and a reference to a MEC group will be taken to be a reference to a consolidated group. This will be enough to ensure that a reference in section 45-865 or 45-870 or subsection 45-30(4) to a head company, or subsidiary member, of a consolidated group will be a reference to the head company, or subsidiary member, of a MEC group rather than the provisional head company, or member (other than the provisional head company) of a MEC group. A reference in those provisions to a head company, or subsidiary member, of a consolidated group will *not* be taken to be to a provisional head company, or member (other than the provisional head company) of a MEC group. ***[Schedule 24, item 18, subsection 45-930(1)]***

8.180 However, those modifications will not apply to subsection 45-865(4). That section itself modifies the operation of subsection 45-865(3) and therefore does not need to be modified further. ***[Schedule 24, item 18, subsection 45-930(2)]***

Section 45-885

8.181 New section 45-885 will affect an entity that ceases to be a subsidiary member of a mature consolidated group and its wholly-owned subsidiaries. While the operation of that section will be extended to members of a MEC group through the new section 45-910 modifications to deal with MEC group members, further and more specific modifications are needed.

8.182 These further modifications ensure that:

- paragraph 45-885(1)(e), which requires the Commissioner to be notified of the consolidation of a consolidated group under section 45-703-50 of the ITAA 1997, is replaced by a paragraph which requires the Commissioner to be notified of the decision to consolidate a MEC group;
- the reference, in subsection 45-885(2) and in the note at the end of that subsection, to paragraph 45-760(2)(a) will be taken to be a reference to that paragraph as it applies in its extended operation to members of a MEC group; and
- the reference to section 45-705 (about when Subdivision 45-Q applies to a head company of a consolidated group), in the note at the end of subsection 45-885(2), will be taken to be a reference to section 45-915 (about when Subdivision 45-Q applies to a provisional head company of a MEC group).

[Schedule 24, item 18, section 45-935]

Application and transitional provisions

8.183 All but one of the amendments discussed in this chapter will take effect from 1 July 2002, along with other aspects of the consolidation measures. ***[Schedule 24, subitem 19(2) and item 23]***

8.184 However, item 1 of Schedule 24, which deals with the instalment income of a life insurance company, will apply in relation to an income year that begins on or after 1 July 2003. Paragraph 8.87 explains the reason for this. ***[Schedule 24, subitem 19(1)]***

Consequential amendments

8.185 The amendments described earlier in this chapter are the more significant consequential changes that need to be made to the PAYG instalments regime so that it can operate consistently with the provisions of the consolidation regime. In particular, they ensure that the PAYG instalments regime operates appropriately for both consolidated groups and MEC groups.

8.186 However, there are other consequential amendments to the TAA 1953 and the dictionary to the ITAA 1997. They are discussed in Table 8.1 and Table 8.2 respectively.

8.187 Unless it is otherwise clear from the context, where the tables refer generally to a consolidated group, or a head company or subsidiary member of a consolidated group, the references should be read as appropriate references to a MEC group, or a provisional head company or other member of a MEC group.

Table 8.1: Consequential amendments to the TAA 1953

Schedule 24, item no.	***Provision amended***	***Explanation***
2 and 6	45-160, 45-720	A new section will be inserted to complement section 45-720. That section states that a head company of a consolidated group cannot choose to be an annual payer while it is a mature head company. New section 45-160 will ensure that a head company will stop being an annual payer if it is an annual payer when it becomes a head company to which Subdivision 45-Q applies. A note will be inserted after section 45-720 to alert the reader to the operation of section 45-160.
3	45-330	Section 45-330 states how an entitys adjusted taxable income is worked out for the purposes of calculating the entitys instalment rate or GDP-adjusted notional tax amount. It includes a provision that applies to life insurance companies. Two new subsections will be inserted. They will apply when a life insurance company has tax losses transferred to it under Subdivision 707-A of the ITAA 1997. The new subsections will complement subsection 45-330(2A). That subsection applies when any other company has tax losses transferred to it under Subdivision 707-A of that Act. Where a life insurance company has had tax losses transferred to it on the

		formation of a consolidated group, the amount of tax losses taken into account when calculating its adjusted taxable income (for instalment rate calculation purposes) will be the lesser of the tax losses: • deducted in the base year; or • carried forward to the next income year. A new note also acknowledges that the life insurance company rules of section 45-330 will apply to a head company of a consolidated group that is taken to be a life insurance company, by section 713-505 of the ITAA 1997. That will happen if a subsidiary member of the group is a life insurance company.
4	notes to 45-700	Section 45-700 is the guide to Subdivision 45-Q which contains the rules that apply to members of mature consolidated groups. The existing notes will be repealed and replaced by 2 new notes. The new notes explain the effect of Subdivisions 45-R and 45-S.
8	45-760(1)	Section 45-760, the exit rule, requires an entity to commence paying instalments when it ceases to be a subsidiary member of a mature consolidated group and does not immediately become a subsidiary member of another mature consolidated group. Subsection 45-760(1) will be repealed and replaced by a new subsection that makes it clear that the exit rule: • only applies to an entity of the kind referred to in section 45-10 that is required to pay PAYG instalments; and • will not apply if the exiting entity immediately joins either a mature consolidated group or a mature MEC group. That is, the exit rule will not apply to a former subsidiary member of a consolidated group that is a partnership or trust as such entities are not required to pay instalments. Further, the exiting entity will not be liable to pay an instalment if it immediately becomes a subsidiary member of another mature group, whatever kind of group it is.
10	Subdivision 45-R heading	The heading to Subdivision 45-R will be amended because the existing heading does not reflect the effect of two new sections being added to the Subdivision.
11	45-850	Section 45-850 is the guide to Subdivision 45-R. It will be repealed and replaced by a new section that extends the guide to deal with the new rules that apply when: • the head company of a mature group is acquired by a member of another group; or • a member of a mature group ceases to be such a member and becomes the head company of a new consolidated group.
12	45-855	Section 45-855 ensures that, until a head company of a consolidated group is a mature head company, each member of the group works out its instalment income without regard to the single entity rule in section 701-1 of the ITAA 1997. That is, when each member of the group pays its instalments, it ignores the fact that the head company will be assessable on the income derived by the member of the group. Paragraph (b) of that section will be repealed and replaced by a new paragraph that takes account of the amendments to section 45-705 made

		by this bill. The revised paragraph ensures that section 45-855 only applies for the period that: • starts when the group comes into existence (as a result of an entitys choice to consolidate the group); and • ends just before the instalment quarter in which a head company of the group is treated as a mature head company for the first time.
13-16	45-860	Section 45-860 applies in the unusual case where the instalment quarter or income year of a subsidiary member of a consolidated group is different from that of the head company. It ensures that a subsidiary member pays an instalment for its instalment quarter or income year that includes the day on which the head company becomes a mature head company. Consistent with the previous item of this table, these amendments ensure that section 45-860 only applies in relation to an instalment payable during the period that: • starts when the group comes into existence (as a result of an entitys choice to consolidate the group); and • ends just before the instalment quarter in which a head company of the group is treated as a mature head company for the first time.
17	45-865	Section 45-865 makes the head company of a consolidated group entitled to a credit against its assessed income tax liability for an income year that is a consolidation transitional year for instalments payable by its subsidiary members. Two new subsections will be inserted. They will ensure that an amount credited to one head company is not taken into account when working out the credit of another head company. They will apply if an entity is a subsidiary member of 2 or more consolidated groups, 2 or more MEC groups, or one or more consolidated groups and one or more consolidated groups. The respective head companies must work out an appropriate basis for apportioning the instalment of an entity that is a subsidiary member of more than one group for an instalment quarter or income year.

Table 8.2: Consequential amendments to the ITAA 1997

Schedule 24, item no.	*Provision amended*	*Explanation*
20	995-1(1)	The definition of ***consolidation transitional year*** will be repealed and replaced by a new definition. The amendment will ensure that the term is appropriately defined for members of both consolidated groups and MEC groups and applies only in relation to the formation of a consolidated group or MEC group under section 703-50 or 719-50. A consolidation transitional year for a member of a consolidated group or MEC group is an income year that satisfies both of the following conditions:

		o the group is in existence during all or a part of that year; o Subdivision 45-Q either does not apply at all to the head company or provisional head company of the group during that year, or starts to apply to that entity for the first time during that year.

Chapter 9

Consolidation: imputation rules

Outline of chapter

9.1 Schedule 9 to this bill introduces imputation rules that are relevant to consolidated groups, namely:

- the application of the exempting entity provisions to consolidated groups;
- the franking of distributions by a member of a consolidated group whose membership interests are held by a non-resident;
- the transfer of franking account balances between eligible tier-1 entities in a MEC group where a new provisional head company is appointed;
- the franking of distributions by eligible tier-1 entities in a MEC group other than by the head or provisional head company; and
- the franking of distributions by entities in a MEC group (other than by eligible tier-1 companies) to non-resident interposed entities.

Context of reform

9.2 As part of the introduction of the consolidation regime, *A Tax System Redesigned* recommended that a consolidated group operate a single franking account at the head entity level and that all the existing franking credits of members of the group be pooled.

9.3 In order to fulfil the recommendations of *A Tax System Redesigned*, the franking account rules for consolidated groups introduced in the May Consolidation Act provide for the pooling of franking credits. The provisions also set out special rules for the operation of the franking accounts of both the head company and of a subsidiary member of a consolidated group during the period of consolidation.

9.4 Consistent with the principles relating to the pooling of franking credits and the operation of a single franking account for a consolidated group, the imputation rules introduced in Schedule 9 to this bill provide for the application of the exempting entity franking rules to a consolidated group, pooling of exempting credits where appropriate, and special rules for the operation of exempting accounts of the head company and subsidiary members during consolidation.

9.5 In addition, the rules introduced in this bill deal with special franking account issues for MEC groups to give practical effect (in relation to imputation) to the recommendations of *A Tax System Redesigned* to allow resident wholly-owned subsidiaries of a foreign company to consolidate for tax purposes as a MEC group.

Summary of new law

Exempting entity rules for consolidated groups

9.6 This section sets out rules to ensure that the exempting entity provisions introduced in the June Consolidation Act apply appropriately to consolidated groups.

9.7 These rules are used to determine the status of a consolidated group (i.e. whether it is an exempting entity, former exempting entity or neither of the 2) and to determine the franking account and exempting account consequences that arise when an exempting entity or a former exempting entity joins a consolidated group.

Special franking rules for MEC groups

Appointment of a new provisional head company

9.8 These rules ensure that where there is a change in the provisional head company during the life of a MEC group (i.e. a new provisional head company is appointed because a cessation event occurs under subsection 719-60(3)) that the franking account balance of the former provisional head company is transferred to the new provisional head company. Note that a cessation event occurs where a company ceases to qualify as a provisional head company of a group or the company ceases to exist.

9.9 The rules provide that where a new provisional head company is appointed as a result of subsection 719-60(3), the franking account balance of the former provisional head company is cancelled and the account becomes inoperative. The new provisional head companys franking account becomes operative and a franking surplus or deficit (as appropriate) arises in the new provisional head companys franking account equal to the surplus or deficit in the former provisional head companys franking account immediately before the new provisional head company is appointed.

Distributions by eligible tier-1 entities other than the provisional head company of the group

9.10 These rules deal with the payment of distributions by eligible tier-1 entities within the MEC group which are not the provisional head company of the group.

9.11 The rules provide that where an eligible tier-1 entity makes a frankable distribution and that entity is not the provisional head company, Part 3-6 (the imputation provisions) operates as if the distribution were a frankable distribution made by the provisional head company.

Distributions by group members not being eligible tier-1 companies whose membership interests are held by non-residents

9.12 These rules deal with the franking of distributions by group members which are not eligible tier-1 companies and whose membership interests are held by non-residents.

9.13 The rules provide that where a frankable distribution is made by a group member whose membership interests are held by non-residents and that entity is not an eligible tier-1 company, Part 3-6 operates as if the distribution were a frankable distribution made by the provisional head company.

Special franking rules for transitional foreign-held entities

9.14 These rules deal with the franking of distributions by a group member whose membership interests are held by a non-resident.

9.15 The rules provide that where a frankable distribution is made by that member, Part 3-6 operates as if the distribution were a frankable distribution made by the head company.

Detailed explanation of new law

Exempting entities and former exempting entities

9.16 Subdivision 709-B modifies the operation of Division 208, which deals with exempting entities and former exempting entities, in relation to consolidated groups. ***[Schedule 9, item 4, section 709-150]***

9.17 Division 208 limits franking credit trading by:

- prescribing that franked distributions paid by corporate tax entities, which are effectively owned by non-residents or tax-exempt entities, will provide franking benefits to members in limited circumstances only; and
- quarantining the franking surpluses of corporate tax entities which were formerly effectively owned by non-residents or tax-exempt entities.

Testing consolidated groups

9.18 The tests in Division 208 (relating to ownership by non-residents) are applied to the head company of a consolidated group to determine whether the group is an exempting entity or a former exempting entity. ***[Schedule 9, item 4, subsection 709-155(1)]***

9.19 However, the application of Division 208 is modified in some circumstances for consolidated groups. ***[Schedule 9, item 4, subsection 709-155(2)]***

9.20 When Subdivision 709-B modifies the operation of Division 208 for consolidated groups, Division 208 is applied to determine the status of the head company of the group and then to determine the status of the subsidiary member. However, the status of the subsidiary member is determined on the assumption that the subsidiary was not actually a member of the group at the time. ***[Schedule 9, item 4, subsection 709-155(3)]***

9.21 Once the status of the subsidiary member has been determined as above, Division 208 does not operate in relation to the subsidiary. ***[Schedule 9, item 4, subsection 709-155(4)]***

9.22 Table 9.1 summarises the operation of the exempting entity rules for consolidated groups.

Table 9.1: Exempting entities, former exempting entities and consolidated groups

		Status of head company of a consolidated group		
		Neither an exempting entity nor a former exempting entity	***Exempting entity***	***Former exempting entity***
Status of subsidiary member	***Neither an exempting entity nor a former exempting entity***	Status of head company does not change. Subsection 709-60(2) transfers any franking account surplus to the head company and subsection 709-60(3) imposes a liability for franking deficit tax if the franking account is in deficit. Under section 709-65 the subsidiary members franking account does not operate.		Status of head company does not change. ***[Schedule 9, item 4, subsection 709-175(5)]*** Sections 709-60 and 709-65 apply.

Table continues on next page

	Status of head company of a consolidated group

		Neither an exempting entity nor a former exempting entity	***Exempting entity***	***Former exempting entity***
Status of subsidiary member	***Exempting entity***	Head company becomes a former exempting entity. ***[Schedule 9, item 4, subsection 709-160(2), item 1 in the table]*** Head company has both a franking account and an exempting account. ***[Schedule 9, item 4, subsection 709-160(2), item 2 in the table]*** Any surplus in the subsidiary members franking account is transferred to the head companys exempting account. ***[Schedule 9, item 4, subsection 709-160(2), item 3 in the table]*** Subsection 709-60(2) does not operate. ***[Schedule 9, item 4, subsection 709-160(2), item 4 in the table]*** If the subsidiary members franking account is in deficit, subsection 709-60(3) imposes a liability for franking deficit tax. Section 709-65 applies.	Status of head company does not change. ***[Schedule 9, item 4, section 709-170]*** Sections 709-60 and 709-65 apply.	Status of head company does not change. ***[Schedule 9, item 4, subsection 709-175(2), item 1 in the table]*** Any franking account surplus of the subsidiary member is transferred to the exempting account of the head company. ***[Schedule 9, item 4, subsection 709-175(2), item 2 in the table]*** Subsection 709-60(2) does not operate. ***[Schedule 9, item 4, subsection 709-165(2), item 3 in the table]***

Table continues on next page

		Status of head company of a consolidated group		
		Neither an exempting entity nor a former exempting entity	***Exempting entity***	***Former exempting entity***

Status of subsidiary member	***Former exempting entity***	Head company becomes a former exempting entity. ***[Schedule 9, item 4, subsection 709-165(2), item 1 in the table]*** Head company has both a franking account and an exempting account. ***[Schedule 9, item 4, subsection 709-165(2), item 2 in the table]*** Any surplus in the subsidiary members exempting account is transferred to the head companys exempting account. ***[Schedule 9, item 4, subsection 709-165(2), item 3 in the table]*** Any deficit in the subsidiary members exempting account is transferred to the subsidiary members franking account. ***[Schedule 9, item 4, subsection 709-165(2), item 4 in the table]*** The subsidiary members exempting account does not operate while it is a subsidiary member of the consolidated group. ***[Schedule 9, item 4, subsection 709-165(2), item 5 in the table]*** Sections 709-60 and 709-65 apply.		Status of head company does not change. ***[Schedule 9, item 4, subsection 709-175(4), item 1 in the table]*** Any surplus in the subsidiary members exempting account is transferred to the head companys exempting account. ***[Schedule 9, item 4, subsection 709-175(4), item 2 in the table]*** Any deficit in the subsidiary members exempting account is transferred to the subsidiary members franking account. ***[Schedule 9, item 4, subsection 709-175(4), item 3 in the table]*** Subsection 709-60(3) imposes franking deficit tax if the subsidiary members franking account is in deficit. Under section 709-65 the subsidiary members franking account does not operate. ***The subsidiary members exempting account does not operate while it is a subsidiary member of the consolidated group. [Schedule 9, item 4, subsection 709-175(4), item 4 in the table]***

The subsidiary member is an exempting entity

9.23 When the head company of a consolidated group is neither an exempting entity nor a former exempting entity as determined under Division 208, and a corporate tax

entity, which becomes a subsidiary member of the group at the joining time, is an exempting entity at that time, then the head company becomes a former exempting entity at the joining time. ***[Schedule 9, item 4, section 709-160]***

9.24 In these circumstances, the head company has both a franking account and an exempting account ***under*** subsection 709-160(2) and the subsidiary members franking account does not operate while it is a member of the group in accordance with section 709-65.

9.25 Any franking surplus in the subsidiary members franking account at the joining time is transferred to the head companys exempting account by the following entries:

- a debit equal to the surplus arises in the subsidiary members franking account at the joining time; and
- a credit equal to the surplus arises in the exempting account of the head company at the joining time.

[Schedule 9, item 4, subsection 709-160(2)]

9.26 As a result of these entries a number of existing rules relating to the treatment of franking accounts upon consolidation and former exempting entities are not required:

- subsection 709-60(2), which transfers a franking account surplus from a subsidiary member to the head company on consolidation, does not apply to the subsidiary member;
- item 1 in the table in section 208-115 (exempting credits) does not apply to the head company;
- item 1 in the table in section 208-120 (exempting debits) does not apply to the head company;
- item 1 in the table in section 208-130 (franking credits and exempting entities or former exempting entities) does not apply to the head company; and
- item 1 in the table in section 208-145 (franking debits and exempting entities or former exempting entities) does not apply to the head company. ***[Schedule 9, item 4, subsection 709-160(2)]***

9.27 It should be noted that if the subsidiary member has a deficit in its franking account at the joining time, it will be liable for franking deficit tax in accordance with subsection 709-60(3).

The subsidiary member is a former exempting entity

9.28 When the head company of a consolidated group is neither an exempting entity nor a former exempting entity, and a corporate tax entity, which becomes a subsidiary member of the group at the joining time, is a former exempting entity at that time, then the head company becomes a former exempting entity at the joining time. ***[Schedule 9, item 4, section 709-165]***

9.29 In these circumstances, the head company has both a franking account and an exempting account. The subsidiary members franking account does not operate while it is a member of the group in accordance with section 709-65 nor does its exempting account. ***[Schedule 9, item 4, subsection 709-165(2)]***

9.30 Any exempting surplus in the subsidiary members exempting account at the joining time is transferred to the head companys exempting account by the following entries:

- a debit equal to the surplus arises in the subsidiary members exempting account at the joining time; and
- a credit equal to the surplus arises in the exempting account of the head company at the joining time.

[Schedule 9, item 4, subsection 709-165(2)]
9.31 Any exempting deficit in the subsidiary members exempting account at the joining time is transferred to the franking account of the subsidiary member by the following entries:

- a credit equal to the deficit arises in the subsidiarys exempting account at the joining time; and
- a debit equal to the deficit arises in the subsidiarys franking account just before the joining time.

[Schedule 9, item 4, subsection 709-165(2)]
9.32 As a result of these entries a number of existing rules relating to the treatment of franking accounts upon consolidation and former exempting entities are not required:

- item 1 in the table in section 208-115 (exempting credits) does not apply to the head company;
- item 1 in the table in section 208-120 (exempting debits) does not apply to the head company;
- item 1 in the table in section 208-130 (franking credits and exempting entities or former exempting entities) does not apply to the head company; and
- item 1 in the table in section 208-145 (franking debits and exempting entities or former exempting entities) does not apply to the head company.

[Schedule 9, item 4, subsection 709-165(2)]
9.33 It should be noted that if the subsidiary member has a surplus in its franking account it will be transferred to the head companys franking account under subsection 709-60(2) and any deficit in its franking account taking into consideration the transfer of any deficit from its exempting account will result in a liability for franking deficit tax in accordance with subsection 709-60(3).
The head company and subsidiary are exempting entities
9.34 The status of a head company of a consolidated group does not change if:

- the head company is an exempting entity; and
- the corporate tax entity becoming a subsidiary member at the joining time is also an exempting entity.

[Schedule 9, item 4, section 709-170]
9.35 The franking account of the subsidiary member does not operate while it is a member of the group in accordance with section 709-65. Any surplus in the subsidiary members franking account will be transferred to the franking account of the head company (subsection 709-60(2)) and any deficit in the subsidiarys franking account will result in a liability for franking deficit tax under subsection 709-60(3).
The head company is a former exempting entity
9.36 When the head company of a consolidated group is a former exempting entity under Division 208, and a corporate tax entity, which becomes a subsidiary member of the group at the joining time, is an exempting entity at that time, then the status of the head company does not change. ***[Schedule 9, item 4, subsections 709-175(1) and (2)]***
9.37 Any franking surplus in the subsidiary members franking account at the joining time is transferred to the head companys exempting account by the following entries:

- a debit equal to the surplus arises in the subsidiary members franking account at the joining time; and

- a credit equal to the surplus arises in the exempting account of the head company at the joining time.

[Schedule 9, item 4, subsection 709-175(2)]
9.38 As a result of these entries subsection 709-60(2), which transfers a franking account surplus from a subsidiary member to the head company on consolidation, does not apply to the subsidiary member. ***[Schedule 9, item 4, subsection 709-175(2)]***
9.39 However, subsection 709-60(3) applies to impose a liability for franking deficit tax if the subsidiarys franking account is in deficit. The subsidiary members franking account does not operate while it is a member of the group under section 709-65.
9.40 When the head company of a consolidated group is a former exempting entity, and a corporate tax entity, which becomes a subsidiary member of the group at the joining time, is a former exempting entity at that time, then the status of the head company does not change. ***[Schedule 9, item 4, subsections 709-175(3) and (4)]***
9.41 Any exempting surplus in the subsidiary members exempting account at the joining time is transferred to the head companys exempting account by the following entries:

- a debit equal to the surplus arises in the subsidiary members exempting account at the joining time; and

- a credit equal to the surplus arises in the exempting account of the head company at the joining time.

[Schedule 9, item 4, subsection 709-175(4)]
9.42 Any exempting deficit in the subsidiary members exempting account at the joining time is transferred to the franking account of the subsidiary member by the following entries:

- a credit equal to the deficit arises in the subsidiarys exempting account at the joining time; and

- a debit equal to the deficit arises in the subsidiarys franking account just before the joining time.

[Schedule 9, item 4, subsection 709-175(4)]
9.43 Section 709-60 operates in relation to the subsidiary members franking account. Neither the subsidiarys franking account (section 709-65) nor the subsidiarys exempting account operates while the subsidiary is a member of the group. ***[Schedule 9, item 4, subsection 709-175(4)]***
9.44 When the head company of a consolidated group is a former exempting entity in accordance with Division 208, and a corporate tax entity, which becomes a subsidiary member of the group at the joining time, is neither an exempting entity nor a former exempting entity at that time, then the status of the head company does not change. ***[Schedule 9, item 4, subsection 709-175(5)]***
9.45 Section 709-60 operates in relation to the subsidiary members franking account and the subsidiarys franking account does not operate while the subsidiary is a member of the group under section 709-65.
The subsidiary members distributions to a foreign resident are taken to be distributions by the head company
9.46 To ensure that frankable distributions made by subsidiary members of a consolidated group receive the benefits of the imputation system contained in Part 3-6, special rules are required.
9.47 Part 3-6 operates as if a frankable distribution made by a subsidiary member of a consolidated group (the foreign-owned subsidiary) had been made by the head company of the group if the foreign-owned subsidiary meets certain requirements in section 703-45, section 701C-10 of the IT(TP) Act 1997 or section 701C-15 of that

Act and the distribution is made to a foreign resident. ***[Schedule 9, item 5, section 709-90]***

MEC groups

9.48 Subdivision 719-H contains imputation rules relevant only to MEC groups. ***[Schedule 9, item 5, section 719-425]***

Transfer of the franking account balance on a cessation event

9.49 When a cessation event happens to a provisional head company of a MEC group (the former head company) and another company (the new head company) is appointed as the provisional head company under subsection 719-60(3), rules are required to transfer franking account balances. ***[Schedule 9, item 5, subsection 719-430(1)]***

9.50 When the new head company is appointed, the following rules apply:

- the franking account of the former head company ceases to operate ***[Schedule 9, item 5, paragraph 719-430(2)(a)]***;
- the new head company has a franking account ***[Schedule 9, item 5, paragraph 719-430(2)(b)]***; and
- any franking surplus or franking deficit in the former head companys franking account just before the cessation event occurred is transferred to the franking account of the new head company ***[Schedule 9, item 5, paragraph 719-430(2)(c)]***.

Distributions by subsidiary members of a MEC group are taken to be distributions by the head company

9.51 To ensure that certain subsidiary members of MEC groups are able to frank distributions under Part 3-6, rules are required.

9.52 Part 3-6 operates as if a frankable distribution made by an eligible tier-1 company that is a member of a MEC group and is not the provisional head company of the group had been made by the provisional head company of the group to a member of the provisional head company. ***[Schedule 9, item 5, subsection 719-435(1)]***

9.53 Part 3-6 also operates as if a frankable distribution made by a subsidiary member of a MEC group (the foreign-owned subsidiary) that is not an eligible tier-1 company was a frankable distribution made by the head company of the group to a member of the head company where the foreign-held subsidiary meets certain requirements in sections 703-45 and 701C-10 of the IT(TP) Act 1997 or section 701C-15 of that Act and the distribution is made to a foreign resident. ***[Schedule 9, item 5, subsection 719-435(2)]***

Special franking rules for transitional foreign-held entities

9.54 Part 3-6 also operates as if a frankable distribution made by a transitional foreign-held entity was a frankable distribution made by the head company of the group to a member of the head company where the foreign-held subsidiary meets certain requirements in sections 703-45 and 701C-10 of the IT(TP) Act 1997 or section 701C-15 of that Act and the distribution is made to a foreign resident. ***[Schedule 9, item 2, section 709-90]***

Example 9.1

Assume B Co and C Co are Australian resident wholly-owned subsidiaries of a foreign holding parent, A Co, and that D Co is a wholly-owned resident subsidiary of C Co. Both B Co and C Co are eligible tier-1 companies of a potential MEC group. Under Division 208, B Co, C Co and D Co are all exempting entities.

On 1 July 2003, B Co and C Co decide to form a MEC group. B Co is appointed the provisional head company of the MEC group with C Co and D Co comprising the other eligible members. The effect of the imputation rules is that a MEC group will,

by definition, always be an exempting entity. Therefore, distributions made by the provisional head company will be subject to Division 208 of the ITAA 1997.
In addition, assume that after the MEC group is formed, E Co, an Australian owned and resident company, is acquired by C Co and therefore becomes a subsidiary member of the MEC group. Once acquired by C Co, E Co (neither an exempting or former exempting entity prior to acquisition) becomes an exempting entity as it is now wholly-owned by an exempting entity (the MEC group).
As a consequence of joining the consolidated group, E Cos franking account balance is transferred to B Co.
The status of the head company as an exempting entity is not affected by E Co becoming a member of the MEC group.
Example 9.2

Assume the facts are as presented in Example 9.1 except that in the present example, E Co is an Australian owned and resident company which was *formerly* 100% owned by a foreign company at the time of joining the MEC group (i.e. it is a former exempting company immediately before acquisiton).
In addition, assume that F Co is also purchased by C Co. F Co is neither an exempting entity nor a former exempting entity prior to acquisition.
Upon being acquired by C Co, E Co becomes an exempting entity as it is now wholly-owned by an exempting entity (the MEC group).
Under Division 208, E Cos exempting account balance is merged with their franking account balance under sections 208-120 and 208-130.
When E Co joins the group, its franking account balance is transferred to B Co in accordance with the ordinary franking account balance transfer rules in Division 709.

The status of the head company as an exempting entity is not affected by E Co becoming a member of the MEC group.
Upon joining the group, F Co also becomes an exempting entity, as it is now wholly-owned by an exempting entity. F Cos franking account is pooled with that of the head companys in accordance with the ordinary franking account balance transfer rules in Division 709.
The status of the head company as an exempting entity is not affected by F Co becoming a member of the MEC group.
Example 9.3

Assume that on 1 July 2003, A Co makes an election to consolidate and becomes the head company of a consolidated group which comprises D Co and C Co as the eligible subsidiary members.
Immediately prior to consolidating, C Co is an exempting entity as it is wholly-owned by an interposed non-resident entity (B Co).
In the above example, the act of consolidating will result in A Co becoming a former exempting entity.
Immediately after consolidating, A Co will have both a franking account balance and an exempting account balance. Its franking account balance will comprise any franking credits it had in its account prior to consolidating, in addition to those franking credits which may have been transferred to it from D Co in accordance with Division 709.
The balance in A Cos exempting account will comprise the transfer of C Cos franking account upon becoming a member of the group.
Consequential amendments
9.55 Section 177EB of the ITAA 1936 is amended to extend its application to exempting credits arising in the exempting account of a head company of a consolidated group. ***[Schedule 9, item 1, subsection 177EB(11)]***

Chapter 10

Technical and consequential amendments for collection of unpaid group debts

Outline of chapter

10.1 This chapter explains technical amendments to Division 721 of the ITAA 1997, and amendments consequential to the introduction of the Division. Division 721 deals with liability for payment of tax and tax-related liabilities where the head company of a consolidated group fails to pay on time.

Context of reform

10.2 The May Consolidation Act inserted Division 721 of Part 3-90 into the ITAA 1997. The Division specifies what happens where the head company of a consolidated group fails to satisfy a group income tax-related liability by the due and payable date. The Division provides that the head company and each of the contributing members of the group are joint and severally liable to pay the group liability, unless the liability is covered by a TSA, in which case the members are liable according to that agreement.

10.3 The technical amendments to Division 721 are required to ensure that the Division operates as intended and is compatible with existing administrative provisions. The consequential amendments are required to ensure that the Division is compatible with the other provisions in the current law.

Summary of the amendments

10.4 The amendments will make a number of changes to provisions of the ITAA 1997. These changes are required to ensure that the consolidation liability rules operate as intended.

10.5 The franking provisions for consolidated groups in Division 709 are amended to ensure that payments of group debts by contributing members, and refunds of group tax to contributing members, will give rise to credits and debits only in the franking account of the head company.

10.6 The table of tax-related liabilities in Division 721 to which the consolidation liability provisions apply is amended to include references to GIC liabilities under section 45-870, and to certain administrative penalties under Divisions 284, 286 and 288 in Schedule 1 to the TAA 1953.

10.7 The provisions in Division 721 which specify when a joint and several liability or a TSA liability are due and payable, and the requirements for notification of the liability, are amended to address situations where the group liability is GIC. The GIC will be due and payable on the day of notification.

10.8 A new provision is inserted into Division 721 to provide that the liability of contributing members under a TSA is separate from but linked to that of the head company for the particular group liability. The new provision will also specify how payments made by a contributing member or by the head company towards discharging the group debt are offset against the other linked liabilities.

10.9 The consequential amendments will insert references to the joint and several liability and TSA liability into the list of tax-related liabilities to which the general recovery provisions in Part 4-15 in Schedule 1 to the TAA 1953 apply.

Comparison of key features of new law and current law

New law	*Current law*
Where a contributing member that has left the group makes a payment in discharge of a joint and several group liability, a credit will only arise in the franking account of the head company. If an amount paid towards a group debt is refunded to a contributing member, a debit will only arise in the head companys franking account.	Where a contributing member that has left the group makes a payment in discharge of a joint and several group liability, a credit may arise in the franking account of the head company and the franking account of the contributing member. Refunds of group tax to a contributing member will result in a debit in both franking accounts.
The list of tax-related liabilities to which	Division 721 applies to tax-related liabilities

Division 721 applies will include GIC for PAYG instalments, and certain administrative penalties.	listed in the table in subsection 721-10(2). The table does not currently include GIC for PAYG instalments, or administrative penalties.
A group GIC liability that is not paid on time is a joint and several liability or TSA liability of a contributing member. The liability is due and payable at the end of the day on which the Commissioner gives the member written notice of the liability. When a group liability is GIC that is payable for a day in respect of an unpaid primary group liability, the Commissioner will be taken to have given notice to a contributing member of the GIC that is payable for a subsequent day on that subsequent day. The GIC will be due at the end of that subsequent day.	The law does not specify how a group GIC liability that is not paid on time accrues to contributing members. The current notification rules are not appropriate for GIC.
The liability of the group and the liabilities of the contributing members are separate liabilities but are linked. When an amount is paid or applied towards discharging the TSA liability, the linked group liability is discharged by the same amount. **When a payment by the head company results in the amount unpaid on the TSA liability exceeding the amount unpaid on the linked liability at that time, the TSA liability is discharged to the extent of the excess. The TSA liability is not reduced if there is no excess.**	**The law does not clearly specify the linked nature of the liability of the head company and the liability of TSA contributing members. The law also does not specify how payments are to be offset against these linked liabilities.**
The table of debts to which recovery provisions in Part 4-15 in Schedule 1 to the TAA 1953 apply includes TSA liabilities arising under Division 721. Joint and several liabilities are referred to in a note to the table.	**The table of debts to which recovery provisions in Part 4-15 in Schedule 1 to the TAA 1953 apply does not refer to the joint and several liability and TSA liabilities arising under Division 721.**

Detailed explanation of the amendments

Franking credits and debits

10.10 The general principle governing the operation of franking accounts for consolidated groups is that a transaction will give rise to a change in the franking account of the head company only. Section 709-65 provides that the franking account of a subsidiary member does not operate during the period of consolidation. Sections 709-70 and 709-75 provide that payments and refunds that would give rise to credits and debits in the franking account of the subsidiary, instead give rise to credits or debits of the same amount in the account of the head company.

10.11 A member of a consolidated group may exit the group but will remain liable to pay the joint and several liability arising under Division 721. The franking account of the member is re-activated when the member leaves a consolidated group. A franking credit would arise in the contributing members franking account if the member makes a payment in discharge of a joint and several liability for which it is liable after the time of leaving (*leaving time*). Similarly, a debit will arise in its franking account where there is a refund of an amount to the exited contributing member. These credits and debits are contrary to the intention of the

imputation rules for consolidation that payments of group debts will give rise to credits and debits only in the franking account of the head company.

10.12 Section 709-95 is inserted into Division 709 to ensure that a payment of group tax by an exited member will not give rise to a franking credit for the member. The new section will apply if an entity ceases to be a subsidiary member and at or after the leaving time pays income tax or a PAYG instalment that would give rise to a credit in its franking account. The payment will not give rise to a credit at the crediting time in the franking account of the former subsidiary. The credit will instead arise in the franking account of the entity that was the head company at the leaving time. The group of which this company is the head company is described in the provisions as the old group to address cases where the group continues, as well as cases where consolidation ceases. ***[Schedule 14, item 1, section 709-95]***

10.13 Section 709-100 is inserted to ensure that a refund of group tax to a contributing member that has exited the group does not give rise to a debit in the franking account of the contributing member. The provision is expressed in similar terms to section 709-95 The debit will instead arise in the franking account of the entity that was the head company at the leaving time. ***[Schedule 14, item 1, section 709-100]***

10.14 Members are also liable to pay amounts under a TSA after leaving the group unless they satisfy the conditions specified in section 721-35. The key condition is that the member makes a payment to the head company before it leaves the group. However, credits and debits will not arise in relation to TSA liabilities because the TSA liability is a separate and distinct liability. The amount paid by the contributing member is an amount that will be credited against the group liability, but it does not itself represent a payment of income tax or of a PAYG instalment.

Additional tax-related liabilities to which Division 721 applies

10.15 Subsection 721-10(1) provides that Division 721 operates if a tax-related liability of the head company of a consolidated group mentioned in the table in subsection 721-10(2) is not paid or otherwise discharged in full by the time the liability became due and payable. The table in subsection 721-10(2) also specifies the period to which the tax-related liability relates. The table is amended to mention additional tax-related liabilities to which Division 721 is to apply, and the period to which the liability relates. The liability for GIC under section 45-875 in Schedule 1 to the TAA 1953 is inserted. The period is the instalment quarter to which the GIC relates. ***[Schedule 14, item 2, subsection 721-10(2), item 60 in the table]***

10.16 The other liabilities inserted are administrative penalties in Schedule 1 to the TAA 1953 that arise in respect of the other liabilities listed in the table. The administrative penalties are a:

- penalty for a tax shortfall under section 284-75;
- penalty for a scheme shortfall under section 284-145;
- penalty for failing to lodge documents on time under section 286-75; and
- penalty for failure to keep or retain records under section 288-25.

[Schedule 14, item 2, subsection 721-10(2), item 65 in the table]

10.17 The relevant period for each of these administrative penalties is the period specified for the liability to which the penalty relates in the table in subsection 721-10(2). This will ensure that only penalties related to liabilities covered by the consolidation regime are subject to Division 721.

10.18 A number of the other administrative penalties specified in Division 288 are not included in the table because they relate primarily to liabilities that are not included in the consolidation regime such as GST and PAYG withholding liabilities. The penalty for preventing access is not included because it would not be possible in practice to determine whether the penalty applies to a liability within the scope of Division 721.

Application of general interest charge

10.19 Subsections 721-15(5) and 721-30(5) require the Commissioner to provide written notice of a joint and several liability or a TSA liability to the person liable. The debt is due 14

days after the date of notification. This notification rule would create difficulties for GIC, because GIC continues to accrue for each day during the 14 day notification period. The amount notified would not represent the full amount of the liability.
10.20 This difficulty is overcome for joint and several liabilities by inserting a new rule into section 721-15 to specify the due date for group GIC liabilities that are not paid on time. The rule will provide that where the group liability is GIC, the liability becomes due and payable at the end of the day on which the Commissioner gives written notice to the contributing member of that liability. ***[Schedule 14, item 3, subsection 721-15(5A)]***
10.21 A new section will also be inserted to address joint and several liabilities to GIC that subsequently accrue on an unpaid group liability. When a group liability is GIC that is payable for a day in respect of an unpaid primary group liability, the Commissioner will be taken to have given notice to a contributing member of the GIC that is payable for a subsequent day on that subsequent day. The GIC will be due for each subsequent day at the end of that day. ***[Schedule 14, item 4, section 721-17]***
10.22 Similar rules are inserted into Division 721 to specify the due date and notification of TSA liabilities. Subsection 721-30(5A) provides the same new rule for TSA liabilities as that provided for joint and several liabilities by subsection 721-15(5A). Section 721-32 is inserted to specify for TSA liabilities the same rule specified for joint and several liabilities by section 721-17. ***[Schedule 14, items 5 and 6, subsection 721-30(5A) and section 721-32]***
10.23 These rules will ensure that GIC liabilities for which contributing members are joint and severally liable or liable under a TSA are payable at a time that is consistent with the general GIC rules. The general rule is section 8AAE of the TAA 1953, which provides that GIC for a day is due and payable to the Commissioner at the end of that day.

Tax sharing agreement liability and group liability are linked

10.24 Section 721-25 creates a liability for the TSA contributing member separate and distinct to the liability of the head company for the group liability. Although separate and distinct, the TSA liability is linked to the group liability to which it relates for the purpose of offsetting payments. Section 721-40 is inserted to describe this characteristic of these liabilities. ***[Schedule 14, item 7, subsection 721-40(1)]***
10.25 Section 721-40 also specifies how payments are to be offset in discharge of the TSA liability and the linked group liability. When an amount is paid or applied towards discharging the TSA liability, the linked group liability is discharged by the same amount. ***[Schedule 14, item 7, subsection 721-40(2)]***
10.26 A separate rule is specified for offsetting payments by the head company against the TSA liabilities. When a payment by the head company results in the amount unpaid on the TSA liability exceeding the amount unpaid on the linked liability at that time, the TSA liability is discharged to the extent of the excess. The TSA liability is not reduced if there is no excess. This rule will ensure that TSA liabilities remain in existence until the group liability is fully discharged. Without this rule a payment towards a group liability could discharge the TSA liabilities of the contributing members to an amount less than the unpaid amount of the group liability. Where the group liability is fully discharged, the unpaid TSA liabilities that are outstanding at that time are reduced to nil to reflect the full discharge of the group liability***. [Schedule 14, item 7, subsection 721-40(3)]***
10.27 These new rules will operate for a liability under a judgement in the same way as they will operate for the TSA liability or group liability on which the judgement is based. ***[Schedule 14, item 7, subsection 721-40(4)]***
10.28 The new rules in section 721-40 do not discharge a liability to a greater extent than the amount of the liability. ***[Schedule 14, item 7, subsection 721-40(5)]***
10.29 Rules of this kind are not required for joint and several liability, as the obligation of the head company and each contributing member is for the one and same liability, rather than for separate but linked liabilities.

Consequential amendments to the TAA 1953

10.30 The tables in subsections 250-10(1) and 250-10(2) of Schedule 1 to the TAA 1953 provide an index to the tax-related liabilities to which the recovery rules in Part 4-15 of that Act apply. Tax-related liabilities for which a contributing member of a consolidated group is

joint and severally liable are also to be recoverable under Part 4-15 of the TAA 1953. However, a reference to section 721-15 would not fit within the current structure of the tables because the section does not by itself impose a liability, rather it specifies the joint and several nature of a group liability. A note is inserted after subsection 250-10(1) to make clear that members and former members of a consolidated group may be jointly and severally liable to pay the tax-related liabilities. ***[Schedule 14, items 8 and 9, subsection 250-10(1) note 2]***

10.31 The table in subsection 250-10(2) is amended to include a reference to section 721-30 of the ITAA 1997, which specifies when the amounts payable under a TSA are due and payable. ***[Schedule 14, item 10, subsection 250-10(2), item 39 in the table]***

10.32 The note inserted after the table in subsection 250-10(1) is also inserted after the table in subsection 250-10(2) to make clear that members and former members of a consolidated group may be jointly and severally liable to pay the tax-related liabilities. ***[Schedule 14, items 11 and 12, subsection 250-10(2) note 2]***

Application provisions

10.33 The amendments will apply from the date of commencement of the consolidation regime, which is 1 July 2002.

Chapter 11
Loss integrity and value shifting interactions with consolidation

Outline of chapter

11.1 This chapter explains consequential amendments to ensure the LIM and GVSR interact appropriately with consolidated and MEC groups. This chapter also explains minor technical corrections and amendments to the LIM and GVSR that help to achieve the same ends.

11.2 These changes focus on the main areas of interaction that have been identified. This is especially so where the existing application of the LIM or GVSR is unclear, or may lead to inappropriate outcomes, where consolidated or MEC groups are involved.

Context of reform

11.3 The LIM and GVSR operate by having regard to losses and value shifts of legal entities in which interests are directly or indirectly held.

11.4 The single entity rule means that the LIM and GVSR have no impact for interests *within* consolidated and MEC groups during consolidation. Loss and value shifting integrity issues are addressed by the leaving tax cost reconstruction rules for such interests (e.g. under Division 711). The single entity rule will not make direct or indirect interests held by non-group members *in* a consolidated or MEC group subject to the provisions of Part 3-90 (consolidated groups). Accordingly, these interests will continue to be subject to the LIM, GVSR or the loss reduction method (as explained in this chapter).

11.5 Further, this bill contains provisions that deal with loss integrity issues that may arise on formation of a consolidated or MEC group, on the entry of members, and on their leaving.

11.6 Amendments are needed to ensure that the integrity of the LIM and GVSR is substantially retained in all of these circumstances.

Summary of new law

LIM	*Key features and effects*
Single entity rule applies in respect of Subdivisions 165-CC and 165-CD. *(Note: A similar rule is not needed for Subdivision 170-D.)*	Only the head company can have a changeover or alteration time. Realised and unrealised losses are taken to be in the head company.
Subdivision 165-CC in relation to the formation of (and entry into) consolidated and MEC groups.	Same business testing for trial year. If test failed, reductions for calculating allocable cost for membership interests or intragroup debts. Loss denial pools with tagged Subdivision 165-CC assets and Subdivision 170-D amounts.
Subdivision 165-CC on leaving from consolidated	Same business testing for the head company on leaving. If test failed, reduce adjustable values of assets to market, or to

and MEC groups	nil (to save compliance costs). Loss denial pool in leaving entity (in some cases).
Subdivision 165-CD in relation to leaving from consolidated or MEC groups.	Revised alteration times based on the head companys reference times and ownership profiles. Otherwise, broadly normal application of Subdivision 165-CD having regard to unrealised losses in leaving entity, or reduction of adjustable values of interests to nil (to save compliance costs).
Subdivisions 165-CC and 165-CD during consolidation.	Broadly normal operation modified by extended single entity rule and loss reduction method for interests other than those in the head company of a consolidated group, or in the top company for the MEC group or that are pooled interests. For Subdivision 165-CD and MEC groups, the adjustments for pooled interests are modified, and there are additional alteration times.
GVSR	
Application of the single entity rule for the purposes of Divisions 723, 725 and 727	The head company is the relevant entity in respect of group dealings and transactions with external parties.
Division 727 during consolidation.	Broadly normal operation modified by an extended single entity rule and the loss reduction method for interests other than those in the head company of a consolidated group, or in the top company for the MEC group or that are pooled interests. For MEC groups, the adjustments for pooled interests are modified.

Comparison of key features of new law and current law

New law	*Current law*
Interaction of LIM and GVSR with consolidated and MEC groups modified or clarified in certain aspects.	Interaction of LIM and GVSR with consolidated and MEC groups either unclear, or inappropriate, in certain aspects.
Loss reduction method applies where interests are not susceptible to the underlying methodologies of the LIM or GVSR.	No loss reduction method applies.

Detailed explanation of new law

11.7 This explanation of the amendments in this chapter is in 8 parts:

- Subdivision 165-CC consequences when an entity becomes a member of a consolidated group or MEC group (paragraphs 11.8 to 11.38);
- Subdivision 165-CC consequences when an entity leaves a consolidated group or MEC group (paragraphs 11.39 to 11.66);
- Subdivision 170-D interaction with Subdivision 165-CC modifications (paragraphs 11.67 to 11.72);
- Subdivision 165-CC in relation to interests in a consolidated group or MEC group (paragraphs 11.73 to 11.82);
- Subdivision 165-CD consequences where an entity leaves a consolidated group (paragraphs 11.83 to 11.93);
- Subdivision 165-CD and Division 727 in relation to interests in a consolidated group or MEC group (paragraphs 11.94 to 11.145);
- LRM (paragraphs 11.146 to 11.169); and

- minor consequential amendments and technical corrections to the LIM and the GVSR (paragraphs 11.170 to 11.175).

  Subdivision 165-CC
  Subdivision 165-CC formation of a consolidated or MEC group, or on entry of a subsidiary member
  11.8 Broadly, if a company does not satisfy the same business test, Subdivision 165-CC may deny capital losses or deductions (or in some cases cause assessable income to be included) after a change of the companys ownership or control (a changeover time) in respect of assets owned by the company at that time, or in respect of certain deductions or losses deferred under Subdivision 170-D at or before that time. Subdivision 165-CC will only have that effect to the extent of the companys RUNL (if any) in respect of that changeover time.
  11.9 Broadly, the same business test requires that the business immediately before the changeover time is compared with the one carried on throughout the income or gain year in which the loss or deduction is claimed or offset.
  11.10 Where a company (whether the head company or subsidiary) has had a changeover time before or at consolidation, such testing is not feasible once the group is formed because the business of the company before consolidation is not comparable with the business of the consolidated group.
  11.11 In broadly the same way as this issue is addressed for realised losses (see Subdivision 707-A), the modified rules under Subdivision 715-A for Subdivision 165-CC unrealised losses will require same business testing having regard to a trial year before consolidation. The trial year is defined in section 707-120 and is usually the year starting 12 months before the joining time and ending just after the joining time. It is assumed that the entity carried on at and just after the joining time the same business that it carried on just before the joining time (see subsection 707-120(3)). ***[Schedule 7, item 1, paragraphs 715-50(1)(d), 715-55(1)(d), 715-60(1)(d) and 715-70(2)(c)]***
  11.12 If the modified same business test is passed, there are no further implications in respect of the pre-consolidation changeover time for Subdivision 165-CC tagged assets that become part of the consolidated or MEC group (or are membership interests or debts in group members). ***[Schedule 7, item 1, section 715-25]***
  11.13 If the test is failed, however:

- there may be a write-down to market value (to the extent of the entitys RUNL) of membership interest or intra-group debt cost amounts used for working out step 1 or step 2 amounts of allocable cost under Division 705 (see sections 705-65 and 705-75) this is to prevent such amounts inappropriately being pushed down onto the tax values of assets which will not carry the Subdivision 165-CC tag of the membership interest or debt; and/or;

- other Subdivision 165-CC tagged assets may be allocated to LDPs which operate similarly to assets tagged to RUNLs in Subdivision 165-CC by reducing realised deductions and losses to the extent of loss denial balance referable to the pool (except that, in the case of an LDP and loss denial balance, there is no further same business testing that test already having been failed). Asset valuation and removal of losses on tagged assets at consolidation would have removed the need for LDPs, but would be inconsistent with the approach on transition which allows the assets of chosen transitional entities to retain their existing tax values. For these cases, the Subdivision 165-CC policy objects are achieved by the use of LDPs.

11.14 There are also additional rules in Subdivision 715-D for Subdivision 165-CC tagged assets being deferred deductions and other amounts under Subdivision 170-D (see paragraphs 11.67 to 11.72 for more detailed discussion).

Threshold conditions

11.15 There are 2 common threshold conditions before Subdivision 715-A is activated.

RUNL balance

11.16 The company must have a residual unrealised net loss in respect of the most recent changeover time for the company. This is called a ***final RUNL***. ***[Schedule 7, item 1, section 715-35 and item 21, subsection 995-1(1)]***

Subdivision 165-CC tagged asset

11.17 The company must have at least one ***Subdivision 165-CC tagged asset***. This is, broadly, an asset taken into account for the most recent changeover time for the company that is still held by the company or is a Subdivision 170-D amount taken into account under paragraph 165-115A(1A)(b) that has not been recognised by the company before consolidation. ***[Schedule 7, item 1, section 715-30 and item 15, subsection 995-1(1)]***

11.18 Assets not covered by Subdivision 165-CC are not Subdivision 165-CC tagged assets. These include assets acquired since the most recent changeover time, or assets acquired for less than $10,000 where the company has made the choice to exclude these under subsection 165-115A(1B). There are no Subdivision 165-CC tagged assets, and therefore no ongoing implications on consolidation, for a company that met the maximum net asset value test for the changeover time. ***[Schedule 7, item 1, paragraphs 715-30(d) and (e)]***

Cases addressed

11.19 Table 11.1 shows the implications for particular entities that become a member of a consolidated or MEC group in respect of Subdivision 165-CC tagged assets where the same business test is failed.

11.20 It is important to note that where the legislation refers to an entity joining a consolidated or MEC group, this will generally apply equally to a formation case (where the joining is on formation) or a case where an entity joins an existing group, unless the context clearly indicates otherwise.

Table 11.1: Group formation or entering an existing group

Entity	***Possible consequences for entity on formation:***	***Possible consequences for entity when it joins an existing group:***
Head company	Subsection 170-D amounts; reduced cost base of membership interest or intra-group debt interest used as component of allocable cost that is, to push-down to assets of a NCS; other tagged assets. ***[Schedule 7, item 1, paragraph 715-15(1)(a), sections 715-50, 715-55 and 715-60]***	Subsection170-D amounts; • reduced cost base of membership interests or intra-group debt interest of acquiring group used as allocable cost that is, to push-down to assets of a joining entity. ***[Schedule 7, item 1, paragraph 715-15(1)(b), sections 715-50 and 715-55]***
A chosen transitional entity (CTE)	Subdivision 170-D amounts; • reduced cost base of membership interests or intra-group debt interest used as allocable cost (only CTE to NCS); • other tagged assets. ***[Schedule 7, item 1, paragraph 715-15(1)(c),***	not applicable a CTE can only arise on formation.

	sections 715-50, 715-55 and 715-70]	
NCS on formation, or subsidiary joining	Subdivision 170-D amounts. ***[Schedule 7, item 1, Subdivision 715-D]***	Subdivision 170-D amounts; • reduced cost base of membership interests or intra-group debt interest of members in entity used as allocable cost that is, to push-down to assets of a joining entity. ***[Schedule 7, item 1, sections 715-50 and 715-55, Subdivision 715-D]***

11.21 The main case (the head company on formation) is described below (see Diagram 11.1 and the following paragraphs) and variations applying in the other cases are then discussed (see Table 11.1)

Head company formation

11.22 The adjustments that are made in respect of Subdivision 165-CC tagged assets of the head company where the SBT is failed in respect of a pre-formation changeover time are outlined in Diagram 11.1.

Diagram 11.1

Adjustments one and two

11.23 The adjustments are only required for membership interests and intra-group debt interests whose reduced cost bases are used to push-down allocable costs calculated under steps 1 and 2 (subsections 705-65(1) and 705-75(1)). This means there are no continuing Subdivision 165-CC consequences for a head companys membership interest or intra-group interest in a non-chosen subsidiary. ***[Schedule 7, item 1, subsections 715-50(3) and 715-55(3)]***

11.24 Determining the allocable cost amount to be used already requires that the market value of the membership interest be known and compared with its cost base or reduced cost base to determine whether cost base, market value or reduced cost base is relevant (see subsection 705-65(1)).

11.25 The need for an adjustment must still be determined even if the interest is a relevant equity or relevant debt interest in a loss company that had an alteration time under Subdivision 165-CD at the same time as the company holding the interest had its most recent changeover time, although any Subdivision 165-CD adjustment may effectively reduce or eliminate the need for a further reduction in the reduced cost base of the interest on consolidation.

Adjustment three

11.26 If the formation time is not a changeover time for the head company, and there are remaining Subdivision 165-CC tagged assets held by the head company and a balance in the RUNL, a LDP is formed. (If the formation time is a changeover time for the head company, there is a fresh application of Subdivision 165-CC for the assets). ***[Schedule 7, item 1, subsection 715-60(1)]***

11.27 The LDP contains all of the remaining Subdivision 165-CC tagged assets held by the head company. The loss denial balance is equal to the final RUNL (as reduced by Adjustments one and two). ***[Schedule 7, item 1, subsection 715-60(2) and items 22 and 23, subsection 995-1(1)]***.

11.28 If Subdivision 170-D has applied to the head company, there may also be implications (discussed in paragraphs 11.67 to 11.72).

Example 11.1

On 3 December 2001, the Head company had a changeover time under Subdivision 165-CC. It calculated an unrealised net loss of $10 million and the following assets were held at the changeover time:

Asset	***Reduced Cost base***	***Changeover time market value***
A	$10 million	$8 million
B	$5 million	$3 million
C	$4 million	$3 million
D	$6 million	$1 million

On 1 July 2002, the Head company and its subsidiaries form a consolidated group, and there is no new changeover time for the Head company or its subsidiaries at that time. The Head company still holds Assets A, B and C at that time. These are not membership interests or intra-group debts. Asset D was disposed of in June 2002 for its 3 December 2001 market value (i.e. for a capital loss of $5 million), and the RUNL balance became $5 million at that time.

Upon consolidating, the Head company must determine whether the same business test is passed for the trial year period. If it is, then there are no further implications for the group in respect of the 3 December 2001 changeover time.

If the same business test is failed, the Head company will have a LDP with a loss denial balance of $5 million. Assets A, B and C will be Subdivision 165-CC tagged assets to that pool. If, for example, Asset A is then realised for a $2 million capital loss, that loss will be denied and the pool will be reduced to $3 million. (There is no further same business testing as that test has already been failed).

If Asset C were instead a membership interest in a non-chosen subsidiary that formed part of the group, and its reduced cost base were used for determining the allocable cost (because the interest had a reduced cost base of $4 million and a market value of $3 million at formation), then the reduced cost base for subsection 705-65(1) purposes would be reduced to $3 million and the RUNL would be reduced to $4 million. This would then form the balance of the LDP referrable to Assets A and B.

11.29 The formation and application of LDPs is considered further in paragraphs 11.64 to 11.66.

Chosen transitional entity cases formation

11.30 The rules apply in the same way as described above to a subsidiary entity that is a CTE when a consolidated group forms.

11.31 Adjustments are made in respect of reduced cost bases of membership interests and intra-group debt interests that form part of the allocable cost in respect of the assets of NCSs.

11.32 If a RUNL balance remains after any such adjustments, a separate LDP in respect of each subsidiary is created in the head company. Whilst a single pool may have been simpler, it could have disadvantaged groups by subjecting certain realised losses to loss denial that would not have happened if the companies had remained separate entities. ***[Schedule 7, item 1, section 715-70]***

Non-chosen subsidiaries formation

11.33 For a subsidiary entity that is a NCS, the approach for the head company formation case applies with the following modifications:

- adjustments one and two are not relevant (because push-down is assumed to address the problem in most cases); and
- adjustment three may apply, but only Subdivision 170-D amounts that have not revived are placed in the LDP (see paragraphs 11.67 to 11.72). The loss denial balance is the final RUNL for the subsidiary entity.

11.34 There are no consequences for the Subdivision 165-CC tagged assets of the joining entity that are membership or intra-group debt interests in *another* subsidiary member because higher level push-down of allocable cost is assumed to have addressed any integrity issue in most cases. Equally, if entities below the NCS are CTEs, membership interests or debts owned by the NCS in the CTE are not relevant in consolidation cost setting for that entity.

11.35 There are also no consequences for the other assets of the NCS. Testing on formation, except where there are Subdivision 170-D amounts, is not needed to preserve the integrity of the Subdivision 165-CC rules, as the push-down of allocable cost from the head company is assumed to remove the integrity problem in most cases. ***[Schedule 7, item 1, subsections 715-50(3), 715-55(3) and 715-70(1)]***

Head company subsidiary joining

11.36 There may be Subdivision 165-CC consequences for the head company of an existing consolidated group or MEC group, if a subsidiary entity joins the group and a membership or intra-group debt interest, whose reduced cost base is used for allocable cost purposes, was a Subdivision 165-CC tagged asset for the most recent post-formation changeover time for the head company. There could also be implications for Subdivision 170-D amounts of the subsidiary.

11.37 For these cases, the rules as for a head company formation case apply, with the following modifications:

- the trial year for the head company SBT testing ends immediately after the joining time for the joining entity and starts 12 months before that time the same business is taken to be carried on at, and immediately after joining as was carried on immediately before joining;
- adjustments one and two only are relevant; and
- the RUNL for the head company is reduced by the amount of any adjustments made.

[Schedule 7, item 1, paragraph 715-15(1)(b)]

Example 11.2

On August 12, 2003, Headco (the head company of a consolidated group) has a changeover time, for which an unrealised net loss of $9 million is calculated. The changeover time assets of Headco include an 80% interest in Joining Co.

In September 2006, Headco acquires the remaining 20% of Joining Co and it joins the consolidated group. Immediately before the joining time, the market value of the 80% interest is $6.4 million.

To work out if there are Subdivision 165-CC implications for allocable cost push-down of the 80% membership interest on entry, the SBT is applied at the time immediately after the changeover time, and for a trial year ending immediately before the joining time for Joining Co.

If the SBT is failed by Headco, then the amount used for the push-down to work out the tax costs of Joining Cos assets is reduced to market value immediately before joining (to the

extent of the RUNL for Headco). This means that the amount used for push-down will be reduced by $1.6 million to $6.4 million.

The RUNL is reduced by that amount.

Subsidiary member joining

11.38 A subsidiary entity becoming a member of an already formed group cannot be a CTE, and there are possible issues only in respect of Subdivision 170-D amounts that become those of the head company. See paragraphs 11.67 to 11.72.

Subdivision 165-CC leaving from a consolidated or MEC group

11.39 On the leaving of an entity from a consolidated or MEC group, similar same business testing issues arise as is the case on formation or entry to an existing group, if the leaving entity takes with it assets that are tagged to a RUNL in respect of a changeover time the head company had during consolidation. That is, the business of the group is not comparable with the business of the leaving entity either before, or after leaving.

11.40 There is no same business issue for LDPs because the test has already been failed, but there is a need to ensure that unrealised losses on such assets are subject to potential adjustment after they depart the group.

11.41 There is no issue in respect of Subdivision 170-D deferred loss or deduction amounts because the entitlement to these remains with the head company (see paragraphs 11.67 to 11.72).

11.42 Whether the leaving entity is a company or trust, there are Subdivision 165-CC implications because this is effectively a leaving of part of the head company, notwithstanding that it leaves as a trust. If this were not done, inappropriate advantages could be obtained by releasing loss assets in trusts rather than companies. ***[Schedule 7, item 1, subsection 715-95(2) and paragraph 715-120(3)(b)]***

11.43 There are 2 scenarios to consider in the leaving case:

- the head company has had a changeover time during consolidation, and has an RUNL with assets tagged to it, some or all of which are being taken by the leaving entity. (If the head company has had a changeover time during consolidation, it will have no LDPs in respect of Subdivision 170-D amounts of a joining entity after the changeover time) (paragraphs 11.46 to 11.55);

- the head company has one or more LDPs with tagged assets and some or all of the assets are being taken by the leaving entity (paragraphs 11.56 to 11.57).

11.44 An exception applies if the leaving time is a changeover time for the leaving entity (including where the head company has a changeover time at that time) (see paragraphs 11.58 to 11.61).

11.45 Following the leaving time, there are no continuing implications under Subdivision 165-CC for the head company in respect of the assets that leave the group. ***[Schedule 7, item 1, section 715-80]***

The head company with RUNL and tagged assets

11.46 In this case, there is same business testing for the head company for the 12 months ending just after the leaving time. The SBT is applied to the 12 months immediately before the leaving time (or the period from when the head company came into existence to just after the leaving time if less than 12 months) and the time just before the head company changeover time. ***[Schedule 7, item 1, subsections 715-95(1) and (3)]***

11.47 If the SBT is passed, the assets can go with leaving entity without adjustment (whether for the purposes of the tax costs taken by the leaving entity or those pushed up under Division 711) and there are no ongoing implications in respect of the head companys changeover.

11.48 However, for the future application of Subdivision 165-CC, the leaving entity (if a company) will assume the head companys reference time and all its membership interests will be taken to have been held by the head company from its reference time to immediately before the leaving time. This will ensure that Subdivision 165-CC can apply appropriately at a later time for leaving the company. There are no further implications for a leaving entity that

is a trust, because it cannot have a changeover time. ***[Schedule 7, item 1, sections 715-85 and 715-290]***

11.49 If the SBT is failed, the head company will have 3 options:

- option one: reduce the reduced cost bases (and other adjustable values where relevant) of tagged assets that are leaving to nil. There is no reduction in the RUNL balance, because it is not known whether the assets are loss or gain assets (and to allow a RUNL reduction may encourage the taking out of gain assets to dissipate the RUNL pool for the group). This option is simple, involves potentially lower compliance costs, and predominantly affects later losses realised on interests, but it may not be ideal for the group.

- option two: determine the market value of the tagged assets leaving to identify loss assets, and reduce their reduced cost bases (and other adjustable values where relevant) to market value, but only to the extent of the RUNL balance. The RUNL balance is reduced to reflect the reduction. Where more than one loss asset leaves in an entity, the reductions are made to the assets on the basis of their adjustable values: largest to smallest. Where an asset has more than one character, the greatest adjustable value is used to determine the order. This option is more complex, and involves valuation costs, but will usually give a better tax outcome for the group.

- option three: the RUNL effectively leaves with the leaving entity as a loss denial pool (LDP). This option is available only if all remaining assets tagged to an RUNL leave with the leaving entity.

[Schedule 7, item 1, subsection 715-95(3), sections 715-100, 715-105 and 715-110]

11.50 For Options One and Two, the relevant adjustable values that are reduced when an asset leaves the group are:

- for a CGT asset, reduced cost base;

- for an item of trading stock, the most recent opening value or, if acquired during the year when it leaves the group, cost;

- for a depreciating asset, adjustable value; and

- for a revenue asset, the amount that would be subtracted in calculating a profit or loss.

[Schedule 7, item 1, subsections 715-145(1) to (3)]

11.51 In practice, option one may rarely be chosen if the leaving assets consist of a significant number of items of trading stock, or such items are expected to have more than a minimal value.

11.52 The above reductions to adjustable values have effect for cost setting on leaving of interests under Division 711, as they are taken into account for working out the head companys terminating values under section 711-30. ***[Schedule 7, item 1, subsection 715-145(4)]***

Example 11.3

There is a changeover time for Headco (the head company of a consolidated group) in 2003. An unrealised net loss of $2 million is calculated, based on changeover time Assets A, B and C (all held on capital account). At that time, Asset A has a reduced cost base of $5 million and market value of $4 million, Asset B has a reduced cost base of $3 million and market value of $2.3 million and Asset C has a reduced cost base of $0.5 million and a market value of $0.2 million.

Leavingco leaves the group with changeover time Assets B and C (Asset A is still held by the group).

Assuming that the SBT would have been failed, Headcos options are:

1. reduce the reduced cost bases of Assets B and C to nil and there is no reduction of Heados RUNL; or

2. reduce reduced cost bases of Assets B and C to their leaving time market values (assume $2.7 million and $0.2 million respectively). The reductions are therefore $0.3 million for each asset. The RUNL for Headco is reduced by $0.6 million to $1.4 million.

The new reduced cost bases for Assets B and C are used for tax cost setting under Division 711.

The third option is not available as not all of Headcos changeover time assets are held by Leavingco.

Choice

11.53 The head company must choose what option is to be used within 6 months of the leaving time, or within a further period allowed by the Commissioner, and provide a notice to the leaving entity. Where no choice is made, the head company will be treated as having chosen the first option. ***[Schedule 7, item 1, sections 715-175 and 715-180]***

11.54 Because the choice may impact on the compliance obligations of the acquirer of leaving entity, this may be a matter of negotiation between acquirer and acquiree during purchase negotiations and the due diligence phase.

11.55 If the third option is chosen, there will be no valuation costs on leaving, but there may be additional compliance costs for the leaving entity as a LDP of tagged assets will need to be maintained. The leaving entity may therefore make a choice (within 6 months of the leaving time) to apply the first or second option instead. ***[Schedule 7, item 1, section 715-185]***

The head company with LDP or LDPs and tagged assets

11.56 The same 3 options as set out above will be available for the head company where a leaving entity leaves with assets tagged to a LDP. ***[Schedule 7, item 1, subsections 715-120(1) and (3), sections 715-125, 715-130 and 715-135]***

11.57 There is, of course, no SBT in this case, because that has already been failed.

Exception: the leaving time is a changeover time for the leaving entity

11.58 If the leaving time is a changeover time for the leaving entity (including where the head company has a changeover time at that time), the above approaches do not apply.

11.59 Whether the leaving time is a changeover time for the leaving entity is determined having regard to the head companys reference time for Subdivision 165-CC purposes and on the assumption that the leaving entity was owned by the head company from its last reference time ***[Schedule 7, item 1, sections 715-85 and 715-290].*** Only a leaving company, not a trust, can have a changeover time.

11.60 If the leaving time is a changeover time for the head company (and therefore for the leaving company), a new RUNL must be determined either for the leaving entity (or for the leaving entity and for the head company in the first case above) and assets tagged appropriately. The reference time will be reset accordingly.

11.61 In respect of the leaving entity, the continuity period will be taken to have ended just after the leaving time, so that the leaving entity will need to satisfy the SBT in respect of the business carried on by the leaving entity at the leaving time. ***[Schedule 7, item 1, subsection 715-90(2)]***

11.62 This treatment is broadly comparable with what would have happened had a subsidiary been sold by a non-consolidated group.

11.63 Diagram 11.2 explains the operation of the Subdivision 165-CC rules where an entity leaves a consolidated group with Subdivision 165-CC tagged assets for a changeover time that happens to the head company. Diagram 11.3 explains the case where an entity leaves a consolidated group with assets that are tagged to a LDP of the head company.

Diagram 11.2: Subdivision 165-CC: The leaving entity leaves with Subdivision 165-CC tagged assets from changeover time that happens to the head company (Headco) (i.e. actual head company RUNL not LDP).

Diagram 11.3: Subdivision 165-CC: The leaving entity leaves with assets tagged to LDPs of head company (Headco).

Loss Denial Pools

11.64 LDPs are needed to maintain the policy object of Subdivision 165-CC as it is not possible within consolidation to tag an asset or a deferred loss to a specific entity. When a LDP is formed, the assets (and Subdivision 170-D amounts) are tagged to a pool instead.

11.65 It is a loss denial pool because, for each case where it is formed, a changeover time has happened and the SBT has already been failed. Consistent with the policy of Subdivision 165-CC, losses on assets or deferred amounts in a LDP will be denied to the extent of the loss denial balance, and the balance will be reduced by that amount (see Example 11.1). ***[Schedule 7, item 1, section 715-160]***

11.66 Common rules that ensure that LDPs operate consistently with the objects of Subdivision 165-CC are listed below.

A tagged asset leaves a LDP.	A tagged asset leaves an LDP when: • a realisation event described in Division 977 of the ITAA 1997 (other than the end of income year for trading stock) happens to it; or • the asset leaves the group in a leaving entity.
A LDP balance is less than a: loss realised on a tagged asset; or the difference between the adjustable value of a tagged asset and its market value (if the second option is chosen for a leaving entity).	The loss is denied, or the adjustable value is reduced, only to the extent of the remaining amount in the LDP. The loss denial balance is reduced to nil.
More than one tagged asset in a LDP is realised at once.	The entity can choose in what order it reduces the loss denial balance.
A LDP ceases to exist.	A LDP ceases to exist if, and only if:

	• there is a changeover time for the entity; • there are no longer any tagged assets or Subdivision170-D amounts; • the loss denial balance becomes nil; • the entity becomes a subsidiary member of a consolidated group; or • ***all assets leave the group, and the head company chooses to treat the pool as having gone with the leaving entity.***

[Schedule 7, item 1, subsection 715-130(5), sections 715-155, 715-160 and 715-165]

Subdivision 170-D amounts in respect of Subdivision 165-CC

11.67 Subdivision 715-D deals with Subdivision 165-CC aspects of the treatment of a companys deferred losses under Subdivision 170-D when it becomes a member of a consolidated or MEC group.

11.68 The concept of a Subdivision 170-D deferred loss is defined in terms of the operation of paragraph 170-255(1)(a) of Subdivision 170-D. It refers to a deduction or capital loss that would otherwise have been made that was disregarded ***[Schedule 7, item 1, subsection 715-310(1)]***. Subdivision 170-D deferred losses become those of the head company because of section 701-5 (entry history rule).

11.69 A deferred loss revives when section 170-275 of Subdivision 170-D treats the originating company as making the capital loss or making the deduction. ***[Schedule 7, item 1, subsection 715-310(2)]***

11.70 Subdivision 715-D makes use of the paragraph 715-30(c) reference to a Subdivision 165-CC tagged asset that is, a CGT asset that has a Subdivision 170-D deferred loss because of paragraph 165-115A(1A)(b).

11.71 Broadly, the Subdivision 170-D deferred losses of the head company and subsidiary members are treated similarly to other Subdivision 165-CC tagged assets in that:

- the head companys own deferred losses at formation time are added to a LDP of the head company created under section 715-60 (if one has been created because of other Subdivision 165-CC tagged assets and failure of the SBT), otherwise a LDP is created on an equivalent basis. Its loss denial balance is equal to the companys final RUNL ***[Schedule 7, item 1, section 715-355]***; or
- a subsidiarys deferred losses (whether on formation or on entry) are treated similarly, but in respect of a separate LDP created in the head company for each affected subsidiary ***[Schedule 7, item 1, section 715-360]***.

  11.72 When a Subdivision 170-D deferred loss revives, it is reduced to the extent of any loss denial balance at that time, and the loss denial balance is reduced by the reduction. The balance is applied in the order in which the Subdivision170-D losses revive, and the head company determines the order if 2 or more revive at the same time. A realisation event for Subdivision 170-D purposes takes priority over another application of the pool for the purposes of section 705-130 unless the realisation event happens after the leaving time. ***[Schedule 7, item 1, section 715-365)]***

  Subdivision 165-CC in relation to interests in a consolidated group or MEC group

11.73 Some consequential amendments are required so that Subdivision 165-CC can apply to consolidated and MEC groups once they have come into existence.
11.74 To facilitate the application of Subdivision 165-CC and consolidated and MEC groups the single entity rule and entry history rule have been extended. The effect of this is that in most respects the group will be treated as a single company (being the head company of the group) when applying this provision. The head company will be the only entity in the group that will be relevant in terms of Subdivision 165-CC. ***[Schedule 7, item 2, section 715-75]***
11.75 Subdivision 165-CC will largely apply on its normal terms. The head company will be the only group member that can have a changeover time in terms of Subdivision 165-CC.
11.76 The normal rules in Subdivision 165-CC will apply to determine when the head company of a consolidated group has a changeover time. The initial reference time, after a consolidated group comes into existence, is that of the head company.
11.77 The fact that MEC groups have more than one company at the top of their structure (eligible tier-1 companies) means that modifications are required so that Subdivision 165-CC can apply to such groups.
11.78 The way in which changeover times for the head company of a MEC group are determined under Subdivision 165-CC will be modified in the following ways:

- changeover times under section 165-115C or 165-115D changes in ownership and control of interests in entities between the top company of the MEC group and the eligible tier-1 companies will not be taken into account in working out if the head company has a changeover time (subject to the following dot point) ***[Schedule 7, item 2, section 719-700]***; and

- the head company of a MEC group will have a changeover time when:

- a potential MEC group ceases to exist, if that groups membership was the same as that of the MEC group;

- there is a change in identity of the top company of the MEC group, but it does not cease to exist; or

- a MEC group ceases to exist because there ceases to be a provisional head company.

[Schedule 7, item 2, subsections 719-705(1) to (3)]

11.79 These modifications are consistent with the COT rules for MEC groups discussed in Chapter 3.

11.80 The first modification has the effect that, in most cases, it is only changes in control and ownership in relation to the top company that are relevant in working out if the head company has a changeover time under section 165-115C or 165-115D. This is appropriate while there is a 100% relationship between the top company and at least one eligible tier-1 company. The initial reference time, for working out when the head company of a MEC group has a changeover time, is when the group came into existence. ***[Schedule 7, item 2, subsection 719-700(2)]***

11.81 The head company of a consolidated or MEC group will work out if it has an unrealised net loss using the normal rules in the Subdivision.

11.82 One effect of extending the single entity rule is that the head company takes into account all group members CGT assets in working out its unrealised net loss at the changeover time.

Subdivision 165-CD: entry / formation and leaving from a consolidated group

Entry / formation

11.83 There are no consequential amendments for the operation of Subdivision 165-CD on entry / formation.

11.84 Where there is an alteration time that has applied before or at consolidation, adjustments made under Subdivision 165-CD may already have the effect of reducing the reduced cost bases of membership interests and intra-group debts relevant for Division 705 allocable cost. If the global method of asset valuation has been used to determine unrealised losses, there is a special rule that applies for allocable cost purposes (see subsection 705-65(3A)).

11.85 For interests in CTEs, the effect of intra-group entity interest reduced cost bases will not be relevant as these will not be pushed down.

Leaving from a consolidated group

11.86 Subdivision 165-CD will broadly have its normal operation on leaving from a consolidated group, but with some important modifications.

11.87 Essentially, the role of Subdivision 165-CD is to make adjustments to prevent duplicate losses being obtained on inter-entity interests where a company has had an alteration time (usually a change of ownership or control), and the company has realised or unrealised losses at that time. Interests of individuals are not affected.

11.88 There is no application of Subdivision 165-CD to interests of subsidiary members of a consolidated group at an alteration time for the head company. This means that there is no mechanism for making adjustments to the reduced cost bases of such inter-entity interests, that, apart from consolidations, would be adjusted to remove duplicate losses based on loss assets in subsidiaries. Where the leaving of a subsidiary entity from a consolidated group does not itself trigger an alteration time, there is a potential for loss duplication, as the adjustable values of unrealised loss assets will be pushed up onto the interests reconstructed under Division 711.

11.89 Example 11.4 explains how the non-application of Subdivision 165-CD to the cases can lead to inappropriate loss duplication.

Example 11.4

Note: RCB means reduced cost base and MV means market value.

A Co (not the head company of a consolidated group) has 3 wholly-owned subsidiaries B Co and C Co held directly, and D Co held indirectly. D Co has an 80% (controlling) interest in Headco, the head entity of a consolidated group.

B Co transfers its 80% interest to C Co. This causes an alteration time (but probably not a changeover time because of the saving rule) for D Co and Headco.

Headco has only one asset, and that asset has an unrealised loss of $100. Subdivision 165-CD adjustments would be made to all of the entity interests above Headco.

However, no adjustment is made for Headcos shares in Subco. (If these entities had not been consolidated, there would have been a reduction in the RCB of Headcos shares in Subco by $100, eliminating the duplicate loss).

If Subco leaves the group with a fresh ownership profile and this leaving would not itself give rise to an alteration time (e.g. a sale of 5%). Headcos reduced cost base for membership interests in Subco will be reconstructed (based on Division 711) at $200.

This would be inappropriate, and would mean a loss of integrity in terms of what is achieved currently by Subdivision 165-CD.

11.90 The integrity of Subdivision 165-CD is achieved in a consolidation leaving environment by:

- modifying the application of Subdivision 165-CD to ensure that post-formation changes in the ownership profile of the head company are effectively accounted for when a company leaves the group; and
- applying Subdivision 165-CD adjustments when the cost for membership interests for a leaving entity that is a trust is being set.

11.91 The way this is achieved is set out in Tables 11.2 and 11.3.

Table 11.2

Where	***These are the consequences on leaving***	***The leaving entity's reference time is***
Leaving entity is a company		
Leaving time would be an alteration time for the leaving entity based on the head companys reference time (immediately after its last alteration time during consolidation if any, otherwise formation time), based on the assumptions in section 715-290 (see paragraph 11.93). See Examples 11.5 and 11.7. ***[Schedule 7, item 1, section 715-245]***	Leaving time is an alteration time for leaving entity. Leaving entity is a loss company if it has an adjusted unrealised loss on leaving assets. Unrealised losses calculated as if leaving entity had no previous alteration times. Adjustments as outlined in table below.	Just after the leaving time.
The head company has had an alteration time during consolidation but leaving time is *not* an alteration time in respect of the head companys reference time for the leaving entity, based on the assumptions in section 715-290. See example 11.6. ***[Schedule 7, item 1, section 715-250***	As above, except only unrealised losses accruing to the head companys last alteration time captured. Adjustments as outlined in table below.	Reference time of leaving entity set to the head companys reference time (after its last alteration time).
The head company has not had an alteration time during consolidation and the leaving time not an alteration time with respect to the head companys formation time, based on assumptions in section 715-290. See example 11.8.	No alteration time for leaving entity.	Reference time is just after formation time.

[Schedule 7, item 1, section 715-260]		
Leaving entity is a trust		
Leaving entity is a trust. ***[Schedule 7, item 1, section 715-270]***	Alteration time. The leaving trust is taken to be a loss company if it has an adjusted unrealised loss based on leaving assets. Adjustments as outlined in table below.	Not applicable. No further application of Subdivision 165-CD.

Table 11.3

Option that may be chosen by the head company	***Consequences for membership interests in leaving entity (for CGT assets, reduced cost bases, trading stock values, and revenue asset costs)*** (Note. For intra-group liabilities, market value of the corresponding asset applies see subsection 711-45(4))
First Option: reduce tax cost setting amounts to nil. ***[Schedule 7, item 1, subsections 715-255(2) and 715-270(6)]***	Tax cost setting amount is reduced just before the leaving time to nil. (This is a compliance cost saving measure, as no valuations will be required at the leaving time. It may not be ideal for the group.)
Second Option: work out modified Subdivision 165-CD adjustments and reduce the amount pushed up on leaving. ***[Schedule 7, item 1, subsections 715-255(3) and 715-270(7)]***	Tax cost setting amount just before leaving time is reduced by Subdivision 165-CD adjustment calculated using the non-formula approach in subsection 165-115ZB(6) on the assumptions that: • loss duplication is to be prevented; • the adjusted unrealised loss is the overall loss; and • all membership interests to be reconstructed under Division 711 are a single relevant equity interest.

11.92 The head company must make the choice of method within 6 months of the leaving time or a further time allowed. If no choice is made, the head company is taken to have chosen the first option. ***[Schedule 7, item 1, subsections 715-255(4), 715-255(5), 715-270(8) and 715-270(9)]***

Additional matters

11.93 Generally, for the purposes of applying the rules discussed in Tables 11.2 and 11.3, and for the continuing application of Subdivision 165-CD for the leaving company, the membership interests in a

leaving entity are treated as having been beneficially held by the head company from the relevant reference time to immediately before the leaving time. ***[Schedule 7, item 1, section 715-290]***

Example 11.5

Headco elects to consolidate the Head Group in 2003, including its wholly-owned subsidiary Sub Co. The original cost of Headcos investment in Subco ($10 million) is pushed down onto Subcos formation time Assets A and B.

There is an alteration time for Headco on 2 May, 2006. On 11 November 2011, Subco leaves the group with Assets B and C when 60% of the interests in Subco are sold by Headco.

The data relevant to the 2006 alteration time and the 2011 leaving time are as follows.

Asset	***Reduced cost base***	***Market value at alteration time (2006)***	***Market value at leaving time for Leaving Co (2011)***
A (disposed of 2008 for $2.5 million)	$5 million	$2.5 million	n.a.
B	$5 million	$ 3.5 million	$0.8 million
C (acquired 2008)	$2.5 million	n.a	$1.5 million

There is an alteration time for Leaving Co on leaving, based on Headcos reference time (2 May 2006).

There are 2 options for Headco in setting the tax costs for interests in Subco on leaving:

Option 1: the reduced cost base of Headcos interests in Subco is reset at nil on leaving.

Option 2: the tax cost setting amount used to determine the reduced cost base of Headcos interests in Subco (ordinarily $7.5 million) is reduced by the unrealised losses at that time ($4.2 million plus $1 million equals $5.2 million). The tax cost setting amount of $2.3 million is applied across the interests.

The reference time for working out whether Leaving Co later has an alteration time is set at immediately after the leaving companys leaving on 11 November 2011.

Example 11.6

Assume the facts in Example 11.5. Assume however that the trigger that leads to Subco leaving the group is the transfer of 5% of Headcos shares in Subco. There is taken to be an alteration time on leaving.

Both options are available for working out the tax cost setting amount for Headcos interests on leaving.

If the second option is chosen, however, the only leaving assets that are taken into account in working out the adjusted unrealised loss for Subco are those that were held by the group at the earlier alteration time (i.e. Asset B). The adjusted unrealised loss is calculated on the basis of the unrealised loss at that time ($5 million less $3.5 million equals $1.5 million). Therefore the tax cost setting amount on leaving is $6 million.

The reference time for working out when there is another alteration time for Subco is set at immediately after Headcos alteration time (2 May 2006).

Example 11.7

Headco (shareholders Justine 60% and Diane 40%) elects to form a consolidated group in July 2002.

In 2005, Diane sells her 40% interest in Headco. In 2007, Subco leaves the group when Headco sells 40% of the shares to an unrelated party.

As there has not been an alteration time for Headco from the time of formation to when Subco leaves, Headcos formation time ownership profile is used to work out if there is an alteration time for Subco on leaving. On this basis, there is an alteration in ownership, as the only interest in shares maintained is Justines indirect interest (36%).

The adjusted unrealised loss for Subco is worked out in the normal way (taking into account all leaving time assets). The reference time for working out when a later alteration time happens for Subco is the time immediately after leaving in 2007.

Example 11.8

Assume the facts as in Example 11.7. Assume, however, that Headco sells 10% of the shares in Subco (rather than 40%).

There is no alteration time on leaving. There is no alteration in ownership, as Justines continuing interests equals 54% of the interests in Subco.

The reference time for working out when Subco has a later alteration time is set just after Headcos formation time. For the period from formation to leaving interests in Subco are taken to be held directly by Headco in Subco.

Subdivision 165-CD and Division 727 in relation to interests in a consolidated group or MEC group

11.94 Some consequential amendments are required so that Subdivision 165-CD and Division 727 can apply to consolidated and MEC groups once they have come into existence. These changes will generally only affect:

- direct and indirect equity or loan interests in the head company of a consolidated group;
- pooled interests in the eligible tier-1 companies of a top company of a MEC group; and
- direct and indirect equity or loan interests in the top company of a MEC group.

11.95 All other direct and indirect equity and loan interests in members of a consolidated or MEC group can be covered by the loss reduction method (see paragraphs 11.146 to 11.169). Specific rules

ensure that Subdivision 165-CD or Division 727 do not apply. ***[Schedule 7, item 1, sections 715-230 and 715-450]***

11.96 Subdivision 165-CD adjusts certain equity and debt in a company, to deal with the effect of the companys losses on the interests. The object is to ensure that the companys losses are not duplicated when interests in the company are realised, to the extent that they accrued to the company while the interest was held by the entity.

11.97 In a similar way, Division 727 makes adjustments in relation to equity and loan interests of certain entities in related entities that are involved in an indirect value shift. Adjustments, generally, reflect the market value effects of an indirect value shift that happens while an entity holds such an interest.

11.98 To apply Subdivision 165-CD and Division 727 on their normal terms to a consolidated or MEC group, an entity would require various information, including details of:

- when group member companies have an alteration time;
- whether the group company had realised or unrealised losses at that time (i.e. whether it is a loss company);
- which interests are relevant equity interests or relevant debt interests in the group member loss company;
- the effect of losses on the market values of relevant equity interests or relevant debt interests in the group member loss company;
- when a group member is a losing entity or gaining entity for an indirect value shift;
- chains of ownership of equity and loan interests in such entities, to determine if the ultimate controller or common ownership requirements are met; and
- what effect the indirect value shift had on the market value of such interests.

11.99 Further issues arise in seeking to apply Subdivision 165-CD and Division 727 to MEC groups. These issues relate to the fact that such groups have more than one company at the top of their structures (eligible tier-1 companies). Unlike consolidated groups, where it can often be assumed that things that happen in the group will affect the value of interests in the head company, for MEC groups this is not the case. For example, if a subsidiary member owned by a particular eligible tier-1 company is involved in an indirect value shift with a non-group entity, only the market value of interests in that eligible tier-1 company will be affected.

11.100 Consolidation means that it is not feasible for Subdivision 165-CD and Division 727 to be applied on a basis that would require an examination of transactions or events, and their effects, within the group.

11.101 To facilitate the application of Subdivision 165-CD and the GVSR (Divisions 723, 725 and 727) to consolidated and MEC groups the single entity rule and entry history rule have been extended. The effect of this is that in most respects the group will be treated as a single company (being the head company of the group) when applying these provisions. For example, the head company will be the only entity in the group that will be relevant in terms of Subdivision 165-CD and Division 727. ***[Schedule 7, item 1, sections 715-215 and 715-410]***

11.102 Some of the effects of extending these rules are:

- the head company will be taken to have owned all CGT assets of group members at an alteration time, and to have made any tax loss or net capital loss for the assumed income year ending at that time; and

- the head company will be taken to have provided and received all economic benefits in terms of an indirect value shift.

Subdivision 165-CD

11.103 The consequential amendments cover situations where a consolidated or MEC group is affected by Subdivision 165-CD (inter-entity loss multiplication).

11.104 A group can be affected by an alteration time under Subdivision 165-CD where the head company has an alteration time. The Subdivision will prevent the duplication of the groups realised and unrealised losses when significant equity and debt interests in the group are realised.

Subdivision 165-CD and consolidated groups

11.105 Subdivision 165-CD will largely apply on its normal terms to consolidated groups. The head company will be the only group member that can have an alteration time in terms of Subdivision 165-CD.

11.106 The normal rules in Subdivision 165-CD will apply to determine when the head company of a consolidated group has an alteration time. The initial reference time, after a consolidated group comes into existence, is that of the head company.

11.107 The head company will also work out if it is a loss company and the amount of its overall loss (if any) using the normal rules in the Subdivision. The individual asset and global methods are both available to work out if the head company has an adjusted unrealised loss.

11.108 One effect of extending the single entity rule is that the head company takes into account all group members CGT assets in working out its adjusted unrealised loss at the alteration time.

11.109 As mentioned in paragraph 11.105, Subdivision 165-CD will only apply to relevant equity interests or relevant debt interests in the head company of a consolidated group. In general terms, the Subdivision adjusts such interests with regard to the market value effect of the losses making up the overall loss of the head company. The formula and non-formula adjustment methods are available.

Double counting rule

11.110 Sections 165-115U and 165-115W of Subdivision 165-CD have double counting rules that apply when the individual asset method is used to work out the adjusted unrealised loss of a loss company. These rules ensure that to the extent an unrealised loss is taken into account at one alteration time for a company, it is not taken into account at a later alteration time. The effect of extending the entry history rule is that the double counting rules can apply.

11.111 Where a company holds an asset at an alteration time before becoming a member of a consolidated or MEC group it will generally not be appropriate for the double counting rules to apply if the head company of the group holds that asset at a later alteration time. This is because Division 705 deals with unrealised losses on assets as part of the cost setting process for assets. ***[Schedule 7, item 1, section 715-225]***

11.112 The exception to this is where on formation of a group the asset is owned by a chosen transitional entity. The double counting rule also needs to apply to assets that the head company owned before it became a group member. In both of these cases Division 705 does not change the tax costs of these assets.

Other modifications

11.113 Applying Subdivision 165-CD to a consolidated group as if it is a single company means that certain losses (e.g. trust losses) that would not normally be covered by the Subdivision are subject to it. This is appropriate because the nature of an entity in a consolidated group is not relevant. What is relevant is that the head entity is a company.

11.114 The application of the LRM (see paragraphs 11.146 to 11.169) to certain interests will mean that some of the relief in Subdivision 165-CD will not be available for those interests for example, the LRM can apply to less than 10% equity holdings. This is because it is not possible to tell if the loss relates to indirect value shifts or reflects losses in the group.

Diagram 11.4: Subdivision 165-CD and consolidated groups

Division 727

Subdivision 165-CD and MEC groups

11.115 The fact that MEC groups have more than one company at the top of their structure (eligible tier-1 companies) means that additional modifications to those for consolidated groups are required so that Subdivision 165-CD can apply to such groups.

When will the head company of a MEC group have an alteration time?

11.116 The way in which alteration times for the head company of a MEC group are determined under Subdivision 165-CD will be modified in the following ways:

- alteration times under section 165-115L or 165-115M changes in ownership and control of interests in entities between the top company of the MEC group and the eligible tier-1 companies will not be taken into account in working out if the head company has an alteration time (subject to the following dot point) ***[Schedule 7, item 2, section 719-720]***;
- the head company of a MEC group will have an alteration time when:
- a potential MEC group ceases to exist, if that groups membership was the same as that of the MEC group;
- there is a change in identity of the top company of the MEC group, but it does not cease to exist; or
- a MEC group ceases to exist because there ceases to be a provisional head company ***[Schedule 7, item 2, subsections 719-725(1) to (3)]***; and
- the head company will have an alteration time just before a trigger time in paragraph 719-555(1)(a). These times are when:
- one or more eligible tier-1 companies cease to be members of the group; or
- a CGT event happens to one or more reset interests in an eligible tier-1 company ***[Schedule 7, item 2, subsection 719-725(4)]***.

11.117 These modifications are consistent with, and complement, the COT rules for MEC groups discussed in Chapter 3.

11.118 The first modification has the effect that, in most cases, it is only changes in control and ownership in relation to the top company that are relevant in working out if the head company has an alteration time under section 165-115L or 165-115M. This is appropriate while there is a 100% relationship between the top company and at least one eligible tier-1 company. The initial reference time, for working out when the head company of a MEC group has an alteration time, is when the group came into existence. ***[Schedule 7, item 2, subsection 719-720(2)]***

11.119 Alteration times resulting from the first and second modifications will only be relevant for direct and indirect equity or loan interests in the top company of a MEC group that are relevant equity interests or relevant debt interests in the head company of that group just before the alteration time. Only pooled interests in relation to the group are covered by alteration times under the third modification. This treatment complements the COT rules for MEC groups. ***[Schedule 7, item 2, sections 719-730 and 719-735]***

11.120 Membership interests in an eligible tier-1 company of a MEC group are not pooled interests if a member of the group holds them. These interests are not covered by the above modifications because Division 711 sets the tax costs of these interests if the eligible tier-1 company leaves the group.

11.121 The existing Subdivision 165-CD rules on how to work out if a company is a loss company and its overall loss at an alteration time applies, including the individual asset and global methods of working out adjusted unrealised losses.

11.122 The normal reduction and other consequences rules in Subdivision 165-CD will apply if the head company is a loss company at an alteration time and the alteration time is not under the third modification discussed above.

11.123 If it is an alteration time under the third modification, the reduced cost base pooled cost amount is reduced by the amount of the head companys overall loss at the alteration time. The normal rules do not apply. ***[Schedule 7, item 2, subsection 719-735(2)]***

Other modifications

11.124 The requirement for a relevant equity interest to be at least a 10% holding does not apply to pooled interests. This is appropriate given the 100% relationship between the top company and the MEC group.

Diagram 11.5: Subdivision 165-CD and MEC groups

Diagram 11.6: Subdivision 165-CD and MEC groups

Division 727

11.125 The consequential amendments also cover situations where a consolidated or MEC group is involved in an indirect value shift under Division 727 (indirect value shifting affecting interests in companies and trusts, and arising from non-arms length dealings).

11.126 A group can be involved in an indirect value shift where a group member provides, or receives, economic benefits because of a non-arms length dealing with a related entity that is *not* a member of the group.

11.127 The rules are required to ensure that the effects of indirect value shifts do not inappropriately distort tax outcomes where one of the entities involved in the value shift is a member of a consolidated or MEC group. For example, if a member of a consolidated group sells a number of assets to an associate of the group for less than market value, this could result in a loss being made when a membership interest in the head company of the group is realised.

11.128 As discussed in paragraph 11.101, the single entity rule and entry history rules have been extended so that the head company is the only relevant group member in applying Division 727 to consolidated or MEC groups.

11.129 The consolidation framework means that it is, generally, not necessary to deal with the effects of indirect value shifts between group members. The effects of such shifts on interests held by one group member in another are generally dealt with by Division 711 or section 701-20 where the later member ceases to be a subsidiary member of the group. The pooling rules in Subdivision 719-K deal with the effect of indirect value shifts within a MEC group on pooled interests.

Division 727 and consolidated groups

11.130 One effect of extending the single entity rule is that the head company of a consolidated group will be the only group member that can be a losing entity or gaining entity in terms of Division 727. This applies from the perspective of the group and affected entities outside of the group.

11.131 Division 727 applies normally in most respects to the head company of a consolidated group. Some points to note are:

- the head company is taken to have provided and received all economic benefits in terms of the Division;
- the control and common ownership tests are applied in the normal way;
- only direct and indirect equity or loan interests in the head company of the consolidated group can be affected interests; and
- adjustments are made with regard to the market value effects of an indirect value shift on affected interests in the head company.

11.132 The first dot point is a consequence of the single entity rule being extended. The third point reflects the fact that direct and indirect equity or loan interests in members of a consolidated group, that are not actually in the head company, are covered by the LRM (see paragraphs 11.155 to 11.163).

11.133 Both the realisation time and adjustable value methods in Division 727 are available to work out the consequences of an indirect value shift involving the head company of a consolidated group. The fourth dot point reflects the fact that both of these methods have regard to the market value effects of the value shift.

Diagram 11.7: Division 727 and consolidated groups

Division 727 and MEC groups

11.134 As for consolidated groups, the head company of a MEC group will be the only group member that can be a losing entity or gaining entity under Division 727.

11.135 In many respects Division 727 applies normally to the head company of a MEC group. Some of the modifications to the operation of the Division are:

- the head company is taken to have provided and received all economic benefits in terms of the Division;
- the only interests that can be affected are:
- direct and indirect equity or loan interests in the top company for the MEC group; or
- pooled interests in eligible tier-1 companies that are members of a MEC group; and
- adjustments are made with regard to the market value effects of an indirect value shift on affected interests in the top company, and pooled cost amounts are adjusted for pooled interests.

11.136 The second dot point notes that only direct and indirect equity or loan interests in the top company for the MEC group and pooled interests can be affected by Division 727 when the head company is involved in an indirect value shift. ***[Schedule 7, item 2, section 719-755]***

11.137 These interests are a subset of direct and indirect equity or loan interests in the eligible tier-1 companies of a MEC group. The full set of these interests are similar in nature to those in the head company of a consolidated group.
11.138 The structure of MEC groups means that direct and indirect equity or loan interests in the top company for a MEC group are indirect equity or loan interests in the head company and other eligible tier-1 companies of the MEC group. Pooled interests are also equity interests in the head company and other eligible tier-1 companies. All other direct and indirect equity or loan interests in eligible tier-1 companies are covered by the LRM.
11.139 There will only be consequences of an indirect value shift for interests in the top company of a MEC group where such interests are affected interests in terms of Division 727. That is, they must be held just before the IVS time by an entity that is related to the head company.
11.140 All other equity or loan interests in members of a MEC group (not eligible tier-1 companies) are also covered by the loss reduction method (see paragraphs 11.155 to 11.163).

11.141 Both the realisation time and adjustable value methods in Division 727 are available to work out the consequences for interests in the top company of an indirect value shift involving the head company of a MEC group. Both of these methods have regard to the market value effects of the value shift and apply whether the head company is a losing entity or gaining entity for the indirect value shift.
11.142 The consequences for pooled interests in eligible tier-1 companies of a MEC group are different. If the head company is a losing entity for an indirect value shift, the cost base and reduced cost base pooled cost amounts are reduced by the amount of the indirect value shift. If the head company is a gaining entity, the pooled cost amounts are increased by the amount of the indirect value shift. The adjustments happen for the first trigger time for the pooled interests at or after the IVS time. [Schedule 7, item 2, subsection 719-755(3)]
11.143 Pooled cost amounts are adjusted in this way because regard cannot be had to which group member was involved in an indirect value shift. Without this information it is not generally possible to tell whether a change in the market value of an interest in an eligible tier-1 company is attributable to the value shift.
11.144 There is no requirement for pooled interests to be affected interests in terms of Division 727. However, in most (if not all) cases they would be affected interests under the Division.

Exceptions and exclusions

11.145 The normal exceptions and exclusions under Subdivision 165-CD and Division 727 will also generally apply.

Note: FIE is a foreign interposed entity and an ET-1 is an eligible tier-1 company. IVS is an indirect value shift. The loss reduction method is discussed in paragraphs 11.146 to 11.169.

Diagram 11.9: Division 727 and MEC groups

Loss Reduction Method

11.146 In their ordinary operation, the loss integrity measures and Division 727 of the GVSR make adjustments having regard to the market value effect of losses in, or value shifts affecting, an entity in which an interest is directly or indirectly held.
11.147 In the context of consolidated groups, such an application is problematic, especially for interests that are not held directly, or indirectly, in the head company. For example, a debt interest of an 80% associate of the head company in a subsidiary of the group.
11.148 The tracing of value problems are compounded in the case of MEC groups where the head entity will not be a relevant top company which might be expected to reflect the effect of group losses and value shifts.
11.149 If the group were not consolidated, it would be feasible to determine what losses or value shifts were relevant to a subsidiary, and therefore what amounts should be relevant in

respect of adjustments for interests held directly or indirectly in that subsidiary. However, in consolidation, the head company is taken to make all the losses and be the relevant entity for value shifts relating to non-group entities.

11.150 It is not considered feasible to require, or to allow, consolidated tax outcomes to be unbundled and recalculated on a legal entity basis for the purposes of applying the value shifting and loss integrity rules to external interests which have some connection with the consolidated or MEC group.

11.151 Thus, it is proposed that certain interests be subject to the LRM in cases where it is not possible to tell whether, and by how much, such interests are affected by a loss or indirect value shift involving the group.

11.152 Broadly, the method will mean that realised losses will be reduced to nil on such interests, unless it can reasonably be shown that the loss is attributable to factors other than group indirect value shifts (internal or external), decreases in the market value of group assets, and group losses.

When the LRM applies

11.153 The LRM applies to the interest of an entity where:

- the realisation of the interest results in a loss for income tax purposes;
- the interest was an equity or loan interest, or indirect equity or loan interest, in a member of a:
- consolidated group; or
- MEC group;

at some time during the period the entity owned it (some interests are excluded); and

- the entity was the head company of the group, a controller of the head company, or an associate of the head company or such a controller, at some time during the period the interest was owned.

[Schedule 7, item 1, section 715-610 and item 2, section 719-775]

11.154 Generally, where the LRM applies it reduces to nil the loss realised for income tax purposes. ***[Schedule 7, item 1, subsection 715-610(1) and item 2, subsection 719-775(1)]***

What interests are affected by the LRM?

11.155 These rules apply to all direct and indirect equity and loan interests in group members of a consolidated group or MEC group that are not covered by the rules relating to Subdivision 165-CD and Division 727.

11.156 Interests in consolidated groups and MEC groups not covered by the LRM are:

- direct and indirect equity or loan interests in the head company of a consolidated group;
- equity interests that are pooled interests in relation to a MEC group;
- direct and indirect equity or loan interests in the top company for a MEC group; and
- membership interests in, or liabilities owed by, an entity leaving the group.

[Schedule 7, item 1, subsection 715-610(2) and section 715-615 and item 2, sections 719-780, 719-785 and 719-790]

11.157 The last dot point in the above paragraph covers interests where special rules apply when an entity leaves the group. For example, Division 711 covers membership interests in a transitional foreign-held subsidiary.

11.158 Interests affected are generally those in a subsidiary member of a consolidated or MEC group, or in entities (below the top company for a MEC group) with pooled interests in eligible tier-1 companies of the group. For example, loans to subsidiary members of a consolidated group, and direct and indirect interests in the entities with such loans.

11.159 Not only must the realised interest of an entity be one covered by the LRM, but the owner must have a specified relationship to the group. That is, not all interests discussed above will be subject to the LRM.

11.160 For a loss on an interest to be affected by the LRM the owner must have:

- been the head company of the group;
- controlled (for value shifting purposes) the head company;
- been an associate of the head company; or
- been an associate of an entity that controlled (for value shifting purposes) the head company,

at some time during the period the interest was owned.

11.161 This ensures that only interests of entities with an appropriate relationship to the group, or its controllers, are subject to the LRM.

11.162 In practice, this means that interests of the top company for a MEC group, and of entities interposed between it and the eligible tier-1 companies of the group will be covered by the LRM (except for pooled interests). This is appropriate because the top company will control (for value shifting purposes) the head company and other entities will be associates of it or the head company.

11.163 These rules also cover interests in (direct or indirect) transitional foreign-held subsidiaries of a consolidated or MEC group.

Reductions to losses realised on affected interests

11.164 Where the LRM applies it reduces to nil losses realised for income tax purposes when a realisation event happens to relevant interests of entities. Division 977 (realisation events, and the gains and losses they realise for income tax purposes) of the ITAA 1997 provides for when a loss is realised by a realisation event. The main case is where a capital loss is made from a CGT event happening to a CGT asset. There are other realisation events for trading stock and revenue assets.

11.165 The loss is not reduced to nil, or it is reduced to a lesser extent, in some cases. This happens where it can be shown that the loss is attributable to things other than:

- something that would be reflected in an overall loss of a group member if it had an alteration time and Subdivision 165-CD applied to members of the group; or
- an indirect value shift, if Division 727 applied to members of the group, and a group member would have been the losing entity or gaining entity for the shift.

[Schedule 7, item 1, section 715-620 and item 2, section 719-795]

11.166 In some situations it may be possible to demonstrate that:

- part of the loss is attributable to a period when the interest was not an interest in the group, other than for interests in eligible tier-1 companies of a MEC group; or
- the interest is an indirect interest in the group, and the loss relates to an interposed non-group entity

11.167 If applying the last dot point, account would need to be taken of any operation of the loss integrity measures and general value shifting regime in respect of such non-group entities.

11.168 Interests covered by the LRM can also be affected by the loss integrity measures and general value shifting regime. For example, where they are relevant equity interests, relevant debt interests or equity or loan interests in non-group entities that have an alteration time or are involved in an indirect value shift. This could include a situation where the head company of a consolidated group has equity interests in an associate with a loan to a subsidiary member. The associate may have an alteration time under Subdivision 165-CD. In this case the head companys equity interest could be affected by the normal rules in Subdivision 165-CD. The LRM would not apply.

11.169 Reductions made under the LRM cannot be taken into account in working out uplifts and gain reductions under Division 727.

Diagram 11.10: Loss reduction method

LIM and GVSR: minor amendments and technical corrections

11.170 The amendments contained in Schedule 26 in relation to the global method of valuing assets under the LIM are explained in the following table.

Amended/inserted	*Effect of amendment/insertion*
ITAA 1997	
Subsection 165-115ZD(4) ***[Schedule 26, item 2]***	Ensures that the method statement deals with a case where the loss that would be realised on the interest is greater than or equal to the value removed from the company. The method statement does not currently do this, but the deficiency has no adverse consequences because of the reasonable adjustment tests in subsection 165-115ZB(6). This change does not therefore affect the practical operation of the law.
Paragraph 165-115ZD(5)(a) ***[Schedule 26, item 3]***	The amendment clarifies the meaning of notional capital gain and notional revenue gain by reference to the definitions in Subdivision 165-CC of the ITAA 1997.
Subsection 165-115ZD(9) ***[Schedule 26, item 4]***	The amendment inserts new subsection 165-115ZD(9). It ensures that if non-overlapping amounts of loss would arise under the capital gains and the revenue provisions on realisation of an equity or debt interest, the total of those amounts is taken into account in determining the amount of any adjustment to be made under section 165-115ZD.
IT(TP) Act 1997	
Subsection 165-115ZD(5) ***[Schedule 26, item 7]***	The amendment inserts new subsection 165-115ZD(5). It provides that if separate amounts of loss would arise under both the capital gains and the revenue provisions on realisation of an equity or debt interest, the total of those amounts is taken into account in determining the amount of any adjustment to be made under section 165-115ZD.

11.171 In addition to the amendments explained in the table, there are minor amendments to subsection 165-115ZD(1) of the ITAA 1997 and subsection 165-115ZD(1) and paragraph 165-115ZD(2)(a) of the IT(TP) Act 1997 to facilitate those amendments. ***[Schedule 26, items 1, 5 and 6]***

11.172 The amendments contained in Schedule 25 in relation to the general value shifting regime are explained in the following table:

Amended/inserted	*Effect of amendment*
ITAA 1997	
Section 136-10 ***[Schedule 25, items 1 to 3]***	The amendments remove a reference to the previous value shifting provisions from the table in section 136-10 and add a reference to CGT event K8, relating to the new direct value shifting rules
Subsection 727-715(3A) ***[Schedule 25, item 8]***	The amendment inserts new subsection 727-715(3A). Under new subsection 727-715(3A), if an equity or debt interest is trading stock or a revenue asset, the tax value used to determine whether the exception applies is the greater of its adjustable value as a CGT asset and its adjustable value as trading stock or a revenue asset.
Paragraph 727-715(4)(b) ***[Schedule 25,***	Amended paragraph 727-715(4)(b) makes it clear that if the threshold is worked out after the start of the income year, the relevant time is when the group relationship was last established between the entities.

item 9]	Normally, the threshold for determining whether the exception in section 727-715 applies is worked out at the start of the income year in which the interest is realised. However, if the entities providing and receiving the services entered into a group relationship after the start of the year, the threshold is worked out when the group relationship began.
Subsection 727-800(6A) ***[Schedule 25, item 10]***	The amendment inserts new subsection 727-800(6A). When the adjustable values of interests in an entity that loses value in a value shift are reduced, a complementary adjustment may be available under section 727-800 to the adjustable values of interests in an entity that gains value. The amounts of adjustments under this section are related to the reductions made to adjustable values of interests in the losing entity. Since there may be different adjustments for interests in the losing entity for different purposes (to their cost bases, reduced cost bases, and adjustable values as revenue assets or as trading stock), new subsection 727-800(6A) specifies which adjustments are relevant in calculating the complementary adjustments available.
IT(TP) Act 1997	
Subsection 723-1(1) ***[Schedule 25, item 11]***	The amendment revises subsection 723-1(1) by adopting the same terminology as is used in Division 723 of the ITAA 1997. The change has no effect on its operation.

11.173 There are also minor amendments in Schedule 25 to correct a number of references to section 104-250; to omit a superfluous word; and to remove an asterisk from a term (loan) which is not currently defined in the ITAA 1997 and is intended to have its ordinary meaning. ***[Schedule 25, items 4 to 7]***

11.174 The allocable cost rules in subsection 705-65(3) are also amended to ensure that any adjustment that would have been required to a realised loss on a membership interest just before the joining time (or under the rules in section 705-75 on an intra-group debt interest at that time) is taken into account for the purposes of subsection 705-65(1) and section 705-75 as a reduction to reduced cost base. ***[Schedule 7, item 7]***

11.175 Schedule 7 also makes a number of amendments to the dictionary for newly defined terms and to modify the scope of existing definitions. ***[Schedule 7, items 14 to item 29]***

Application and transitional provisions

11.176 Amendments addressing interactions with consolidation rules and other rules (Schedule 4) apply from the start of consolidations regime (1 July 2002).

11.177 Amendments to the loss integrity rules in Subdivision 165-CD global method apply from the commencement of those rules (at or after 1.00 pm Australian Capital Territory time on 11 November 1999). ***[Schedule 26, item 8]***

11.178 Amendments to the value shifting provisions apply from the start of the various GVSR Divisions affected (generally, 1 July 2002). ***[Schedule 25, item 12]***

Consequential amendments

11.179 There are no consequential amendments.

Chapter 12

Consolidation: technical amendments

Outline of chapter

12.1 This chapter explains:

- the rule that determines, for the purposes of the consolidation membership rules in Division 703 of the ITAA 1997, the time at which beneficial ownership of shares in a company changes when its shares are bought or sold by a consolidated group;

- technical amendments to provisions in Division 703 of the ITAA 1997 that relate to the period within which a choice to consolidate must be notified to the Commissioner; and
- amendments to the ITAA 1936 to ensure that the existing provisions in the income tax law to encourage investment in R&D interact properly with the consolidation provisions.

The amendments are in Schedules 2, 3 and 23 to this bill.

Context of reform

Beneficial ownership timing rule

12.2 Under the consolidation rules, a company becomes a member of a consolidated group when all its shares are beneficially owned, directly or indirectly, by the head company.

12.3 Concern was expressed about potential uncertainty as to when shares in a company become or cease to be beneficially owned, and therefore as to when the company joins or leaves a consolidated group as a result of becoming or ceasing to be wholly-owned

12.4 The potential for uncertainty arises because the time at which full beneficial ownership is transferred is a matter of interpretation. For example it is arguable that the vendor and purchaser may come to a different conclusion about the time at which it has occurred. This could potentially create uncertainty about when a company joins or leaves a consolidated group, or leaves one consolidated group and joins another. Certainty is important because upon a company joining a consolidated group, the head company becomes liable for its income tax liabilities.

12.5 In response, the timing rule has been developed in consultation, to deal with the majority of cases. This rule provides added certainty about the time at which a company joins or leaves a consolidated group, and generally accords with commercial practice as to when beneficial ownership of shares changes.

Period for notifying a choice to consolidate

12.6 This bill contains amendments to the membership rules for ordinary consolidated groups to rectify a technical deficiency relating to the timeframe within which the Commissioner must be notified of a choice to consolidate an eligible group of entities.

Research and development

12.7 The income tax law contains a number of provisions to encourage companies to invest in R&D activities. The September Consolidation Act made some amendments to ensure that this intention was not frustrated simply because a company was part of a consolidated group or because it joined or left such a group. This bill contains further such amendments. They aim to preserve the policies behind both regimes to the greatest extent possible.

Summary of new law

Beneficial ownership timing rule

12.8 A change in beneficial ownership of the shares in the company will be taken to have occurred at the time the vendor ceased to be entitled, and the purchaser became entitled to be registered as holder of the shares. This rule will apply where beneficial ownership changes as a consequence of an arms length transaction between non-related parties.

Period for notifying a choice to consolidate

12.9 Amendments will ensure that subsection 703-50(3) of the ITAA 1997, which describes the period within which a choice to consolidate can be notified to the Commissioner, is consistent with the underlying policy intent.

Research and development

12.10 The amendments prevent the possibility of 2 balancing adjustments applying when an asset used for R&D activities is lost or disposed of. They also modify the balancing adjustment that does apply, to ensure that it brings the correct figure to account in consolidation cases.

12.11 The amendments also make a number of minor amendments to correct errors in the current law or made by the September Consolidation Act.

Comparison of key features of new law and current law

New law	*Current law*
A timing rule has been introduced to	The law does not specifically prescribe the time at

provide certainty as to the time at which beneficial ownership changes as a result of a contract for the sale of shares, viz at the time entitlement to be registered moves from the vendor to the purchaser.	which beneficial ownership of shares in a company changes for the purposes of the consolidation membership rules.
Where the head company is required to lodge an income tax return for the income year in which a consolidated group comes into existence, the latest day that the head company can notify the Commissioner of its choice to consolidate is the day on which the head company gives the Commissioner that income tax return. **This will be the case irrespective of the day that is chosen for the consolidated group to come into existence.**	**Where the last day of an income year is nominated as the day on which a consolidated group is to come into existence, it is arguable that the latest day that the head company can notify the Commissioner of the choice to consolidate is the day on which the head company gives the Commissioner its income tax return for the next income year.**
New law	***Current law***
R&D assets that, because of consolidation, qualify for deductions under *both* the old expenditure-based treatment and the newer depreciation treatment will only use the balancing adjustment for the depreciation treatment. However, it is modified to take into account deductions claimed under the older treatment.	There is a balancing adjustment for R&D assets eligible for the old expenditure-based deduction and a separate balancing adjustment for those eligible for the newer depreciation-based deduction. In some cases, both adjustments can apply to the same asset.

Detailed explanation of new law

Beneficial ownership timing rule

12.12 A change in beneficial ownership of the shares in the company as a consequence of an arms length contract between non-associated parties will be taken to have occurred at the time the vendor ceased to be entitled, and the purchaser became entitled to be registered as holder of the shares. This rule will apply for the purposes of determining when a company becomes or ceases to be a member of a consolidated group (including a multiple entry consolidated group). ***[Schedule 2, item 1, section 703-33]***

12.13 The rule provides a timing overlay to section 703-30 of the ITAA 1997 in certain circumstances, while maintaining the policy intention of that section. It will not apply unless there has been a change in beneficial ownership of the relevant shares.

12.14 That is, beneficial ownership will remain the test for whether an entity is a wholly-owned subsidiary of another entity. Where beneficial ownership in shares of a company has changed as a result of a contract, the rule dictates at what point of time the change took place, for the purposes of determining the point in time at which the company began or ceased to be a member of a consolidated group.

12.15 The rule provides an outcome that:

- provides greater certainty than time of change in beneficial ownership alone. Different parties to a transaction might take differing views as when beneficial ownership is transferred in particular facts and circumstances; and
- is consistent with the policy intention of the consolidation membership rules, which is to consider only those interests that establish ownership.

12.16 Generally, the proposal provides the required certainty and aligns with commercial practice.

When does the timing rule apply?

Sale of shares in a company

12.17 The timing rule addresses concerns expressed in relation to the sale of shares in companies.

Between non-associates dealing at arms length

12.18 Further, the timing rule will only apply to dealings at arms length between parties that are not associates. This limitation protects against collusion between vendor and purchaser to effect a joining or leaving time that is not in accordance with the true transfer of ownership for other purposes.

12.19 If the parties to the contract are not dealing at arms length, or are associates, the basic rule set out in section 703-30 will apply. The time of the change in membership status will be when beneficial ownership changed. This will be determined according to the particular facts and circumstances.

What is entitlement to be registered?

12.20 Entitlement to be registered is a concept known to the law relating to companies, and refers to the ownership rights that give rise to the entitlement of a purchaser of shares in a company to be registered as holder of those shares in the companys register of members.

12.21 The concept has been used in the timing rule to ensure that a consolidated group is not required to bring the income of a target company into the group merely because, for example, it has signed a contract to purchase the shares in the company. Rather, that requirement commences when the vendor and the purchaser have done everything required under the contract to transfer ownership to the purchaser.

Things that do not prevent entitlement to be registered

12.22 Under this rule a member of a consolidated group will be entitled to be registered as the owner of shares in a purchased company notwithstanding that it has not, for example, paid the relevant stamp duty, or obtained any approval of the transfer that may be required from the directors of the target company.

12.23 So, for example, a member of a consolidated group could not claim that it is not entitled to be registered (thus avoiding the company becoming a member of the group and the consequent obligations) for the purpose of section 703-33 by reason only of its failure to pay State stamp duty on the transfer of the shares. A purchaser who fails to take the steps necessary to take advantage of its entitlement to become registered on the companys register of members cannot argue that it is not so entitled.

Period for notifying a choice to consolidate

12.24 Subsection 703-50(3) of the ITAA 1997 describes the period within which a choice to consolidate is required to be notified to the Commissioner. Where the head company is required to lodge an income tax return for the income year in which the consolidated group comes into existence, the underlying policy intention is for the period to start on the day on which the group consolidates and end on the day that that return is given to the Commissioner.

12.25 In certain circumstances, the period for notifying the choice is unintentionally extended by subsection 703-50(3). In particular, this occurs where a choice is made for the group to come into existence on the last day of the head companys income year. Arguably in this case, the end of the period for giving the choice is extended to the day on which the return for the next income year is given to the Commissioner. Amendments are made to rectify this problem. ***[Schedule 3, item 1, subparagraph 703-50(3)(b)(i)]***

Research and development

Balancing adjustments for R&D assets

12.26 The rate at which an asset depreciates for tax purposes does not necessarily reflect the actual decline in its value. Therefore, when the asset is sold for other than its depreciated value, the tax law brings an amount to account to reflect that difference. Sometimes, that amount is income and sometimes it is a deduction. In either case, the amount is called a balancing adjustment.

12.27 The R&D provisions were amended in 2001 to apply a depreciation-like treatment to assets used for R&D activities. Until then, deductions had been allowed for expenditure on such assets. That older treatment applies to expenditure under contracts entered into before noon 29 January 2001 in the Australian Capital Territory and the new treatment applies

afterwards. When an asset is sold, different balancing adjustments apply depending on which of those treatments applied to the asset.

12.28 Since the same asset cannot be covered by both of those treatments under the current law, only one of the balancing adjustments could apply when the asset is sold. However, in some consolidation situations it is possible for both treatments, and therefore both balancing adjustments, to apply.

12.29 The September Consolidation Act dealt with the possibility of deductions being claimed both under the old treatment and the newer depreciation treatment. It did not deal with concurrent application of the balancing adjustments.

Only one balancing adjustment applies

12.30 If both the expenditure, and the depreciation, balancing adjustments could apply, only the depreciation balancing adjustment will apply ***[Schedule 23, item 3, subsection 73BAG(1) of the ITAA 1936]***. Section 73BF of the ITAA 1936 and section 40-292 of the ITAA 1997 provide for the depreciation balancing adjustment.

12.31 The depreciation balancing adjustment was chosen because it will continue to operate into the future. The expenditure balancing adjustment (subsections 73B(23) and (24B) of the ITAA 1936) does not apply to any expenditure made under a contract entered into after 29 January 2001 (see subsections 73B(15AAA) and (15AAAA) of the ITAA 1936).

Amendments to the balancing adjustments

12.32 The balancing adjustment for R&D assets uses a modified version of the formula used for the balancing adjustment for normal depreciating assets, to reflect the fact that at least some of the depreciation would have been deducted at 125%.

12.33 The modified formula requires you to work out the proportion of the depreciation that was deducted at 125%. The same proportion of the normal balancing adjustment is then increased by 25% (see subsection 73BF(3) of the ITAA 1936 and subsection 40-292(4) of the ITAA 1997).

12.34 Because of the amendments made by the September Consolidation Act, the 125% deductions may be reduced by amounts of expenditure on the asset deducted under the old treatment. Therefore, the current amendments will increase the 125% depreciation deductions by the amount of those reductions, so that the formula correctly works out the proportion of the balancing adjustment that should be increased by 25%. ***[Schedule 23, item 8, subsection 73BF(3B) of the ITAA 1936]***

12.35 However, the 125% depreciation deductions are only increased by those reductions for that purpose if:

- the balancing adjustment is a *deduction* rather than an amount of assessable income;
- the head companys aggregate R&D expenditure for the year is more than $20,000; and
- the asset had been used exclusively for carrying on R&D activities since the consolidation provisions set its tax cost.

[Schedule 23, item 8, subsection 73BF(3A) of the ITAA 1936]

12.36 Those preconditions reproduce the same preconditions that the current law imposes in deciding whether to increase the balancing adjustment for the old expenditure treatment by 25% (see paragraphs 73B(23)(c), (e) and (f) and (24B)(c), (e) and (f) of the ITAA 1936).

12.37 The only change to those preconditions is that the requirement for the asset to have been used exclusively for R&D activities is limited to the period *after* its tax cost was set by the consolidation provisions. That change is in accordance with the fresh start approach that consolidation takes for depreciating assets generally.

Example 12.1: Deductible balancing adjustment

Janz Petrochemicals Ltd runs a laboratory and uses an electron microscope in its research. It acquired the microscope for $300,000 and had been writing off that expenditure under the old treatment. When the Masson Fuels group acquired Janz, only $100,000 remained to be deducted. The tax cost of the microscope was set at $450,000 in the hands of the Masson group. The group depreciates the microscope at a 20% rate on a straight-line basis.

In year 1, it claimed a $125,000 deduction under the old treatment (which is the last $100,000 of the original expenditure deducted at 125%). It also worked out a notional depreciation deduction of $90,000 under the new treatment but reduced it to nil because of the old treatment deduction (see section 73BAF of the ITAA 1936 in the September Consolidation Act). The other $10,000 of the expenditure deducted under the old treatment was carried over to year 2.
In year 2, it again worked out a notional depreciation deduction of $90,000. That was reduced to $80,000 because of the $10,000 carried over from year 1. At 125%, it claimed a deduction of $100,000. The microscope then had an adjustable value of $270,000 (i.e. $450,000 (2 $90,000)).
If the group sold the asset at that time for $250,000, there would be a balancing adjustment deduction. This would start at the $20,000 difference between the sale price and the adjustable value but would be increased by 25% to the extent that the decline in value from $450,000 was eligible for 125% deductions. Assuming that the preconditions were satisfied, the calculation would also include the expenditure deducted under the old treatment after the group acquired the asset. The calculation would be:

The $5,000 increase in the deduction here reflects the fact that, taking into account the expenditure that was deducted under the old treatment, all of the decline in the microscopes value was deductible at 125%.
12.38 Another amendment reduces the assets adjustable value for the purposes of working out the balancing adjustment. A depreciating assets adjustable value is its cost less its decline in value for tax purposes. The amendment reduces the adjustable value by the amount of expenditure on the asset that was deducted under the old treatment (after the entity joined the consolidated group) but has not yet been used to reduce the notional depreciation deductions under the new treatment. ***[Schedule 23, item 3, subsection 73BAG(2) of the ITAA 1936]***
Example 12.2: Variation to adjustable value
Suppose the group in the previous example had sold the microscope for $380,000 at the end of year 1. Its adjustable value at that time would have been $360,000 (i.e. the $450,000 less the $90,000 depreciation for the year). However, $10,000 of the deductible expenditure under the old treatment remained to be offset against depreciation in future years. That would be applied to reduce the adjustable value to $350,000, increasing the balancing adjustment from $20,000 to $30,000.
12.39 This amendment reflects the fact that, whenever the expenditure that is deductible under the old treatment exceeds the depreciation deduction, it is effectively bringing forward future depreciation. The decline in the assets value wont catch up with that until the excess that is carried forward has been used up. If the asset were sold before then, the excess would never be used up, so the balancing adjustment would never recognise the depreciation that was brought forward. The amendment corrects that by reducing the assets adjustable value by the amount of future depreciation that has not yet been caught up.
12.40 Some minor amendments are needed to ensure that the balancing adjustment can apply at all when deductions are also being claimed under the old expenditure treatment. The balancing adjustments are only triggered when deductions are claimed under section 73BA of the ITAA 1936 (see paragraph 73BF(1)(b) of the ITAA 1936 and paragraph 40-292(1)(b) of the ITAA 1997). The 25% modification can only apply if at least one deduction was claimed under that section at the 125% rate (see subsection 73BF(2) of the ITAA 1936 and subsection 40-292(3) of the ITAA 1997).
12.41 If deductions are claimed under the old expenditure treatment, deductions under the new depreciation treatment are reduced (see section 73BAF in the September Consolidation Act). If that reduces the depreciation deductions to nil, the preconditions for the balancing adjustment would not be satisfied. Therefore, the amendments ensure that the preconditions are satisfied if they would have been satisfied but for those reductions. [Schedule 23, items 4, 7, 10 and 11, paragraph 73BF(1)(b) and subsection 73BF(2) of the ITAA 1936 and paragraphs 40-292(1)(b) and (3)(b) of the ITAA 1997]
Minor research and amendment amendments

12.42 Some notes are added to existing provisions to inform readers of the effect of the substantive R&D amendments. ***[Schedule 23, items 1, 2, 6 and 12, subsections 73B(23), (24B) and 73BF(1) of the ITAA 1936 and section 40-292 of the ITAA 1997]***
12.43 Paragraph 73BF(1)(b) of the ITAA 1936 incorrectly refers to section 73BI as the provision under which a company can choose a tax offset instead of its R&D deductions. The provision it should refer to is section 73I and the amendments make that change. ***[Schedule 23, item 4, subparagraph 73BF(1)(b)(i) of the ITAA 1936]***
12.44 Subsection 701-55(2) of the ITAA 1997 lists some depreciation provisions and explains how they apply when an assets tax cost has been set by the consolidation regime. The amendments add sections 73BA and 73BF of the ITAA 1936 to the list because they also provide for depreciation. ***[Schedule 23, item 13, subsection 701-55(2) of the ITAA 1997]***
12.45 The September Consolidation Act amended the TAA 1953 to provide an administrative penalty when a former subsidiary fails to advise its former head company that it has recouped an amount for which the head company had claimed an R&D deduction (see item 15 of Schedule 11 to that Act). The penalty is one penalty unit for each 28 day period that the former subsidiary fails to provide that advice. No limit was imposed on the maximum amount of that penalty. To be consistent with similar penalties, the amendments limit the penalty to a maximum of 5 penalty units. ***[Schedule 23, item 14, paragraph 286-80(2)(b) of Schedule 1 to the TAA 1953]***

Application and transitional provisions

12.46 These amendments will take effect on 1 July 2002, along with other aspects of the consolidation measure.

Consequential amendments

Research and development

12.47 An amendment to section 73BF provides that the term aggregate research and development amount has the same meaning in that section as it has in section 73B ***[Schedule 23, item 9, subsection 73BF(7)]***. This term is used in section 73BF for the first time because of the amendment discussed in paragraph 12.35

Chapter 13

Simplified imputation system

Outline of chapter

13.1 Schedules 27 to 30 to this bill will amend Part 3-6 of the ITAA 1997 to insert rules for the following aspects of the SIS:

- venture capital franking;
- cum dividend sales and securities lending arrangements; and
- machinery provisions, for example, the rules relating to franking account returns and assessments.

13.2 These rules complement the core SIS rules set out in the *New Business Tax System (Imputation) Act 2002*, which apply from 1 July 2002.
13.3 In addition, consequential amendments will be made to the ITAA 1936 in relation to:

- section 177EA, the general anti-avoidance provision dealing with franking credit trading and dividend streaming; and
- certain dividend withholding tax provisions.

Summary of new law

13.4 These rules generally replicate the former provisions in Part IIIAA of the ITAA 1936, with changes to reflect the new rules and terminology of the SIS rules. The law has been rewritten using clearer and more accessible drafting techniques developed as part of the tax law improvement project.
13.5 The consequential amendments will ensure that section 177EA and the dividend withholding tax provisions operate as intended in relation to the SIS rules.

Detailed explanation of new law

Venture capital franking

Scheme of the legislation

13.6 The venture capital franking provisions are designed to encourage venture capital investment in Australia by allowing resident complying superannuation funds (and like entities) a special tax offset which enables them to receive venture capital gains free of tax through PDFs.

13.7 Eligible superannuation entities will receive a tax offset for CGT paid by PDFs on venture capital investments. To trace the CGT paid by the PDFs through to their shareholders, the concept of venture capital franked dividends applies.

13.8 For eligible superannuation funds (and like entities) that receive a venture capital franked dividend, the dividend will be exempt income. However, the shareholder will also receive a tax offset for the attached venture capital credits which effectively exempts from tax the underlying venture capital gain.

New provisions

13.9 The new venture capital franking provisions are in Division 210 of the ITAA 1997. In line with the rules that apply to ordinary companies, the franking and venture capital sub-accounts of PDFs will be maintained on a tax-paid basis.

13.10 Table 13.1 provides cross-references from the new provisions in the ITAA 1997 to the former provisions in the ITAA 1936.

Table 13.1: New venture capital franking provisions and equivalent ITAA 1936 provisions

Provisions	*ITAA 1997*	*ITAA 1936*
Franking a distribution with a venture capital credit.	210-30	160AQF
What is a participating PDF.	210-40	No equivalent provision
Which distributions can be franked with a venture capital credit?	210-50	160ASEL(1) and (2)
Amount of the venture capital credit on a distribution.	210-60	160ASEL(3) and (4)
Additional information to be included when a distribution is franked with a venture capital credit.	210-70	160AQH
Draining the venture capital surplus when a distribution frankable with venture capital credits is made.	210-80	160ASEM
Venture capital sub-account.	210-100	160ASEB
Venture capital credits.	210-105	160ASED(1) and (3)
Determining the extent to which a franking credit is reasonably attributable to a particular payment of tax.	210-110	160ASED(2)
Participating PDF may elect to have venture capital credits arise on its assessment day.	210-115	160ASED(4) and (5)
Venture capital debits.	210-120	160ASEG 160ASED(6) to (9) 160ASEM(2) 160ASEJ 160ASEH(1)
Venture capital debit where CGT limit is exceeded.	210-125	160ASEH
Venture capital surplus and deficit.	210-130	160ASEC
Venture capital deficit tax.	210-135	160ASEN
Effect of a liability to pay venture capital deficit tax on	210-140	160AQJ(1C)

franking deficit tax.		
Effect of a liability to pay venture capital deficit tax on the franking account.	210-145	160APVP
Provisions	***ITAA 1997***	***ITAA 1936***
Deferring venture capital deficit.	210-150	subsection 4(2)[1]
Tax offset for certain recipients of distributions franked with venture capital credits.	210-170	160ASEP(1)
Amount of the tax offset.	210-175	160ASEP(2) and (3)
Application of Division 207 where the recipient is entitled to a tax offset under section 201-105.	210-180	160AQT(6)

Cum dividend sales and securities lending arrangements
Scheme of the legislation
13.11 Broadly speaking, these provisions provide for the flow of imputation credits when interests are sold under a cum-dividend contract on a stock exchange or a franked distribution is received by a borrower under a securities lending arrangement.
13.12 A member to whom a franked distribution is paid in respect of a particular share is able to pass that distribution on to either a transferee under a contract for the sale of the interest on the stock exchange or to a lender under a securities lending arrangement. A transferee who receives a distribution from a member has the same status as the original member and is able to pass that distribution on to another transferee or lender. The member who may transfer membership status is the actual person whose name in the interests is registered, a person who has the right to be registered as the member or a transferee or lender who has obtained membership status by a previous application of this rule.
13.13 Where the franked distribution is paid on shares that are the subject of a cum-dividend contract of sale the franked distribution paid is able to be transferred to the person to whom the member (see paragraph 13.12) was under an obligation to transfer the interests at the time the company closed its books to determine the members to whom the distribution would be paid.
13.14 A member who is a borrower under a securities lending arrangement at the time the company determined the entitlement to the distribution and under an obligation to transfer the distribution to the lender, is able to transfer the franked distribution to the lender.
New provisions
13.15 The new provisions dealing with the transfer of membership status for tax purposes are in Division 216 of the ITAA 1997. Table 13.2 provides cross-references from the new provisions to the former provisions in the ITAA 1936.
Table 13.2: New cum dividend sales and securities lending arrangement provisions and equivalent ITAA 1936 provisions

Provision	*ITAA 1997*	*ITAA 1936*
On-market sale with a distribution statement by securities dealer.	210-20	160AQUB
Cum-dividend sale statement by party.	210-25	160AQUC
Securities lending arrangements statement by borrower.	**216-30**	**160AQUD**
When distributions made to a member will be taken to have been made to someone else.	**216-1**	**160AQUA(1)**
First situation (cum-dividend sales).	**216-5**	**160AQUA(1)**
Second situation (securities lending arrangements).	**210-10**	**160AQUA(1)**

Distribution closing time.	216-15	160AQUA(2)

Machinery provisions

Scheme of the legislation

13.16 The proposed machinery provisions for the SIS are broadly based on the former machinery provisions in Divisions 8 to 12 of Part IIIAA of the ITAA 1936. The machinery provisions relate to:

- the lodgement of returns, assessments, and the collection and recovery of tax relevant to the imputation system;
- evidentiary requirements and objection rights as they apply to franking returns and assessments;
- imposition of the GIC;
- record keeping requirements; and
- the power of the Commissioner to obtain information from tax agents.

13.17 Part IIIAA formerly imposed a franking deficit tax and in certain circumstances, franking additional tax, where a companys franking account was in deficit at the end of the franking year. In circumstances where a deficit was deferred to the following income year, a deficit deferral tax and a deficit deferral penalty tax were imposed. Under the new rules, these 4 taxes are effectively rolled into one tax, that is, franking deficit tax.

13.18 The benchmark rules impose a new tax called over franking tax. Accordingly, the machinery provisions including items, those relating to assessment, collection and recovery, will also apply to over franking tax.

New provisions

13.19 The new machinery provisions will be in Division 214 of the ITAA 1997. Table 13.3 provides cross-references from the new provisions in the ITAA 1997 to the former provisions in the ITAA 1936.

Retrospective franking

13.20 Private companies are generally permitted to frank distributions within the period of 4 months after the end of the income year. However, a private company will not be able to frank distributions retrospectively if a franking deficit tax liability would arise or be increased as a consequence. ***[Schedule 28, item 1, subsection 202-75(4)]***

Significant variation of benchmark percentage

13.21 An entity is required by section 204-75 to notify the Commissioner of a significant variation in the benchmark percentage from one franking period to the next. This notification must be given either with a franking return or within one month after the end of the income year in which the franking period occurs. ***[Schedule 28, item 2, subsection 204-75(4)]***

13.22 Some new rules are required to reflect the rolling-in of deficit deferral tax into franking deficit tax. An amendment to a franking assessment will arise automatically if a corporate tax entity has an franking deficit tax liability in respect of a franking account deficit at the end of the income year and then receives a refund of tax after the end of the income year that results in an increased franking deficit tax liability. ***[Schedule 28, item 3, section 214-65]***

13.23 However, an amendment will not arise where the 14 day period for payment of a franking deficit tax liability arising in respect of a tax refund would expire on or before the end of the month following the income year. In this case, the due date is extended to the end of the month following the income year and a company would simply show a revised franking account balance and a franking deficit tax liability on the franking return, which would be assessed under section 214-50. This outcome is achieved because section 214-40, which requires a company to lodge a return within 14 days for a franking deficit tax liability arising in respect of a tax refund, does not apply where an entity has an outstanding franking return at the time a tax refund is received. ***[Schedule 28, item 3, sections 214-40 and 214-50]***

Late balancing companies

13.24 A parallel set of machinery provisions for late balancing companies that elect to have their franking deficit tax liability determined on 30 June rather than at the end of their income year is provided in Division 214 of the IT (TP) Act 1997. ***[Schedule 28, item 13, Division 214 of the IT(TP) Act 1997]***

Table 13.3: New machinery provisions and equivalent ITAA 1936 provisions

Provision	***ITAA 1997***	***ITAA 1936***
Notice to give a franking return general notice.	214-5	160ARE
Notice to a specific corporate tax entity.	214-10	160ARF
Content and form of a franking return.	214-15	160ARG
Franking account balance.	214-20	160APA
Venture capital sub-account balance.	214-25	160APA
Meaning of franking tax.	214-30	No equivalent
Effect of a refund on franking returns.	214-40	160AREA
Evidence.	214-43	160ARS
Commissioner may make a franking assessment.	214-45	160ARK
Commissioner taken to have made a franking assessment on first return.	214-50	160ARH
Part-year assessment.	214-55	160ARJ
Validity of assessment.	214-56	160ARQ
Objections.	214-57	160ART
Evidence.	214-58	160ARS
Amendments within 3 years of the original assessment.	214-60	160ARN(1)
Amended assessments are treated as franking assessments.	214-63	160ARN(9)
Further return as a result of a refund affecting a franking deficit tax liability.	214-65	No equivalent
Later amendments on request.	214-70	160ARN(6)
Later amendments failure to make proper disclosure.	214-75	160ARN(3)
Later amendments fraud or evasion.	214-80	160ARN(3)
Further amendment of an amended particular.	214-85	160ARN(5)
Other later amendments.	214-90	160ARN(1), (4)
Amendment on review.	214-95	160ARN(7)
Notice of amendments.	214-100	160ARM
Due date for payment of franking tax.	214-115	160ARU
GIC.	214-120	160ARW
Refunds of amounts overpaid.	214-125	160ARR
Record keeping.	214-130	160ASC
Power of Commissioner to obtain information.	214-135	160ASD
Tax agents.	214-140	160ASE

Consequential amendments to ITAA 1936

13.25 Consequential amendments have been made to the following provisions of the ITAA 1936 to reflect the new SIS rules and terms:

- section 177EA, the general anti-avoidance provision dealing with franking credit trading and dividend streaming ***[Schedule 29, item 11]***; and

- paragraphs 128B(3)(aaa), 128B(3)(ga) and 128B(3)(gaa), which deal with the interaction between the imputation system and the dividend withholding tax regime ***[Schedule 29, items 8 to 10]***.

Application and transitional provisions

13.26 These amendments generally apply to events arising on or after 1 July 2002, when the SIS rules commenced. ***[Clause 2]***

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New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002

Clauses

Bill reference	*Paragraph number*
Clause 2	13.26

Schedule 1: Consolidation: amendments of various cost base provisions

Bill reference	*Paragraph number*
Items 1 and 2, subsections 705-155(2) and (3) and section 705-230	5.56
Item 1, subsection 705-155(4)	5.57
Item 1, subsection 705-155(5)	5.58
Item 1, subsection 705-155(6)	5.59
Item 3	5.117
Item 4, subsection 705-90(3)	5.115
Items 5 to 8	5.117
Items 9 and 10, subsections 705-160(1) and 705-235(1)	5.62
Items 9 and 10, subsections 705-160(2) and 705-235(2)	5.67
Items 9 and 10, subsections 705-160(3) and 705-235(3)	5.68
Items 9 and 10, paragraphs 705-160(2)(a) and (b) and 705-235(2)(a)	5.66
Items 9 and 10, subsections 705-160(4) and 705-235(4)	5.70

Items 9 and 10, subsections 705-160(5) and 705-235(5)	5.71
Items 9 and 10, paragraphs 705-160(4)(a), (b) and (c) and 705-235(4)(a) and (b)	5.69
Item 11, section 705-60, item 3A in the table	5.46
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Item 14, subsection 705-93(1)	5.46
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Items 15 and 22, subsections 705-147(2) and (5) and 705-227(2) and (5)	5.51
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Item 23, subsection 701-25(4)	5.101
Item 24, subsection 701-45(3)	5.96
Item 25, subparagraph 701-75(3)(a)(ii)	5.101
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Schedule 2: Consolidation: beneficial ownership

Bill reference	***Paragraph number***
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Schedule 3: Consolidation: technical amendment of membership rules

Bill reference	***Paragraph number***
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Schedule 4: Consolidation: adjustments for errors etc

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Item 2, subsection 705-315(2)	5.19
Item 2, subsection 705-315(3)	5.19
Item 2, subsection 705-315(4)	5.19
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Item 1, section 713-500	1.9

Item 1, section 713-505	1.11
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Item 1, paragraph 713-515(1)(b)	1.39
Item 1, paragraph 713-515(1)(c)	1.48
Item 1, paragraph 713-515(2)(a)	1.36, 1.43
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Item 1, subsection 713-515(3)	1.49
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Item 10, subsection 713-505(2) of the IT(TP) Act 1997	1.65
Item 10, subsection 713-505(3) of the IT(TP) Act 1997	1.66
Item 10, subsection 713-505(4) of the IT(TP) Act 1997	1.67
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Item 10, subsection 713-520(2) of the IT(TP) Act 1997	1.64, 1.85
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Item 5, section 701C-30, note 1(c)	4.42
Item 5, section 701C-35	4.45
Item 5, section 701C-40	4.52
Item 5, section 701C-50	4.59
Item 5, subsection 701C-10(6)	4.15
Item 5, subsection 701C-10(7)	4.17
Item 5, subsection 701C-15(4)	4.26
Item 5, subsection 701C-25(2)	4.39
Item 5, subsections 701C-10(1) to (5)	4.12
Item 5, subsections 701C-15(1) to (3)	4.25

Schedule 17: Consolidation: transitional cost setting rule relating to roll-overs

Bill reference	***Paragraph number***
Items 1 and 2, subsections 701-35(1) and 701-35(2)	5.103
Item 2, subsection 701-35(3)	5.83
Item 2, paragraph 701-35(3)(a)	5.85
Item 2, paragraph 701-35(3)(b)	5.86
Item 2, paragraph 701-35(3)(c)	5.87
Items 2 and 3, paragraph 701-35(3)(c) and section 719-163	5.89

Schedule 18: Consolidation: extra transitional provision for foreign tax credits

Bill reference	***Paragraph number***

Item 1	7.87
Item 1, subitem 11(2) of Schedule 10 of the June Consolidation Act	7.88

Schedule 19: Consolidation: amendment of losses rules

Bill reference	***Paragraph number***
Item 1, subsection 701-30(3A)	6.13, 6.19; Example 6.1
Item 1, paragraph 701-30(3A)(a)	6.17
Item 1, subparagraph 701-30(3A)(b)(i)	6.17
Item 1, subparagraph 701-30(3A)(b)(ii)	6.17
Item 2	6.29
Item 2, subsection 701-30(8)	6.22, 6.28
Item 2, subsection 701-30(9)	6.23
Item 2, subsections 701-30(8) and (9)	6.31
Item 3	6.29
Item 4, subsections 707-326(1) and (2)	6.49
Item 4, paragraph 707-326(1)(b)	6.39
Item 4, subsection 707-326(3)	6.51
Item 4, subsection 707-326(4)	6.51
Item 4, subsection 707-326(5)	6.52
Item 5, subsection 707-328A(1)	6.40
Item 5, paragraph 707-328A(1)(a) and subsection 707-328A(2)	6.44
Item 5, paragraph 707-328A(1)(b)	6.44
Item 5, paragraph 707-328A(1)(c)	6.44
Item 5, paragraph 707-328A(1)(d)	6.42
Item 5, paragraph 707-328A(1)(d)	6.44

Item 5, subsection 707-328A(3)	6.40
Item 5, subsection 707-328A(4)	6.42
Item 5, subsection 707-328A(5)	6.48
Item 5, subsection 707-328A(6)	6.39, 6.48
Item 5, subsection 707-328A(7)	6.46
Item 6, subitem 39(10) of the May Consolidation Act	6.28
Item 7	6.55

Schedule 20: Consolidation: transfers of losses involving financial corporations

Bill reference	***Paragraph number***
Item 1, subsection 20(1A) and item 2, subsection 20(1A)	6.60
Item 3, paragraph 26C(3)(c)	6.67
Item 3, subsections 26C(2) and (3)	6.66
Item 4, subsection 170-5(5)	6.61
Item 5, subsection 170-75(1)	6.62
Item 5, subsection 170-75(2)	6.65
Item 5, paragraph 170-75(2)(b)	6.64
Item 5, subsection 170-75(3)	6.63
Item 7, subsection 170-175(1)	6.62
Item 7, subsection 170-175(2)	6.65
Item 7, paragraph 170-175(2)(b)	6.64
Item 7, subsection 170-175(3)	6.63

Schedule 21: Consolidation: CGT events relating to various cost base provisions

Bill reference	***Paragraph number***
Item 1	5.139
Items 2 and 4	5.140

Item 3, subsection 104-505(1)	5.124
Item 3, subsection 104-505(2)	5.125
Item 3, subsection 104-505(3)	5.124
Item 3, section 104-510	5.128
Item 3, subsection 104-510(2)	5.129
Item 3, subsection 104-515(1)	5.132
Item 3, subsection 104-515(2)	5.134, 5.138
Item 3, subsection 104-515(3)	5.133
Item 3, subsection 104-520(1)	5.136
Item 3, subsection 104-520(3)	5.137
Items 5 to 7	5.141

Schedule 22: Consolidation: thin capitalisation

Bill reference	***Paragraph number***
Item 1, subparagraph 820-599(2)(c)(iv)	7.92, 7.96
Item 1, subparagraphs 820-599(2)(c)(v)	7.96

Schedule 23: Consolidation: research and development

Bill reference	***Paragraph number***
Items 1, 2, 6 and 12, subsections 73B(23), (24B) and 73BF(1) of the ITAA 1936 and section 40-292 of the ITAA 1997	12.42
Item 3, subsection 73BAG(1) of the ITAA 1936	12.30
Item 3, subsection 73BAG(2) of the ITAA 1936	12.38
Items 4, 7, 10 and 11, paragraph 73BF(1)(b) and subsection 73BF(2) of the ITAA 1936 and paragraphs 40-292(1)(b) and (3)(b) of the ITAA 1997	12.41
Item 4, subparagraph 73BF(1)(b)(i) of the ITAA 1936	12.43
Item 8, subsection 73BF(3A) of the ITAA 1936	12.35
Item 8, subsection 73BF(3B) of the ITAA 1936	12.34
Item 9, subsection 73BF(7)	12.47

Item 13, subsection 701-55(2) of the ITAA 1997	12.44
Item 14, paragraph 286-80(2)(b) of Schedule 1 to the TAA 1953	12.45

Schedule 24: Pay as you go (PAYG) instalments

Bill reference	***Paragraph number***
Item 1, subsection 45-120(2A)	8.86
Item 5, section 45-705	8.28
Item 5, subsection 45-705(1)	8.29
Item 5, subsection 45-705(2)	8.30
Item 5, subsection 45-705(3)	8.39
Item 5, subsection 45-705(4)	8.45
Item 5, subsection 45-705(5)	8.50
Item 5, paragraph 45-705(5)(a)	8.51
Item 5, paragraph 45-705(5)(b)	8.53
Item 5, paragraph 45-705(5)(c)	8.56
Item 5, paragraph 45-705(5)(d)	8.61
Item 5, subsection 45-705(6)	8.55
Item 5, subsection 45-705(7)	8.59
Item 5, subsection 45-705(8)	8.65
Item 5, subsection 45-705(9)	8.64
Item 7, subsection 45-740(1)	8.67
Item 7, subsection 45-740(2)	8.68
Item 7, subsection 45-740(3)	8.71
Item 7, subsection 45-740(4)	8.71
Item 7, paragraphs 45-740(3)(a), (c) and (d)	8.70
Item 7, paragraph 45-740(3)(b)	8.73
Item 7, subsection 45-740(5)	8.74

Item 7, subsection 45-740(6)	8.75
Item 7, subsection 45-740(7)	8.76
Item 7, subsection 45-740(8)	8.77
Item 9, subsection 45-775(4)	8.79, 8.80
Item 9, subsection 45-775(5)	8.79, 8.81
Item 18, Subdivision 45-S	8.111
Item 18, section 45-880	8.89
Item 18, subsection 45-880(1)	8.90
Item 18, subsection 45-880(2)	8.93, 8.94
Item 18, subsection 45-880(3)	8.96
Item 18, subsection 45-880(4)	8.97
Item 18, subsection 45-880(5)	8.94
Item 18, subsection 45-880(6)	8.92
Item 18, subsection 45-880(7)	8.99
Item 18, section 45-885	8.104
Item 18, subsections 45-885(1) and (4)	8.105
Item 18, paragraph 45-885(2)(a)	8.107
Item 18, paragraph 45-885(2)(b)	8.108
Item 18, subsection 45-885(3)	8.106
Item 18, section 45-905	8.111
Item 18, subsections 45-910(1) and (2)	8.152
Item 18, paragraph 45-910(3)(e)	8.118
Item 18, subsection 45-910(1)	8.112
Item 18, subsection 45-910(2), Table item 1	8.114
Item 18, subsection 45-910(2), Table item 2	8.115
Item 18, subsection 45-910(2), Table item 3	8.116
Item 18, subsection 45-910(2)	8.113

Item 18, subsection 45-910(3)	8.117
Item 18, paragraph 45-910(3)(h)	8.178
Item 18, section 45-913	8.118
Item 18, subsection 45-915(1)	8.123
Item 18, subsection 45-915(2)	8.124
Item 18, subsections 45-915(3) and (5)	8.132
Item 18, subsections 45-915(4) and (5)	8.140
Item 18, subsection 45-915(6)	8.144
Item 18, paragraph 45-915(6)(a)	8.145
Item 18, paragraph 45-915(6)(b)	8.146
Item 18, paragraph 45-915(6)(c)	8.147
Item 18, subsection 45-915(7)	8.150
Item 18, subsection 45-915(8)	8.149
Item 18, section 45-917	8.153
Item 18, subsection 45-920(1)	8.156
Item 18, paragraph 45-920(2)(a)	8.157
Item 18, paragraph 45-920(2)(b)	8.158
Item 18, subsection 45-920(3)	8.161
Item 18, paragraphs 45-920(3)(a), (c) and (d)	8.160
Item 18, paragraph 45-920(3)(b)	8.163
Item 18, subsection 45-920(4)	8.160
Item 18, subsections 45-920(5)	8.161
Item 18, subsection 45-920(6)	8.164
Item 18, subsection 45-920(7)	8.165
Item 18, subsection 45-920(8)	8.166
Item 18, subsection 45-920(9)	8.167
Item 18, section 45-922	8.169

Item 18, section 45-925	8.175
Item 18, subsection 45-930(1)	8.179
Item 18, subsection 45-930(2)	8.180
Item 18, section 45-935	8.182
Subitem 19(1)	8.184
Subitem 19(2)	8.183
Item 21, subsection 995-1(1), paragraph (a) of the definition of created	8.36
Item 21, subsection 995-1(1), paragraph (b) of the definition of created	8.52, 8.129
Item 22, subsection 995-1(1)	8.31
Item 22, subsection 995-1(1), paragraph (a) of the definition of initial head company instalment rate	8.32, 8.125
Item 22, subsection 995-1(1), subparagraph (b)(i) of the definition of initial head company instalment rate	8.34, 8.127
Item 22, subsection 995-1(1), subparagraph (b)(ii) of the definition of initial head company instalment rate	8.35, 8.128
Item 23	8.183

Schedule 25: Value shifting

Bill reference	***Paragraph number***
Items 1 to 3	Table in 11.172
Items 4 to 7	11.173
Item 8	Table in 11.172
Item 9	Table in 11.172
Item 10	Table in 11.172
Item 11	Table in 11.172
Item 12	11.178

Schedule 26: Loss integrity rules: global method of valuing assets

Bill reference	***Paragraph number***

Item 1	11.171
Item 2	Table in 11.170
Item 3	Table in 11.170
Item 4	Table in 11.170
Items 5 and 6	11.171
Item 7	Table in 11.170
Item 8	11.177

Schedule 28: Venture capital franking

Bill reference	***Paragraph number***
Item 1, subsection 202-75(4)	13.20
Item 2, subsection 204-75(4)	13.21
Item 3, sections 214-40 and 214-50	13.23
Item 3, section 214-65	13.22
Item 13, Division 214 of the IT(TP) Act 1997	13.24

Schedule 29: Consequential amendments relating to the simplified imputation system

Bill reference	***Paragraph number***
Items 8 to 10	13.25
Item 11	13.25