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HOUSE OF REPRESENTATIVES

NEW BUSINESS TAX SYSTEM (CONSOLIDATION) BILL (No. 1) 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.

<i>Abbreviation</i>	<i>Definition</i>
AASB	Australian Accounting Standards Board
<i>A Platform for Consultation</i>	Review of Business Taxation: <i>A Platform for Consultation</i>
<i>A Tax System Redesigned</i>	Review of Business Taxation: <i>A Tax System Redesigned</i>
ADF	approved deposit fund
ASIC	Australian Securities and Investment Commission
ATO	Australian taxation Office
BAS	business activity statement
CFC	controlled foreign company
CGT	capital gains tax
Commissioner	Commissioner of Taxation
COT	continuity of ownership test
December 2000 exposure draft	New Business Tax System (Consolidation) Bill 2000 exposure draft
February 2002 exposure draft	New Business Tax System (Consolidation) Bill 2002 exposure draft
GDP	gross domestic product
ESAS	Employee Share Acquisition Scheme
FBT	fringe benefits tax
FIF	foreign investment fund
GIC	general interest charge
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
ITRA 1986	<i>Income Tax Rates Act 1986</i>
MEC	multiple entry consolidated
PAYG	pay as you go
PDF	pooled deposit fund
PST	pooled superannuation trust
RSA	retirement savings account
SAC	Statement of Accounting Concept
SAP	substituted accounting period

<i>Abbreviation</i>	<i>Definition</i>
SBT	same business test
TAA 1953	<i>Taxation Administration Act 1953</i>
TSA	tax sharing agreement
Thin Capitalisation legislation	<i>New Business Tax System (Thin Capitalisation) Act 2001</i>

General outline and financial impact

Consolidated groups

The consolidation measure represents a significant change to the taxation of corporate groups. Due to its magnitude, the measure will be enacted progressively via a series of bills. Schedule 1 to this bill contains most of the key elements of the measure. Broadly, the rules contained in this bill will:

- allow wholly-owned groups of entities to make a choice to consolidate and therefore be treated as a single entity for the purposes of determining income tax liability;
- determine the membership of a consolidated group, including the membership of certain groups with a single non-resident head company;
- determine the cost (for income tax liability purposes) of assets, including membership interests, in relation to consolidated groups;
- allow, in certain circumstances, pre-consolidation losses to be transferred to the head company of a consolidated group, and prescribe how those losses may subsequently be used by the head company;
- allow the transfer of franking credits to a consolidated group;
- determine PAYG instalments for consolidated groups;
- determine tax liability for income tax payments within a consolidated group where a head company fails to pay on time; and
- remove certain existing grouping provisions, including those allowing transfer of losses and CGT roll-over relief for the transfer of assets between wholly-owned company groups.

Date of effect: Wholly-owned entity groups will be allowed to choose to consolidate under this scheme from 1 July 2002. The existing grouping provisions will continue to operate in parallel with the consolidation regime until 1 July 2003, subject to special rules applying to consolidated groups with a head company with a SAP. In general, such SAP groups will retain access to grouping provisions until the date of consolidation, provided that the head company chooses to consolidate from the first day of their next income year commencing after 1 July 2003.

Proposal announced: The proposals were announced in Treasurer's Press Release No. 58 of 21 September 1999.

Financial impact: The consolidation measure is expected to cost approximately a billion dollars over the forward estimate period. This cost largely relates to the transitional concessions and the expectation that groups will be able to use their losses faster than is allowed under the current law.

Compliance cost impact: The measures in this bill are expected to reduce ongoing compliance costs by ensuring that:

- intra-group transactions are ignored for taxation purposes, so that taxation and accounting treatment are more closely aligned;
- administrative requirements, such as multiple tax returns and multiple franking account, losses, foreign tax credit, and PAYG obligations, are reduced; and
- integrity measures aimed at preventing loss duplication, value shifting or the avoidance or deferral of capital gains within groups do not apply within a consolidated group.

The consolidation regime will necessitate some initial up-front costs for groups as they familiarise themselves with the new law, update software and notify the ATO of a choice to consolidate. Large corporate groups may incur greater start-up costs in determining the market values of group assets. These costs will be alleviated by a transitional measure under which the group can elect (prior to 1 July 2003) to bring assets into the group at their existing cost bases. Groups that form after the transitional period may use the market value guidelines developed by the ATO to minimise compliance costs.

Summary of regulation impact statement

Regulation impact on business

Impact: Medium to high.

Main points:

- The consolidation measure will implement a system which treats wholly-owned groups as a single entity for income tax purposes.
- Consolidation will address efficiency and integrity problems in the existing taxation of wholly-owned groups, including compliance and general tax costs, double taxation, tax avoidance through intra-group dealings, loss cascading and value shifting.

- The regime will assist in the simplification of the tax system, resulting in both reduced taxpayer compliance costs and ATO administration costs, improve the efficiency of business restructuring and strengthen the integrity of the income tax system.
- Wholly-owned groups that do not consolidate will no longer have access to grouping rules, which currently provide some of the benefits intended to be replaced by consolidation.

Chapter 1

Overview of consolidation

Outline of explanatory memorandum

1.1 Where a consolidated group is formed, the group is treated as a single entity for income tax purposes. Broadly, this means that the subsidiary entities lose their individual income tax identities and are treated as parts of the head company of the consolidated group (rather than separate entities) for the purposes of determining income tax liability during the period in which they are members of the group.

1.2 The consolidation regime will apply primarily to a wholly-owned group of Australian resident entities that chooses to form a consolidated group for income tax purposes. In general, such a group must be wholly-owned by an Australian resident company. Specific rules provide for the membership of certain resident wholly-owned subsidiaries of a foreign holding company (MEC group). Eligible wholly-owned groups will be able to choose to form a consolidated group from 1 July 2002.

1.3 Chapter 2 deals with the core rules of consolidation, such as the single entity rule, and their consequences. Chapter 3 explains the rules dealing with the formation and membership of a consolidated group, including rules about the types of entities that are eligible to join, and making the choice to form a consolidated group. Chapter 4 deals with the membership rules relating to MEC groups.

1.4 The subsequent chapters deal with other specific rules necessary for the implementation of the consolidation regime, including:

- setting of the cost of assets of entities that join or leave a consolidated group (including membership interests);
- the transfer and use of losses relating to a pre-consolidation period;
- the treatment of franking accounts in consolidated groups;
- applying the PAYG instalments regime to members of consolidated groups in an appropriate way;
- rules that apply where a head company fails to satisfy a group income tax related liability on time and which allow the recovery of that group liability directly from other members of the group; and
- removal, cessation or modification of the existing loss transfer and CGT asset rollover grouping provisions under the ITAA 1997.

1.5 The general principles for taxation of consolidated groups – single entity rule, membership, setting of cost bases and treatment of losses – were contained in the December 2000 exposure draft. These rules were refined and reflected in the subsequent February 2002 exposure draft. The measures introduced in this bill take into account further submissions and feedback received following the release of the exposure drafts.

1.6 Subsequent legislation to be introduced to implement the remaining aspects of the consolidation regime will include the following topics:

- further cost setting rules – including those applying to formation of a consolidated group, transitional rules, joining another consolidated group, MEC groups and trusts;
- core rules applying to MEC groups;
- life insurance;
- interaction of the consolidation regime with international tax provisions;
- treatment of attribution accounts and foreign tax credits;
- interposition of a non-operating head company;
- removal of the intercorporate dividend rebate;
- treatment of imputation exempting and former exempting companies;
- removal of grouping for thin capitalisation purposes; and
- other consequential amendments, including further consequential amendments to PAYG instalments.

Context of reform

1.7 To promote business efficiency, as well as tax system integrity, *A Tax System Redesigned* recommended that groups of wholly-owned entities be permitted to choose to be taxed as a single entity rather than on an entity by entity basis.

1.8 The existing grouping provisions of the ITAA 1997 and the ITAA 1936 (such as those relating to loss transfer and CGT rollover relief for asset transfers) and the intercorporate dividend rebate allow groups of companies to obtain the benefits of single entity treatment for some purposes. In other respects, however, the income tax system continues to require each entity to account separately for intra-group transactions and intra-group debt and equity interests.

1.9 Consolidation will address both efficiency and integrity problems existing in the taxation of wholly-owned entity groups, many of which arise from this inconsistent treatment. These include:

- compliance and general tax costs;
- double taxation where gains are taxed when realised and then taxed again on the disposal of equity;
- tax avoidance through intra-group dealings;
- loss cascading by the creation of multiple tax losses from the one economic loss; and
- value shifting to create artificial losses where there is no actual economic loss.

1.10 These problems will be addressed by ceasing to recognise multiple layers of ownership within a wholly-owned group and by treating wholly-owned groups as a single entity for income tax purposes.

1.11 The consolidation regime will therefore:

- assist in the simplification of the tax system;
- reduce both compliance costs and tax revenue costs associated with the existing tax treatment of company groups;
- improve the efficiency of business restructuring; and
- strengthen the integrity of the income tax system.

1.12 It is intended that the benefits to be achieved by consolidation as described above should therefore encourage wholly-owned groups to enter into the regime. Wholly-owned groups that choose to remain outside the consolidation regime will also lose entitlement to grouping rules which currently provide some of the benefits intended to be replaced by consolidation.

Comparison of key features of new law and current law

1.13 The following table summarises the key differences between the proposed tax treatment of consolidated groups and the treatment of wholly-owned groups under the current law.

<i>New law</i>	<i>Current law</i>
A consolidated group is taxed as a single entity for all income tax purposes.	Each entity in a wholly-owned group is taxed as a separate entity. For some purposes however, company groups can obtain benefits from being treated as a single entity.
All intra-group transactions are ignored.	Only some intra-group transactions are ignored (e.g. certain asset transfers under CGT rollover).
Consolidation, and therefore grouping, is available not only to companies but also to trusts within a wholly-owned group. In determining whether a company is wholly-owned, certain ESAS shares are disregarded.	The current grouping provisions are only available to the companies within a wholly-owned group. The existence of ESAS shares in a company will prevent the company from qualifying as a wholly-owned subsidiary of its holding entity.
Gains realised within a consolidated group are recognised only once.	There is the potential for the double taxation of economic gains.
Loss integrity and value shifting rules do not apply to transactions between the members of a consolidated group.	Loss integrity and value shifting rules apply to transactions between the members of corporate groups.
Losses realised within a consolidated group are recognised only once.	There is the potential for the duplication and cascading of losses. Loss integrity measures apply when there has been substantial duplication.
Losses and franking credits of the group are pooled.	Losses can be transferred within a wholly-owned corporate group. Franking credits can be distributed within the group if attached to inter-group franked dividends.
Resident wholly-owned groups will be able to form a consolidated group despite the fact that the group's single parent company is a non-resident.	A resident wholly-owned group of a non-resident parent company is able to access current grouping concessions.
In general, the head company of a consolidated group will be liable for the income tax debts of the group.	Individual entities within a wholly-owned group are liable for individual income tax debts.
The head company of a consolidated group will be responsible for the PAYG instalments obligations of the group once the Commissioner gives it is an instalment rate worked out from its first assessment as the head company of that group.	Individual entities within a wholly-owned group are responsible for PAYG instalments obligations on an individual basis.
Generally, loss transfer and CGT rollover relief rules no longer apply to wholly-owned groups.	Wholly-owned groups of companies may use loss transfer provisions and CGT rollover relief.

Summary of new law

1.14 The following summarises the key principles of consolidation.

<i>What does consolidation mean?</i>	Following a choice to consolidate, a consolidated group is to be treated as a single taxpaying entity for income tax purposes during the period of consolidation.
<i>What is a consolidated group?</i>	<p>A consolidated group consists of:</p> <ul style="list-style-type: none"> • a head company; and • all of the subsidiary members of the group (if any). <p>In general, before a consolidated group can exist, there must be:</p> <ul style="list-style-type: none"> • a consolidatable group in existence; and • an effective choice made by the head company of that group to consolidate the group.
<i>What entities are eligible to be subsidiary members of a consolidated group?</i>	Broadly, all the wholly-owned resident subsidiaries of the head company, which may be companies, trusts or partnerships. Certain minority ESAS shares may be disregarded in determining whether a subsidiary is eligible to join a consolidated group.
<i>Can the wholly-owned subsidiaries of a foreign resident company consolidate?</i>	Yes. Certain resident wholly-owned subsidiaries without a single resident head company may form a consolidated group known as a 'MEC' group.
<i>What tax history or tax attributes does a subsidiary member bring to a consolidated group?</i>	Generally, a subsidiary brings its income tax history into a consolidated group. Certain tax attributes such as franking credits and losses are brought into a consolidated group subject to specific rules.
<i>What tax history or tax attributes does a subsidiary member take with it after leaving a consolidated group?</i>	Generally, a subsidiary leaves a consolidated group with the tax history relating to the assets and liabilities it takes out of the group. Tax attributes such as franking credits and losses remain with the group.
<i>Can the head entity revoke the choice to consolidate?</i>	No.
<i>When may a group make a choice to consolidate?</i>	Generally, from 1 July 2002.

What happens to grouping concessions if a wholly-owned group does not consolidate on 1 July 2002?

Generally, in the first year of the consolidation regime, loss transfer and CGT rollover entitlements cease on the date of consolidation. If a choice to consolidate does not occur by 1 July 2003, grouping entitlements cease as of that date (except in limited circumstances applying to SAP groups that consolidate after 1 July 2003).

Detailed explanation of new law

1.15 The consolidation regime implements a set of recommendations made in *A Tax System Redesigned*. Those recommendations have led to the development of a set of rules that provide the basis on which groups are permitted to consolidate and be treated as a single entity for income tax purposes. The regime is underpinned by rules for the setting of cost of assets according to the asset-based model discussed in *A Platform for Consultation* and recommended by *A Tax System Redesigned*.

Key features of the foundations of the consolidation regime

Core rules

Single entity rule

1.16 Following a choice to consolidate, a group of wholly-owned entities is treated as a single entity for income tax purposes. Subsidiary members of the group are treated as parts of the head company rather than as separate income tax identities.

Inherited history rules

1.17 The head company inherits the income tax history of a subsidiary member when the latter joins a consolidated group. When a subsidiary member leaves a group, it takes with it only the income tax history that relates to the assets, liabilities and businesses it leaves with. This recognises that the entity is different from any entity that joined the group.

Cost setting rules

1.18 The cost setting rules set the cost for income tax purposes of assets of entities when they become subsidiary members of a consolidated group and of membership interests in those entities when they cease to be subsidiary members of the group.

1.19 These rules recognise that the head company's cost of becoming the holder of all of the assets is an amount, which reflects the cost to the group of acquiring the entity. When an entity leaves a group, the alignment of the head company's costs for membership interests in each entity and its assets is preserved by recognising the cost of those interests as an amount equal to the cost of the entity's assets at that time reduced by the amount of its liabilities.

Group membership and choice to consolidate

Ordinary groups

1.20 A consolidated group consists of an Australian resident head company and all of its Australian resident wholly-owned subsidiaries. The subsidiary members may be companies, trusts or partnerships. Separate rules may apply to foreign owned groups with no single Australian resident head company. In determining whether a subsidiary is wholly-owned for the purposes of the membership rules, ESAS shares are disregarded in certain circumstances.

1.21 The broad rationale underlying the rules that limit the types of entities that are eligible to be a member of a consolidated group is to ensure that consolidated groups receive a tax treatment like ordinary Australian resident companies and that relative concessional treatment is neither effectively gained by nor denied to entities by becoming a member of a consolidated group.

1.22 An eligible wholly-owned group becomes a consolidated group after notice of a choice to consolidate is given to the Commissioner. A decision to consolidate is irrevocable. Additional notification rules apply when an entity becomes, or ceases to be, a member of a consolidated group.

MEC groups

1.23 Specific rules allow certain resident wholly-owned subsidiaries of a foreign company to form a consolidated group known as a MEC group. Without this measure, wholly-owned resident subsidiaries of a foreign resident company would not be able to form a consolidated group in the absence of a single Australian resident head company unless they were restructured. The aim of this measure is to ensure that existing company groups that currently have access to grouping provisions (e.g. loss transfer and CGT rollover) will be able to form a consolidated group despite not having a single resident head company.

1.24 A MEC group consists of 2 or more eligible tier-1 companies of a foreign resident company and all the resident entities that are wholly-owned subsidiaries of those eligible tier-1 companies. Broadly, an eligible tier-1 company is the entity that is a foreign company's first tier of investment into Australia. A MEC group can be formed either by a choice being made to form a group or as a result of a consolidated group converting into a MEC group.

1.25 One of the eligible tier-1 companies in the MEC group will be treated as the head company of the group. The remaining members of the MEC group will be treated as subsidiary members of the group.

Losses

1.26 This measure also deals with the transfer to and utilisation of losses by a consolidated group. When an entity becomes a member of a consolidated group, its unused carry forward losses are tested to determine whether they can be transferred to the group. Broadly, a loss can only be transferred to the head company of a consolidated group if the loss could have been used outside the group by the entity seeking to transfer it.

1.27 The utilisation of losses transferred to a consolidated group is subject to an annual limit that is determined by reference to the fraction of the group's income and gains considered to have been generated by the entity that transferred the losses. This is referred to as the available fraction method.

1.28 Two concessions are provided for certain company losses transferred to a consolidated group when it forms during the transitional period (i.e. 1 July 2002 to 30 June 2004). The first concession increases the available fraction. It is provided in recognition that, under the existing group loss transfer rules, an entity can use its losses to shelter not just its own income but also the income of another member of the same wholly-owned group. The second concession allows eligible losses to be used over 3 years instead of by reference to their available fraction. This alternative loss utilisation method is provided in recognition that the available fraction method departs from the method in Recommendation 15.3 of *A Tax System Redesigned*.

Franking accounts in consolidated groups

1.29 Special imputation rules will apply to consolidated groups. During the period of consolidation, the head company of the group will maintain a single franking account for the consolidated group and subsidiary members will have inoperative franking accounts during the period in which they are members of a consolidated group. At the time at which a subsidiary member joins a consolidated group, any surplus in its franking account is transferred to the head company's franking account. If, however, the subsidiary's franking account is in deficit at the joining time, the subsidiary will be liable to pay franking deficits tax (and the deficit is extinguished).

1.30 During the period that a subsidiary is a member of a consolidated group, any franking credits or debits that would otherwise have arisen in the franking account of the subsidiary member (i.e. were it not a member of a consolidated group with an inoperative account) are attributed to the franking account of the head company.

1.31 Special rules deal with the franking of distributions by a subsidiary member of a consolidated group to members holding certain kinds of interests including ESAS shares and non-share equity interests.

PAYG instalments

1.32 This bill also contains consequential amendments that set out how the PAYG instalments rules will apply to the members of a consolidated group. The rules will ensure that a head company of a consolidated group will pay PAYG instalments towards its income tax liability in much the same way as any single company does now. The rules also explain what happens when an entity joins or leaves a consolidated group.

1.33 There are also special rules which are necessary for the transitional period from formation of a consolidated group until the head company of the group is given an instalment rate, by the Commissioner, that is worked out from the head company's first assessment as the head company of that group. These rules essentially provide that, during the transitional period, each member of the consolidated group will continue to pay PAYG instalments as it does under the current law, that is, as if it were not a member of a consolidated group. Instalments payable by the subsidiary members of a consolidated group in the transitional period will be credited against the assessment of tax payable by the head company of the group.

Group income tax liability

1.34 This measure also contains rules for determining the income tax liability within a consolidated group in the event of default of income tax payments by the head company. In the event of the head company's default, the income tax liability will be recovered directly from the subsidiary members of the group.

Removal of grouping provisions

1.35 Amendments in this Bill also remove certain existing grouping provisions of the ITAA 1997. Those that allow the transfer of losses and CGT rollover relief for transfer of assets between wholly-owned company groups will cease to apply following the introduction of the consolidation regime. Consequently, wholly-owned groups that do not choose to consolidate will, in general, no longer have access to grouping rules outside of consolidation.

1.36 These rules will be retained in a limited form for certain transactions. Resident subsidiaries in a wholly-owned group will retain the ability to transfer losses where that loss transfer involves an Australian branch of a foreign bank.

1.37 Further, CGT asset rollover relief will be retained for wholly-owned groups where assets are transferred between non-resident companies, or a non-resident company and the head company of a consolidated group or MEC group. Rollover relief will also be retained where an asset is transferred between a non-resident and a company that is not a member of a consolidatable group.

Further detail about the consolidation regime

1.38 The above key features and other supporting concepts are discussed in detail in the following chapters.

Table 1.1: Further details about consolidation

<i>Topic</i>	<i>Chapter</i>
Core rules	2
Membership rules	3
Resident wholly-owned subsidiaries of a common foreign holding company	4
Cost setting rules	5
Transferring losses to a consolidated group	6
Determining whether a transferred loss can be used by a consolidated group	7
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Application and transitional provisions

1.39 The consolidation regime applies from 1 July 2002.

Chapter 2

Core rules

Outline of chapter

2.1 This chapter explains the core rules of the consolidation regime, comprising the:

- single entity rule;
- inherited history rules; and
- cost setting rules for assets.

2.2 The rules are contained in Division 701 of the ITAA 1997.

Context of reform

2.3 Taxing groups as single entities addresses problems associated with the taxation of wholly-owned groups, identified in *A Tax System Redesigned*, such as:

- *tax impediments to business organisation* – for example, compliance costs and possible tax costs of liquidating a redundant company in a wholly-owned group;
- *high compliance costs* – for example, the costs of dealing with the tax implications of intra-group dividends;
- *double taxation* – where gains realised in ordinary commercial transactions are taxed again on the disposal of equity;
- *tax avoidance through intra-group dealings* – for example, manipulating dealings between group companies to reduce or defer tax;
- *loss cascading* – where group companies (as well as companies that are less than 100% owned) can use a chain of companies to create multiple tax losses based on one initial economic loss; and
- *loss duplication* – where losses realised in carrying on a business or on disposal of assets are realised again on the disposal of equity.

2.4 The single entity treatment, coupled with the inherited history rules and special rules for setting the cost for tax purposes of assets of entities joining and leaving consolidated groups, will:

- simplify the tax system and reduce ongoing compliance costs;
- promote economic efficiency by providing a taxation framework that allows Australian businesses to adopt organisational structures based more on commercial rather than tax considerations; and
- promote equity by improving the integrity of the tax system.

Summary of new law

2.5 Following a choice to consolidate, a group of eligible wholly-owned entities is treated as a single entity for the purposes (core purposes) of working out its income tax liability or losses. Subsidiary entities lose their individual income tax identity on entry into a consolidated group and are treated as parts of the head company.

2.6 The following are some of the consequences of the single entity treatment for working out the group's income tax liability or losses:

- the group lodges a single consolidated income tax return, removing the need for provision of income tax returns by individual subsidiary members;
- the assets and liabilities of the subsidiary members are treated as if they were assets and liabilities of the head company;
- the actions of the subsidiary members (e.g. acquisition or disposal of assets) are treated as if they had been undertaken by the head company; and
- intra-group transactions are ignored.

2.7 The February 2002 exposure draft contained rules which provided that things that happened to a subsidiary entity before it joined the group could not be attributed to the head company for the purposes of working out its income tax liability or losses (entry clean slate rule). Similarly, when subsidiaries exited the consolidated group, they did so with a fresh income tax identity, so things that happened to them before they joined or while they were a member of a group cannot generally be taken into account in working out their post-consolidation income tax liability or losses (exit clean slate rule). Consultation identified that these rules created significant compliance costs as a consequence of certain assets and expenditure changing character from being on revenue account to capital account. As a consequence of consultation the clean slate approach was replaced with an inherited history approach.

2.8 The core rules provide for the inheritance of history where an entity becomes part of a consolidated group and where an entity leaves a consolidated group. Broadly, things that happened to an entity before it became a subsidiary member of the group are attributed to the head company for the core purposes discussed in paragraph 2.13 (entry history rule). Where a subsidiary leaves a group, the history in relation to the assets, liabilities and businesses that the entity takes with it will be taken into account in working out its post consolidation income tax liability or losses (exit history rule).

2.9 When an entity becomes a subsidiary member of a consolidated group the membership interests in the entity held by the group are ignored and the cost for tax purposes of the assets which become those of the head company is set in accordance with the cost setting rules. These rules recognise the cost of the assets as an amount reflecting the group's cost of acquiring the entity.

2.10 Rules that preserve the alignment between the head company's cost for membership interests in the entity and the entity's cost of assets also apply when an entity leaves a group. Immediately before a subsidiary member leaves a consolidated group, the head company recognises the membership interests in the leaving entity. The cost for income tax purposes of those interests is set at an amount that reflects the group's cost of the net assets of the leaving entity.

2.11 Where a subsidiary member leaves a consolidated group the exit history rule applies so that the assets the entity takes with it will retain their cost (for income tax purposes) in the hands of the entity.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
A consolidated group is treated as a single entity for all income tax purposes.	Each entity in a wholly-owned group is taxed as a separate entity. For some purposes, however, company groups can obtain benefits from being treated as a single entity.
Intra-group transactions will attract neither income tax consequences nor compliance costs for a consolidated group.	Only some intra-group transactions will escape income tax consequences (e.g. CGT rollover relief is available for some assets but not revenue assets). All intra-group transactions will attract compliance costs.

Detailed explanation of new law

The single entity rule

2.12 The income tax treatment of a consolidated group flows from the rule that 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 the income tax law recognises for the purposes of working out the income tax liability or losses of a consolidated group. For example, a transfer of an asset from one subsidiary member to another is treated like a transfer from one division of a company to another division. Such a transaction could not have any income tax consequences, as no disposal between distinct entities would have occurred (an entity cannot transact with itself). [*Schedule 1, item 2, section 701-1*]

2.13 An entity is treated, for the core purposes, as part of the head company while it is a subsidiary member of a consolidated group. The core purposes also set out the reasons for which the inherited history rules apply. The core purposes are:

- for the head company, working out its income tax liability or loss for any period during which it is the head company of a consolidated group, or any later income year [*Schedule 1, item 2, subsection 701-1(2)*]; and
- for a subsidiary member, working out its income tax liability or loss for any period during which it is a subsidiary member of a consolidated group, or any later income year [*Schedule 1, item 2, subsection 701-1(3)*].

2.14 The single entity treatment applies only to the period during which the entity is a subsidiary member, but the purposes for which the treatment is recognised also extend to later income years. This is because there may be income tax consequences in later income years relating to:

- the fact that the entity was treated as part of the head company rather than an individual entity during a period of membership of a consolidated group; and
- things done while an entity was a subsidiary member of a consolidated group (and therefore taken to have been done by the head company).

2.15 The single entity rule also applies to partnerships and trusts, which have net income rather than taxable income. [*Schedule 1, item 2, section 701-65*]

2.16 The single entity rule will ensure that the ITAA 1997 and the ITAA 1936 operate in respect of a consolidated group as if the subsidiaries are absorbed into the head company, which is the relevant taxpayer. A number of implications flow from the application of this rule.

Consequences of the single entity rule

Accounting and returns

2.17 The consolidated group will:

- effectively maintain a common tax accounting period for all its member entities;
- keep consolidated accounts for certain tax purposes, for example franking, losses and foreign tax credits;
- lodge a single income tax return, with no separate lodgment requirements imposed on its members.

Intra-group transactions

2.18 Transactions between members of a consolidated group will be ignored for income tax purposes. For example, payment of management fees between group members will not be deductible or assessable for income tax purposes. In addition, intra-group dividends will not be assessable or subject to the franking regime.

2.19 Assets can therefore be transferred between member entities without income tax consequences. This removes the need to adhere to formal CGT rollover arrangements and depreciation balancing adjustment relief. Similarly, there will be no need to undertake cost base adjustments following transactions that may otherwise be subject to the value shifting provisions of the ITAA 1997. Shares in a group company can be bought back without the possibility of triggering a capital gain or loss. A group company can be liquidated without the possibility of triggering either a deemed dividend or a capital gain or loss.

Treatment of assets

2.20 The assets, liabilities, etc. of the subsidiary member are treated for income tax purposes as if they were owned by the head company, as this is the only entity the income tax law recognises.

Liability

2.21 In general, the head company will be liable for the income tax-related liabilities of the consolidated group that are referable to the period of consolidation. Special rules apply to allow the recovery of income tax-related liabilities directly from other members of the group where the head company has failed to pay that group liability on time.

Other consequences of the single entity rule

2.22 Some examples of the effect of absorption of the subsidiaries into the head company (for the purposes of working out its income tax liability or losses) are that during consolidation:

- the taxable income of the taxpayer under section 4-15 of the ITAA 1997 refers to that of the head company. This calculation is made on the basis that income and deductions are assessed or allowable under the ITAA 1997 to the head company only;
- a provision such as section 262A of the ITAA 1936 (which refers to record keeping requirements) should be read as requiring the head company to adopt those obligations insofar as they relate to the assessment of its income tax liability. Under the single entity rule, those obligations rest with the head company as it is regarded as the taxpayer during the period of consolidation;
- for the purpose of determining any relevant income tax consequences arising out of the holding or disposal of assets:
 - assets that a member entity brings into a consolidated group are taken to be held by the head company as well as assets that the entity acquires whilst a member of the group;
 - the head company is taken to hold any assets for so long as they are held by an entity while it is a subsidiary member of the group and to do anything in relation to those assets that is done by the subsidiary member;
 - if a CGT event happens in relation to any CGT assets held by any entity while a subsidiary member of the group, that event is taken to happen in relation to the asset while held by the head company and anything done by the subsidiary entity as part of the CGT event is taken to have been done by the head company; and
 - the trading stock that is sold between members of the same wholly-owned group will no longer be recognised as trading stock but will be treated as consumables. This is because, following consolidation, intra-group transactions are ignored for income tax purposes.

Things not affected by the single entity rule

2.23 Only income tax matters relating to the income tax activities of member entities while they are part of a consolidated group are currently embraced by the single entity rule. [*Schedule 1, item 2, section 701-1*]

2.24 This means that obligations or rights that relate to assessments of income tax in respect of periods prior to a subsidiary joining a consolidated group remain with that subsidiary. Any rights or obligations of a subsidiary in relation to an income tax assessment before the entity became a subsidiary member of a consolidated group continue to operate notwithstanding that the subsidiary has become a member of a consolidated group. For example, a subsidiary may pursue an objection in relation to an assessment of income tax for a pre-consolidation period at any time while it is in a consolidated group.

2.25 Only income tax obligations are comprehended by the single entity rule. For example, obligations such as FBT liability continue, as does a withholding obligation of the subsidiary under the ITAA 1936 or under the TAA 1953 while the subsidiary entity is a member of a consolidated group. An entity's obligation to collect the income tax payable by a third party is not related to working out that entity's income tax liability or losses. Therefore, an entity's withholding obligations relating to the tax payable by a third party continues despite the entity being a subsidiary member of a consolidated group.

Characterisation of assets and transactions

2.26 Following an election to consolidate, the single entity rule has the effect that for the purposes of assessing the income tax position of the head company, the head company is taken to hold all the assets and liabilities of its subsidiaries and to enter into the transactions of its subsidiaries. This is because the subsidiary members are treated as if they are parts of the head company for income tax purposes.

2.27 With the exception of intra-group dealings, the mere act of consolidation is not expected to change the character of transactions, where assets continue to be held by a consolidated group in the same manner as held by a member of the group prior to consolidation.

2.28 As is the situation under current law, it may be relevant to consider the nature of a transaction undertaken by a subsidiary member of a wholly-owned group in the context of the activities of the group as a whole, in order to determine the income tax character of a particular act or transaction in an assessment of the consolidated group. The income tax character of a transaction undertaken by a consolidated group will continue to be a question of fact to be determined in the light of all the relevant circumstances.

2.29 It is possible for assets of the same type to be held for dual purposes within one wholly-owned group. For example, at any point in time one piece of land may be held as trading stock (e.g. for the purposes of land development) while another may be held as a capital asset (e.g. for the purposes of housing business premises) by a group. If that wholly-owned group chooses to consolidate, the current law will apply using existing principles and case law. Transactions under consolidation

are subject to the same scrutiny for the purposes of characterisation as those involving a single taxpayer.

Concepts supporting the single entity rule

Inherited history rules

2.30 As discussed, subsidiary members cease to be recognised as individual income tax identities upon consolidation. Rules are provided to identify the history that an entity takes with it into a consolidated group or takes with it when it leaves a group. This history can affect the future tax liabilities of the group that it joins. The inherited history can also affect future tax liabilities of a subsidiary member after it leaves a group. The inherited history rules reduce the compliance costs that would result if the previous history had been ignored and a ‘clean slate’ approach (reflected in the February 2002 exposure draft) adopted.

Entry history rule

2.31 Everything that happened in relation to an entity before it became a subsidiary member of a consolidated group is taken to have happened in relation to the head company for the purposes of calculating the head company’s income tax liability or tax losses after it becomes a member. The entry history rule does not affect an entity’s responsibility for taxation liabilities relating to pre-consolidation periods. [*Schedule 1, item 2, section 701-5*]

What history is inherited?

2.32 As a consequence of the entry history rule a head company may be entitled to certain deductions for expenditure incurred by a joining entity prior to it joining the group. Examples are entitlements to deductions for expenditure on borrowing expenses, gift deductions (where the entitlement to the deduction is spread), water facilities, connecting power or telephone lines, certain business related costs and expenditure allocated to a project pool. A head company may also be entitled to a deduction for a debt that is brought into a consolidated group which subsequently goes bad.

2.33 A head company may also need to include assessable income as a consequence of something that happened to a joining entity prior to consolidation. For example, an entity may have received a prepayment for which the assessable income is included over the period of the provision of the services. A head company may also be assessable on the receipt of a recoupment of expenditure made by a subsidiary member prior to its entry into the group. Also an entity before joining a group may have elected to defer tax on the profit from the disposal or death of livestock or elected to defer the inclusion of the profit on a second wool clip.

2.34 Further comments on the consequences of the history rules is provided in paragraph 2.47.

What history is not inherited?

2.35 Only history in respect of things that affected taxable income or could affect a later taxable income of the head company is inherited. Consequently history in relation to franking credits and foreign tax credits would not be inherited.

2.36 Through the cost setting rules the head company is allocated a cost for the assets of an entity based on its cost of acquiring the entity. The history in relation to the cost of an asset will be affected where the cost of the asset is set on entry to consolidation. For example, there are rules for working out the decline in value of depreciating assets for which the tax cost is set on entry (see paragraph 2.53).

2.37 The history inherited under the entry history rule will be affected where another provision of the income tax law modifies the treatment that is to be given to the head company (see paragraph 2.81). For example there are specific rules dealing with the amount of losses that can be brought into a consolidated group when an entity becomes a subsidiary member.

Exit history rule

2.38 Where a subsidiary member leaves a consolidated group the entity takes with it the history in relation to the assets, liabilities and businesses that cease to be part of the head company as a consequence of its leaving. The exit history rule is narrower than the entry history rule. This reflects that the entity that leaves the group is a different entity to any entity that enters the group. This is a result of the ability to transfer assets and businesses within the group so that the entity that leaves may bear no resemblance to the entity that entered. [*Schedule 1, item 2, section 701-40*]

2.39 The exit history rule applies for the core purposes of working out the entity's income tax liability or loss for any period following it ceasing to be a part of the head company. [*Schedule 1, item 2, subsection 701-40(1)*]

What history is inherited?

2.40 The history that is inherited by an entity that leaves a consolidated group is the history relating to:

- any assets;
- any liabilities, including anything that is treated as a liability according to generally accepted accounting concepts; and
- any businesses,

that the entity takes when it leaves the group. [*Schedule 1, item 2, subsection 701-40(2)*]

2.41 The meaning of liabilities in this context is broader than the meaning of liability in the context of the cost setting rules (i.e. step 2 of working out the allocable cost amount).

2.42 The history in relation to a business covers such things as the entitlements and obligations in respect of carrying on a business (such as a primary production business) or the carrying on of particular activities.

2.43 The discussion in paragraphs 2.32 and 2.33 will also be relevant when an entity leaves a group where it relates to an asset, liability or business that an entity takes with it when it leaves.

2.44 The history that is inherited by an entity when it leaves a consolidated group may relate to the history in respect of an asset, liability or business from the period before that asset, liability or business became part of the head company as a consequence of the entry history rule.

[Schedule 1, item 2, subsection 701-40(3)]

What history will not be inherited?

2.45 Through the cost setting rules, an entity that leaves a group is allocated a cost for the assets consisting of liabilities owed to the entity by members of the consolidated group that it has left and assets consisting of membership interests in any of the former members of the group that leave at the same time. The history in relation to the cost of these assets will be affected where the cost of the asset is set on exit from a consolidated group.

2.46 The exit history rule will also be affected where another provision of the income tax law modifies the treatment that is to be given to the head company (see paragraph 2.81). For example, there are rules to ensure that losses are not taken by an entity that exits a group.

Other consequences of the inherited history rules

2.47 Some examples of the effect of the inherited history rules are:

- The pre-CGT status of assets that are brought into a consolidated group by an entity that becomes a subsidiary member will be inherited as a consequence of the entry history rule. Likewise, the exit history rule will ensure that the pre-CGT status of assets that an entity takes with it when it leaves a consolidated group will be inherited by that entity. This maintains the current law's treatment of pre-CGT asset transfers within wholly-owned groups. However, any acquisition of membership interests in the entity would still cause pre-CGT status in the asset to be lost if it resulted in the ultimate owners not continuing to hold majority underlying interest in the asset.

- Private income tax rulings issued to an entity before it becomes a member of a consolidated group will apply to the head company insofar as the relevant facts have not changed either by reason of consolidation (e.g. because they relate to intra-group transactions, which are ignored) or otherwise. Private income tax rulings that relate to particular assets, liabilities or businesses that a leaving entity takes out of a group will apply to the leaving entity insofar as the relevant facts have not changed either by reason of the entity ceasing to be a member of a consolidated group or otherwise.

Cost setting rules

2.48 The single entity rule is supported by rules that set the cost for income tax purposes of assets that a subsidiary member brings into the consolidated group. Rules also set the cost of certain assets where a subsidiary member leaves a consolidated group.

Cost setting rules – entry

2.49 The assets of subsidiary members, which are treated during consolidation as being assets of the head company, have their cost for tax purposes set at the joining time. The cost is set under rules that treat the head company's cost of acquiring the entity as its cost of acquiring the entity's assets, including its businesses. This cost is worked out and allocated to the individual assets according to rules explained in Chapter 5. *[Schedule 1, item 2, section 701-10; Subdivision 705A]*

Special rules for trading stock

2.50 Where the same item of trading stock has its cost set on being brought into a consolidated group more than once in the same income year for a head company then only the amount at which the cost is set on the last of the times it is set is taken into account for the head company. Multiple resetting of the same item of trading stock may occur, for example, where the same item is brought into a consolidated group by an entity and that item is taken by an entity that leaves and which subsequently rejoins the same consolidated group in the same income year. Only the last resetting is taken into account because under the cost setting rules this cost becomes the opening cost of the trading stock for the head company purposes and it is only appropriate to take it into account once. *[Schedule 1, item 2, section 701-10(5)]*

2.51 Where the same trading stock leaves a consolidated group (as a result of a subsidiary member leaving) or has its value set at the start of the income year (as a consequence of an entity becoming a subsidiary member) more than once in the same income year then the following rule will apply. The amount at which the trading stock has its cost for tax purposes set is only taken into account in working out the head company's terminating value for a particular occasion when a subsidiary member leaves where the tax cost setting occurs before the entity leaves and there are no intervening tax cost setting or subsidiary members leaving with the same trading stock. *[Schedule 1, item 2, subsection 701-10(6)]*

Excluded assets

2.52 No cost is allocated to those assets called 'excluded assets'. An asset is an ***excluded asset*** if an amount has been deducted when working out the head company's amount to be allocated to the assets of the entity becoming a subsidiary member (see paragraph 4.42). *[Schedule 1, item 2, subsection 701-10(7) and subsection 705-35(2)]*

2.53 Section 701-55 explains the meaning of the expression 'a tax cost is set'. In setting the tax cost of an asset to which the capital allowance provisions in Subdivisions 40-A to 40-D and sections 40-425 to 40-445 and the simplified tax system provisions in Subdivision 328 apply, the cost for tax purposes is set on the basis that those provisions apply as though:

- the asset was acquired by the head company at the time the entity became a subsidiary member of the consolidated group with a reset cost for tax purposes;
- the head company is taken to have chosen for the asset the same method of working out the decline in value (i.e. if the entity had chosen the prime cost method then the head company will be taken to have chosen the prime cost method);
- if the prime cost method applies and the asset's tax cost setting amount does *not* exceed the joining entity's terminating value for the asset – the asset is taken to have an effective life for the head company consisting of the remaining effective life of the asset at the time it becomes an asset of the head company;
- if the prime cost method applies and the tax cost setting amount exceeds the joining entity's terminating value for the asset – the head company is required to make a new choice of effective life under section 40-95 (disregarding subsections (2) and (5) and any choice to use the effective life determined by the Commissioner is limited to one that is in force at the time the entity becomes a subsidiary member; and

- if the diminishing value method applies – the asset is taken to have the same effective life for the head company as it had for the entity.

Other than where a new choice is required, the effective life that is used for this purpose is the effective life that was chosen and being used by the entity just before it became a subsidiary member of the consolidated group. This may be different to the relevant Commissioner's determination of effective life at that time. *[Schedule 1, item 2, subsection 701-55(2)]*

2.54 For the purposes of setting the cost for tax purposes of an asset to which the trading stock provisions in Division 70 of the ITAA 1997 apply, those provisions apply as though the assets become trading stock of the head company at the start of the income year in which the entity becomes a subsidiary member of the group. *[Schedule 1, item 2, subsection 701-55(3)]*

2.55 In setting the cost for tax purposes of an asset to which Division 16E of Part III of the ITAA 1936 applies, those provisions apply as though the asset was acquired by the head company at the time the entity became a subsidiary member of the consolidated group with a reset cost for tax purposes. *[Schedule 1, item 2, subsection 701-55(4)]*

2.56 In setting the cost for tax purposes of an asset to which the CGT provisions apply, those provisions apply as though the cost base or reduced cost base is reduced or increased so that the cost base or reduced cost base is equal to the cost that is set. *[Schedule 1, item 2, subsection 701-55(5)]*

2.57 In setting the cost for tax purpose of an asset to which provisions not covered in the discussion in paragraphs 2.53 to 2.56, the provisions apply as though the assets 'cost' is reset. *[Schedule 1, item 2, subsection 701-55(6)]*

2.58 Under the cost setting rules the cost for assets that become assets of the head company when an entity becomes a subsidiary member are set at the 'tax cost setting amount'. Table 2.1 sets out what is the assets tax cost setting amount in the particular circumstances.

Table 2.1: Tax cost setting amount

<i>Circumstances in which the asset's tax cost is set:</i>	<i>The asset's tax cost setting amount is:</i>
Setting the cost to head company of assets brought into a consolidated group when an entity becomes a subsidiary member (i.e. where section 701-10 applies).	The amount worked out under the cost setting rules (see discussion in Chapter 5).
Setting the cost to head company of membership interests in an entity that leaves a consolidated group (i.e. where section 701-15 applies)	The amount worked out under section 711-15 (where a single or section 711-55 (where more than one entity exits) (see Chapter 5).
Setting the cost to head company of assets consisting of liabilities owed to members of a consolidated group by an entity that leaves the group (i.e. where section 701-20 applies).	The market value of the asset.
Setting the cost of assets for an entity that leaves a consolidated group for assets consisting of liabilities owed to the entity by members of the group (i.e. where section 701-45 applies).	The market value of the asset.
Setting the cost of membership interests which an entity becomes holder on leaving a consolidated group (i.e. where section 701-50 applies).	The amount worked out under section 711-55 (see Chapter 5).

[Schedule 1, item 2, section 701-55]

2.59 There are no tax consequences for an entity as a result of joining a consolidated group except where the rules dealing with transactions between entities that merge on consolidation apply (see paragraphs 2.70 to 2.74). On joining a group, for the purposes of working out the subsidiary's income tax liability or tax loss for the period up to the joining time, the subsidiary is taken to have disposed of each item of trading stock it brings into the group for an amount equal to:

- if the item was on hand at the beginning of the income year, its value under section 70-40;
- if the asset was not on hand at the beginning of the income year:
 - for livestock, the cost of the asset; or
 - for other assets, the amount, if any, of the expense in acquiring the item.

This ensures that there are no tax consequences for the entity in respect of the trading stock as a consequence of the entity becoming a subsidiary member of the group. *[Schedule 1, item 2, subsection 701-35(4)]*

2.60 Other than the impact of the rules for transactions between entities that merge on consolidation, the entity is *not* taken to have disposed of its other assets, or incurred any income tax consequences, as a consequence of becoming a subsidiary member of a consolidated group. *[Schedule 1, item 2, section 701-35]*

2.61 The subsidiary will be entitled to a deduction for the decline in value of its depreciating assets in the period up to the joining time under the capital allowances provisions of the existing income tax law.

Cost setting rules – exit

2.62 Where a subsidiary member leaves a consolidated group the head company recognises, just before the time the entity leaves, the membership interests in the leaving entity. These membership interests would not be recognised whilst the entity was a member of the group. The cost for the membership interests is set at a cost equal to the head company's cost for the net assets that the leaving entity takes with it. This preserves the alignment between the cost for membership interests in the entity and its assets. The rules for working out the cost for the net assets are explained in Chapter 5. *[Schedule 1, item 2, section 701-15]*

2.63 Where a number of related entities leave the group, at the one time, the same principle (discussed in paragraph 2.62) applies to the membership interests held by one entity in any of the other entities (see Chapter 5). *[Schedule 1, item 2, section 701-50]*

2.64 Where a subsidiary member leaves a consolidated group with a liability owing to a member of the group, the liability is recognised for income tax purposes as an asset of the head company just before the time it leaves. The cost for income tax purposes of such an asset at the time it leaves is set at its market value at that time. Such an asset would not be recognised whilst the entity was a group member because intra-group transactions are ignored under the single entity rule. *[Schedule 1, item 2, section 701-20 and item 3 in the table in section 701-60]*

2.65 There are no income tax consequences for the head company as a result of an entity leaving the group except where the rules dealing with transactions between entities that separate apply (see paragraphs 2.75 to 2.77). When an entity leaves a consolidated group, the head company is taken to dispose of each item of trading stock the leaving entity takes with it from the group for an amount equal to:

- if the item was on hand at the beginning of the income year, its value under section 70-40 of the ITAA 1997;

- if the asset was not on hand at the beginning of the income year,
 - for livestock, the cost of the asset; or
 - for other assets, the amount, if any, of the expenditure incurred in acquiring it.

2.66 Other than the impact of rules for transactions between entities that separate, the head company is *not* taken to have disposed of its other assets, or incurred any income tax consequences, as a consequence of the assets leaving the consolidated group. This ensures that there are no tax consequences for the head company in respect of the trading stock as a consequence of the entity leaving the group. [*Schedule 1, item 2, section 701-25*]

2.67 Where an entity that leaves a consolidated group takes with it an asset consisting of liabilities owed to it by members of the group the tax cost of that asset is set, at the leaving time, at an amount equal to the market value of the asset at that time. [*Schedule 1, item 2, section 701-45 and item 3 in the table in section 701-60*]

2.68 Other assets that the leaving entity takes with it from the head company will, as a consequence of the exit history rule, have the same cost for tax purposes as they would for the head company at the time the entity left the group. Consequently, for example, CGT assets will have the same cost base or reduced cost base as they had for the head company at the time the entity leaves the group. Similarly, trading stock and depreciating assets take their respective costs and adjustable values that they had for the head company. In relation to calculating the decline in value for depreciating assets an entity that leaves a group will be taken to have made the same choice of method for working out the decline in value as the asset had immediately before it ceased to be held by the head company.

Exceptions to core rules

Pre-existing arrangements between a consolidated group and entities that become or cease to be subsidiary members of the group

2.69 Ongoing arrangements of various kinds involving income and expenditure can exist between a consolidated group and an entity that becomes a subsidiary member or ceases to be a subsidiary member of the group. Examples of such arrangements include loans subject to interest, provision of property under a lease or prepayment for the future provision of goods or services, including insurance. These arrangements, which can straddle the joining or leaving time, are disregarded for income tax purposes whilst the entity is a subsidiary member of the group. Therefore, specific provision is required to ensure that the appropriate amount of assessable income and deductions are brought to account for things occurring under such arrangements when the entity that becomes a

subsidiary member or ceases to be a subsidiary member is outside the group.

Where identities merge

2.70 Where an arrangement exists between an entity that becomes a subsidiary member and an existing member of its joined group, the total of pre-joining time deductions under the arrangement are aligned with the amount of service provided under the arrangement up to the joining time. The amount of deductions required to achieve this alignment is worked out using the formula :

$$\begin{array}{l} \text{proportion of all things to be done} \\ \text{under the arrangement that were} \\ \text{done before the joining time} \end{array} \times \begin{array}{l} \text{total deductions} \\ \text{under the} \\ \text{arrangement} \end{array}$$

[Schedule 1, item 2, section 701-70]

2.71 Where the amount of deductions allowable for earlier income years is less than the amount required for the alignment of deductions with service provided up to the joining time, the balance of deductions required to achieve that alignment then becomes allowable. In the case of the joining entity, the balance of deductions is allowable for the income year that ends at the joining time. In the case of the head company, the balance of deductions is allowable for the income year that includes the joining time.

2.72 Where the amount of deductions allowable for earlier income years is more than the amount required for the alignment, the alignment is achieved by including the excess deductions in assessable income. The amounts are included in assessable income in the same years as additional deductions would have been allowed, if that were required for alignment (see paragraph 2.71).

2.73 Where the amount of assessable income for earlier income years is more or less than the amount required for the alignment of assessable income with service provided up to the joining time, the balance of assessable income required to achieve that alignment is then made. This alignment is achieved in a similar manner as for deductions. If the amount of assessable income for earlier years is less than proportionate to the services provided up to the joining time, the balancing amount is added to assessable income. If amount of assessable income for earlier years is more, the balancing amount is an allowable deduction. Adjustments to align assessable income with service provided are made for the same income years as adjustments to align deductions would be made, if required.

2.74 Where the head company and the entity that becomes a subsidiary member were previously members of the same consolidated group and the arrangement was in place when the parties ceased to be members of that group, the only things taken into account in relation to the arrangement are things to be done, deductions allowable for expenditure and amounts to be included in assessable income after they ceased to be members of that group. If the head company and the entity that becomes a subsidiary member were previously members of the same consolidated group on more than one occasion, this provision is applied by reference to the most recent of those occasions.

Where identities separate

2.75 Where an arrangement exists between an entity that ceases to be a subsidiary member and a member of the group it is leaving, the total of post-leaving time deductions under the arrangement are aligned with the amount of service to be provided under the arrangement after the leaving time. The amount of deductions to be allowed to achieve this alignment is worked out using the formula :

$$\begin{array}{l} \text{proportion of all things to be done} \\ \text{under the arrangement that} \\ \text{are to be done after the leaving time} \end{array} \times \begin{array}{l} \text{total deductions} \\ \text{under the} \\ \text{arrangement} \end{array}$$

[Schedule 1, item 2, section 701-75]

2.76 Where the deductions that would otherwise be allowable to:

- a leaving entity, for the income year that starts at the leaving time and all subsequent income years; or
- a head company for the income year that includes the leaving time and all subsequent years,

are different from the amount allowable under the formula, the deductions are adjusted so that they equal the amount under the formula.

2.77 Similarly, where the amounts that would otherwise be assessable to:

- an entity that ceases to be a subsidiary member, for the income year that starts at the leaving time and all subsequent income years; or
- a head company for the income year that includes the leaving time and all subsequent years,

are disproportionate to the things to be done under the arrangement after the leaving time, the amounts assessable are adjusted in the same manner as that for deductions.

Accelerated depreciation

2.78 The tax history that is inherited by a head company where a subsidiary member becomes part of the head company will be affected by the tax cost setting rules. A consequence of the tax cost setting rules is that the cost history in respect of an asset will be affected where the tax cost is reset on entry to a consolidated group. In particular, in setting the tax cost for depreciating assets subject to Subdivisions 40-A to 40-D and sections 40-425 to 40-445 of the ITAA 1997, those capital allowance provisions apply as though the assets were acquired at the time the entity joins the group. Consequently, the history in respect of entitlement to accelerated depreciation is lost, because the history in respect of the original acquisition date is lost when the asset has its cost reset for tax purposes on entry to a consolidated group.

2.79 However, a head company will be entitled to accelerated depreciation in respect of a depreciating asset that is brought into the consolidated group when an entity becomes a subsidiary member of the group where:

- the head company's tax cost setting amount for a depreciating asset when a subsidiary member joins a consolidated group is not more than the subsidiary member's terminating value (see paragraph 5.28) for that asset; and
- the subsidiary member was entitled to accelerated depreciation.

[Schedule 1, item 2, section 701-80]

2.80 The head company can also choose to reduce the cost that is set for the depreciating asset to the subsidiary's terminating value for that asset (see paragraphs 5.42 and 5.43).

Other exceptions to the core rules

2.81 The operation of the core rules is subject to any contrary provisions in Part 3-90 or in another part of the income tax law *[Schedule 1, item 2, section 701-85]*. For example, the operation of the inherited history rules will be affected by the rules covering the treatment of losses and franking credits. These rules are discussed in Chapters 6 to 10.

Accounting for non-membership periods of a subsidiary entity

2.82 When a subsidiary entity becomes a member of a consolidated group part way through the income year, it ceases to be a taxpayer in its own right because of the operation of the single entity rule during consolidation. When a subsidiary member leaves a group part way through an income year, it becomes a taxpayer again, but is different from when it became a subsidiary member because intra-group transactions such as asset transfers between group members are ignored. While the single entity rule

alone would achieve the correct calculation of income tax liability and losses of an entity that is outside a consolidated group for one part of an income year (either because it becomes a member or leaves the group part way through the income year), it would not ensure the separate income tax and loss calculations in an income year during which it has more than one such period.

2.83 Special rules therefore operate to ensure that pre- and post-consolidation calculations are undertaken separately, and that there is no netting off between any 2 or more parts of the same income year in which the entity is outside a group (of course, it has no taxable income during its period/s of membership of a consolidated group). For consistency, these rules apply whether the entity is outside a consolidated group for one only, or more than one, period during the income year. This treatment reflects the fact that an entity loses its individual income tax identity upon joining a consolidated group, and when it leaves it is different for income tax purposes from the entity that became a subsidiary member. This is because intra-group transactions such as asset transfers between group members are ignored, so an entity may leave the consolidated group with assets and businesses completely different from those it had when it entered the group. *[Schedule 1, item 2, section 701-30]*

2.84 Notional figures are worked out for the entity's taxable income, income tax payable on that taxable income and any losses for each part of the income year in which the entity is outside a group. These figures are worked out as if the start and end of that part were the start and end of the income year, ignoring things that happened in any other such periods. *[Schedule 1, item 2, subsections 701-30(3) and (4)]*

2.85 The entity's income tax liability for the financial year is worked out by adding the notional income tax liability figures (calculated for each part of the income year in which it is outside a group) rather than by reference to the entity's taxable income for the whole year. *[Schedule 1, item 2, subsections 701-30(3), (5) and (6)]*

2.86 The entity can have a loss for the income year only if it has a loss in the part of the income year ending at the end of the income year *[Schedule 1, item 2, subsection 701-30(7)]*. This is because when an entity joins a consolidated group either its losses are transferred into the group in accordance with the loss transfer rules (described in Chapter 6) or they are effectively cancelled and cannot be used by any entity *[Schedule 1, item 2, section 707-150]*. Because notional income tax liability is worked out separately for each part of the income year in which the entity is a taxpayer in its own right, losses in a later part of the income year cannot be used to offset income in an earlier part. *[Schedule 1, item 2, subsection 701-30(3)]*

2.87 These rules apply equally to entities with SAPs.

Example 2.1

A group consolidates mid-way through its income year. The subsidiaries work out their income tax liabilities for the part of the income year up to joining time as if the start and end of that period were the start and end of its income year respectively.

Example 2.2

In one income year, an entity is a single taxpayer, then becomes a subsidiary member of a consolidated group part way through the year and subsequently leaves the group without immediately joining another group. During that income year, there are 2 parts of the year in which the entity is a taxpayer in its own right.

For example, in the first part of the year, the entity has tax payable of \$10,000, worked out by reference to its notional taxable income for that part.

While the entity is a member of a consolidated group it is not a taxpayer but part of the head company, and so does not have any taxable income, income tax liability or losses in respect of that part of the income year.

The entity has a loss of \$5,000 for the part of the income year after it left the consolidated group. The entity is able to carry forward this loss, subject to the normal loss utilisation rules, for its future use. Nil tax is payable in respect of this part.

The total amount of tax payable by the entity for the whole of the financial year is:

$$\$10,000 + \text{nil} = \$10,000$$

The entity has a loss of \$5,000 for the income year.

Application and transitional provisions

2.88 The consolidation regime will apply from 1 July 2002.

2.89 Under rules to be introduced in a later bill a head company may elect on formation of a consolidated group to adopt the transitional option of using a joining entity's 'terminating value' as its cost for the assets that are brought into the group by the subsidiary members.

Consequential amendments

2.90 There are various consequential amendments to the ITAA 1997 in relation to the measures discussed in this chapter. These amendments are

related to the rules for working out an entity's income tax liability or losses if the entity becomes and ceases to be a member of a consolidated group in a single income year (section 701-30). [*Schedule 3, Part 1, item 1*]

2.91 Consequential amendments have been made to subsection 995-1(1) to include references to new dictionary terms. [*Schedule 5, items 10, 19, 27, 30, 31 and 32*]