ATTACHMENT A

CONSOLIDATION: CHANGES TO THE RESIDUAL TAX COST SETTING AND RIGHTS TO FUTURE INCOME RULES

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

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

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

3. When a consolidated group acquires a company, the shares in the acquired company cease to be recognised for taxation purposes and the company's assets effectively become assets of the head company. The tax costs of those assets are reset at an amount that reflects their respective share of the group's cost of acquiring the joining company. However, some specified assets (such as cash) retain their original tax cost.

4. A specific provision in the income tax law[1] deals with how the reset tax cost for an asset is used when applying other provisions of the income tax law to that asset. If a provision in the income tax law that is not specifically mentioned in that provision applies to the asset, the residual tax cost setting rule[2] applies to specify the use of the tax cost setting amount.

THE 2010 AMENDMENTS TO THE CONSOLIDATION REGIME

5. The consolidation regime was introduced from 1 July 2002. In December 2005, the then government announced technical changes to the consolidation provisions, including changes to the residual tax cost setting rule, to ensure the legislation had its intended effect. A further package of changes was announced by the former government in 2007. The present Government re-committed to the whole package of 22 consolidation measures in the 2008-09 Budget.

6. When a Bill containing the 22 consolidation measures was introduced into the House of Representatives in February 2010[3], the revenue impact of the package of changes was stated as formally unquantifiable, but not expected to be significant. However, while the Bill was in the Parliament, the Australian Taxation Office (ATO) identified revenue risks arising from the measure changing the residual tax cost setting and rights to future income rules. As a result, the Bill was

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[1] Section 701-55 of the *Income Tax Assessment Act 1997* (ITAA 1997).
[2] Subsection 701-55(6) of the ITAA 1997.
[3] Tax Laws Amendment (2010 Measures No. 1) Bill 2010.

amended in the Senate to reduce the cost of this measure, and the statement of the revenue impact for the measure was changed to 'significant'. The Bill was passed by the Parliament on 12 May 2010 and assented to on 3 June 2010.

7. During the development of the 2010 amendments to modify the residual tax cost setting rule, the rights to future income rule was developed to address concerns raised during consultation. These amendments sought to remove uncertainty in the law by clarifying that, for some assets, the reset tax cost of the asset (rather than its original tax cost) is used when a taxing point later arises for the asset. They also clarified the tax outcomes for assets that are rights to future income (such as an entitlement to unbilled income). The amendments were made retrospective to 2002 because they were thought to be merely returning the regime to its originally stated intent.

WHY ARE CHANGES TO THE 2010 AMENDMENTS NEEDED?

8. Shortly after passage of the 2010 amendments, it became clear that the new rules, combined with a change to the accounting standard on intangible assets[4] and an ATO Taxation Ruling on the meaning of an asset for consolidation purposes[5], could result in the recognition of the tax costs of some assets being brought forward, in an unanticipated way.

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

10. On 30 March 2011 the Assistant Treasurer asked the Board of Taxation to examine the operation of the residual tax cost setting and rights to future income rules[6]. The Board concluded that the scope of the rules, as enacted, appeared to be broader than was intended at the time of their announcement in 2005. These rules, combined with the effect of other long-standing elements of the consolidation regime, could allow consolidated groups to access deductions that are not available to taxpayers outside the consolidation regime. Consequently, the revenue impact of the rules was likely to be significantly larger than expected.

11. Changes to the operation of the residual tax cost setting and rights to future income rules are necessary to protect a significant amount of revenue that would otherwise be at risk, and to make the tax outcomes for consolidated groups more consistent with those for entities outside consolidation.

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

13. As the 2010 changes operated with effect back to 2002, some of the further changes will need to do so too. These changes prevent the retrospective operation of unintended effects of, and perceived weaknesses in, the law.

14. The transitional period changes will protect taxpayers who acted on the basis of the current law before the Board of Taxation review was announced.

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[4] Australian Accounting Standard AASB 138.
[5] Taxation Ruling TR 2004/13.
[6] See Media release No. 045 issued by the Assistant Treasurer and Minister for Financial Services and Superannuation.

15. The prospective changes primarily implement the recommendations made by the Board of Taxation to improve the operation of the consolidation tax cost setting rules. These changes will increase certainty for taxpayers and make the tax outcomes for consolidated groups more consistent with the tax outcomes that arise when assets are acquired by entities outside the consolidation regime.

RIGHTS TO FUTURE INCOME

16. Rights to future income can be classified into the three broad categories.

Table 1: Categories of rights to future income

Category 1	Rights to receive income where the work has been done, or the goods or services have been provided, by the joining entity before the joining time
Category 2	Rights to receive income where the work will be done, or the goods or services will be provided, after the joining time under a contract that was entered into before the joining time, excluding any rights to income that are contingent on the renewal of the contract (such as rights under a renewal clause which may give rise to the extension of an existing contract, or to a future contract, under which income would be receivable)
Category 3	Rights to receive income arising from an expectation of future work or future provision of goods or services (due to, for example, existing customer relationships), including any rights to income that are contingent on the renewal of the contract

17. If a right to future income is held by a joining entity that is acquired by a consolidated group, the tax cost of the right is reset under the tax cost setting rules. Under the rights to future income rules, the head company can deduct the tax cost setting amount allocated to an 'acquired' right to future income over, broadly, the lesser of 10 years or the life of the contract[7].

18. However, if a right to future income is held by a joining entity that is already owned by the group (that is, on formation of a group), the right is normally treated as a retained cost base asset[8]. 'Already owned' rights to future income will continue to be treated as retained cost base assets.

THE PRE-12 MAY 2010 PERIOD[9]

WHAT CHANGES ARE BEING MADE TO THE TAX COST SETTING RULES FOR THE PRE-12 MAY 2010 PERIOD?

19. The changes to the tax cost setting rules for the pre-12 May 2010 period will restore the tax cost setting rules that operated prior to the 2010 amendments[10] (the original tax cost setting rules). However, some modifications will be made to the original tax cost setting rules to:

- ensure that certain assets are excluded from the scope of the residual tax cost setting rule and, in most cases, treated as goodwill;
- ensure that no value is attributed to certain contractual rights to future income;

[7] Sections 716-405 and 716-410 of the ITAA 1997.
[8] Subsection 705-25(4B) and paragraph 705-25(5)(d)of the ITAA 1997.
[9] The 2010 amendments were passed by both Houses of Parliament on 12 May 2010.
[10] That is, section 701-55 of the ITAA 1997, including subsection 701-55(6), as it operated prior to the 2010 amendments.

- ensure that the reset tax costs for assets that are Category 1 rights to future income are deductible; and
- ensure that the reset tax costs for assets that are consumable stores are deductible.

Certain assets excluded from the scope of the residual tax cost setting rule and treated as goodwill

20. The original tax cost setting rules will be modified to clarify that the residual tax cost setting rule does not apply to allow deductions for certain specified assets (excluded assets). The excluded assets are:

- mine site improvements[11];
- the value of in-force business under life insurance and general insurance contracts;
- customer relationship assets, know-how and other accounting intangible assets (which are not CGT assets but that are akin to, or form part of, the goodwill CGT asset); and
- rights to future income, other than Category 1 rights to future income that qualify for a specific deduction.[12]

21. The reset tax costs for the excluded assets (other than mine site improvements[13]) will be allocated to the head company's goodwill asset. A goodwill asset is a CGT asset. The tax cost allocated to the goodwill asset will be recognised for tax purposes when the group no longer holds the goodwill asset. This will happen, for example, when:

- a subsidiary member leaves the group taking the relevant goodwill asset with it;
- the goodwill asset is sold; or
- the goodwill asset ceases to exist.[14]

No value attributed to certain contractual rights to future income

22. The original tax cost setting rules will be modified to ensure that, for tax cost setting purposes, no market value (and therefore no allocable cost amount) is attributed to a contractual right to future income where:

- the contractual right to future income arises from an asset; and
- the combined market value of the asset and the right does not exceed the market value of the asset (worked out on the basis that the asset is unencumbered).

23. As a result, the tax cost setting rules will allocate tax cost to the underlying asset. However, if the combined market value of the asset and the right does exceed the market value of the asset (worked out on the basis that the asset is unencumbered), the excess market value will be attributed to the right for tax cost setting purposes. If the right is not a Category 1 right to future income that

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[11] The ATO is currently considering whether certain mine site improvements are depreciating assets, and therefore come within the scope of subsection 701-55(2) of the ITAA 1997. If the ATO adopts the position that such improvements are not covered by subsection 701-55(2), the issue will be further reviewed.
[12] This means that the residual tax cost setting rule will not enliven the operation of section 40-880 of the ITAA 1997.
[13] See footnote No. 9.
[14] Taxation Ruling TR 1999/16 explains how the CGT provisions apply to goodwill.

qualifies for a deduction, the reset tax cost for the right will be allocated to the head company's goodwill asset.

The reset tax costs for Category 1 rights to future income will be deductible

24. The original tax cost setting rules will be modified to ensure that the reset tax costs for 'acquired' Category 1 rights to future income are deductible. To qualify for a deduction, a Category 1 right to future income must arise under an agreement that was entered into between the joining entity and another entity before the joining time where, under the agreement, the other entity has agreed to pay an amount to the joining entity and:

- the amount can be identified as being in respect of work (but not goods) that has been performed or partially performed before the joining time by the joining entity for the other entity but has not been completed to the stage where, at the joining time, a recoverable debt has arisen in respect of the completion or partial completion of the work; or

- the amount can be identified as being in respect of goods or services that have been provided before the joining time by the joining entity to the other entity, where a recoverable debt has not yet arisen in respect of the provision of the goods or services.

25. The tax cost setting amount for these rights to future income will be deductible as follows:

- to the extent that the head company reasonably expects the recoverable debt to arise within 12 months after the joining time, the deduction will be allowed in the income year in which the joining time occurs; and

- the deduction for the remaining part of the tax cost setting amount will be allowed in subsequent income years over the period during which the income is derived.

The reset tax costs for consumable stores will be deductible

26. The original tax cost setting rules will be modified to ensure that the general deduction provision[15] applies to the tax cost setting amount for assets that are consumable stores. This will ensure that the head company can deduct the tax cost allocated to consumable stores.

WHAT CLAIMS ARE AFFECTED BY THE PRE-12 MAY 2010 PERIOD CHANGES?

27. The changes to the original tax cost setting rules for the pre-12 May 2010 period will apply to claims (in respect of any income year) arising from the operation of the tax cost setting rules in respect of:

- an entity that joined a consolidated group before 12 May 2010; or

- an arrangement that was entered into before 10 February 2010[16], regardless of the joining time.

28. However, as outlined in Table 2, the changes to the original tax cost setting rules may not apply to a claim if it is covered by:

- a private binding ruling or written advice under an Advance Compliance Agreement issued before 31 March 2011; or

- a notice of assessment or amended assessment that issued before 31 March 2011.

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[15] Section 8-1 of the ITAA 1997.

[16] Table 3 outlines the time that an arrangement is taken to be entered into.

29. In some cases the benefits of a claim are realised over two or more income years (that is, the claim has a 'tail'). This could happen, for example, if:

- the claim gives rise to a carry forward loss;
- the claim is for a deduction that is spread over more than one year; or
- the claim relates to a taxing point that arises in an income year after the year in which the joining time occurs.

30. Where the tail of a claim is covered by a private binding ruling or Advance Compliance Agreement issued before 31 March 2011, the claim will be allowed and will not be affected by the changes to the original tax cost setting rules. Otherwise, the application of the changes to the law for the pre-12 May 2010 period to the tail will depend on the time that the relevant assessment or amended assessment issues.

Table 2: Application of the changes to the original tax cost setting rules for the pre-12 May 2010 period

	If the claim is covered by:	**The claim will be treated as follows:**
1.	A private binding ruling or written advice under an Advance Compliance Agreement issued before 31 March 2011	The claim will be allowed if the taxpayer acts in accordance with the ruling or advice. Therefore, the changes to the original tax cost setting rules for the pre-12 May 2010 period will not apply to the claim.
2.	An assessment or amended assessment where the notice issued before 12 May 2010	The claim will be allowed if it is covered by: • the specific deductions for consumables and certain Category 1 rights to future income; or • the original tax cost setting rules, unless the claim relates to a customer relationship asset, know-how or other accounting intangible asset. Therefore, the changes to the original tax cost setting rules for the pre-12 May 2010 period will not generally apply to the claim. However, if the claim relates to a customer relationship asset, know-how or other accounting intangible asset, the change to the original tax cost setting rules to treat the relevant asset as a goodwill asset will apply.
3.	An assessment or amended assessment where the notice issued between 12 May 2010 and 30 March 2011	The claim will be allowed if it is covered by the current residual tax cost setting and rights to future income rules[17], as modified for the transitional period. Therefore, the changes to the original tax cost setting rules for the pre-12 May 2010 period will not apply to the claim.
4.	None of the above	The changes to the original tax cost setting rules for the pre-12 May 2010 period will apply to the claim.

[17] That is, existing subsections 701-55(5C) and (6) of the ITAA 1997, subject to the changes to the law for the transitional period outlined below.

Commissioner's power to amend assessments

31. Under the ordinary operation of the income tax law, the Commissioner has the power to amend an assessment, or further amend an amended assessment, that has been issued to a taxpayer. In broad terms:

- for most individuals and small business taxpayers, the Commissioner can generally amend an assessment, or further amend an amended assessment, within two years;
- for entities that are not small business taxpayers or have more complex tax affairs, the Commissioner can generally amend an assessment, or further amend an amended assessment, within four years; and
- where there has been an under-assessment of tax due to fraud or evasion, the period within which the Commissioner can amend an assessment, or further amend an amended assessment, is unlimited.[18]

32. The Commissioner's power to amend an assessment, or further amend an amended assessment, will generally be unchanged. However, where a claim is covered by a notice of assessment or amended assessment that issued before 31 March 2011, when reviewing the assessment or amended assessment, the Commissioner must apply the law that applies at the time the notice of assessment or amended assessment issued (as outlined in Table 2).

33. If a taxpayer has not yet made a claim for a deduction that becomes allowable because of the changes to the original tax cost setting rules (such as a claim for consumable stores) for the pre-12 May 2010 period, the taxpayer will be able to request an amendment to an assessment, or a further amendment to an amended assessment, by the later of:

- the end of the normal period for requesting an amendment to the assessment, or a further amendment to the amended assessment; or
- two years after the changes to the law for the pre-12 May 2010 period are enacted.

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

34. The law will be changed so that no interest is payable on income tax refunds for the period prior to 12 May 2010 as a result of an amendment to allow a deduction because of the changes to the residual tax cost setting rule or the rights to future income rule.

35. That is, the effect of Part IIB (Interest on Overpayments Resulting from Assessments) and Part III (Interest on Overpayments Resulting from Decisions to which the Act applies) of the *Taxation (Interest on Overpayments and Early Payments) Act 1983* will be switched off where:

- the overpayment or early payment relates to an assessment or a decision that is made in respect of claim for deduction by an entity that joined a consolidated group before 12 May 2010; and
- the claim arises because of the changes to the residual tax cost setting and rights to future income rules.

36. However, this modification will not apply where the interest has already been paid to taxpayers.

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[18] Section 170 of the *Income Tax Assessment Act 1936* (ITAA 1936).

37. In addition, no interest or penalties will be payable where additional tax becomes payable because the Commissioner amends an assessment that issued before 31 March 2011, or further amends an amended assessment that issued before that date, to disallow a deduction for a claim because of the changes to the residual tax cost setting and rights to future income rules for the pre-12 May 2010 period.

THE TRANSITIONAL PERIOD (12 MAY 2010 TO 30 MARCH 2011[19])

WHAT CHANGES ARE BEING MADE TO THE TAX COST SETTING RULES FOR THE TRANSITIONAL PERIOD?

38. During the transitional period, the tax cost setting rules that were enacted in 2010 by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (the current tax cost setting rules[20]) will be retained. However, modifications will be made to implement the Board of Taxation's Option C proposals[21]. In this regard, The Board concluded that:

> *These clarifications would address material areas of uncertainty in the operation of the existing rules, and ensure the rules operate in a way that is consistent with the apparent policy intent. They would also ensure that the income tax law applies consistently to consolidated groups and other taxpayers.*[22]

39. Therefore, changes will be made to the current tax cost setting rules:

- to treat certain types of assets as goodwill;
- to ensure that no value is attributed to certain contractual rights to future income; and
- to ensure that the residual tax cost setting rule does not apply to mine site improvements.

40. As a result, the current residual tax cost setting rule will apply to ensure that the head company can deduct the reset tax cost for consumable stores under the general deduction provision.

41. In addition, the current rights to future income rules will operate so that, the head company can deduct the reset tax cost for a Category 1 or 2 right to future income, unless the right is treated as goodwill as outlined below.

Certain types of assets treated as goodwill

42. The current tax cost setting rules will be amended to specify that the following types of assets are treated as goodwill and are therefore excluded from the scope of the general deduction provision and the business capital expenditure provision:

- a non-contractual asset akin to goodwill (such as a customer relationship asset, know-how or another accounting intangible asset which is not a CGT asset but is akin to, or forms part of, the goodwill CGT asset;

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[19] The Assistant Treasurer announced the Board of Taxation review of the residual tax cost setting and rights to future income rules on 30 March 2011.
[20] That is, existing subsections 701-55(5C) and (6) of the ITAA 1997.
[21] Paragraph 7.12 to 7.20 of the Report by the Board of Taxation on its *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.
[22] Paragraph 7.13 of the Report by the Board of Taxation on its *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.

- a contractual term, to the extent that its value is contingent on the renewal of the contract (such as renewal clauses which may give rise to the extension of an existing contract, or to a future contract, under which income would be receivable); and

- a contract entered into by the joining entity with another entity, to the extent that the other entity can unilaterally cancel the contract without paying compensation or a penalty.

43. A goodwill asset is a CGT asset. The tax cost allocated to the goodwill asset will be recognised for tax purposes when the group no longer holds the goodwill asset. This will happen, for example, when:

- a subsidiary member leaves the group taking the goodwill asset with it;

- the goodwill asset is sold; or

- the goodwill asset ceases to exist.[23]

No value attributed to certain contractual rights to future income

44. The current tax cost setting rules will be amended to ensure that no market value (and therefore no allocable cost amount) is attributed to a contractual right to future income for tax cost setting purposes where:

- there is a contractual right to future income from an asset; and

- the combined market value of the asset and the right does not exceed the market value of the asset (worked out on the basis that the asset is unencumbered).

45. As a result, the tax cost setting rules will allocate tax cost to the underlying asset. However, if the combined market value of the asset and the right does exceed the market value of the asset (worked out on the basis that the asset is unencumbered), the excess market value will be attributed to the right for tax cost setting purposes. If the right is an asset that is specifically treated as goodwill, the reset tax cost for the right will be allocated to the head company's goodwill asset.

The residual tax cost setting rule will not apply to mine site improvements

46. The current tax cost setting rules will be amended to clarify that the residual tax cost setting rule does not apply to mine site improvements. [24]

WHAT CLAIMS ARE AFFECTED BY THE TRANSITIONAL PERIOD CHANGES?

47. The changes to the current tax cost setting rules for the transitional period will apply to claims (in respect of any income year) arising from the operation of the residual tax cost setting rule or the rights to future income rule in respect of:

- a joining time that was before 12 May 2010 where a claim is covered by a notice of assessment or amended assessment issued between 12 May 2010 and 30 March 2011;

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[23] Taxation Ruling TR 1999/16 explains how the CGT provisions apply to goodwill.
[24] The ATO is currently considering whether certain mine site improvements are depreciating assets, and therefore come within the scope of subsection 701-55(2) of the ITAA 1997. If the ATO adopts the position that such improvements are not covered by subsection 701-55(2), the issue will be further reviewed.

- a joining time that was on or after 12 May 2010 that happens under an arrangement entered into between 10 February 2010 and 12 May 2010 (including a joining time that happens after 30 March 2011); and

- a joining time that happens under an arrangement entered into at any time between 12 May 2010 and 30 March 2011 (including a joining time that happens after 30 March 2011).

48. The time that an arrangement is taken be entered into is set out in Table 3.

Table 3: Time that an arrangement is taken to be entered

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

49. Table 4 outlines the application of the changes to the current tax cost setting rules in the transitional period to claims.

Table 4: Application of the changes to the current tax cost setting rules for the transitional period

	If the claim is covered by:	**The claim will be treated as follows:**
1.	A private binding ruling or written advice under an Advance Compliance Agreement issued before 31 March 2011	The claim, including the tail of the claim covered by the ruling or advice, will be allowed if the taxpayer acts in accordance with the ruling or advice. Therefore, the changes to the current tax cost setting rules for the transitional period will not apply to the claim or to the tail of the claim.
2.	An assessment or amended assessment where the notice issued after 12 May 2010	The changes to the current tax cost setting rules for the transitional period will apply to the claim. Therefore, the claim will be allowed if it comes within the scope of the transitional period law.

Commissioner's power to amend assessments

50. Under the ordinary operation of the income tax law, the Commissioner has the power to amend an assessment, or further amend an amended assessment, that has been issued to a taxpayer.

51. The Commissioner's power to amend an assessment, or further amend an amended assessment, will generally be unchanged. However, where a claim is covered by the transitional period, when reviewing the assessment or amended assessment, the Commissioner must apply the current tax cost setting rules with the modifications that apply during the transitional period.

No interest will be payable where additional tax becomes payable

52. The current operation of the law will be amended so that no interest or penalties will be payable where additional tax becomes payable because the Commissioner amends an assessment that issued before 31 March 2011, or further amends an amended assessment that issued before that date, to disallow a deduction for a claim because of the changes to the residual tax cost setting and rights to future income rules for the transitional period.

THE PROSPECTIVE PERIOD (AFTER 30 MARCH 2011)

WHAT CHANGES ARE BEING MADE TO THE TAX COST SETTING RULES FOR THE PROSPECTIVE PERIOD?

53. The changes for the prospective period are based on the recommendations by the Board of Taxation to improve the operation of the consolidation regime and to ensure that the tax outcomes for consolidated groups are more consistent with the outcomes that arise outside the consolidation regime[25]. These changes (the new tax cost setting rules) are:

- to apply the tax cost setting rules only to assets already recognised for taxation purposes;
- to modify the residual tax cost setting rule to apply a business acquisition approach;
- to ensure that the reset tax costs for assets that are consumable stores or that qualify as work in progress are deductible; and
- to treat entitlements to future income that arise under contracts as retained cost base assets.

The tax cost setting rules will apply only to assets already recognised for taxation purposes

54. Under the consolidation provisions, the tax costs of assets held by a joining entity that become assets of the head company are reset under the tax cost setting rules[26]. Some specified assets retain their original tax cost[27].

55. Under the new tax cost setting rules, the assets held by a joining entity will have their tax costs set only if those assets are recognised for taxation purposes. However, the tax costs of assets that give rise to deductions for business capital expenditure[28] will not be set.

56. Assets that are recognised for taxation purposes are primarily CGT assets. A CGT asset is defined to mean:

- any kind of property; or
- a legal or equitable right that is not property[29].

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[25] Chapter 6 of the Report by the Board of Taxation on its *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.
[26] Section 701-10 of the ITAA 1997.
[27] Section 705-25 of the ITAA 1997.
[28] Section 40-880 of the ITAA 1997.

57. For the avoidance of doubt, a CGT asset is specifically taken to include:

- part of, or an interest in, an asset that is property or a legal or equitable right that is not property;
- goodwill or an interest in it;
- an interest in an asset of a partnership;
- any other interest a partnership.[30]

58. Therefore, the definition of CGT asset includes revenue assets[31], depreciating assets[32], trading stock[33], 'Division 230 financial arrangements'[34], assets covered by the foreign currency gains and losses provisions[35], traditional securities[36] and qualifying securities[37], even though these assets are not taxed under the CGT provisions[38].

The residual tax cost setting rule will be modified to apply a business acquisition approach

59. The Board of Taxation concluded that:

> *In the current business environment, the consolidation tax cost setting rules are primarily recognised on the acquisition of an entity by a consolidated group, as opposed to on the formation of a consolidated group. Therefore, where the residual tax cost setting rule applies, the revenue or capital character of an asset for a consolidated group should be determined on the same basis that would apply if the group were to acquire an asset as part of a business acquisition.*[39]

60. Although this is consistent with the preliminary views of the Board to adopt an asset acquisition approach as part of its broader post-implementation review of consolidation, the Board notes that it is still considering the question of whether an asset acquisition approach should be adopted more broadly.[40]

61. Therefore, under the new tax cost setting rules, the current residual tax cost setting rule will be retained, but with modifications to ensure that the outcomes under the rule are closer to those that arise outside consolidation under a business acquisition approach.

62. Under a business acquisition approach, the head company will be treated as having acquired the assets of the joining entity as if they were acquired directly, as part of a business acquisition. The revenue or capital character of the assets will then be determined based on the character of the asset in the hands of the head company, rather than the joining entity.

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[29] Subsection 108-5(1) of the ITAA 1997.
[30] Subsection 108-5(2) of the ITAA 1997.
[31] Section 977-50 of the ITAA 1997.
[32] Section 40-30 of the ITAA 1997.
[33] Section 70-10 of the ITAA 1997.
[34] Definition of 'Division 230 financial arrangement' in subsection 995-1(1) of the ITAA 1997.
[35] Division 775 of the ITAA 1997.
[36] Section 26BB of the ITAA 1936.
[37] Division 16E of the ITAA 1936.
[38] Division 118 of the ITAA 1997.
[39] Paragraph 6.12 of the Report by the Board of Taxation on its *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.
[40] Paragraph 6.16 of the Report by the Board of Taxation on its *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.

63. As a result of the adoption of the business acquisition approach, it is expected that the tax costs allocated to many revenue assets under the residual tax cost setting rule will be recognised only when the asset leaves a consolidated group. An asset leaves a consolidated group when:

- the asset is disposed of, or another CGT event happens to the asset; or
- an entity leaves the group taking the asset with it.

64. Assets which cannot be separately sold by the joining entity (such as non-contractual customer relationships, know-how and other accounting intangible assets) will be treated as part of the goodwill of the head company. A goodwill asset is a CGT asset. The tax cost allocated to the goodwill asset will be recognised for tax purposes when the group no longer holds the goodwill asset. This will happen, for example, when:

- a subsidiary member leaves the group taking the goodwill asset with it;
- the goodwill asset is sold; or
- the goodwill asset ceases to exist.[41]

65. As a result of the adoption of the business acquisition approach for the residual tax cost setting rule, the entry history rule will not be relevant for the purposes of determining the treatment of assets covered by the residual tax cost setting rule.

The reset tax costs for consumable stores will be deductible

66. If a consolidated group purchases consumable stores directly, the general deduction provision applies to allow a deduction for the cost of purchasing the stores at the time they are acquired or as they are used (depending on circumstances).

67. Given the nature of consumable stores, the same outcome is appropriate where consumable stores are held by an entity that joins a consolidated group. Therefore, the new tax cost setting rules will specify that consolidated groups can apply the general deduction provision to the reset tax costs of assets that are consumable stores held by a joining entity.

The reset tax costs for assets that qualify as work in progress will be deductible

68. Outside of the income tax consolidation regime, if an entity has work in progress, a specific provision[42] applies to allow a deduction for the work in progress amounts.

69. To ensure a consistent outcome for consolidated groups, the new tax cost setting rules will ensure that this specific provision applies where work in progress is held by an entity that becomes a member of a consolidated group because it is acquired by the group. That is, the operation of the specific provision that applies to allow a deduction for the work in progress amounts will be modified to ensure that it operates effectively where the joining entity holds a work in progress amount.

70. In addition, the existing provisions that allow a deduction for rights to future income for consolidated groups[43] will be repealed.

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[41] Taxation Ruling TR 1999/16 explains how the CGT provisions apply to goodwill.
[42] Section 25-95 of the ITAA 1997.
[43] Sections 716-405 and 716-410 of the ITAA 1997.

71. Currently, if a right to future income is held by a joining entity that is already owned by the group (that is, in a formation case), the right is treated as a retained cost base asset with a tax cost setting amount equal to its terminating value[44]. This outcome will remain unchanged.

Entitlements to future income that arise under contracts will be treated as retained cost base assets

72. Under the new tax cost setting rules, if a contract held by an entity that joins a consolidated group gives rise to an entitlement to future income, the contract will be treated as a retained cost base asset, with a tax cost setting amount equal to the joining entity's terminating value for the asset.

73. The joining entity's terminating value for the asset is the asset's cost base just before the joining time – that is, in broad terms, the amount paid by the joining entity to acquire the asset to the extent that it has not been allowed as a deduction.

74. An entitlement to future income includes a Category 1, 2 or 3 right to future income (other than work in progress) or any other right to income that arises under a contract (such as a right to income that arises under an insurance contract or a reinsurance contract).

WHAT CLAIMS ARE AFFECTED BY THE PROSPECTIVE PERIOD CHANGES?

75. The new tax cost setting rules for the prospective period will apply to claims arising from the operation of the tax cost setting rules to an entity that joins a consolidated group on or after 31 March 2011, except when the joining time happens under an arrangement entered into between 10 February 2010 and 30 March 2011 covered by the transitional period.

[44] Paragraph 705-25(5)(d) of the ITAA 1997.