CONSOLIDATION AND TOFA INTERACTIONS

23 JUNE 2008

PURPOSE

1. The purpose of this paper is to seek comment on a proposed approach that aims to provide an appropriate interaction between the tax consolidation regime and the proposed Taxation of Financial Arrangements (TOFA) regime.

2. The aim is to provide an interaction which results in:

   - economic gains and losses made from a financial arrangement are recognised only once for a consolidated group or MEC group (a consolidated group), for income tax purposes[1]; and

   - gains and losses made from a financial arrangement are spread over the life of the arrangement regardless of whether that arrangement becomes that of a head company due to an entity joining the consolidated group or that of a leaving entity due to the entity leaving the group.[2]

BACKGROUND

3. The TOFA regime (proposed Division 230 of the *Income Tax Assessment Act 1997)* was introduced into Parliament on 20 September 2007 in the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007 (the TOFA Bill). The TOFA Bill lapsed on the calling of the 2007 Federal election.

4. The two overarching objectives of the Division 230 tax treatment for financial arrangements are to allow for greater efficiency and to lower compliance costs.

5. Division 230 will provide for gains or losses from a financial arrangement to be spread over the life of the arrangement for income tax purposes using one of a number of methods. These are the accruals method, the elective fair value method, the elective foreign exchange retranslation method, the elective financial reports method and the elective hedging method. A realisation method is available if no other method applies.

6. The tax consolidation regime commenced on 1 July 2002. The regime allows for a wholly owned group of entities with a company as the head entity to form a single consolidated group and thereby be treated as a single tax entity for income tax purposes. A key objective underpinning the consolidation regime is the removal of the

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1 Section 700-10 of the ITAA 1997.

2 Proposed section 230-1 of the ITAA 1997.

potential for dual recognition of the same economic benefit or loss realised by a consolidated group.

7. Only some of the consequential amendments dealing with the consolidation regime were included in the TOFA Bill.

8. Discussion Paper 19 'Interaction with the Taxation of Financial Arrangements Regime' was released on 5 October 2007 and dealt with the interactions between the consolidation regime and the proposed TOFA regime.

9. This discussion paper builds on Paper 19 and on comments submitted to the Treasury.

OVERVIEW

10. This paper proposes two principles, supported by subordinate rules, on which the interaction of TOFA and the tax consolidation rules should be premised.

11. These principles and subordinate rules seek to maintain, to the extent possible, the policy underpinning both the tax consolidation regime and TOFA.

12. Put simply, the interaction should allow for Division 230 to spread gains and losses made from a financial arrangement by the relevant entity over the period it is held by that entity.

13. The relevant entities would be the following while it holds the financial arrangement:

    - an entity that brings a financial arrangement into a consolidated group;
    - an entity that is the head company of a consolidated group where the head company is taken to hold a financial arrangement; and
    - an entity that was a subsidiary member of a consolidated group but has left the group.

14. The interaction between the TOFA regime and consolidation regime should be such that for the head company there continues to be a systematic prevention of the potential to recognise a gain or loss in respect of the financial arrangement more than once while it is held in the group.

15. A discussion is provided on the two principles supported by examples that demonstrate how the principles and subordinate rules would operate were the necessary income tax law amendments legislated to reflect the concepts in this paper.

16. Please note that this paper does not discuss the application of the interaction between the TOFA regime and the functional currency rules for consolidated groups as contained in Paper 19. Comments have been received on this topic and are being considered by Treasury.

17. Nothing in this paper should be taken as an interpretation of the current income tax law.

FEEDBACK

Comments on the approach, including compliance implications, can be forwarded to Tony Regan, Manager, Company Tax Unit (email: anthony.regan@treasury.gov.au) or Peter Van de Maele, Finance and Strategy Unit (email: peter.vandemaele@treasury.gov.au) by close of business on Friday 11 July 2008.

Principles

Principle 1

An entity takes into account for income tax purposes so much of a gain or loss from a financial arrangement that arises from the application of the relevant Division 230 methodology while the entity either actually holds or is taken to hold the financial arrangement.

Gains and losses subject to a Division 230 spreading method

18. As a result of Principle 1, gains and losses from financial arrangements would be brought to account on the following basis in respect of a single financial arrangement over the life of that financial arrangement:

   - Gains or losses recognised during the period the arrangement is held by an entity joining a consolidated group (pre-joining time) should be brought to account by the joining entity over that pre-joining period.

   - Gains or losses recognised during the period the arrangement is held (or taken to be held because of the single entity rule) by a head company of a consolidated group (post-joining and pre-leaving time) should be brought to account by the head company over that period.

   - Gains or losses recognised during the period the arrangement is held by an entity that has left a consolidated group (post-leaving time) should be brought to account by the leaving entity over that post-leaving period.

Gains and losses not subject to a Division 230 spreading method

19. Where an entity accounts for a gain or loss under the Division 230 realisation method, the gain or loss continues to be recognised on a realisation basis while held by that entity regardless of whether that entity joins or leaves a consolidated group.

20. To the extent an entity holds a financial arrangement that is not subject to Division 230, the entity will continue to apply the tax treatment afforded outside Division 230. As a result, any gain or loss is not brought to account under one of the Division 230 spreading methods by such an entity holding the arrangement on joining or leaving a consolidated group.

Principle 2

Division 230 is applied to a financial arrangement that commences to be held by the head company or leaving entity, because of the single entity rule applying or ceasing to apply, on the same basis as if the head company or leaving entity had commenced to hold the arrangement at that time as a result of having directly acquired the arrangement.

Consolidation regime and the single entity rule

21. The single entity rule in the consolidation regime is the key principle that allows for a group of wholly owned entities to be treated as part of the head company and not as separate tax entities in their own right whilst they remain a subsidiary member of the consolidated group. One result of this is if an entity joins a consolidated group while holding a financial arrangement, the head company of that group will be taken to hold the arrangement for income tax purposes.[3]

22. Equally, when a subsidiary member leaves the group, the single entity rule ceases to apply to the leaving entity allowing for the income tax legislation to commence recognising the entity in its own right from the time of leaving the group. Further, that entity is taken to be a different entity to that which may have joined a consolidated group.[4]

Principle 2 and consolidation

23. Principle 2 would require the head company or leaving entity to apply Division 230 to the newly acquired financial arrangement on the same basis as it would if it had actually acquired a new financial arrangement from another entity. The tax value the entity is taken to have when it commences to hold the arrangement is determined by subordinate rule 1 which is discussed below.

24. Principle 2 can result in the new holder of the arrangement applying a different method for spreading the gain or loss than that used by the original holder.

25. For example, if a joining entity recognises a gain or loss using the compounding accruals method for a financial arrangement, the head company will be required to apply the fair value method to that arrangement if Division 230 would require that outcome as a result of the head company having elected the fair value method for its existing relevant financial arrangements.

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3 Section 701-1 of the ITAA 1997.

4 Explanatory Memorandum, *New Business Tax System (Consolidation) Act 2002* paragraph 2.39.

Subordinate rules

Subordinate rule 1

The opening tax cost for an asset (a right to a financial benefit), that is or forms part of a financial arrangement, on commencing to be an asset of either the head company or leaving entity is equal to the closing tax cost of the asset in the hands of the entity[5] ceasing to hold the asset as a result of either an entity joining the group or a subsidiary member leaving the group[6].

The closing tax cost for an asset is:

(a) an amount that, if the financial arrangement had been disposed of just before joining or leaving time, would result in no balancing adjustment arising under Subdivision 230-G where the gain or loss is brought to account under the compounding accrual method, or[7;8]

(b) its fair value just before joining time or leaving time whichever time is relevant.[9]

However, paragraphs (a) and (b) would not apply (to provide a closing tax cost) in respect of an asset if:

(c) the arrangement is not subject to Division 230 just before joining or leaving time; or

(d) the arrangement is subject to Division 230, using the realisation method, just before joining or leaving time.

Instead, in the case of (c) and (d), only an opening tax cost for the asset is worked out, being its fair value just before the joining time or leaving time, whichever time is relevant.[10]

Note that the proposed interaction rules would not apply where either the joining entity and head company are not subject to Division 230 at the time of joining, or the head company and the leaving entity are not subject to Division 230 at the time of leaving.

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5 The closing tax cost is determined as a result of the entity ceasing to hold the asset.

6 If eligibility for the various elective methods in proposed Division 230 were disturbed by the proposed approach then consideration would need to given to that situation.

7 The compounding accrual method is similar to that used for a qualifying security subject to Division 16E of the ITAA 1936 at subsection 705-30(2) of the ITAA 1997.

8 In the case where there is more than one asset forming part of the financial arrangement, this amount would need to be spread on a reasonable basis between those assets.

9 The TOFA Bill has similar rules for when an entity leaves a consolidated group in proposed section 230-195 (fair value); section 230-240 (foreign retranslation); and section 230-370 (reliance on financial reports). Further, proposed section 230-210 (fair value); section 230-250 (foreign retranslation); and section 230-380 (reliance on financial reports) also adopt reacquisition for fair value if an entity fails to meet the requirement for those elective methods and moves to a compounding accrual method.

10 Paragraphs (c) and (d) ensure that a Division 230 spreading method is not inadvertently applied to an entity's financial arrangement for a period it holds the arrangement either on the Division 230 realisation method or a non Division 230 treatment. For this reason there is no need to provide a closing balance for that entity on either joining or leaving a consolidated group.

26. This subordinate rule supports Principles 1 and 2 by providing a tax cost for consolidation tax cost setting purposes, of an asset coming into a consolidated group via an entity becoming a subsidiary member of the group, in such a way that allows for the appropriate spread of gains or losses to the relevant entities.

27. It is proposed that all assets subject to subordinate rule 1 be retained cost base assets for consolidation tax cost setting purposes.

28. A single financial arrangement may consist of a right to a financial benefit in one income year and an obligation to provide a financial benefit in a subsequent income year. While a single value for the whole arrangement may be recorded for accounting purposes at a point in time, it is proposed that the subordinate rule can look to the right to a financial benefit in the one year separately from the obligation to provide a financial benefit in the subsequent year.

29. This is required as it is possible to deal with one or more of the rights that form part of a financial arrangement independently from the financial arrangement itself. For example, a taxpayer may assign a right to a financial benefit to another entity that is not party to the original financial arrangement. A tax cost will need to be allocated to such a right in order to determine the appropriate gain or loss on a sale of the right for tax purposes in a manner that is consistent with the Division 230 part disposal rules. It is by being able to identify each such right, in applying the consolidation tax cost setting process that an appropriate income reflex is achieved.

30. Case study 2 uses an interest rate swap to demonstrate the proposed approach. Importantly, the case study also demonstrates the above approach will not seek to separate an amount into a single right and a single obligation where there is an agreement to receive or pay the net difference between the right and the obligation.[11]

31. An amendment would also be required to ensure that on leaving a consolidated group, the closing tax cost for an asset in the hands of the head company becomes the opening tax cost for the leaving entity.

32. However, for an asset that is part of a financial arrangement that is not subject to Division 230 or has its gains or losses taken into account using the realisation method in Division 230 just before the leaving time, the asset's opening tax cost for the leaving entity would be its fair value immediately before leaving if after leaving Division 230 would immediately apply to the financial arrangement.

33. For liabilities that form part of a financial arrangement, it is proposed that the history rules apply to allow Principles 1 and 2 to operate as intended. This is consistent with

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11 For example, case study 2.3 identifies the fair value of a financial arrangement as having a net present value of $219,271 at the time of joining a consolidated group. This financial arrangement consists of a right to a financial benefit in year one and an obligation in year two. Subordinate rule 1 would allow for a recognition of the net present value of a $10,000 receipt in year one as an asset and the net present value of the $250,000 payment due in the subsequent year as a liability for the ACA process. While the net payment of $10,000 in year one represents a net payment being the difference between a right to receive a financial benefit and an obligation to provide a financial benefit in the one income year, subordinate rule 1, in this case, only looks to the single right to the net payment of $10,000 and not to the underlying right and obligation before being netted off.

the current operation of the consolidation regime which has a reliance on the recorded amount for a liability in accordance with accounting standards or statement of accounting concepts made by the Australian Accounting Standards Board.[12]

34. This treatment is appropriate as it supports the objectives of the consolidation tax cost setting rules. On joining a consolidated group those rules are aimed at providing sufficient tax costs to reflect at least the amount a head company paid for a joining entity plus the assumption of any joining entity liabilities by the head company as a result of the joining.

35. Equally, for the tax cost setting rules on exit, the tax cost setting process should also recognise this approach for a liability leaving with a leaving entity.

36. By recognising this recorded liability, a key objective of the consolidation regime is being achieved due to the prevention of double taxation of gains or duplication of losses for a consolidated group.[13]

37. It is through an application of subordinate rule 1 for assets and subordinate rule 2 (history rule) for liabilities at the time of joining or leaving a consolidated group that an appropriate amount of gain or loss in respect of a financial arrangement can be brought to account by the joining entity or head company in respect of the period it held the arrangement during the income year immediately before joining or leaving.[14]

Subordinate rule 2

For financial arrangements that are either brought into a consolidated group by a joining entity, or leave a group with a leaving entity, history will only be available to the extent the head company, or leaving entity, requires history to achieve an outcome consistent with Principles 1 and Principle 2.

38. Where an entity joins a consolidated group with an asset, that forms part of the financial arrangement, the asset would be taken to have been acquired by the head company of that group for an amount equal to the tax cost setting amount at the joining time.[15]

39. A similar rule would be needed for a leaving entity commencing to hold the asset that forms part of the financial arrangement.

12 Taxation Ruling 2004/14.

13 Section 705-10 of the ITAA 1997.

14 This is consistent with the approach in the TOFA Bill when an entity leaves a consolidated group in proposed section 230-195 (fair value); section 230-240 (foreign retranslation); and section 230-370 (reliance on financial reports). This also applies for a hedging arrangement where either the joining entity or head company ceases to hold the arrangement because of the joining or leaving event: see item 2(a) in the table to section 230-265.

15 Proposed new rule for assets forming part of a financial arrangement modelled on subsection 701-55(4) of the ITAA 1997 for qualifying securities. Note that the proposed rule would not rely on a provision akin to subsection 701-55(6).

40. The general rule would allow **only** so much history to the head company or leaving entity that is required to obtain an outcome consistent with Principles 1 and 2.[16]

41. A consistent outcome would be achieved where it is established that:

- there is no duplication of gains and losses recognised for the consolidated group; and
- where Division 230 applies, it applies to the financial arrangement on the same basis as if either the head company or leaving entity had commenced to hold the arrangement at the time of joining or leaving.

42. For example, if a head company wishes to continue to apply the hedging method to a financial arrangement that was brought into the consolidated group via a joining entity, the head company would need to satisfy the record keeping requirements in Division 230.[17] Such records would need to be in place at or soon after the hedge was originally created or acquired. It is intended that such history, to the extent it would be necessary to achieve an outcome consistent with Principle 1 and 2, would be permissible despite the rule treating the head company as having commenced to hold the financial arrangement at the time of joining.

43. A general rule is proposed to achieve the above outcome. Such a general rule is necessary as it is not possible to prescribe every anticipated situation where such history may or may not be required in future.

OTHER ISSUES

44. The following issues will also need to be addressed to ensure the appropriate interaction between consolidation and TOFA.

Modification to the operation of the consolidation allocable cost amount (ACA) calculation

45. The consolidation regime's ACA calculation is a process where the correct amount of tax cost is recognised for the head company for an entity joining or leaving a consolidated group.

46. In the joining case, the income tax law should recognise an amount of tax cost for the head company equal to the nominal amounts the head company paid for the joining entity plus any liabilities the head company will assume as a result of acquiring the joining entity. This benchmark is used in the worked examples to test the appropriateness of the results from those examples.

47. The ACA process, in general, has the aim of meeting this benchmark. The tax cost recognised for the group should largely be the amount paid for the joining, plus any liabilities of the joining entity, plus any inherited deductions (deductions the joining entity has not yet claimed but will do so on the basis of pre-joining outlays, for

16 This rule is akin to those currently in Subdivisions 715-J and 715-K of the ITAA 1997.

17 Proposed section 230-310 of the ITAA 1997.

example legal costs).[18] To achieve this outcome the ACA is effectively calculated first looking at the amount paid for, and the liabilities of, the joining entity and then reducing this by any inherited deductions.[19]

48. The same objective exists with the ACA process on a subsidiary member of a group leaving the consolidated group.

49. Because the TOFA regime may provide for deductions on an accrual basis and not on a realisation basis (that is, a joining entity can bring in deductions spread over the life of a financial arrangement into a consolidated group on the basis of future accruals of losses), the joining ACA should not be reduced by those future Division 230 deductions that have not as yet accrued though are anticipated to do so in the future.[20] This is because such anticipated deductions are distinguished from inherited deductions, being amounts recognised as a deduction at the time they are incurred before either joining or leaving a consolidated group though that deduction is subsequently spread over more than one income year such as legal expenses.

50. The same is applicable for the exit ACA process, however the ACA should not be increased by future Division 230 deductions that leave the group.[21] Case study 1 demonstrates this point.

Assessable income and deductions spread over several consolidation membership and non-membership periods[22]

51. The consolidation regime provides for an apportionment rule for assessable income and deductions that are spread over several consolidation membership or non-consolidation membership periods.

52. The apportionment rules will not be needed as proposed Division 230, and Principle 1, will achieve an appropriate spreading of any gains or losses from a Division 230 financial arrangement in situations where the one financial arrangement is held by either or all the following entities during the life of the arrangement: the joining entity, the head company or the leaving entity.

Deferred tax liabilities

53. While the TOFA regime would bring about a greater alignment between the tax law and accounting recognition of the value of assets and liability the alignment may not always be complete.

54. In such cases it is possible for a deferred tax asset or deferred tax liability to be recognised when an entity joins a consolidated group or leaves a consolidated group in respect of a financial arrangement that is on hand at that time.

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18 Subsection 705-10(2) of the ITAA 1997.

19 The reduction in the joining ACA is determined under step 7 of the ACA calculation in section 705-115 of the ITAA 1997.

20 Section 705-60 of the ITAA 1997.

21 Section 711-35 of the ITAA 1997.

22 Subdivision 716-A of the ITAA 1997.

55. While the current consolidation regime recognises the value of deferred tax liabilities for the purposes of the ACA process, it is proposed that all deferred tax liabilities not be recognised in the ACA process in respect of Division 230 financial arrangements.

56. This approach will provide a truer reflection of the tax costs for the head company when an entity joins or leaves a consolidated group.

Transitional issues

57. The proposed transitional rules for Division 230 would allow a taxpayer to elect to have all of their financial arrangements that are in place before the commencement of Division 230 be subject to Division 230.

58. Where such a transitional election is made the taxpayer will apply a transitional balancing adjustment to pre-existing financial arrangements. A positive amount results in an amount of assessable income and a negative amount results in a deductible amount. The amounts are spread equally over the following four income years.

59. From the time of the commencement of Division 230, gains and losses arising on these financial arrangements post transitional balancing adjustment time will be brought to account using one of the methods provided for by Division 230.

60. Where such an arrangement becomes that of a head company because an entity joins the consolidated group, Principle 2 would cause the head company to apply Division 230 to these arrangements on the same basis as if the head company had actually acquired the arrangements at the time of joining. This is because such joining time will always be post commencement of Division 230. The same approach is taken where a subsidiary member of a consolidated group leaves the group with such an arrangement and the head company had applied the transitional balancing adjustment.

61. To allow the head entity or leaving entity to undo the transitional rule election would compromise the irrevocable nature of this election.

62. Additionally, where the transitional balancing adjustment results in an amount to be included in assessable income in an income year after the time of joining or leaving, the future tax liability should be recognised at step 2 of the joining ACA or step 4 of the leaving ACA .The same modification should be reflected in the exit ACA process. Note that these amounts are not impacted by the proposed treatment for deferred tax liabilities as these future tax liabilities relate to gains that have been crystallised at the time of applying the transitional balancing adjustment. The converse would also apply. If the transitional balancing adjustment results in an amount being deductible in an income year after the time of joining or leaving, the future deduction should be recognised at step 7 of the joining ACA or step 2 of the leaving ACA.

Case Study 1 — Basic example demonstrating entry/exit case

63. This case study demonstrates the application of Principles 1 and 2 and the subordinate rules. The case study is modelled on Case Study 1 in the explanatory memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007 in Chapter 13.

64. This case study assumes the financial arrangement's overall loss is brought to account using the compounding accrual method by all the relevant entities holding the arrangement at any one time during the life of the arrangement.

65. The reason for the 'vanilla' example is to allow for a clearer demonstration of the legislative approach proposed in this paper for the interaction between the TOFA regime and consolidation regime when a single financial arrangement is held by various entities during the term of the arrangement.

Facts

66. Go Co is incorporated with $50,000. Go Co purchases a refrigerated truck from Big Rig Co with the payment of $100,000 for the vehicle to occur on 30 June 2013. Go Co takes delivery of the vehicle on 1 June 2010.

67. Because of the application of Division 230, the opening depreciating cost of the truck will be $74,546.58.[23] However for simplicity assume the truck is to be depreciated over 10 years at $7,500 per annum. Also assume Go Co has $20,000 rental income each year.

68. On 30 June 2010 Go Co is acquired by the head entity of a consolidated group, Head Co 1.

69. On 30 June 2012 Go Co is sold by Head Co 1 to Head Co 2, the head entity of another consolidated group.

What are the gains and losses under the financial arrangement?

70. Assuming an interest rate of 10 per cent and daily compounding, the value of Go Co's obligation to pay $100,000 on 30 June 2013 is $74,546.58 at 1 June 2010. This amount is the value of the financial benefit taken to be received by Go Co.[24]

71. Taking into account the financial benefit of $74,546.58 which is taken to be received and the financial benefit of $100,000 which is to be provided under the financial arrangement, Go Co will have a Division 230 loss of $25,453.42 from the financial arrangement.

72. As the loss of $25,453.42 is to be accrued, the loss will be spread over the period starting when Go Co has the financial arrangement using a compounding accruals method.

Schedule for each accrued loss for each compounding interval

Year ending	Amortised cost (year start) (a)	Accrued loss for tax purposes (b)	Cash flows (c)	Amortised cost (year end) (a) + (b) – (c)
30 June 2010	$0.00	–$586.26	$74,546.58	–$75,132.85
30 June 2011	–$75,132.85	–$7,513.28	$0.00	–$82,646.13
30 June 2012	–$82,646.13	–$8,264.61	$0.00	–$90,910.75
30 June 2013	–$90,910.75	–$9,091.07	–$100,000.00	$0.00

23 Proposed section 230-440 of the ITAA 1997.

24 Proposed subsection 230-440(2) of the ITAA 1997.

How will consolidation apply?

73. The following would be the income tax treatment if joining entity had not joined a consolidated group.

Tax periods	1/6/10 to 30/6/10	1/7/10 to 30/6/11	1/7/11 to 30/6/12	1/7/12 to 30/6/13
Div 230 deduction	$586.26	$7,513.28	$8,264.61	$9,091.07
Depreciation	$613	$7,500	$7,500	$7,500
Rental income	$1,643	$20,000	$20,000	$20,000
Taxable income	$443.74	$4,986.72	$4,235.39	$3,408.93
Tax expense	$133.12	$1,496.00	$1,270.62	$1,022.68
Cash at hand	$51,509.88	$70,013.88	$88,743.26	$107,720.58

74. On 30 June 2010 Go Co joins a consolidated group. To determine the new tax costs for Go Co's assets on becoming assets of Head Company 1, Head Company 1 will identify Go Co's assets and liabilities on 30 June 2010. This will allow for the joining allocable cost amount (ACA)[25] to be calculated for Go Co.

75. As the joining time coincides with the end of Go Co's standard income year, Principle 1 will be automatically satisfied in that $586.26 of the TOFA loss that accrued while Go Co was recognised for income tax purposes as a separate entity will be claimed as a Division 230 deduction by Go Co.

Entry ACA calculation for 30 June 2010

76. The balance sheet at the entry time is:

Assets	
Truck (WDV)[26]	$73,933.58
Cash	$51,509.88
Liabilities	
Truck loan	$75,132.85 (the present value of the financial obligation)
Equity	
Capital	$50,000
NPAT[27]	$310.62

77. Head Company acquires Go Co for $50,310.61 representing the net value of Go Co.

78. The ACA will be:

Step 1	$50,310.61 (cost base of shares in Go Co)
Step 2	$75,132.85 (present value of the liability)
Steps 3 to 7	Nil
Total ACA	**$125,443.46**

79. The total ACA plus the remaining Division 230 deductions should reflect the nominal amounts paid and to be paid by Head Company 1 (that is, the $50,310.61 paid and the $100,000 to be paid equal $150,310.61).

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25 Division 705 of the ITAA 1997.

26 Written down value.

27 Net profit after tax.

80. The ACA of $125,443.46 will be allocated to the cash and truck as follows:

Retained cost base asset:	
Cash	$51,509.88
Reset cost base asset:	
Truck	$73,933.58
Division 230 deductions	$24,868.96
Total	**$150,312.42**

81. The sum of ACA plus the remaining Division 230 deductions should equal the sum of the nominal value of the economic outlay by Head Company 1 of acquiring Go Co of $50,310.61 and the nominal value of the future obligation of $100,000 which is **$150,312.42** (ignoring rounding error).

82. Importantly, note that there is no requirement to reset the cost of the financial obligation in this situation, as reliance on the proposed general history rule in subordinate rule 2 can be had to allow Head Company 1 to carry forward the amortised cost of the financial obligation of $75,132.85. This outcome is consistent with both Principle 1 and Principle 2.

83. Case study 2 will demonstrate in detail the application of subordinate rule 1 which is about determining the tax cost for an asset that forms part of a financial arrangement.

84. On 30 June 2012 Go Co is sold by Head Company 1 to Head Company 2. As a result it is necessary to apply the exit ACA rules for the leaving entity and to then apply the entry ACA for that leaving subsidiary (Go Co) for Head Company 2.

Exit ACA calculation for 30 June 2012

85. The assets and liabilities at the exit time are:

Assets	
Truck (WDV)	$58,933.58
Cash	$88,743.26
Liabilities	
Truck loan	$90,910.75 (the present value of the financial obligation)

86. The ACA will be:

Step 1	$147,676.84
Step 4	-$90,910.75
Total ACA	**$56,766.09**

87. Head Company 2 acquires Go Co from Head Company 1 for $56,766.09 representing the net value of Go Co. As the ACA on exit equals the amount paid for the shares, no capital gain will arise for Head Company 1.

88. As with the case when Go Co joined Head Company 1's consolidated group, the time of exit coincides with Head Company's end of income year. Head Company 1 will have claimed a deduction of $7,513.28 for the 2010-11 income year and $8,264.61 for the 2011-12 income year under Division 230. This outcome reflects Principle 1.

89. However, if Go Co had left Head Company 1's consolidated group part way through the group's income year, Principle 1 would apply to ensure the losses for the financial arrangement that accrued for that part of the income year for Head Company 1 were taken into account for Head Company 1's income tax purposes.

90. Head Company 2 will need to determine the ACA for Go Co as at 30 June 2012.

Entry ACA for 30 June 2012

Step 1	$56,766.09
Step 2	$90,910.75
Steps 3 to 7	Nil
Total ACA	**$147,676.84**

91. Total ACA plus remaining Division 230 deductions should reflect the nominal amounts paid and to be paid by Head Company 2. That is, $56,766.09 has been paid and $100,000 is to be paid on maturity of the loan being **$156,766.09**.

92. The ACA allocation will be:

Retained cost base asset:	
Cash	$88,743.26
Reset cost base asset:	
Truck	$58,933.58
Future Division 230 deductions	$9,091.07
Total tax costs available	**$156,767.91**

93. The sum of ACA plus the remaining Division 230 deductions matches the ultimate outflow (ignoring the rounding error).

Conclusion

94. The case study has demonstrated that the proposed approach has achieved an outcome that is consistent with the overarching aim of the interaction between the consolidation regime and TOFA regime:

- Economic gains and losses from a financial arrangement are recognised only once for a consolidated group for income tax purposes.

- Gains and losses from a Division 230 financial arrangement are spread over the life of the arrangement, regardless of whether the arrangement becomes that of a head company because of an entity joining the group or that of the leaving entity because of that entity leaving the group.

CASE STUDY 2 — INTEREST RATE SWAP[28]

95. These three examples look at how Division 230 gains and losses would be returned where an entity joins a consolidated group using various methods. The case study is modelled on Case Study 2 in the explanatory memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007 in Chapter 13, incorporating the same assumptions in respect of fair value calculations.

96. The examples are:

- joining entity on accruals and head entity on fair value;
- joining entity on fair value and head entity on fair value; and
- joining entity on realisation basis (outside of Division 230) and head entity on fair value.

Case study 2.1 — joining entity compounding accrual/head entity fair value

Facts

97. Risky Co was incorporated on 1 July 2011 with $10 million. It bought land for $10 million and leases it out at $750,000 per annum. Risky Co's turnover is less than $100 million however it has made an election to apply Division 230 to its financial arrangements[29]. Risky Co has not chosen one of the elective methods in Division 230 therefore the compounding accrual method will apply to any gains and losses made on the financial arrangement.

98. On 1 July 2011 Risky Co enters into an interest rate swap with a third party. Under the swap, the notional principal is $100 million. The term of the swap is three years. Both the fixed rate and floating rate payments are due on 30 June 2012, 30 June 2013 and 30 June 2014. Under the swap, Risky Co makes floating rate payments and receives fixed rate payments.

99. Fixed rate payments are determined by the fixed rate prevailing at the commencement of the swap and floating rate payments are determined by the floating rate prevailing on 1 July 2011 for payment due on 30 June 2012 and on the day 12 months prior to the payment date for the remaining floating rate payments.

100. The agreement allows for payments and receipts, which are payable or receivable on the same day, to be netted off.

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28 Based on case study 2 in the Explanatory Memorandum to the TOFA Bill.

29 Proposed subsection 230-405(5).

101. The interest rates during the term of the swap are:

Table 1

Date	Fixed Rate	Floating Rate
1 July 2011	5.75%	6.25%
30 June 2012	5.75%	5.74%
30 June 2013	5.75%	5.21%

102. The cash flows for Risky Co under the swap arrangement are therefore:

Table 2

Date	Pays floating	Receives fixed	Net cash flow
30 June 2012	$6,250,000	$5,750,000	-$500,000
30 June 2013	$5,740,000	$5,750,000	$10,000
30 June 2014	$5,210,000	$5,750,000	$540,000
Overall gain			**$50,000**

103. Risky Co applies the Division 230 compounding accrual method to the sufficiently certain overall gains and losses on the swap.

104. On 31 December 2012 (the joining time), Risky Co is acquired by Head Co, the head company of a consolidated group, for its market value. Head Co has made a fair value election under Subdivision 230-C.

What will be the gain or loss in each year for each entity?

105. Applying Principle 1, Risky Co will return a gain or loss for the year ended 30 June 2012 and for the period 1 July 2012 to 31 December 2012 under the accruals method. In line with Principles 1 and 2. Head Co will return a gain or loss for each remaining period using the fair value method assuming the Head Co holds the swap until maturity.

Calculations made during the term of the swap

Risky Co for year ended 30 June 2012

106. Risky Co determines the value of the financial benefits to be provided or received at the time that it begins to hold the financial arrangement. Risky Co is required to assume that it will hold the arrangement until maturity.[30];[31] Maturity occurs at the time the last payment is made at the end of Year 3.

Date	Pays floating	Receives fixed	Net cash flow
30 June 2012	$6,250,000	$5,750,000	-$500,000
30 June 2013	$6,250,000	$5,750,000	-$500,000
30 June 2014	$6,250,000	$5,750,000	-$500,000
Overall loss			**-$1,500,000**

30 Consistent with the assumptions in Case Study 2 in the explanatory memorandum to Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007 in Chapter 13, interests rates are assumed to remain constant over the life of the arrangement at each point of determining the respective fair values.

31 Proposed paragraph 230-110(2)(a) of the ITAA 1997.

107. Risky Co spreads the sufficiently certain overall loss from the time at which it starts to have the arrangement to the time at which it will cease to have the arrangement.[32]

108. The interest payments are periodic in nature with the notional principal remaining constant during the term of the swap. Accordingly, Risky Co uses a straight line method to allocate the overall loss, $1.5 million, across the three-year term of the swap arrangement.

109. Therefore, the loss from the swap arrangement that is to be allocated for the income year ending 30 June 2012 by Risky Co is $500,000.

Risky Co for the period 1 July 2012 to 31 December 2012

110. On 30 June 2012 the interest rate decreases to 5.74 per cent. Risky Co had estimated its overall loss based on an interest rate of 6.25 per cent. Because of the change in interest rate Risky Co re-estimates the values of the financial benefits which it has to provide under the floating leg of the swap.[33]

111. On 30 June 2012 Risky Co's re-estimated financial benefits are calculated as follows:

Date	Pays floating	Receives fixed	Net cash flow
30 June 2012	$6,250,000	$5,750,000	-$500,000[34]
30 June 2013	$5,740,000	$5,750,000	$10,000
30 June 2014	$5,740,000	$5,750,000	$10,000
Overall loss			**-$480,000**

112. Risky Co now expects to make an overall loss of $480,000, due to the change in interest rate. As explained above, Risky Co spreads the gains and losses from the swap on a straight line basis. The $20,000 re-estimated future gain is spread on that basis over the remaining two years of the swap.

113. Therefore, for the period 1 July 2012 to 31 December 2012 Risky Co should, according to Principle 1 in conjunction with subordinate rule 1, return as assessable income a gain of $5,000.[35] Note that the demonstration of this application is provided in paragraphs 120 to 124.

114. Assume, at the joining time, Risky Co has the following assets and liabilities:

Cash	$550,000[36]
Land	$10 million (cost base and market value)
Derivatives	$18,401 (present values of two $10,000 payments [37])
Current tax liability	$114,000[38]

32 Proposed section 230-130 of the ITAA 1997.

33 Proposed subsection 230-120(3) and section 230-160 of the ITAA 1997.

34 The amount is paid.

35 The assumption is that 50 per cent of $10,000 payment due on 30 June 2013 has accrued up to 31 December 2012.

36 In the year ended 30 June 2012 Risky Co had rental income of $750,000, a payment of $500,000 and a tax payment of $75,000. In the part year ended 31 December 2012 the only income was $375,000 from the rental property.

37 Refer to the table in paragraph 141.

115. Assume therefore Head Co would pay $10,454,401 for Risky Co, being the fair value of the assets and liabilities of Risky Co.

116. Entry ACA calculations as at 31 December 2012 are:

Step 1	$10,454,401 (cost base of shares in Risky Co)
Step 2	$114,000
Steps 3 to 7	Nil
Total ACA	**$10,568,401**

117. The ACA of $10,568,401 will be allocated to the assets as follows:

Retained cost base assets	
Cash	$550,000
Derivative	$5,000 (as per subordinate rule 1)
Reset cost base asset:	
Land	$10,013,401

Head Co for the six month period to 30 June 2013

118. Head Co has made a fair value election and will take into account any changes in the present value of the swap over the period and any cash flows made under the swap for its income tax purposes.

119. Head Co must calculate the present value of the expected remaining net cash flows over the remaining life of the swap arrangement. The closing value of the swap at 30 June 2013 will be:

Payment date	Payment amount	Discount factor	Present value of remaining cash flows
30 June 2014	$540,000	1 / (1 + 5.21%)	$513,259

Calculation of opening tax cost

120. The opening tax cost for Head Co using subordinate rule 1 will be Risky Co's closing tax cost just before Risky Co joined the consolidated group. Because Risky Co is applying the compounding accrual method to the gains or losses for the swap, the closing tax cost is the amount of consideration that Risky Co would need to receive if it were to dispose of the financial arrangement just before the joining time, without an amount being included in assessable income or allowable as a deduction to it under proposed Subdivision 230-G.

Calculation of closing tax cost

121. Here Principle 1 is applied to Risky Co for the income year ending at the time of joining.[39] At that time, 31 December 2012, Risky Co has an entitlement to a payment of $10,000 on 30 June 2013. For simplicity, assume 50 per cent of the $10,000 accrued gain relates to the period 1 July 2012 to 31 December 2012 and is therefore included in

38 Liability for the part year ended 31 December 2012 is income of $375,000 plus Division 230 gain of $5,000 at 30 per cent.

39 Section 701-30 of the ITAA 1997.

Risky Co's assessable income. This amount of $5,000 assessable income is relevant for part (e) of the formula below.

122. The Subdivision 230-G balancing adjustment formula is:

Balancing adjustment = (a + b + c) — (d + e + f).

Where:

a = the total benefits received under the financial arrangement.

At 31 December 2012 no financial benefits have been received by Risky Co.

b = the total deductions under the financial arrangement before the transfer or cessation.

At 31 December 2012 Risky Co has claimed a deduction of $500,000.

c = the total deductions under the financial arrangement after the transfer or cessation.

There are no deductions after the joining time for Risky Co.

d = the total benefits provided under the financial arrangement.

At 31 December 2012 Risky Co has made one payment of $500,000.

e = the total assessable income under the financial arrangement before the transfer or cessation.

At 31 December 2013 Risky Co will have returned $5,000 for the gain in the period 1 July 2012 to 31 December 2012.

f = the total assessable income under the financial arrangement after the transfer or cessation.

There is no assessable income after the joining time for Risky Co.

123. Therefore, the amount that Risky Co would need to sell the arrangement just before joining time to ensure no balancing adjustment is:

$0 + (X + $500,000 + $0) — ($500,000 + $5,000 + $0) therefore X = $5,000.

124. As such, the opening tax cost of the asset that forms part of the financial arrangement for Head Co should be $5,000.

Head Co for the period 1 January 2013 to 30 June 2013

125. The fair value gain or loss for Head Co for the period to 30 June 2013 will be:

Opening value	Closing value	Net cash flows	Gain or loss
$5,000	$513,259	$10,000	$518,259

126. Note that the $5,000 is not the actual opening fair value of the swap. The opening value has been calculated as a result of applying subordinate rule 1 in the context where the joining entity was applying the compounding accrual method in Division 230 to the swap. It is by this rule that Principle 1 is met.

Head Co for the period 1 July 2013 to 30 June 2014

127. As the closing balance at 30 June 2013 for the fair value of the swap is $513,259 and the only cash flow in the year is the final payment of $540,000, the amount to be returned as assessable income by Head Co for the year ending 30 June 2014 is:

Opening value	Closing value	Net cash flows	Gain or loss
$513,259	$0	$540,000	$26,741

Total Division 230 gains taken into account for the swap

128. In a previous table it was shown Risky Co would have returned an overall Division 230 gain of $50,000 if it had in fact held the swap until maturity. The fact Risky Co joined the group should not alter the amount of overall gain that is to be included in assessable income on the swap in accordance with the proposed approach to the interaction between the consolidation regime and the TOFA regime.

129. The table below demonstrates how this outcome has been achieved:

Entity/method	Period	Amount of deduction or assessable income
Risky Co/accrual	1 July 2011 to 30 June 2012	-$500,000
Risky Co/accrual	1 July 2012 to 31 December 2012	$5,000
Head Co/fair value	1 January 2013 to 30 June 2013	$518,259
Head Co/fair value	1 July 2013 to 30 June 2014	$26,741
Overall gain		**$50,000**

Proof of Division 230 and consolidation outcomes

130. The difference between the amounts Head Co has paid and will pay for Risky Co's assets and the value of Risky Co's assets at the end of the term of the swap should equate to Head Co's taxable income in respect of Risky Co and its swap assuming the value of the land has not changed and no other amounts of income or outgoings other than those in respect of the swap.

131. Head Co paid $10,454,401 for the shares in Risky Co and paid out Risky Co's $114,000 tax liability that was brought into the group. In return Head Co acquired $550,000 cash and land worth $10,000,000 and received two payments on the swap of $10,000 on 30 June 2013 and $540,000 on 30 June 2014. Therefore, the overall economic gain for Head Co in nominal terms is $531,599.

132. The Division 230 fair value gains to Head Co on acquiring Risky Co equal $545,000.

133. The difference between the economic gain to Head Co and the taxable income in respect of Risky Co is made up of the difference between the fair value of the swap at the time of joining ($18,401) and the opening value of the swap ($5,000) for Head Co under subordinate rule 1.

134. This occurs as a result of the combined impact of Principle 1 and subordinate rule 1 in that the accrued gains or losses for the swap are brought to account for Risky Co using the Division 230 method it applies for the period up to the joining time.

135. However, note that the cost base of the land has increased from $10,000,000 to $10,013,401. If therefore the Head Company had sold the land for our assumed unchanged market value it would have a capital loss of $13,401 to offset the increase in Division 230 gains of the same amount.

136. An alternative approach would be to alter subordinate rule 1 and treat Risky Co as having sold the derivative for its fair value at the joining time. Such an approach would result in Risky Co increasing its taxable income for the six month period from 1 July 2012 to 31 December 2012 by $13,401. This would also leave the cost base of the land as $10,000,000.

Case study 2.2 — joining entity fair value/head entity fair value

Facts

137. Assume the same facts as Case study 2 except Risky Co has made a fair value election under Subdivision 230-C.

138. In addition to Case study 2.1, it is assumed that the floating interest rate is 6 per cent at 31 December 2012.

Calculations made during the term of the swap

139. Principle 1 requires Risky Co to return a gain or loss for the income year ended 30 June 2012 and for the period 1 July 2012 to 31 December 2012 under the fair value method. In line with Principles 1 and 2 Head Co will return a gain or loss for each remaining period using the fair value method on the basis it holds the swap until maturity.

Risky Co for year ended 30 June 2012

140. As Risky Co has made a fair value election (Subdivision 230-C), it will include any gains and losses on the swap by reference to changes in the present value of the swap over the life of the swap and any cash flows made under the swap.

141. Risky Co must calculate the present value of the remaining net cash flows at the end of each year. The closing value of the swap at 30 June 2012 is calculated as:

Payment date	Estimated payment amount	Discount factor	Present value of remaining cash flows
30 June 2013	$10,000	$1 / (1 + 5.74\%)$	$9,457
30 June 2014	$10,000	$1 / (1 + 5.74\%)^2$	$8,944
Present value of cash flows			**$18,401**

142. Therefore, the gain or loss for this period is:

Opening value	Closing value	Net cash flows	Gain or loss
$0	$18,401	$-500,000	-$481,599

Risky Co for the period 1 July 2012 to 31 December 2012

143. Risky Co must calculate the present value of the remaining net cash flows at the end of income year. Risky Co assumes that on 30 June 2014 it will have to pay $250,000 based on the floating interest rate of 6 per cent at 31 December 2012.

144. Therefore, the closing value of the swap at 31 December 2012 is:

Payment date	Estimated payment amount	Discount factor	Present value of remaining cash flows
30 June 2013	$10,000	1 / (1 + (6% / 2))	$9,709
30 June 2014	-$250,000	1 / (1 + 6%) x (1 + (6% / 2))	-$228,980
Present value of cash flows			**-$219,271**

145. Therefore, the gain or loss for this period is:

Opening value	Closing value	Net cash flows	Gain or loss
$18,401	-$219,271	$0	-$237,672

Head Co for the period 1 January 2013 to 30 June 2013

146. The opening value of the financial arrangement under the fair value method for Head Co will be the closing value for Risky Co, being -$219,271.

147. Head Co has made a fair value election (Subdivision 230-C) and so will include in its assessable income the change in the present value of the swap over the period and any cash flows made under the swap.

148. Head Co must calculate the present value of the remaining net cash flows at the end of each year[40]. The closing value of the swap at 30 June 2013 is:

Payment date	Payment amount	Discount factor	Present value of remaining cash flows
30 June 2014	$540,000	1 / (1 + 5.21%)	$513,259

149. Therefore, the gain or loss for this period is:

Opening value	Closing value	Net cash flows	Gain or loss
-$219,271	$513,259	$10,000	$742,530

Head Co for the period 1 July 2013 to 30 June 2014

150. As the closing balance at 30 June 2013 for the fair value of the swap is $513,259 and the cash flows in the year are the final payment of $540,000, the amount to be returned as assessable income by Head Co for the year ending 30 June 2014 is:

Opening value	Closing value	Net cash flows	Gain or loss
$513,259	$0	$540,000	$26,741

40 Note the interest rate has moved back to 5.21 per cent.

Total Division 230 gains taken into account for the swap

151. In Table 2, at the start of Case study 2 above, it was shown that Risky Co would have returned an overall Division 230 gain of $50,000 if it had in fact held the swap until maturity. The fact Risky Co joined the group should not alter the amount of overall gain that is to be included in assessable income on the swap in accordance with the proposed approach to the interaction between the consolidation regime and the TOFA regime.

152. The table below demonstrates this outcome has been achieved:

Entity/method	Period	Amount of deduction or assessable income
Risky Co/fair value	1 July 2011 to 30 June 2012	-$481,599
Risky Co/fair value	1 July 2012 to 31 December 2012	-237,672
Head Co/fair value	1 January 2013 to 30 June 2013	$742,530
Head Co/fair value	1 July 2013 to 30 June 2014	$26,741
Overall gain		**$50,000**

What will be the consolidation effect on Risky Co joining the consolidated group?

153. At the joining time, Risky Co has the following assets and liabilities:

Cash	$544,480[41]
Land	$10 million (cost base and market value)
Derivatives asset	$9,709 (present value of future $10,000 receivable)
Derivatives liability	$228,980 (present value of future $250,000 payment)
Current tax liability	$41,199[42]

154. Head Co would therefore pay the market value of $10,284,010 for Risky Co.

155. Entry ACA calculation for 31 December 2012:

Step 1	$10,284,010 (cost base of shares in Risky Co)
Step 2	$270,179 (derivative liability + current tax liability)
Steps 3 to 7	Nil
Total ACA	**$10,554,189**

156. The ACA of $10,554,188 will be allocated to the assets as follows:

Retained cost base assets:	
Cash	$544,480
Derivative asset	$9,709
Reset cost base asset:	
Land	$10,000,000

41 In the year ended 30 June 2012 Risky Co had income of $750,000, a payment of $500,000 and a tax payment (based on the Division 230 loss of $481,599) of $80,520 ($750,000 – $481,599 @ 30 per cent). In the part year ended 31 December 2012 the only income was $375,000.

42 Liability for the part year ended 31 December 2012 is income of $375,000 less proposed Division 230 loss of $237,671 at 30 per cent.

Proof of Division 230 and consolidation outcomes

157. Note that the closing fair value for the swap overall was -$219,271 for the joining entity at the joining time. Consistent with Principle 1 and subordinate rule 2 (general history rule) this will become the opening value for Head Co.

158. The closing fair value for the swap for Head Co at 30 June 2013 (based on the floating rate of 5.21 per cent) will be $513,259. As a result Head Co will make a $742,530 fair value gain for the six month period to 30 June 2013. This is as a result of the change in interest rate of 6 per cent (at the joining time) moving to 5.21 per cent at 30 June 2013.

159. Head Co will make a $26,741 fair value gain for the period 1 July 2013 to 30 June 2014.

160. Assume, in relation to Risky Co, the only amounts brought to account for income tax were the two fair value gains totalling $769,271. This amount reflects the nominal gain made by the Head Co as a result of acquiring the assets of Risky Co.

161. That is, Head Co paid $10,284,010 for the shares in Risky Co and discharged Risky Co's $41,199 tax liability, a total of $10,325,209.

162. In return, Head Co has acquired assets with a value of $11,094,480 consisting of $544,480 cash, a $10,000 receipt on the swap at 30 June 2013, a $540,000 receipt on the swap on 30 June 2014 plus land valued at $10,000,000. The difference between these two amounts is $769,271, being an amount equal to the amount of fair value gain the Head Company made on the swap.

Case study 2.3 — joining entity not under Division 230/head entity fair value

Facts

163. Assume the same facts as case study 2 except Risky Co has a turnover of less than $100 million though no election is made to apply Division 230 to the financial arrangement. Also assume gains and losses made from the financial arrangement are accorded a realisation tax treatment outside Division 230.

What will be the gain or loss in each year for each entity?

164. Using Principle 1, Risky Co will return a loss for the year ended 30 June 2012 and a gain for the period 1 July 2012 to 31 December 2012 on a realisation basis. In line with Principles 1 and 2 Head Co will return a gain or loss for each remaining period using the fair value method on the basis it holds the swap until maturity.

Risky Co for year ended 30 June 2012

165. Risky Co has not elected to apply Division 230 to the financial arrangement and ordinarily takes into account cash flows for income tax purposes when the amounts are received or paid.

166. The only amount received or paid by Risky Co in the year ending 30 June 2012 is a payment of $500,000 and this will be claimed as a deduction.

Risky Co for the period 1 July 2012 to 31 December 2012

167. Risky Co makes no payments and receives no payments in respect of the swap during the period 1 July 2012 to 31 December 2012.

Head Co for the six month period to 30 June 2013

168. Head Co has made a fair value election (Subdivision 230-C) and so will include in its assessable income the change in the present value of the swap over the period and any cash flows made under the swap.

169. The opening value of the swap arrangement for Head Co will be the fair value at 31 December 2012 (the joining time). This is calculated as follows:

Payment date	Estimated payment amount	Discount factor	Present value of remaining cash flows
30 June 2013	$10,000	1 / (1 + (6% / 2))	$9,709
30 June 2014	-$250,000	1 / (1 + 6%) x (1 + (6% / 2))	-$228,980
Present value of cash flows			**-$219,271**

170. Head Co must also calculate the present value of the remaining net cash flows at the end of each year. The closing value of the swap at 30 June 2013 is:

Payment date	Payment amount	Discount factor	Present value of remaining cash flows
30 June 2014	$540,000	1 / (1 + 5.21%)	$513,259

171. Therefore, the gain or loss for this period is:

Opening Value	Closing Value	Net cash flows	Gain or loss
-$219,271	$513,259	$10,000	$742,530

Head Co for the period 1 July 2013 to 30 June 2014

172. As the closing balance at 30 June 2013 for the fair value of the swap is $513,259 and the cash flows in the year are the final payment of $540,000, the amount to be returned as assessable income by Head Co for the year ending 30 June 2014 is:

Opening value	Closing value	Net cash flows	Gain or loss
$513,259	$0	$540,000	$26,741

Total returned amounts

173. The amounts returned are:

Period	Entity	Amount
Risky Co	1 July 2011 to 30 June 2012	-$500,000
Risky Co	1 July 2012 to 31 December 2012	$0
Head Co	1 January 2013 to 30 June 2013	$742,530
Head Co	1 July 2013 to 30 June 2014	$26,741
Total		**$269,271**

What will be the consolidation effect of Risky Co joining the consolidated group?

174. At the joining time, Risky Co has the following assets and liabilities:

Cash	$550,000[43]
Land	$10 million (cost base and market value)
Derivatives asset	$9,709 (present value of future $10,000 receivable)
Derivatives liability	$228,980 (present value of future $250,000 payment)
Current tax liability	$112,500[44]

175. Head Co would therefore pay the market value of $10,218,229 for Risky Co.

176. Entry ACA calculation for 31 December 2012:

Step 1	$10,218,229 (cost base of shares in Risky Co)
Step 2	$341,480 (derivative liability + current tax liability
Steps 3 to 7	Nil
Total ACA	**$10,559,709**

177. The ACA of $10,559,709 will be allocated to the assets as follows:

Retained cost base assets:	
Cash	$550,000
Derivative asset	$9,709
Reset cost base asset:	
Land	$10,000,000

Proof of Division 230 and consolidation outcomes

178. Note as a result of Principle 1 and subordinate rule 1, Head Co will have an opening value for the swap, as at 30 June 2012, of $219,271. As this is the same opening value for Head Co as in Case study 2.2, the outcomes will be identical for Head Co in the case study as for case study 2.2.

179. Head Co will have a fair value gain of $769,271 in respect of the swap. Making the same assumptions as in Case study 2.2 in respect of Risky Co while it is in the consolidated group, this amount is equal to the difference between the amount Head Co paid for Risky Co (the cost of the shares in Risky Co and assumption of Risky Co's tax liability) and the value of the assets in Risky Co at the end of the term of the swap.

180. Unlike Case studies 2.1 and 2.2 Risky Co does not recognise a gain or loss on the swap on joining the consolidated group. However, any increase or decrease in the value of the swap will be reflected in the value of the shares in Risky Co at the joining time, resulting in an adjusted capital gain or capital loss for the shareholders commensurate to the changes in value of the swap.

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43 In the year ended 30 June 2012 Risky Co had income of $750,000, a payment of $500,000 and a tax payment of $75,000. In the part year ended 31 December 2012 the only income was $375,000.

44 Liability for the part year ended 31 December 2012 is income of $375,000 at 30 per cent.