



Taxation Determination

Income tax: consolidation: can the head company of a consolidated group claim a deduction under section 8-1 of the *Income Tax Assessment Act 1997* for interest paid on funds borrowed from outside the group, where the funds were borrowed either before or after formation of the consolidated group, by it or a subsidiary member to buy shares in an existing subsidiary member from another member of the consolidated group?

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Ruling

1. Yes. The head company of a consolidated group will be able to claim a deduction provided that it can demonstrate that the essential character of the interest is expenditure that has a sufficient connection with the operation or activities which more directly gain or produce the head company's assessable income or is necessarily incurred in carrying on a business for that purpose and provided that the expenditure is not of a capital, private or domestic nature.

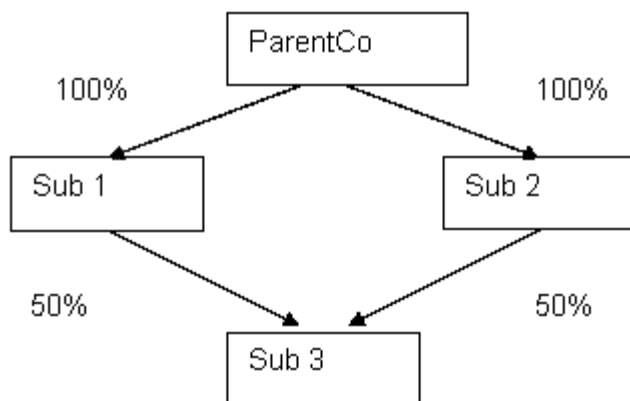
Example

2. *Facts*

- *ParentCo has two wholly owned subsidiaries, Sub 1 and Sub 2, each of which has a 50% share in Sub 3.*

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- *The group consolidates and ParentCo (the head company) decides to restructure by purchasing Sub 3 from its other subsidiaries.*
- *ParentCo takes out a loan from a non-group member for \$100,000 and purchases the shares in Sub 3 from Subs 1 and 2.*
- *Sub 1 and Sub 2 invest the funds they receive from ParentCo on the stock exchange in companies from which they expect to receive dividends.*



- *ParentCo, as the head company of the consolidated group, must apply section 8-1 of the Income Tax Assessment Act 1997 (ITAA 1997) on a single entity basis to determine the deductibility of the interest paid on the borrowed funds. From ParentCo's point of view, tracing the borrowed funds indicates that they were used to acquire additional assets which, under the SER, the head company is now taken to own. The new assets are expected to produce assessable dividend income. Consequently, the interest on the borrowed funds will be deductible to the head company under section 8-1 of the ITAA 1997.*

Date of effect

3. This Determination applies to years commencing both before and after its date of issue. However, this Determination does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination.

Appendix 1 – Explanation

① *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Explanation

4. The general principles governing the deductibility of interest apply to the head company of a consolidated group. These principles are set out in Taxation Ruling TR 95/25 at paragraphs 2 and 3. Paragraphs 12 to 17 of that Ruling provide further guidance on how these principles apply to companies.

5. The deductibility of interest on the funds borrowed must be determined having regard to all the facts (taking account of the effect of the single entity rule (SER) in section 701-1 of the ITAA 1997) and considering the connection between the interest expense and the gaining of the head company's assessable income or the carrying on of the head company's business for the purpose of producing assessable income.

6. When determining whether the head company of a consolidated group can claim a deduction for interest it is important to recognise that, for income tax purposes, the SER can affect how certain actions and transactions are to be viewed. Under the SER subsidiary members are taken to be parts of the group's head company rather than separate entities while they are members of the consolidated group. Accordingly, if a subsidiary member borrows funds and pays interest on those borrowings it is the head company that is taken to have borrowed the funds and to have incurred the interest expense (see subparagraph 8(a) of Taxation Ruling TR 2004/11). It is the head company that may be entitled to claim a deduction under section 8-1 of the ITAA 1997 in respect of the interest payment.

7. Where the shares in an existing subsidiary member are or were acquired by another member of the consolidated group then the operation of the SER means that, for income tax purposes:

- Dividends paid on the subsidiary member's shares that were acquired from another group member will not be assessable income in the hands of the head company. This is because dividend payments between members of a consolidated group are treated as the movement of funds between two parts of the same entity, being the head company (see TR 2004/11 paragraph 10).
- After consolidation the payment by one member of the consolidated group for the purchase of shares in another member will be seen as the movement of the funds between two parts of the same entity, being the head company.

8. As the head company does not have the prospect of receiving assessable dividends on the shares acquired in the existing subsidiary member (see Taxation Ruling IT 2606 at paragraph 9), this can no longer be the basis for allowing the interest deduction to the head company.

9. The head company will need to demonstrate that the essential character of the interest is expenditure that has a sufficient connection with the operation or activities which more directly gain or produce the head company's assessable income, provided that expenditure is not of a capital, private or domestic nature. Where the funds were borrowed by a subsidiary member before joining the consolidated group, the entry history rule in section 701-5 of the ITAA 1997 may assist in establishing the existence of such a connection.

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10. Where relevant, tracing the ultimate use of the borrowed funds may assist in establishing the required connection to the derivation of the head company's assessable income or business carried on for that purpose.

11. Where the connection between the interest expense and the production of assessable income is clear by reference to the objective facts, the expense will generally be deductible without any need to have regard to the head company's purpose (*Fletcher & Ors v. FC of T* 91 ATC 4950; (1991) 22 ATR 613).

References

Previous draft:

TD 2005/D30

Related Rulings/Determinations:

IT 2606; TR 95/25; TR 2004/11

Subject references:

- consolidation
- interest
- single entity rule

Legislative references:

- TAA 1953
- ITAA 1997 8-1
- ITAA 1997 701-1
- ITAA 1997 701-5

Case references:

- Fletcher & Ors v. FC of T 91 ATC 4950,
(1991) 22 ATR 613

ATO references

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