TR 2004/D2 - Income tax: consolidation: the meaning and application of the single entity rule in Part 3-90 of the Income Tax Assessment Act 1997

This document has been finalised by TR 2004/11.

Draft Taxation Ruling

Income tax: consolidation: the meaning and application of the single entity rule in Part 3-90 of the *Income Tax Assessment Act 1997*

Contents Para

Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office.*

What this Ruling is about

1. This Ruling explains what the single entity rule (SER) in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) is and how it applies to a consolidated group. In particular, the Ruling considers the scope of the SER and the income tax consequences that flow from its application to dealings between group members.

Date of effect

2. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. However, the final Ruling will 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 final ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Ruling

The SER Principle

3. Section 701-1 of the ITAA 1997 is a key provision of the consolidation regime. It is the means by which the members of a consolidated group are treated as a single entity for income tax purposes. The application and scope of the SER is determined in the context of the ITAA 1997 and its objectives.

4. The SER principle operates for the purposes set out in subsections 701-1(2) and (3) of the ITAA 1997 (the core purposes). These purposes are to work out the amount of the liability for income tax or the amount of a loss of the head company and its subsidiary members for a relevant period. When considered in context with other provisions of the ITAA 1997, a broad interpretation of the core provisions is warranted. This gives effect to the intended operation of the SER which is to apply the income tax laws to a consolidated group as if it were a single entity. The broad interpretation ensures that income tax law provisions apply to the consolidated group on the basis it is a single entity with the head company being that entity. Examples of such provisions are those that work out the head company's taxable income, the application of credits and offsets, record keeping requirements and matters in respect of penalties and offences.

5. The SER does not apply to a consolidated group where a tax law requires a group member to do something in relation to the income tax affairs of a non-group entity (for example, a group member's obligation to collect the income tax payable by a third party).

Consequences of the SER

6. For income tax purposes the SER deems subsidiary members to be parts of the head company rather than separate entities during the period that they are members of the consolidated group.

7. As a consequence, the SER has the effect that:

(a) the actions and transactions of a subsidiary member are treated as having been undertaken by the head company;

(b) the assets a subsidiary member of the group owns are taken to be owned by the head company (with the exception of intra-group assets) while the subsidiary remains a member of the consolidated group;

(c) assets that arise from the rights and obligations that exist between members of a consolidated group (intra-group assets) are not recognised for income tax purposes as assets of the head company while the SER applies to the consolidated group. An example of an intra-group asset is a debt that is created when one member of a consolidated group borrows money from another group member; and

(d) dealings that are solely between members of the same consolidated group (intra-group dealings) will not result in income or a deduction to the group's head company.

8. An example of an intra-group dealing is the transfer of a CGT asset from one group member to another. This transfer is not treated for income tax purposes as a disposal or acquisition in the hands of the head company. Although the legal transfer of the CGT asset between the subsidiary members occurs at general law it has no income tax consequences as the group's head company is taken to be the owner of the asset both before and after the transfer.

9. Another example is the payment of a dividend from one member of a consolidated group to another group member. For income tax purposes this transaction is treated as a movement of funds between two parts of the same entity (the head company) rather than the payment of a dividend. For income tax purposes the group members paying and receiving the dividend are not seen as separate entities.

10. If intra-group assets are subject to a dealing or transaction involving an entity that is not a group member, the income tax consequences for the head company must have regard to the fact that the subsidiaries are treated as parts of the head company under the SER that is, essentially, as if the head company were a divisional company.

11. Whether this results in a different tax outcome for the head company than is apparent from the legal form of the dealing or transaction will depend on the appropriateness of outcomes so produced, having regard to the intended treatment of the group as a single entity for income tax purposes.

Entities outside the consolidated group not affected by SER

12. The SER treats a consolidated group as a single entity for the purpose of applying income tax laws to the consolidated group. The SER does not affect the application of those laws to an entity outside of the consolidated group. The income tax position of entities outside of the group will not be affected by the SER when they deal or transact with a member of a consolidated group.

Parts of an entity expressly recognised

13. The SER provides the means for achieving broad parity between the income tax position of a head company of a consolidated group (as a single entity) and a company carrying on a business through divisions. If an income tax provision expressly allows for the recognition of part of a single entity for income tax purposes then that provision will apply on the same basis to the head company as for a non-consolidated company.

Modification of the SER in certain circumstances

14. Section 701-85 of the ITAA 1997 provides that the operation of the SER is subject to the provisions in Part 3-90 of the ITAA 1997 or any other provision of the Income Tax Assessment Acts (and certain related Acts) that so require, either expressly or impliedly.

MEC Groups

15. The views expressed in this Ruling apply equally to a multiple entry consolidated (MEC) group where appropriate.

Explanation

The SER principle

16. The SER in section 701-1 of the ITAA 1997 provides that:

(1) If an entity is a *subsidiary member of a *consolidated group for any period, it and any other subsidiary member of the group are taken for the purposes covered by subsection (2) and (3) to be parts of the *head company of the group, rather than separate entities, during that period.

Head company core purposes

(2) The purposes covered by this subsection (the head company core purposes) are:

(a) Working out the amount of the *head company's liability (if any) for income tax calculated by reference to any income year in which any of the period occurs and any later income year; and

(b) Working out the amount of the head company's loss (if any) of a particular *sort for any such income year.

Entity core purposes

(3) The purposes covered by this subsection (the entity core purposes) are:

(a) Working out the amount of the entity's liability (if any) for income tax calculated by reference to any income year in which any of the period occurs and any later income years; and

(b) Working out the amount of the entity's loss (if any) of a particular *sort for any such income year.

17. The principle underlying the SER is to treat a consolidated group as a single entity, with the head company being that entity for income tax purposes. To this end the SER deems the subsidiary members of the consolidated group to be parts of the head company rather than separate entities.

18. The SER principle operates for the head company and entity core purposes (the core purposes). See subsections 701-1(2) and (3) set out above. In interpreting these subsections, consideration needs to be given to the context in which they appear. The context suggests that a broad view of the core purposes is intended, allowing the SER to apply to a consolidated group for all income tax purposes. This interpretation is consistent with the guide material to Part 3-90 of the ITAA 1997, specific provisions in that Part and statements in the Explanatory Memorandum to the *New Business Tax System (Consolidation) Bill (No. 1)* 2002 (the EM).

19. The scope of the core purposes is expressed in the opening statement in the Guide to the consolidation regime at section 700-1. It states '[t]his Part allows certain groups of entities to be treated as single entities for *income tax purposes*.' [emphasis added].

20. The EM at paragraph 2.22 supports this scope:

> Some examples of the effect of absorption of the subsidiaries into the head company (for the purpose of working out the income tax liability or losses) are that during consolidation:
>
> - The taxable income of the taxpayer under section 4-15 of the ITAA 1997 refers to that of the head company. This calculation is made on the basis that income and deductions are assessed or allowable under ITAA 1997 to the head company only;
> - A provision such as section 262A of the ITAA 1936 (which refers to record keeping requirements) should be read as requiring the head company to adopt those obligations insofar as they relate to the assessments of its income tax liability. Under the single entity rule, those obligations rest with the head company as it is regarded as the taxpayer during the period of consolidation;
> - …

21. Specific provisions in Part 3-90 of the ITAA 1997 are also consistent with a broad interpretation of the scope of the core purposes. For example, Division 721 (about liability for payment of tax where the head company fails to pay on time) provides guidance on the scope of the core purposes. The Guide to section 721-1 refers to an income tax liability of the head company as an 'income tax related liability'. Paragraph 721-10(1)(a) of the ITAA 1997 is more express in its terms by referring to 'a *tax-related liability mentioned in subsection (2) (*a group liability) of the head company* of a consolidated group…' [emphasis added]. An example of such income tax related liabilities in subsection 721-10(2) of the ITAA 1997 is the

general interest charge. This liability is treated as the head company's liability.

22. As a result, Division 721 supports the view that section 701-1 of the ITAA 1997 allows for the application of the income tax laws to a head company on behalf of the consolidated group. For example, income tax provisions in respect of income tax-related liabilities, such as the general interest charge, will apply to the head company on the basis that the consolidated group is a single entity.

23. Such a view is supported by paragraphs 11.13 and 11.17 of the EM:

> [11.13] The head company of a consolidated group is solely liable, in the first instance, for group liabilities. This is because, *as an implication of the single entity rule*, an income tax-related liability of a consolidated group is, in fact, an income-tax liability of the head company. [emphasis added]
>
> …
>
> [11.17] Section 250-10 of Schedule 1 to the TAA 1953 provides a list of tax-related liabilities. For groups consolidating for income tax purposes, a similar list is provided [in subsection 721-10(2) of the ITAA 1997], *identifying the tax-related liabilities of a head company of a consolidated group that are properly considered as related to the income tax obligations of the group* and therefore within the scope of the consolidation regime. [emphasis added]

24. Accordingly, the references to *income tax purposes* in the Guide to Part 3-90 of the ITAA 1997 and to *income tax-related liabilities* in Division 721 of the ITAA 1997, along with the explanations in the EM support the view that the core purposes allow the SER to operate on the basis that income tax laws apply to a consolidated group as a single entity.

25. This ensures that such matters as the working out of the consolidated group's taxable income, the application of credits and offsets, record keeping requirements and matters in respect of penalties and offences are addressed on the basis that the group is a single entity with the head company as that entity. This broadly provides parity of income tax treatment between a consolidated group, treated as a single entity, and a non-consolidated company.

26. The SER does not apply to a consolidated group where a tax law requires a group member to do something in relation to the income tax affairs of a non-group entity (for example, a group member's obligation to collect the income tax payable by a third party) – see paragraph 2.25 of the EM. This is because such laws do not relate to the income tax position of the group. They are more relevant to the non-group entity's income tax affairs.

Application of the SER principle

27. The single entity principle is an example of the new style of 'principle-based drafting'. In this style of drafting, Parliament expresses its intended policy [outcome] in broad and simple language, in this case by equating a consolidated group with a single entity. A necessary feature of such a style of drafting is the omission of statutory mechanisms for effecting the policy for each provision of the income tax law (although in some cases they are provided).

28. The single entity rule is not a mere statutory fiction to be used itself as a mechanism for achieving the outcome intended by policy. In fact, applying the single entity rule across the board as a statutory fiction may have the opposite of the intended effect: it may defeat the policy by producing results in relation to transactions that could never occur for a single company that operates by division.

29. Rather, when considering transactions or dealings the appropriate use of the rule is to indicate when, and for what purposes, transactions or parts of transactions are to be disregarded in determining the income tax position of the head company of the consolidated group. For this reason, the rule will apply in different ways to a transaction, depending on the purpose for which a transaction is being considered. When it is being considered in relation to the assessment of a taxpayer that is not a consolidated group, it is not applied at all. When a transaction involves members of a consolidated group and an external party, either at one time or sequentially, the rule disregards the transaction to the extent necessary to achieve taxation of the consolidated group as if it were a single entity, and in a way that results in that outcome. This last category exhibits the most complexity because the rule will often disregard steps in transactions, rather than entire transactions, and may only disregard them at a certain stage.

Consequences of the SER

30. The Guide to the consolidation regime at section 700-1 expresses the intention of the law to treat a consolidated group as a single entity. It provides '[f]ollowing a choice to consolidate, subsidiary members are treated as part of the head company of the group rather than as separate income tax identities'.

31. To the extent the SER applies to the consolidated group to treat the group as a single entity, with the head company as that entity, any consequences flowing from this deeming are to be treated as the actual state of affairs of the head company. *Marshall (Inspector of Taxes) v. Kerr* [1993] STC 360 at 366, which was subsequently approved in the appeal decision in the House of Lords, supports this position (per Gibson, J):

> '...I further bear in mind that because one must treat as real that which is only deemed to be so, one must treat as real the consequences and incidents inevitably flowing from or

> accompanying that deemed state of affairs, unless prohibited from doing so.'

32. A consequence flowing from the SER is that while an entity is a subsidiary member of a consolidated group, actions and transactions of that member are treated as having been undertaken by the head company. In addition, the assets owned by subsidiary members of the group are taken to be owned by the head company, (other than assets that arise from the rights and obligations that exist between members of the group) [see the EM – paragraphs 2.12, 2.20 and 2.26].

33. A further consequence of the SER is that intra-group dealings and transactions are not recognised for income tax purposes while the SER applies to the consolidated group. This is clearly the intent of the legislation as indicated in the EM. For example, paragraph 2.12 recognises that an entity cannot transact with itself. Furthermore, paragraph 2.18 states that intra-group transactions are not recognised:

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

34. The EM at paragraph 2.12 also concludes that an intra-group transfer of an asset could not have income tax consequences as an entity cannot transact with itself. This is consistent with the common law principle that generally an entity cannot transact with itself. For example, in *Gulland v. Federal Commissioner of Taxation* (1983) 83 ATC 4352 at 4365; 14 ATR 335 at 351 Kennedy J observed that:

> 'There appears to be no doubt that, putting on one side the case of a person's acting in two capacities, one person cannot contract with himself, whether alone or jointly with another. For example, in Salmond and Williams Principles of the Law of Contract (2nd ed 1945) at page 23 the following appears:
>
>> "In as much as the conception of obligations is bilateral and all contracts have for their object the creation of obligations, there must be at least two parties to a contract..." '

35. This is also the basis for paragraph 2.9 of the EM which provides that 'when an entity becomes a subsidiary member of a consolidated group the membership interests in the entity held by the group are ignored'. As a result, the intra-group rights and obligations that are derived from the holding of membership interests within a group are no longer recognised. Dealings within the consolidated group in respect of these rights and obligations cannot trigger income tax consequences in respect of the head company.

36. In summary, the SER ensures that the income tax laws will apply to a consolidated group on the basis that the group is a single entity with all of the actions and transactions undertaken by the subsidiary members of the group being imputed to the head company in order to allow for the proper administration of the income tax laws

to the consolidated group. The SER, broadly speaking, allows for parity between the income tax position of a consolidated group, treated as a single entity, and of a company carrying on business in divisions.

Entities outside the consolidated group not affected by SER

37. The SER is not concerned with the income tax position of an entity that is not a member of a consolidated group. Therefore, the fact that the SER treats a consolidated group as a single entity does not mean that an entity outside the consolidated group cannot have regard to intra-group dealings and assets of the group where such dealings and assets are relevant for that entity's income tax purposes. There are specific exceptions, however, to this proposition in sections 715-215 and 715-410 of the ITAA 1997. For example, section 715-410 extends the SER for all the purposes of Part 3-95 (value shifting). This means that from the perspective of an entity outside the consolidated group, economic benefits provided by or to a subsidiary member of a consolidated group are treated as having been provided by or to the head company of the group.

Parts of an entity expressly recognised

38. The SER provides the foundation for the income tax laws to be applied to the head company of a consolidated group (representing the consolidated group) broadly on the same basis as it does for a non-consolidated company. Once the SER applies to a consolidated group the provisions of the income tax law apply to the group as if it is a single entity with the head company as that entity. Where a provision of the income tax law expressly provides for part of a non-consolidated company to be given specific tax treatment this would also be true for the head company of a consolidated group where the head company meets the necessary requirements for that specific treatment.

Modification of the SER in certain circumstances

39. The SER may be modified in certain circumstances. Section 701-85 of the ITAA 1997 provides that '[t]he operation of each provision of this Division is subject to any provision of this Act that so requires, either expressly or impliedly.' As such, the operation of the SER may be modified by a provision in Part 3-90 of the ITAA 1997 or any other provision of the Income Tax Assessment Acts (and certain related Acts) that so requires it, expressly or impliedly.

40. We think this subjects the SER to the purposes of the other provisions of the Act. Whilst the intention is for consolidated groups to be treated as single entities and comparably to the way non-consolidated companies are treated, if achieving the purposes of another provision runs contrary to this broad intent, the SER should yield to those

purposes. Whether section 701-85 will apply in any given situation will depend on the particular provisions being considered.

Alternative view

41. An alternative view exists in respect of the scope of the head company and entity core purposes. That view is based on a literal reading of the core purposes and limits them to working out the primary liability for income tax or loss of the head company.

42. The Commissioner does not accept this view because the SER treats a consolidated group as a single entity, with the income tax laws applying to that entity. Provisions in respect of the group's income tax position, such as income tax related liabilities, have sufficient connection with the group's primary liability for income tax so that they fall within the scope of the core purposes

43. Another alternative view of the meaning of the SER is to apply the income tax laws to each subsidiary member of a consolidated group on a stand-alone basis requiring a netting-off of intra-group transactions in order to achieve the income tax position for the consolidated group. This consolidated income tax position is then imputed to the head company. This would require the income tax laws to recognise all intra-group transactions and assets that flow from recognising each member as a separate taxpayer along with the rights and obligations that flow from dealings between two or more distinct entities.

44. This view requires a reading down of the description of the SER in subsection 701-1(1) which states '[i]f an entity is a **subsidiary member* of a *consolidated group for any period, it and *any other subsidiary member of the group are taken for the purposes covered by subsection (2) and (3) to be parts of the *head company of the group, rather than separate entities*, during that period.' [emphasis added].

45. This view also recognises the membership interests within a consolidated group and members of the group as companies and shareholders. However, ceasing to recognise membership interests and subsidiary members while a group is consolidated is a fundamental building block of the consolidation regime (for example see paragraph 2.9 of the EM). For these reasons, the alternative view is not accepted as the better view.

Your comments

46. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date.

Due date:	**6 August 2004**
Contact officer:	**Sandra Peacock**
E-mail address:	**Sandra.Peacock@ato.gov.au**
Telephone:	**(02) 6216 2237**
Facsimile:	**(02) 6216 3007**
Address:	**2 Constitution Ave** **CANBERRA ACT 2600**
Contact officer:	**Bill Steven**
E-mail address:	**Bill.Steven@ato.gov.au**
Telephone:	**(08) 8208 2022**
Facsimile:	**(08) 8208 1898**
Address:	**91 Waymouth St** **ADELAIDE SA 5000**

Detailed contents list

47. Below is a detailed contents list for this draft Taxation Ruling:

Commissioner of Taxation
7 July 2004

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 92/20

Subject references:

- consolidated group
- head company
- income tax purposes
- intra-group assets
- single entity rule
- transacting with oneself

Legislative references:

- TAA 1953 Pt IVAAA
- TAA 1953 Sch 1 250-10
- ITAA 1936 262A
- ITAA 1997 4-15
- ITAA 1997 Pt 3-90
- ITAA 1997 700-1
- ITAA 1997 701-1
- ITAA 1997 701-1(1)
- ITAA 1997 701-1(2)
- ITAA 1997 701-1(3)
- ITAA 1997 701-85
- ITAA 1997 715-215
- ITAA 1997 715-410
- ITAA 1997 Div 721
- ITAA 1997 721-1
- ITAA 1997 721-10(1)(a)
- ITAA 1997 721-10(2)
- ITAA 1997 Pt 3-95

Case references:

- Gulland v. Federal Commissioner of Taxation (1983) 83 ATC 4352; 14 ATR 335
- Marshall (Inspector of Taxes) v. Kerr [1993] STC 360

Other references:

- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002
- Principles of the Law of Contracts, Salmond and Williams, 2nd Ed 1945

ATO references
NO: 2004/6620
ISSN: 1039-0731