


TR 2007/2 - Income tax: application of the same business test to consolidated and MEC groups - principally, the interaction between section 165-210 and section 701-1 of the Income Tax Assessment Act 1997

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Taxation Ruling

Income tax: application of the same business test to consolidated and MEC groups – principally, the interaction between section 165-210 and section 701-1 of the *Income Tax Assessment Act 1997*

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This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (unless we are satisfied that the ruling is incorrect and disadvantages you, in which case we may apply the law in a way that is more favourable for you – provided we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

What this Ruling is about

1. This Ruling sets out the Commissioner's views on how the same business test applies in the context of determining whether deductions are available to the head company of a consolidated group in respect of:

- prior year tax losses;
- bad debts;
- net capital losses; or
- foreign losses.

2. This Ruling also sets out the Commissioner's views on the application of the same business test to head companies that are required to determine whether they calculate their taxable income and tax loss, or net capital gain and net capital loss, for an income year under Subdivision 165-B or Subdivision 165-CB of the *Income Tax Assessment Act 1997* (ITAA 1997). These views on the same business test are also relevant in terms of the application of Subdivision 165-CC of the ITAA 1997 to a head company.

3. Unless otherwise specified:

- all legislative references in this Ruling relate to the ITAA 1997; and
- all references to tax losses include a reference to tax losses, net capital losses, foreign losses or bad debts.

Key consolidation concepts

4. Subsection 701-1(1) provides that, for the head company core purposes, an entity which is a subsidiary member of a consolidated group for any period, and any other subsidiary member of the group, are taken to be parts of the head company during that period. This is the 'single entity rule'.

5. Subsection 701-1(2) sets out the head company core purposes to which subsection 701-1(1) refers. In terms of subsection 701-1(2), the head company core purposes are 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 or any later income year, and working out the amount of the head company's loss (if any) for any such income year.

6. Taxation Ruling TR 2004/11: Income tax: consolidation: the meaning and application of the single entity rule in Part 3-90 of the ITAA 1997, explains the meaning and application of the 'single entity rule'.

7. Section 701-5 provides that, for the head company core purposes in relation to the period after an entity becomes a subsidiary member of the group, everything that happened in relation to the entity before it became a subsidiary member is taken to have happened in relation to the head company. This is the 'entry history rule'. However, section 165-212E provides:

For the purposes of the *same business test, if an entity (the **joining entity**) becomes a *subsidiary member of a *consolidated group or a *MEC group, section 701-5 (the entry history rule) does not operate to take the *business of the *head company of the group to include the business of the joining entity before it become a *member of the group.

Section 165-212E applies from 1 July 2002.¹

¹ On 8 May 2007, the Government announced in the Australian Government – Budget Measures 2007-8, Budget Paper No. 2 that it would improve and clarify the loss recoupment rules by ensuring that the 'entry history' rule is disregarded in applying the same business test, with effect from 1 July 2002. The announcement advised that the proposed amendment would reduce uncertainty and ensure that outcomes under the rules are consistent with policy intent.

Class of entities/Scheme

8. This Ruling applies to:
- (a) the head company of a consolidated group or a multiple entry consolidated (MEC) group that is seeking a deduction for a prior year tax loss, foreign loss or the application of a net capital loss, or a deduction for a bad debt in a year of income in which the head company is unable to demonstrate that the requirements of the continuity of ownership test in section 165-12 or section 165-123 (as appropriate) are satisfied;
 - (b) the head company of a consolidated group or a MEC group that is required to calculate its taxable income or tax loss under Subdivision 165-B, or net capital gain or net capital loss under Subdivision 165-CB;
 - (c) the head company of a consolidated group or a MEC group that has an unrealised net loss at the time of a change of ownership or control and must determine, in accordance with Subdivision 165-CC, whether that unrealised net loss will restrict the extent to which a future capital loss or revenue loss can be taken into account; and
 - (d) the head company of a consolidated group or a MEC group that has accumulated tax losses or net capital losses at the time that it is acquired by another consolidated group and is seeking to determine the extent to which those losses can be transferred to the head company of the new consolidated group (Subdivision 707-A).

Definitions

9. In this Ruling the terms '**same business test**', '**new business test**' and '**new transactions test**' have the meanings adopted in Taxation Ruling TR 1999/9: Income tax: the operation of sections 165-13 and 165-210, paragraph 165-35(b), section 165-126 and section 165-132. Those terms are discussed in the Ruling section of TR 1999/9 and the relevant paragraphs are set out below.

11. Subsections 165-210(1) and 165-210(2) include three tests, each of which must be satisfied by a company in order for the company to meet the requirements of section 165-13 and section 165-210 and thereby not be prevented by section 165-10 from deducting prior year losses. The first test is in subsection 165-210(1) and comprises a positive requirement that the company carry on at all times during the period of recoupment the same business as the business that it carried on at the change-over. The second and third tests are in subsection 165-210(2) and they comprise the respective

negative requirements that the taxpayer does not carry on certain businesses and does not enter into certain transactions during the period of recoupment.

12. The requirement in section 165-13 and subsection 165-210(1) ... is referred to in this Ruling as the 'same business test'. For the purpose of the same business test, a company is treated as carrying on one overall business at the change-over and during the period of recoupment since the reference to 'business' in the same business test is a reference to all of the activities carried on by the company at the change-over and during the period of recoupment, irrespective of whether those activities constitute or are treated by the company as constituting separate or distinct activities, enterprises, divisions or undertakings carried on by the company.

13. In the same business test, the meaning of the word 'same' in the phrase 'same business as' imports identity and not merely similarity; the phrase 'same business as' is to be read as referring to the same business, in the sense of the identical business. However, this does not mean identical in all respects: what is required is the continuation of the actual business carried on immediately before the change-over. Nevertheless, it is not sufficient that the business carried on after the change-over meets some industry wide definition of a business of the same kind; nor would it be sufficient for there to be mere continuance of business operations from immediately before the change-over into the period of recoupment, if the business had so changed that it could no longer be described as the same business. The analysis of whether the same business continues after the change-over may give rise to questions of degree and ultimately depends on the facts of the case. In making the analysis it needs to be acknowledged that a company may expand or contract its activities without necessarily ceasing to carry on the same business. The organic growth of a business through the adoption of new compatible operations will not ordinarily cause it to fail the same business test provided the business retains its identity; nor would discarding, in the ordinary way, portions of its old operations. But, if through a process of evolution a business changes its essential character, or there is a sudden and dramatic change in the business brought about by either the acquisition or the loss of activities on a considerable scale, a company may fail the test.

14. The requirement in subsections 165-13 and 165-210(2) ... relating to 'business of a kind' is referred to in this Ruling as the 'new business test'. In the new business test there is a reference to 'business of a kind' that the company did not carry on before the change-over. In the new business test the word 'business' has a different meaning from the word 'business' in the same business test; it refers to each kind of enterprise or undertaking comprised in the overall business carried on by the company at the change-over and during the period of recoupment. The new business test puts a limit on the type of expansion the company may undertake if it is to retain the benefit of accumulated losses; for the taxpayer may not engage in an undertaking or enterprise of a kind in which it did not engage before the change-over and still benefit from accumulated losses.

15. The requirement in section 165-13 and subsection 165-210(2) ... relating to a 'transaction of a kind' not entered into in the course of the taxpayer's business operations is referred to in this Ruling as the 'new transactions test'. The new transactions test is directed to preventing the injection of income into a loss company that has satisfied the same business test and the new business test. The new transactions test includes all transactions entered into in the course of the company's business operations and not merely those that are 'isolated' or 'independent'. However, generally speaking, the new transactions test is not failed by transactions of a type that are usually unmotivated by tax avoidance, namely, transactions that could have been entered into ordinarily and naturally in the course of the business operations carried on by the company before the change-over. Conversely, a transaction entered into during the period of recoupment and which is outside the course of the business operations before the change-over, or which is extraordinary or unnatural when judged by the course of the business operations before the change-over, is usually a transaction of a different kind from the transactions actually entered into by the company before the change-over.

16. The content of the word 'kind' in the new transactions test and the new business test, when applied in a particular case, is to be derived from the course of the company's business operations before the change-over. A transaction from which income is derived during the period of recoupment, which could have been entered into before the change-over in the course of the company's business operations, and which is neither extraordinary nor unnatural in the context of the business carried on by the company at the change-over, is generally a transaction of the same kind as transactions actually entered into by the company before the change-over.

17. In the new transactions test, 'transaction' refers to any operation or dealing from which income directly or indirectly flows or arises, and a company enters into a transaction for the purposes of the new transactions test if it engages or participates in it. The new transactions test is intended to extend to every means by which a company may derive income, including transactions of a passive or investment character. The words 'business operations' refer to everything that a company undertakes or does; together, the business operations constitute the business, meaning the overall business, of the company.

18. The word 'income' in subsection 165-210(2) does not include amounts that are 'de minimis'.²

10. Both '**test time**' and '**same business test period**' are defined in various provisions of the ITAA 1997, and for the purpose of this Ruling those phrases take the meanings:

- (a) specified in section 165-13 when considering deductions for prior year tax losses, foreign losses, the application of prior year net capital losses and the determination of whether or not unrealised net losses will limit the extent to which capital or revenue losses can be taken into account;

² See also paragraphs 30 to 90 of TR 1999/9 for a discussion of these terms.

- (b) specified in section 165-35 when working out the taxable income or tax loss, or the net capital gain or net capital loss, for an income year during which the head company has not maintained the same ownership and control;
- (c) specified in section 165-126 when considering deductions for bad debts; and
- (d) specified in section 707-125 or section 707-135 when considering the extent to which previously unutilised losses can be transferred to the head company of a consolidated group that has acquired another company with unutilised losses.

11. A reference in this Ruling to a consolidated group should be read as including a MEC (multiple entry consolidated) group.

Ruling

The same business test and the single entity rule

12. If in respect of a particular year of income the head company of a consolidated group has failed a relevant continuity of ownership test, then the same business test in section 165-210 will be relevant when calculating taxable income to determine the income tax liability of the head company. The single entity rule therefore will apply in this context (refer to section 701-1 and TR 2004/11).

13. The conditions to be satisfied under the same business test are explained in TR 1999/9 and relevant paragraphs have been reproduced at paragraph 9 of the Definitions section of this Ruling. Broadly speaking, the same business test in section 165-210 is satisfied by a company where at all times during the same business test period:

- it carried on the same business (meaning the business of the company as an entirety, or its 'overall business') that it carried on immediately before the appropriate test time (subsection 165-210(1));
- it did not carry on any business (meaning a particular undertaking or enterprise) other than a business of a kind carried on before the test time as part of the overall business (subsection 165-210(2));
- it only derived income from transactions of a kind that it entered into in the course of the overall business before the test time (subsection 165-210(2)); and
- the anti-avoidance provisions in subsection 165-210(3) do not apply.

14. Under the single entity rule of subsection 701-1(1), subsidiary members of a consolidated group are taken for the purposes of the same business test (section 165-210) (among other purposes), to be parts of the head company. In this context, the principles set out in TR 1999/9 in respect of the application of the same business test to a single company apply equally to the head company of a consolidated group.

15. When determining the one overall business carried on by the head company of a consolidated group for the purposes of subsection 165-210(1) it is necessary to have regard to the activities of the subsidiary members of the group. Applying the principles of TR 1999/9, one overall business of the head company is to be identified by examining all of the activities, enterprises or undertakings carried on:

- at the appropriate test time by all those entities that were members of the consolidated group at that time; and
- by all entities during that part of the same business test period when they were members of the consolidated group.

16. When applying the new business test and new transactions test to the head company (subsection 165-210(2)), regard must be had to the enterprises, undertakings and transactions that were carried on or entered into before the test time by entities while they were members of the consolidated group. These activities are then compared with the enterprises, undertakings and transactions carried on or entered into by all entities while they are members of the consolidated group during the same business test period. This comparison determines whether the enterprises, undertakings and transactions before the test time and during the same business test period are different in kind.

17. In relation to the new business and new transactions tests, it is not necessary that a business carried on or a transaction entered into during the same business test period by an entity in the group be of a kind carried on by that **same** entity before the test time. In accordance with the operation of the single entity rule, where an entity within the group undertook a business or transaction of that kind before the test time when that entity was a member of the consolidated group, the new business or new transactions test will be satisfied.

18. Activities, undertakings and enterprises taking place within a consolidated group (not involving the derivation of income through dealings outside the group) will be relevant for characterising the business of the head company. This will be the case notwithstanding the fact that individual transactions between group members will not be recognised as happening under the same business test because of the single entity rule which treats group members as parts of the head company for the purpose of determining its income tax liability. The relevance of intra-group activities and transactions for the same business test is described further in the Explanation section of this Ruling and illustrated by Examples 3 and 6 of this Ruling.

Section 165-212E and the entry history rule

19. Working together, section 165-212E and the entry history rule in section 701-5 operate in such a way that the activities of an entity during any period when that entity was not a member of a consolidated group are ignored when determining either the 'business' of the head company of a consolidated group, or whether the new business test or the new transactions test have been satisfied.

Examples

20. The examples set out in paragraphs 28 to 59 of this Ruling illustrate the application of the same business test, the new business test and the new transaction test to the head company of a consolidated group. Furthermore, the examples in paragraphs 96 to 184 of TR 1999/9, which illustrate the application of the same business test to a single company, are of assistance in determining the application of the same business, new business and new transactions tests to the head company of a consolidated group.

Facts

21. **Hold Co** is the head company of a consolidated group. It holds shares in other companies but otherwise does not conduct any business activity. Hold Co has a 30 June tax year.

22. **Property Co 1**, **Property Co 2**, and **Property Co 3** are all 100% subsidiaries of Hold Co. Each is a parent of a number of property development companies. The Property Co 1 sub-group is involved in the construction and sale of residential apartments. The Property Co 2 sub-group is involved in commercial and industrial property development. The Property Co 3 sub-group is engaged in the construction and management of shopping centres. Traditionally, property development has been the core business of the group and success in this industry has facilitated new business acquisitions by the group and expansion into other industries.

23. The Hold Co group acquired, prior to 1 July 2002, **Retail Co** and its subsidiaries, a large but ailing national department store chain, which had a presence in many of the shopping centres managed by the Property Co 3 sub-group. Over time, the profitability of the department store chain was restored and began to contribute significantly to the overall profits of the Hold Co group.

24. The Hold Co group also acquired, prior to 1 July 2002, **Mag Co 1**, **Mag Co 2**, and **Mag Co 3** which were engaged in the business of magazine publishing. Apart from a general desire to move into the print media business, Hold Co also saw natural synergies in terms of advertising its retail business. Mag Co 1 and Mag Co 2 are responsible for the production of two popular culture magazines released weekly and monthly respectively, which have an extremely wide national circulation. Mag Co 3 produces a quarterly fishing magazine which has a very limited circulation. The scale of the business operations of Mag Co 3 is negligible by comparison to Mag Co 1 and Mag Co 2.

25. The group comprising Hold Co and all of its wholly owned subsidiaries was consolidated on 1 July 2002.

26. After a massive downturn in the property and retail sectors, the Hold Co consolidated group incurred large tax losses during the years ended 30 June 2003 and 2004. In March 2004 some of the entities in the Property Co 3 sub-group were transferred to the Property Co 2 sub-group as a number of shopping centres were to be re-developed as industrial properties. On 31 March 2004, there was a change in majority ownership of Hold Co.

27. This factual matrix is the starting point for each of the discrete examples set out in paragraphs 28 to 59 of this Ruling.

Example 1

28. Hold Co has to apply Subdivision 165-B to work out the taxable income and loss for the income year ended 30 June 2004 unless it satisfies the same business test (refer section 165-35). For the application of that test, the test time is 31 March 2004 and the same business test period is the period from the change of ownership to 30 June 2004.

29. The activities being carried on by entities within the group immediately prior to 31 March 2004 and during the period from 31 March to 30 June 2004 have to be examined in accordance with the principles set out in paragraphs 59 to 62 of TR 1999/9 to establish if the same business test in subsection 165-210(1) is satisfied. In essence this involves a comparison of the business of the relevant taxpayer immediately before the test time with the business of the taxpayer during the same business test period. As a consequence of the operation of the single entity rule in section 701-1, the business of Hold Co as the head company of the consolidated group would be characterised as one overall business that incorporates the various elements of property development, retail activity and magazine publishing conducted by the group.

30. If the same business test is satisfied (subsection 165-210(1)), it would then be necessary to examine whether any entities in the consolidated group had engaged in new enterprises or undertakings that generated assessable income during the same business test period. The new business test will be failed if a new enterprise or undertaking is not of a kind carried on by the group before the change of ownership occurred.

31. The transactions undertaken by all entities in the consolidated group during the same business test period would also have to be examined to determine whether or not any assessable income has been derived by the group from transactions of a kind not undertaken by the group before 31 March 2004.

32. If the same business test of subsection 165-210(1) is satisfied and the examination of the enterprises, undertakings and transactions of the entities when they were members of the consolidated group reveals that no assessable income has been derived during the same business test period from a business or transaction of a kind not undertaken before the test time (in terms of subsection 165-210(2)), Hold Co will be considered to have passed the same business test and will not be required to calculate its taxable income and tax loss for the year ended 30 June 2004 under Subdivision 165-B.

Example 2

33. During the year ended 30 June 2005, Hold Co transfers all of the business activities of Mag Co 1 to Mag Co 2 and liquidates Mag Co 1 which previously produced culture magazines.

34. In that year, Hold Co seeks a deduction for losses incurred in the year ended 30 June 2003 and, because of the change of ownership on 31 March 2004, relies on the same business test being satisfied.

35. The question for consideration in this case is whether or not the liquidation of Mag Co 1 will cause failure of the same business test as outlined in subsection 165-210(1).

36. The same business test involves comparison of the business of the relevant taxpayer immediately before the test time with the business of the taxpayer during the same business test period. In this example the test time is 31 March 2004, and the same business test period is the year ended 30 June 2005. The business of Hold Co as the head company of the consolidated group would be characterised as one overall business that incorporates the various elements of property development, retail activity, and magazine publishing conducted by the group.

37. The liquidation of Mag Co 1 has not changed the business taken to be carried on by Hold Co as the head company of the consolidated group. The activities conducted by Mag Co 1 before the test time are still being conducted by the group during the same business test period and will be taken into account in the identification of the business of Hold Co at each of those times.

Example 3

38. During the year ended 30 June 2005, Hold Co disposes of all of its shares in Mag Co 3 and the group ceases to be involved in the publishing of the fishing magazine. However Mag Co 1 continues to provide printing and pre-production services to Mag Co 3 on the same basis as it did prior to the disposal of Mag Co 3. Hold Co commences to derive assessable income from the provision of these external services to Mag Co 3, this charge having previously been an intra-group transaction and therefore ignored under the single entity rule.

39. In the year ended 30 June 2005, Hold Co seeks a deduction for losses incurred during the year ended 30 June 2003 and, because of the change of ownership on 31 March 2004, relies on the same business test being satisfied (section 165-210).

40. The immediate question for consideration in this example is whether or not the disposal of the business of Mag Co 3 causes failure of the same business test. As stated in paragraph 13 of TR 1999/9, the analysis of whether the same business continues after a change of ownership may give rise to questions of degree and ultimately depends on the facts of the case. In making the analysis, it needs to be acknowledged that a company may expand or contract its activities without necessarily ceasing to carry on the same business.

41. Identifying and defining the one overall business of the relevant taxpayer, that is, Hold Co as the head company of the consolidated group, involves looking at all the things done and the activities carried out:

- immediately before the test time, 31 March 2004, by entities that were members of the group at that time; and
- by entities during the year ended 30 June 2005 (the same business test period) when they were members of the consolidated group.

42. The business of Hold Co as the head company of the consolidated group would be characterised as one overall business that incorporates the various elements of property development, retail activity, and magazine publishing conducted by the group.

43. As outlined under the Facts at paragraph 24 of this Ruling the business of Mag Co 3 is negligible in relation to the overall activities of the consolidated group. In these circumstances, the disposal of Mag Co 3 and its related business activities is unlikely, of itself, to cause failure of the same business test (in terms of subsection 165-210(1)).

44. If the disposal of the shares in Mag Co 3 produces assessable income (for example a net capital gain), the new transactions test must be applied. Having regard to all the relevant circumstances of the Hold Co group, if it were concluded that the transaction is of a kind that could have been entered into ordinarily and naturally in the course of the business operations carried on by Hold Co, the new transactions test is, for this reason alone, unlikely to be failed (refer to paragraphs 15 and 16 of TR 1999/9).

45. In respect of the assessable income derived by Hold Co from printing and pre-production services provided by Mag Co 1 to Mag Co 3, the question of the possible application of the new business test or the new transactions test arises. The activities of printing and pre-production would be recognised within the consolidated group before the change of ownership on 31 March 2004 although agreements between group members to provide such services for consideration would not be recognised under the single entity rule. The fact that printing and pre-production activities had been carried on previously within the group would point to a conclusion that the new business test is satisfied. Furthermore, this fact would assist in reaching a conclusion that the agreement to provide services of that nature is one that could have been entered into ordinarily and naturally in the course of the business operations carried on by Hold Co before the change of ownership. In these circumstances, the service agreement from which Hold Co derives assessable income would not be considered to be a transaction of a different kind to those entered into by the group before the change of ownership. This is likely to be the case even if Mag Co 3 was not previously charged for these services.

Example 4

46. During the year ended 30 June 2005 the existing members of the consolidated group continued to carry on all of the activities they carried on immediately before the change of ownership occurred on 31 March 2004, and there were no significant changes to the nature or scale of each of those activities. On 1 September 2004, Hold Co acquired all of the shares in Boat Co 1 which had conducted a ferry service since before 31 March 2004. Boat Co 1 is a very profitable company and adds significantly to the income of the consolidated group for the remainder of the year ended 30 June 2005.

47. In the year ended 30 June 2005, Hold Co seeks a deduction for losses incurred during the year ended 30 June 2003 and, because of the change of ownership on 31 March 2004, relies on the same business test being satisfied. The test time for the purposes of subsection 165-13(2) is 31 March 2004 and the same business test period is the year ended 30 June 2005.

48. The first issue for consideration in this case is the impact, if any, that the acquisition of Boat Co 1 and its associated activities has on the identification of the business of Hold Co as the head company of the consolidated group for the purpose of the same business test.

49. The business of Hold Co as the head company of the consolidated group would be characterised by reference to all of the activities carried on by members of the group during the period in which they were members of the group. This process results in one overall business conducted by the group incorporating the various elements of property development, retail activity, magazine publishing, and from 1 September 2004, the ferry service.

50. Due to the application of section 165-212E when characterising the business of Hold Co at 31 March 2004 (the test time) it is necessary to ignore the activities of Boat Co prior to it becoming a member of the consolidated group. Consequently, the business of Hold Co at that time does not include the ferry business. In this case, it is unlikely that Hold Co will satisfy the requirements of the same business test and no deduction will be available during the year ended 30 June 2005 for the tax loss incurred during the year ended 30 June 2003.

51. Even if, as a result of the analysis of the activities of the consolidated group at the relevant times, it is determined that the business of Hold Co as the head company of the consolidated group has not been sufficiently changed by the introduction of Boat Co 1 to cause failure of the same business test in subsection 165-210(1), the new business test under subsection 165-210(2) would be failed as the business of Boat Co is of a kind that Hold Co did not carry on before the test time, and the loss deduction would not be available to Hold Co for the year ended 30 June 2005.

Example 5

52. In July 2004, Hold Co acquires Mag Co 4 which produces a quarterly fishing magazine. Mag Co 4 also runs a fishing boat hire activity which it has operated since 30 April 2004. The boat hire activity contributes some income to the consolidated group but does not achieve the level of profitability that was anticipated at the date of acquisition of the company. In May 2005, Mag Co 4 ceases the boat hire activity.

53. Hold Co seeks to claim a deduction in the year ended 30 June 2005 for losses incurred in the year ended 30 June 2003 and, because of the change of ownership on 31 March 2004, relies on the same business test being satisfied.

54. The publication of the fishing magazine by Mag Co 4 is not a new kind of business because Mag Co 3 previously carried on this kind of business while a member of the consolidated group. However, the boat hire activity is not a business of a kind that Hold Co carried on before the test time and, as it is a business that produces assessable income for Hold Co during the same business test period, Hold Co will fail the new business test in the year ended 30 June 2005 and will be unable to deduct the 2003 loss.

Example 6

55. During the year ended 30 June 2003, Retail Co develops computer software for its business operations which is a major advance on previously available software. This software is made available to the Property Co 1, 2 and 3 sub-groups. Retail Co derives intra-group licensing fees which are ignored for the purposes of calculating the income tax liability of Hold Co under the single entity rule.

56. In July 2004, Retail Co executes a multiple year software licensing contract with a major software provider which is external to the consolidated group. Hold Co as head company of the consolidated group derives significant assessable income from this niche activity of licensing its software to a third party during the year ended 30 June 2005.

57. In the year ended 30 June 2005, Hold Co seeks a deduction for losses incurred during the year ended 30 June 2003 and, because of the change of ownership on 31 March 2004, relies on the same business test being satisfied. In this case it would need to be determined whether the software licensing activities are sufficient to result in the overall business of Hold Co being characterised as a different business to that previously conducted before the change of ownership for the purposes of the same business test per subsection 165-210(1).

58. If as a result of the analysis of the activities of the consolidated group at the relevant times it is determined that the business of Hold Co has not been sufficiently changed by the licensing of software outside the group to cause failure of the same business test (subsection 165-210(1)) the new business test and new transactions tests of subsection 165-210(2) will need to be considered.

59. The license agreements between Retail Co and the entities within the Property Co sub-groups would not be recognised because of the single entity rule. However, the activities of software development and use of new software within the group would still be recognised as constituent elements of the overall business of Hold Co. These activities within the consolidated group before the change of ownership would point to a conclusion that the licensing agreement with the external software provider does not result in failure of the new business test. Furthermore, recognition of these activities would assist in reaching a conclusion that the external licensing agreement is neither extraordinary nor unnatural having regard to the overall business carried on by Hold Co at the time of the change in ownership. In these circumstances, the new transactions test also would not be failed.

Date of effect

60. This Ruling applies both before and after its date of issue. However, the Ruling 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 Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

20 June 2007

Appendix 1 – Explanation

❶ *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.*

61. In respect of the test in subsection 165-210(1), this Ruling adopts the approach that a head company carries on one overall business identified by reference to all the consolidated group activities.

The structure of section 165-210

62. Paragraphs 24 to 27 of TR 1999/9 explain that subsections 165-210(1) and (2) provide three tests, (the **same business test**, the **new business test** and the **new transactions test**) each of which must be satisfied by a company in order to satisfy the requirements of section 165-210. The principles set out in TR 1999/9 about the operation of those tests, the identity of a business of a company and the issues that are relevant to be considered in identifying a business that is being carried on, are also applicable in relation to the head company of a consolidated group.

The meaning of 'the business' of the head company of a consolidated group

63. The effect of the single entity rule, section 701-1, is that the tests contained in section 165-210 will apply to the head company of a consolidated group as if the subsidiary members of the group are parts of the head company. Effectively, the tests will apply to the group in a similar way to how they would apply to a non-consolidated company carrying on a business in divisions.

64. Because each subsidiary member is taken to be a part of the head company, rather than a separate entity, the business of the head company must be ascertained by reference to all of the activities carried on by all of the entities during a relevant period, or at a relevant point in time, provided that the entities were members of the consolidated group during that relevant period or at that relevant point in time.

65. Paragraphs 28 and 29 of TR 1999/9 set out the meaning of the word 'business' in relation to a single company and explore the different contexts in which the word is used in section 165-210. TR 1999/9 explains the meanings that the word can have within those different contexts for companies operating as a distinct commercial entity. In seeking to satisfy subsection 165-210(1), the head company of a consolidated group will need to examine each of the activities, enterprises or undertakings being carried out at the appropriate test time by all those entities that were members of the consolidated group at that time; and by all entities during that part of the same business test period when they were members of the consolidated

group. The identification of each of those activities, enterprises and undertakings, and the determination of what is relevant to examine in relation to the business of the consolidated group that is taken to be carried on by the head company, should be done in accordance with the principles set out in TR 1999/9.

66. It has been suggested that circumstances could arise where the activities and operations of wholly-owned subsidiary members are sufficiently numerous and diverse that the head company is, as a matter of fact, in the business of holding interests in other companies or 'in the business of being in business'. This suggestion fails to recognise that, consistent with the single entity rule, the overall business of the head company is to be identified by reference to the various activities, enterprises and undertakings of the subsidiary members and cannot constitute the holding of interests in wholly owned subsidiary members. Further, characterising the business of a head company as simply 'being in business' can never be a satisfactory outcome of a rigorous factual assessment of the whole of the business activities undertaken, regardless of the diversity of these overall activities. However, there may be instances where the head company of a consolidated group holds investments in one or more less than wholly owned subsidiaries. In this instance the overall business of the consolidated group for the purposes of subsection 165-210(1) may include being in the business of holding investments in other entities.

The new business test

67. In the new business test there is a reference to business of a kind that the company did not carry on before the test time. In the new business test, the word 'business' has a different meaning from the word 'business' in the same business test; it refers to each kind of enterprise or undertaking comprised in the overall business carried on by the consolidated group before the test time and during the same business test period (refer to paragraphs 28 and 29 of TR 1999/9). The new business test puts a limit on the type of expansion that the group may undertake if it is to retain the benefit of accumulated losses. In order for the head company to benefit from accumulated losses, it must not derive assessable income from an enterprise or undertaking of a kind that it is not treated as having been engaged in before the test time.

68. If, during the same business test period, any member of the consolidated group commences to derive assessable income from an enterprise or undertaking of a kind that was not carried on by the group before the test time, the head company would fail the test.

69. It must however be noted that because of the operation of the single entity rule, satisfaction of the new business test may be achieved if a new business carried on by an entity in the consolidated group during the same business test period is of a kind carried on by any entity during the period before the test time when that entity was a member of the consolidated group.

The new transactions test

70. In the context of consolidation, the new transactions test is directed at preventing the injection of income into a consolidated group, the head company of which has satisfied the same business test and the new business test in relation to accumulated losses. The new transactions test looks at all transactions (other than intra-group) entered into in the course of the group's business operations by an entity while a member of the group. It is not merely concerned with those transactions that are 'isolated' or 'independent'. A transaction entered into during the same business test period which is:

- outside the course of the group's business operations, before the test time; or
- extraordinary or unnatural when judged by the course of the group's business operations before the test time,

will usually be a transaction of a different kind from those transactions entered into or carried on before the test time by an entity while a member of the consolidated group.

Intra-group activities and transactions

71. The single entity rule treats subsidiary members of a consolidated group as parts of the head company for the purpose of working out the income tax liability of the head company. Accordingly, intra-group transactions are not recognised for the purpose of applying the same business test which is relevant for working out the income tax liability of the head company after a change in ownership.

72. However, activities, undertakings and enterprises taking place within a consolidated group (in the sense that they do not involve the derivation of income through dealings outside the group) will still be relevant for characterising the business of the head company notwithstanding the fact that individual transactions between group members are not recognised because of the single entity rule. For example, in a consolidated group where a product is manufactured by a member entity and sold by wholesale to another member entity that sells the product externally, the business of the head company of that consolidated group would be characterised as both the manufacturing and retailing of that product. The sale transactions between the member entities are not recognised but the manufacturing activity is relevant for characterising the business of the head company for the purposes of the same business, new business and new transactions tests. Examples 3 and 6 in this Ruling further illustrate the relevance of intra-group activities in this context.

Section 165-212E and the entry history rule

73. Section 165-212E provides that for the purposes of the same business test, if an entity becomes a subsidiary member of a consolidated group, the entry history rule does not operate to take the business of the head company of the group to include the business of the joining entity before it became a member of the group.³

74. When read with the entry history rule in section 701-5, the effect of section 165-212E is that the activities of an entity during any period when that entity was not a member of a consolidated group are ignored when determining either the 'business' of the head company of a consolidated group, or whether the new business test or the new transactions test have been satisfied.

³ On 8 May 2007, the Government announced in Australian Government – Budget Measures 2007-8, Budget Paper No. 2 that it would improve and clarify the loss recoupment rules by ensuring that the 'entry history' rule is disregarded in applying the same business test, with effect from 1 July 2002. The announcement advised that the proposed amendment would reduce uncertainty and ensure that outcomes under the rules are consistent with policy intent.

Appendix 2 – Alternative views

❶ *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.*

75. There are a number of alternative views to those expressed in this Ruling. Those views and the Commissioner's responses are set out below.

Only the head company's business is relevant

76. Under one alternative approach the business of the head company is determined by reference only to the activities of that company. Under this approach only the activities actually undertaken by the head company would be considered in seeking to identify the business being carried on at the relevant test time and during the same business test period. The activities being undertaken by other members of the consolidated group would be ignored.

77. Applying the same business test to the head company without reference to the activities of other entities of the consolidated group is not compatible with the stated intention of the consolidation legislation or the objectives sought to be achieved by the same business test provisions.

78. For this approach to be arguable, it is necessary to read the words 'working out the amount of the head company's liability (if any) for income tax' in subsection 701-1(2) very narrowly. Those words would need to be interpreted in such a way that determining the business the head company carried on immediately before the test time, as required by subsection 165-210(1), is not considered to be working out the head company's liability for income tax, that is, it is not considered to be for head company core purposes.

79. TR 2004/11 explains the operation of the single entity rule (SER). Several paragraphs from that Ruling are set out below:

Consequences of the SER

7. 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.

8. 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 where the rights and obligations are between members of a consolidated group (intra-group assets) are not recognised for income tax purposes during the period they are held within the group whether or not the asset, as a matter of law, was created before or during the period of consolidation (see also paragraph 11 and paragraphs 26-28); and
- (e) dealings that are solely between members of the same consolidated group (intra-group dealings) will not result in ordinary or statutory income or a deduction to the group's head company.

24. This ensures that working out the consolidated group's taxable income and losses and offsets, record keeping requirements and penalties, are addressed on the basis that the group is a single entity with the head company as that entity. Broadly, this provides parity of income tax treatment between a consolidated group, treated as a single entity, and a non-consolidated company.

80. Given this explanation it is not considered appropriate to read subsection 701-1(2) so narrowly that the business of the head company, for the purposes of applying section 165-210, does not take into account the activities of the subsidiary members of the consolidated group. The intention of the same business test is to provide a basis for allowing deductions for prior year tax losses to a company which has undergone a change of ownership. The deduction is available where the objective evidence indicates that the change of ownership is not followed by a change of business, or the introduction of new business activities or income earning transactions, providing a new source of assessable income against which the new owners can offset the accumulated losses. In a consolidated group the head company is the only entity that returns any assessable income and is the only entity entitled to a deduction for tax losses. All of the activities of the consolidated group must be considered when determining both the assessable income and allowable deductions of the head company. Likewise all the activities of the consolidated group are relevant when applying the same business test.

Multiple 'businesses' of the head company

81. There is another alternative approach under which the head company is viewed as carrying on a number of businesses for the purposes of subsection 165-210(1). This view stems from the propositions that in a pre-consolidated context each company identifies its own overall business for the purposes of subsection 165-210(1) and that it is not appropriate or realistic to identify and define a single overall business of a consolidated group.

82. The legislative basis for this view is said to be paragraph 23(b) of the *Acts Interpretation Act 1901* which states (in part) that '... unless the contrary intention appears ... words in the singular number include the plural and words in the plural number include the singular'. Therefore the word 'business' in sections 165-13, 165-126, 165-132 and 165-210 should be taken to include the plural 'businesses'. Consequently, when examining the business of the head company of a consolidated group for the purposes of applying the same business test, it is necessary to consider the businesses of all members of that group.

83. One method of characterising the 'business' of the head company of the consolidated group under this view is to identify the separate businesses being conducted by the individual members of the consolidated group by reference to the activities being carried on immediately before the test time by each individual entity in the group. All of these separate businesses are then taken to be distinct businesses carried on by the head company. If any of those businesses cease to be carried on before the end of the same business test period, the test in subsection 165-210(1) will not be satisfied.

84. This would require application of the principles set out in TR 1999/9 to each of the entities in the consolidated group at the test time to identify the business being carried on by each entity. It would then be necessary to apply those principles to the activities of entities in the group throughout the same business test period to ascertain whether or not those businesses identified at the test time have continued during the relevant period. In this regard, it would not be necessary that the businesses are being carried on by the same entities, or even that the entities that conducted the businesses at the test time continue to be members of the group. It would only be required that the identified businesses continue to be carried on by the consolidated group.

85. It would also be necessary to identify whether or not any entity in the consolidated group has commenced to derive assessable income from either of the following:

- A business of a kind that had not previously been undertaken by a member of the consolidated group before the test time.
- A transaction of a kind that had not previously been entered into in the course of the business operations that had been conducted by a member of the consolidated group before the test time.

86. A cessation of the business activities of one entity within the consolidated group, even if the activities of that entity are insignificant in terms of the overall profitability of the group, could result in the head company failing the test in subsection 165-210(1).

87. A second method of characterising the 'business' of the head company of the consolidated group under this view is by reference to all the activities being undertaken by members of the consolidated group immediately before the test time and then aggregating some of those activities into discrete businesses. Under this approach if the activities of two or more members of the group are sufficiently integrated, they can be identified as constituting one business. As with the first method, the consolidated group may be identified as carrying on a number of businesses but, unlike that approach, the number of those businesses is not determined by the number of entities in the group at the test time.

88. This approach would require detailed analysis of the activities of all entities in the group at the test time and a decision as to which activities are sufficiently integrated to support a conclusion that those activities are part of one business. The businesses identified as being conducted at the test time would be compared with the businesses being carried on throughout the same business test period. If any of those businesses has ceased, the head company may not satisfy the requirements of subsection 165-210(1). If any new business has been commenced, the head company would not satisfy paragraph 165-210(2)(a) unless that new business is of a kind with one of the businesses carried on by the group before the test time.

89. These two methods depend, for their effectiveness, on there being no contrary intention to 'business' in subsection 165-210(1) being read as including 'businesses'. The Commissioner considers that section 165-210 does express such a contrary intention.

90. Paragraphs 28 and 29 of TR 1999/9 explain the meaning of 'business'. Subsection 165-210(1) would not achieve the desired outcome in either a consolidated or non-consolidated context if the word 'business' is read as 'businesses'.

Section 165-212E does not 'turn off' the entry history rule for the purposes of applying the same business test, new business test or the new transactions test

91. It has been argued that section 165-212E does not actually prevent the operation of the entry history rule because of a mismatch between the wording of that section and the wording of the entry history rule in section 701-5. Section 165-212E is drafted in terms of not taking '... the *business of the *head company of the group to include the business of the joining entity before it became a *member of the group'. However, section 701-5 is drafted in terms of '... everything that happened in relation to it before it became a subsidiary member ...'. That is, the entry history rule is not directly concerned with the business carried on by an entity prior to it becoming a subsidiary member. Consequently, it is argued that a provision that requires the 'business' of an entity to be disregarded does not also require that the actual underlying activities of the entity be disregarded.

92. Alternatively it has been argued that section 165-212E does not 'turn off' the entry history rule for the purposes of applying the new business or new transactions tests, as the section only refers to the 'same business test', a defined term. The 'same business test' as defined in subsection 165-210(1) is a separate and standalone concept from the new business and new transactions tests in subsection 165-210(2). Further, it is contended that the relevant paragraphs in the Explanatory Memorandum to the Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005 contain no reference to a purpose of determining whether the new business or new transactions tests apply.

93. The Commissioner does not agree with these alternative arguments. Firstly, when section 165-212E makes it necessary to disregard the business of the joining entity before it became a subsidiary member, this naturally refers to the transactions and activities constituting that business. Secondly, the Commissioner's view is that the reference to 'same business test' in section 165-212E incorporates both the positive condition and the negative conditions of section 165-210 and thereby 'turns off' the entry history rule for the purposes of the same business test, the new business test, and the new transactions test.

94. It is considered that the legislative context of section 165-210 supports the view that the defined term, 'same business test', represents a single, integrated test comprising a positive condition in subsection 165-210(1) and the negative conditions in subsections 165-210(2) and (3). This is the case notwithstanding that TR1999/9 and this Ruling use the terms **same business test**, **new business test** and **new transactions test** as a short-hand method of referring to the positive condition and two of the negative conditions.

95. Furthermore, it is considered that the two alternative arguments would not be compatible with the purpose of section 165-212E and the clear statement as to its intended operation, and would result in anomalous outcomes. Section 165-212E ensures consistency of treatment between a consolidated group commencing a new business activity and a consolidated group acquiring a subsidiary member that conducts that activity.

96. Under a restricted application of section 165-212E as contended under the alternative views, after a change in ownership of a head company the consolidated group may acquire a subsidiary that conducts business activities not of a kind carried on by any member of the group before the test time. Inappropriately, the new business test would not be failed if the subsidiary had been carrying on those activities before joining the group at a time before the date of the ownership change of the head company. This anomaly is underlined by considering the case where the new subsidiary commenced to carry on those business activities before joining the group but only after the time at which there was a change in ownership of the head company. In these circumstances, the new business test would be failed. There is no sensible reason for distinguishing these two sets of circumstances.

97. The Explanatory Memorandum to the Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005 confirms the intended operation of section 165-212E in respect of the activities of a joining entity without restriction to only the primary test under subsection 165-210(1):

3.17 This Bill clarifies that the entry history rule does not operate to deem the head company of a consolidated or MEC group to carry on the activities of a subsidiary member of the group during a period before the subsidiary member joined the group. ...

3.18 When an entity joins a consolidated or MEC group, its activities are treated as activities of the head company from its joining time for the purposes of the SBT. Activities that the entity carried on before the joining time are not attributed to the head company for the purposes of determining whether the head company carried on the same business.

98. When read in context a combination of section 165-212E and the entry history rule in section 701-5 operate in such a way that the activities of an entity during any period when that entity was not a member of a consolidated group are ignored when determining either the 'business' of the head company of a consolidated group, or whether the new business test or the new transactions test have been satisfied.

Appendix 3 – Detailed contents list

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References

Previous draft:

TR 2006/D4

Related Rulings/Determinations:

TR 1999/9; TR 2004/11;
TR 2006/10

Subject references:

- consolidated group
- consolidation - multiple entry consolidated group
- consolidation - same business test
- entry history rule
- head company
- head company of a MEC group
- losses
- MEC
- MEC losses
- new business test
- new transactions test
- same business test
- single entity rule

Legislative references:

- ITAA 1997 165-10
- ITAA 1997 165-12
- ITAA 1997 165-13
- ITAA 1997 165-13(2)
- ITAA 1997 Subdiv 165-B
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- ITAA 1997 Subdiv 165-CB
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- ITAA 1997 165-126
- ITAA 1997 165-132
- ITAA 1997 165-210
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- ITAA 1997 165-212E
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Other references:

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- Explanatory Memorandum to the Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005

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