

Worked example

Single entity treatment – sale of intragroup asset to non-member

Description This example shows how the sale of an intragroup asset to an entity outside the consolidated group is treated according to the transaction's economic substance for the group as a whole. Examples are given for the sale of an option, interest stream and debt.

Commentary When a consolidated group is formed, the group is treated as a single entity for income tax purposes → section 701-1 ITAA 1997. Broadly, this means that on joining a consolidated group the subsidiary members lose their individual income tax identities and are treated as parts of the head company of the consolidated group (rather than as separate entities) for the purposes of determining the head company's income tax liability.

In effect, the consolidated group is treated as if it were a single divisional company. Intragroup assets and liabilities and intragroup transactions have no income tax consequences. The head company is the only entity the income tax law recognises for the purposes of working out the group's income tax liability or losses. → 'Single entity treatment', C9-1-110

A transaction between group members may give rise to an 'intragroup asset', such as an option, interest stream or debt.

When an intragroup asset is sold or assigned to an entity outside the consolidated group, there are no income tax consequences from the transaction that gave rise to the intragroup asset but the transaction with the outside party is recognised for the purposes of working out the head company's income tax.

The transaction with the outside party is treated according to its economic substance for the group as a whole, without regard to internal transactions. Transactions where intragroup assets are transferred to a non-group entity are recognised as a transfer by the head company. For example, the disposal of an intragroup CGT asset will ordinarily result in CGT event A1 (section 104-10 of the ITAA 1997) happening to the head company. The cost base of the asset in such a case will only be incidental costs incurred by the group to non-group members in relation to the transfer. However, in the case of the transfer of an intragroup debt, because the transfer is in substance equivalent to borrowing money or obtaining credit from another entity, no CGT event happens (see Taxation Determination TD 2004/33).

The asset may therefore be treated (for the purposes of working out the head company's income tax) as something different from its legal form.

The Tax Office has issued Taxation Ruling TR 2004/11 and the following taxation determinations related to this topic: TD 2004/35, TD 2004/39, TD 2004/45, TD 2004/46, TD 2004/83, TD 2004/84, TD 2004/85.

Note

Sale of membership interests

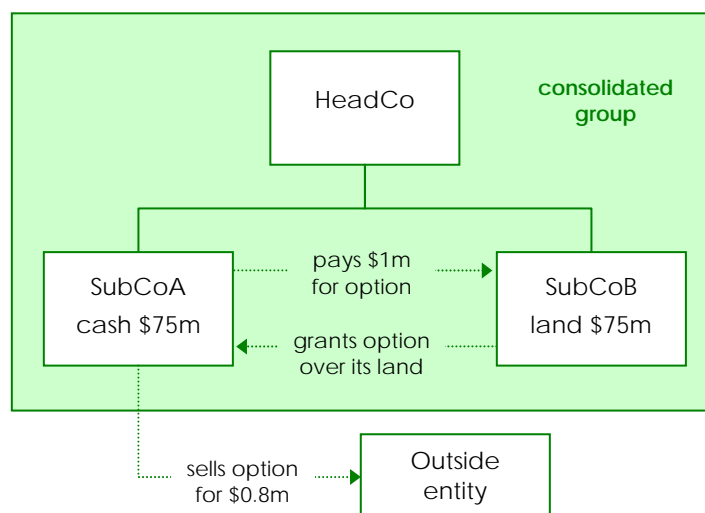
Special rules apply where membership interests in a subsidiary member are sold to a non-member by the head company. The Tax Office has issued the following taxation determinations related to this topic: TD 2004/40, TD 2004/41, TD 2004/47.

Example – sale of option

Facts SubCoA and SubCoB are subsidiary members of a consolidated group, of which HeadCo is the head company (figure 1). At the time of consolidation:

- SubCoA's only asset is \$75 million cash, and
- SubCoB's only asset is land, with a cost base of \$75 million and market value of \$75 million.

Figure 1: Sale of intragroup option outside group



SubCoB grants SubCoA a call option over the land for \$1 million. There are no income tax consequences of this transaction, as the granting of the option is not recognised for HeadCo's income tax purposes.

As a result:

- SubCoA has cash on hand of \$74 million and an option with a market value of \$1 million, and
- SubCoB has cash of \$1 million and land with a cost base of \$75 million.

No cost has flowed outside the group. (Assume that the group has incurred no costs in relation to the transfer.)

SubCoA later sells the option to an entity outside the consolidated group for \$0.8 million (the value of the option has fallen as a result of a fall in the market value of the land).

Assume that the group as a whole has incurred no costs in relation to the transfer.

Calculation In legal form, SubCoA has sold an option. The transaction with the outside party is treated according to its economic substance for the group as a whole, without regard to internal transactions. The sale of the intragroup asset to a non-group entity is recognised as a CGT event A1 (section 104-10 of the ITAA 1997) happening to the head company. The cost base will only be incidental costs incurred by the group to non-group members in relation to the transfer.

Thus, while the sale price to the third party is less than the purchase price to SubCoA, the consolidated group has not made an economic loss from the assignment of the option to the third party for market value:

- The head company has sold an option to an entity outside the group.
- The group has received capital proceeds of \$0.8 million from the transaction.
- CGT event A1¹ (disposal of a CGT asset) is triggered, resulting in a capital gain of \$0.8million – the difference between the amount received for the option (\$0.8 million) and the incidental costs incurred by the group (nil).
- The cost base for the land remains \$75 million, which will be available on disposal of the land (if the option is exercised or otherwise).

This treatment is in accordance with single entity principle set out in section 701-1. → 'Treatment of assets', C2-1

→ Taxation Determination TD 2004/34

¹ Section 104-10, ITAA 1997.

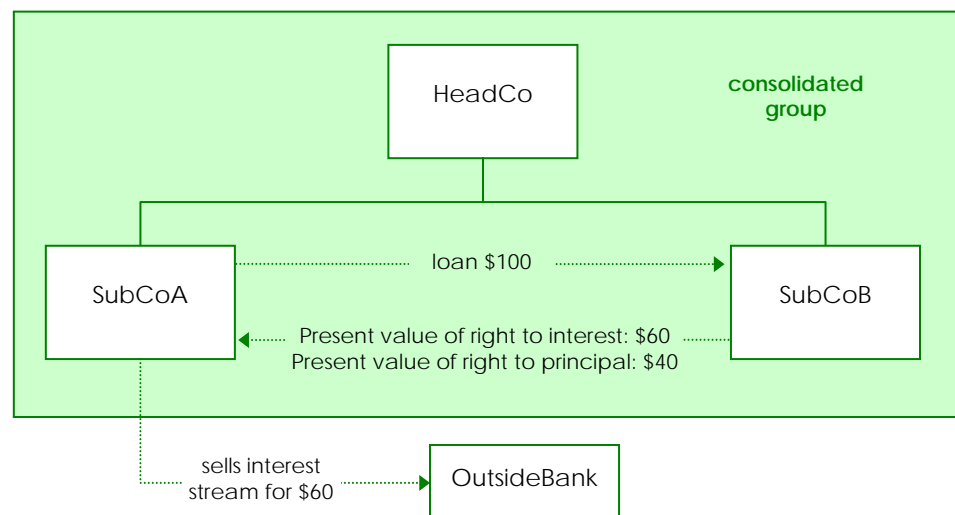
Example – sale of interest stream

Facts SubCoA and SubCoB are subsidiary members of a consolidated group of which HeadCo is the head company (figure 2).

SubCoA lends \$100 to SubCoB in an interest-only loan at 10% for 10 years. For the purposes of working out HeadCo's income tax position, the intragroup debt is ignored. No deductions are allowed for interest payments by SubCoB to SubCoA, and no income is returned by SubCoA in respect of such payments.

The present value of the right to interest payments is \$60 and the present value of the right to repayment of principal is \$40. SubCoA then sells the interest stream to OutsideBank for \$60.

Figure 2: Sale of intragroup income stream outside group



Calculation In legal terms, SubCoB is making interest payments on a loan, with the entitlement to receive the payments assigned by SubCoA to OutsideBank. In terms of the consolidated entity, however, the group has received \$60 from OutsideBank and will make 10 payments of \$10.

In terms of the consolidated entity, the transaction has the substance of a *credit foncier* (blended payments) loan (a single receipt of \$60 and an obligation to make 10 payments of \$10 to end the liability to the person paying \$60 to the consolidated entity). Thus, applying the single entity model, the transaction would be treated as a *credit foncier* loan and each payment would be dissected into interest and principal components for tax purposes.

Example – sale of debt

Facts SubCoA and SubCoB are subsidiaries of HeadCo. Before the group consolidates, SubCoA lends SubCoB \$25 million (figure 3).

On 1 July 2002 the group consolidates, with HeadCo as head company. For the purposes of working out HeadCo's income tax position, the intragroup debt is ignored. No deductions will be allowed for interest payments by SubCoB to SubCoA, and no income will be returned by SubCoA in respect of such payments.

As a result of a rise in market interest rates, the market value of the debt falls. On 1 September 2003 SubCoA sells the debt to OutsideCo for \$20 million.

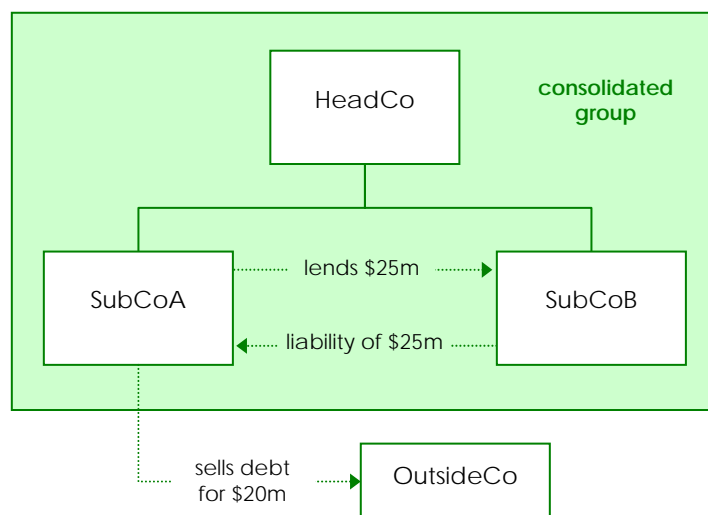


Figure 3: Sale of debt outside group

Calculation The assignment of the intragroup debt is treated, in accordance with its economic substance for the group, as if HeadCo is entering into a new loan. This does not constitute a CGT event² → Taxation Determination TD 2004/33. Therefore there are no income tax consequences for the group as a result of the transaction. This accords with the income tax treatment of a single company undertaking the same transaction and is consistent with the single entity rule.

From the group (single entity) point of view, the economic substance of the transaction is receipt of \$20 million in consideration for an obligation to repay an amount of \$25 million.

² Sections 104-35(5)(a) and 104-155(5)(a), ITAA 1997.

HeadCo is treated as having an obligation to repay \$20 million principal on the loan. The \$5 million difference between the amount received and amount to be repaid is treated as an interest expense. Division 16E of the ITAA 1936 applies, and this amount will be recognised over the life of the loan.

References

Income Tax Assessment Act 1936, Division 16E

Income Tax Assessment Act 1997, section 8-1

Income Tax Assessment Act 1997 – as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), section 701-1

Taxation Ruling TR 2004/11 – Income tax: consolidation: the meaning and application of the single entity rule in Part 3-90 of the *Income Tax Assessment Act 1997*

Taxation determinations

TD 2004/33 – Income tax: consolidation: capital gains: does a CGT event happen to the head company of a consolidated group if a debt is created within the consolidated group and later transferred to a non-group entity?

TD 2004/34 – Income tax: consolidation: capital gains: does section 104-10 (CGT event A1) of the *Income Tax Assessment Act 1997* apply to the head company of a consolidated group where an option granted within the consolidated group is later transferred to a non-group entity?

TD 2004/35 – Income tax: consolidation and capital gains tax: does section 104-10 (CGT event A1) of the *Income Tax Assessment Act 1997* apply to the head company of a consolidated group where a licence granted within the consolidated group is later transferred to a non-group entity for no capital proceeds?

TD 2004/36 – 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 the interest paid on funds borrowed before consolidation and on-lent interest-free to a subsidiary member of the consolidated group?

TD 2004/37 – Income tax: consolidation: are intra-group money lending transactions or dealings taken into account in determining if the head company of a consolidated group is carrying on business as a money lender?

TD 2004/39 – Income tax: consolidation: capital gains: does CGT event A1 in section 104-10 of the *Income Tax Assessment Act 1997* happen to the head company of a consolidated group if an asset is sold by a subsidiary member to an entity outside the group?

TD 2004/40 – Income tax: consolidation: capital gains: does CGT event A1 in section 104-10 of the *Income Tax Assessment Act 1997* happen to the head company of a consolidated group when a contract is made to sell a membership interest in a subsidiary member of the group to a purchaser outside the group?

TD 2004/41 – Income tax: consolidation: capital gains: can membership interests in a subsidiary member of a consolidated group be recognised for the purpose of applying the market value substitution rule in section 116-30 of the *Income Tax Assessment Act 1997* if CGT event A1 happens to the group's head company when a contract is entered into to dispose of the interests?

TD 2004/42 – Income tax: consolidation: capital gains: does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* affect the application of CGT event I1 in section 104-160 if a company which is a subsidiary member of a consolidated group stops being an Australian resident?

TD 2004/43 – Income tax: consolidation: capital gains: for the purposes of the capital gains tax provisions in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997*, is the head company of a consolidated group taken to have acquired an asset, which a subsidiary member brings to the group, at the same time that the subsidiary member acquired it?

TD 2004/44 – Income tax: consolidation: capital gains: does the transfer of an asset between members of a consolidated group affect the ownership period of the head company for the purposes of applying the small business 15 year exemption in Subdivision 152-B of the *Income Tax Assessment Act 1997*?

TD 2004/45 – Income tax: consolidation: capital gains: how does the controlling individual condition in paragraph 152-110(1)(c) of the *Income Tax Assessment Act 1997* (one of the conditions for the small business 15 year exemption in Subdivision 152-B) apply to the head company of a consolidated group in respect of the sale of an asset brought into the group by a subsidiary member?

TD 2004/46 – Income tax: consolidation: capital gains: is the controlling individual condition in paragraph 152-305(2)(b) of the *Income Tax Assessment Act 1997* (one of the conditions for the small business retirement exemption) applied to the head company of a consolidated group?

TD 2004/47 – Income tax: consolidation: capital gains: does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* affect the application of the controlling individual test in paragraph 152-10(2)(a) when a CGT event happens to a share or trust interest that is a membership interest in a subsidiary member (company or trust) of a consolidated group?

TD 2004/48 – Income tax: consolidation: capital gains: for the purposes of Subdivision 125-C of the *Income Tax Assessment Act 1997*, can the head company of a consolidated group meet the requirements of a demerging entity in subsection 125-70(7) where a subsidiary member is demerged from the group?

TD 2004/49 – Income tax: consolidation: capital gains: does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* apply in determining whether the consequences in Subdivision 125-C of the *Income Tax Assessment Act 1997* apply to the head company of a consolidated group where one or more subsidiary members hold ownership interests in an entity outside the group that is being demerged?

TD 2004/50 – Income tax: consolidation: capital gains: if a subsidiary member of a consolidated group acquires shares in a company outside the group (the original company) under a scrip for scrip arrangement, is the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* relevant in determining the eligibility for rollover of shareholders in the original company?

TD 2004/51 – Income tax: consolidation: capital gains: does section 124-784 of the *Income Tax Assessment Act 1997* apply to determine the cost base of equity or debt issued by an acquiring entity to its ultimate holding company as part of a scrip for scrip arrangement if those companies are members of a consolidated group?

TD 2004/68 – Income tax: consolidation: Division 7A: if a private company that is a head company or subsidiary member of a consolidated group makes a payment or a loan, or forgives a debt to a shareholder (or shareholder's associate) external to the consolidated group, does the single entity rule apply to the calculation of the distributable surplus under section 109Y of the *Income Tax Assessment Act 1936*?

TD 2004/69 – Income tax: consolidation: Division 7A: if a private company, as a member of a consolidated group, makes a payment, a loan or forgives a debt to a shareholder (or shareholder's associate), that is also a member of the consolidated group, does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* prevent the application of Division 7A of the *Income Tax Assessment Act 1936* to the transaction?

TD 2004/79 – Income tax: consolidation: capital gains: if an entity makes a capital gain prior to becoming a subsidiary member of a consolidated group, can it choose to apply the small business replacement asset roll-over under Subdivision 152-E of the *Income Tax Assessment Act 1997* if it acquires a replacement asset after it has become a member of the group?

TD 2004/81 – Income tax: consolidation: capital gains: does the deregistration of a subsidiary member of a consolidated group cause a 'new event' to happen under paragraph 170-275(1)(a) of the *Income Tax Assessment Act 1997* if, before the subsidiary joined that group, a transfer of shares in it was a 'deferral event' under section 170-255 and the group's head company is the 'originating company' for the deferral event?

TD 2004/82 – Income tax: consolidation: capital gains: can the exemption in section 152-125 of the *Income Tax Assessment Act 1997* apply to a payment made by the head company of a consolidated group to a CGT concession stakeholder of the head company in respect of a capital gain made on the disposal of an asset legally owned by a subsidiary member of the group for which disposal the head company obtained the small business 15 year exemption?

TD 2004/83 – Income tax: can the assignment of an intra-group debt or income stream to an entity that is not a member of the consolidated group give rise to a debt interest for the head company of the group under Division 974 of the *Income Tax Assessment Act 1997*?

TD 2004/84 – Income tax: can Division 16E of Part III of the *Income Tax Assessment Act 1936* apply to a head company of a consolidated group where the principal of an intra-group loan is assigned by a member of the group to a non-member?

TD 2004/85 – Income tax: can Division 16E of Part III of the *Income Tax Assessment Act 1936* apply to a head company of a consolidated group where an intra-group income stream is assigned by a member of the group to a non-member?

Revision history

Section C9-5-230 first published 3 December 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	References to new taxation determinations. Change to figure 3.	To correct error.
16.12.05	Revisions to Commentary and to Calculation (p. 3).	New tax determinations.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- <http://assistant.treasurer.gov.au> (Assistant Treasurer's press releases)
- www.treasury.gov.au (Treasury papers on refinements to the consolidation regime).