Tax-related expenses – post-consolidation expenses relating to a subsidiary's tax affairs

It will be common for expenses to be incurred after consolidation relating to the tax affairs of a subsidiary member for periods before it joined a consolidated group. Such expenses may include the cost of preparing the income tax return for the period before consolidation or contesting in the courts a pre-consolidation assessment. Post-consolidation expenses may also arise from dealing with ancillary matters and other income taxes imposed under various Acts but assessed under the *Income Tax Assessment Act 1997* (ITAA), such as obligations relating to PAYG withholding amounts, PAYG instalments, withholding tax, interest on overpayments, franking deficit tax penalties and the general interest charge (GIC) – but (apart from the GIC) do not include the taxes themselves.

The other deductible tax-related expenditures are:

- the GIC itself
- GST Act penalties for errors in varying instalments, and
- valuation requirements for gifts and conservation covenants.

→ section 25-5, ITAA 1997

This paper addresses the following questions:

- Who can claim for the tax-related expenses of a subsidiary member in regard to its pre-consolidation tax affairs (such as expenses relating to objecting to a pre-consolidation assessment or an audit of the pre-consolidation period)?
- Does a subsidiary member continue to have its own tax affairs after consolidation, separate from those of the head company?
- Can the head company deduct the amount calculated as interest payable on a debit amendment to the subsidiary entity? Does it need to include overpayments under section 15-35 as assessable income?
- Can the head company claim a deduction for a penalty payable by the subsidiary under the GST Act given that the subsidiary is responsible for its own GST obligations?

Subsidiaries are part of the head company

Under the single entity rule, the subsidiary members of a consolidated group are taken to be parts of the head company, for the head company and entity core purposes – i.e. working out the income tax liability of the head company.

Section 25-5 of the ITAA 1997 (dealing with tax-related expenses) relates to working out the income tax liability of the taxpayer (in this case the head company), therefore it is covered by the core purposes.

When looking at a provision of the income tax law to determine the income tax liability of the head company, the provision must be read as if the subsidiary members of the group are parts of the head company rather than separate entities.

Paragraph 2.26 of the Explanatory Memorandum to the first consolidation Bill supports this by indicating that under the single entity rule the head company is taken to have entered into the transactions of the subsidiary members.

Thus, subsection 25-5(1) may be read as follows:

> You [the Head company] can deduct expenditure you [or what is treated as a part of you under the consolidation regime] incur to the extent that it is for:
>
> **(a)** managing your *tax affairs [or those of a part of you]; or
>
> **(b)** complying with an obligation imposed on you [or a part of you] by a *Commonwealth law, insofar as that obligation relates to the *tax affairs of an entity; or
>
> **(c)** the *general interest charge under Division 1 of Part IIA of the *Taxation Administration Act 1953*; or
>
> **(ca)** a penalty under Subdivision 162-D of the *GST Act; or
>
> **(d)** obtaining a valuation in accordance with section 30-212 or 31-15.

Note that, while this section of the *Consolidation reference manual* mainly addresses expenses relating to 'tax affairs' (see paragraphs (a) and (b) above), the same principles apply to the other tax-related expenses covered by subsection 25-5(1) – i.e. under paragraphs (c), (ca) and (d).

Tax affairs

Under paragraphs 25-5(1)(a) and (b) an entity can deduct expenditure incurred in managing its tax affairs or complying with an obligation imposed under a Commonwealth law relating to its tax affairs. The expenditure may relate to a past, present or future year of income of the entity. The single entity rule in conjunction with the entry history rule in section 701-1(5) means that the subsidiary members are treated as parts of the head company and that the head company inherits as history everything that happened to the subsidiary. This includes the tax history of the subsidiary.

Under section 721-15 the members of a consolidated group have joint and several liability for the group's income tax liability. That liability can be modified if there is a tax sharing arrangement under section 721-25 in place.

The head company is responsible for any tax liability accrued by itself before formation. A subsidiary member is responsible for its income tax liability for any period when it is not a subsidiary member.

If a subsidiary member contests an assessment for a pre-consolidation period, expenses will be incurred relating to income tax assessed to the subsidiary for a period before it joined the consolidated group.

When these expenses are incurred, the only entity that is recognised for income tax purposes is the head company. Under the entry history rule (section 701-5), the tax affairs of the subsidiary member before joining the consolidated group become those of the head company. This does not mean that the head company is responsible for the subsidiary member's pre-consolidation tax liability; rather that expenditure incurred after the joining time in relation to the subsidiary member's pre-consolidation tax affairs will be deductible to the head company under section 25-5. This outcome is consistent with TD 2003/10 and TD 2003/11, which suggest that after consolidation the 'tax affairs' of the subsidiary members become part of the head company's tax affairs.

Example 1

Sub 1 has a long standing appeal to the High Court relating to an assessment of income for the year ending 30 June 2000. Sub 1 becomes a subsidiary member of a consolidated group on 1 July 2002. It pays legal fees of $45,000 during the year ending 30 June 2004.

The issue of whether the amount is deductible under subsection 25-5(1) goes to the calculation of the head company's income tax liability and therefore relates to the head company core purposes. Under the entry history rule the pre-consolidation tax affairs of the subsidiary member are taken to be the tax affairs of the head company.

While the subsidiary remains liable for the basic tax liability related to the assessment, the head company may deduct, under subsection 25-5(1) of the ITAA 1997, expenses incurred in contesting the assessment.

Example 2

A joining entity needs to lodge its own return for the period up to consolidation. The expense will generally be incurred while it is a subsidiary member.

Who can claim the cost of preparing the return?

The head company may claim expenses incurred in preparing the return.

The general interest charge

Subsection 25-5(3) allows you to deduct expenditure you incur to the extent that it is for the general interest charge (GIC) under Division 1 of Part IIA of the Taxation Administration Act (TAA). Subsections 8AAB(4) and (5) of the TAA give an index of provisions within the ITAA and other Acts under which the GIC can be imposed. Many of these provisions relate to withholding.

As with expenses relating to a subsidiary's tax affairs, GIC applied in relation to a subsidiary member's pre-consolidation periods is generally deductible by the head company.

Example:

After a group consolidates on 1 July 2002 a subsidiary member receives for its 2001 year return a debit amendment, which incurs a GIC under section 170AA of the ITAA 1936.

Subsection 25-5(3) relates to working out the income tax liability of a taxpayer, i.e. the head company. In applying this subsection to the head company of a consolidated group, the subsidiary members are parts of the head company (section 701-1); therefore, an expense of a subsidiary member is an expense of a part of the head company. The GIC imposed under section 170AA is an allowable deduction to the head company.

Other matters

- Penalties imposed on a subsidiary under subdivision 162-D of the GST Act are allowable deductions to the head company.
- Expenses for valuations required for gifts and conservation covenants incurred post-consolidation for deductions claimed by a subsidiary member during a pre-consolidation period are allowable deductions to the head company.
- Interest on overpayments payable by the Tax Office under section 15-35 which relate to a subsidiary's pre-consolidation period are to be included as assessable income of the head company.

References

Income Tax Assessment Act 1997, sections 13-35, 25-5, 30-212, 31-15

Taxation Administration Act 1953, Division 1 of Part IIA

A New Tax System (Goods and Services Tax) Act 1999, Subdivision 162-D

New Business Tax System (Consolidation) Act 2002 (No. 68 of 2002)

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002

Taxation Determinations TD 2003/10 and TD 2003/11

Revision history

Section C9-1-130 first published 5 April 2004.

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).