Application of Part IVA to elections to consolidate

Introduction

The *Income Tax Assessment Act 1997* has been amended to provide for certain companies, trusts and partnerships in a group to be taxed as if they were one taxpayer. The opportunity to be taxed as one taxpayer (in technical language, 'to consolidate') is a 'choice' offered by the Act to the head entity of a group of companies, trusts and partnerships; and in many circumstances exercising the choice results in taxation that is less in comparison with the tax payable by the separate members of a group if the choice is not exercised.

Many taxpayers are at present re-organising their affairs with a view to exercising the choice to consolidate.

The Commissioner of Taxation has been asked to provide his opinion on when the general anti-avoidance provisions of the *Income Tax Assessment Act 1936*, that is, Part IVA of that Act, will or may apply to schemes involving such re-organisations. If Part IVA applies to a scheme, the Commissioner is empowered, but not compelled, to make a determination to cancel a tax benefit obtained in connection with it.

The purpose of this paper is to provide guidance to taxpayers and tax practitioners on the application of Part IVA. The paper will be updated from time to time as needed.

Section 177C(2)

Subsection 177C(2) provides that a tax benefit is not obtained by a taxpayer in connection with a scheme if it is—

> "… attributable to the making of an agreement, choice, declaration, election or selection, the giving of a notice or the exercise of an option (expressly provided for by this Act … or the *Income Tax Assessment Act 1997* [with certain exceptions]) by any person …"

provided—

> "the scheme was not entered into or carried out by any person for the [sole or dominant] purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised, as the case may be".

Except in the case of certain CGT rollovers, this exclusion applies to schemes that are more broadly defined than merely making the election[1]. The decision

[1] Subsection (2A) excludes tax benefits obtained from certain CGT elections from the operation of Part IVA only if the scheme consists of the election and nothing more. Thus for CGT even the limited choice principle available for revenue elections is excluded.

to consolidate is a 'choice' within the meaning of subsection 177C(2)[2]. Therefore tax benefits attributable to the choice to consolidate are not tax benefits as defined (unless the relevant subparagraph (ii) of subsection 177C(2) is applicable).

'Attributable'

When is a tax benefit "attributable" to an election? 'Attributable' simply means 'capable of being attributed', and 'attribute', in the relevant sense, means "to ascribe as an effect to a cause"[3]. The Act therefore asks whether the tax benefit is to be ascribed to the election, rather than to something else. If it is appropriate to ascribe the tax benefit to something other than the election, subsection 177C(2) has no application. The question will ordinarily be one of fact. But much will depend on the nature of the election. When, for example, an amount is excluded from the assessable income of a taxpayer, or an allowable deduction is allowed to a taxpayer, directly by making an election to exclude that income or obtain that deduction, it will be self-evident that the tax benefit is attributable to the making of the election. The election will be the direct cause of the tax benefit.

However, the choice to consolidate is not of that type. It is an unusual election. First, it is made only by the head company. Second, it applies not only to the members of the group at the time it is made, but to members joining the group after it is made. And third, and most important, its direct effect is only to render certain statutory fictions applicable to the members of the group (in order to tax the members of the group as if they were one taxpayer, namely, the head company). The tax effects of choosing to consolidate flow from the application of those statutory fictions. The statutory fictions affect the application of almost every substantive provision of the Act so far as they relate to taxpayers to whom the choice to consolidate applies.

When an election to consolidate is made, the effect of these fictions is, among other things, that the head entity is taken to have the allowable deductions that but for the election would be deductions of the members of the group, and to incur the capital losses of its subsidiaries; similarly, the subsidiaries cease to derive their assessable income, for it is taken to be derived by the head entity. Thus each subsidiary ceases to have income included in its assessable income, and each head entity is allowed deductions or taken to incur capital losses that but for the election it would not be allowed or be taken to have incurred.

The omission of an amount from the assessable income of a member (and its derivation by the head company), and the incurring of an allowable deduction by the head company (instead of the member) are in themselves obviously to be attributed to the election to consolidate. The choice to consolidate is the

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[2] See section 703-50 of the *Income Tax Assessment Act 1997*: "A company may make a choice in the approved form … that the consolidatable group is taken to be consolidated … if the company was the head company of the group …"

[3] Shorter Oxford Dictionary, 2nd Edition.

direct cause of these effects of the statutory fictions. These effects would otherwise be tax benefits within the meaning of subsection 177C(1). However, by reason of subsection 177C(2), the Part is prevented from applying unless subpara.177C(2)(a)(ii), and its equivalents for each tax benefit, applies.

Not all tax benefits affected by the consolidation rules will be attributable to the choice to consolidate in the relevant sense. The effect of the choice to consolidate may have a merely incidental connection with obtaining a tax benefit. Thus, a member of a group might enter into a scheme to obtain an allowable deduction that, but for consolidation would be allowable to it. The scheme might be defined to include, all the steps giving rise to the allowable deduction under the substantive law, but not the election to consolidate. In the same way, a member might carry out a scheme that resulted in an amount being omitted from what but for consolidation would be its assessable income. In these cases, the effect of the election to consolidate is merely, in the first case, that the head company obtains the deduction, rather than the subsidiary, and in the second case, that it is the head company's assessable income that is reduced by the scheme, rather than the subsidiary's. In these two cases the tax benefit arises from the scheme, not from the election to consolidate. The election to consolidate is merely incidental to the obtaining of the tax benefit; the tax benefit is not therefore 'attributable' to the choice the taxpayer has made. Thus, subsection 177C(2) does not operate to prevent Part IVA from applying to the scheme.

Consolidation also contains other elections, such as those relating to the 'available fraction' (losses) and to working out the cost of assets (relevant to capital allowance deductions and CGT). These may have a direct effect on deductions, and, insofar as they affect the calculation of future capital gains, an indirect effect on assessable income. Again, since these effects will amount to tax benefits that are normally directly attributable to the election, subsection 177C(2) will prevent the Part from applying unless subpara.177C(2)(b)(ii) applies. Likewise, however, s.177C(2) will not prevent the Part from applying to those cases where the cause of the tax benefit is not the election, but a separate scheme.

Subparagraph (ii)

In those cases where the tax benefit obtained from a scheme is attributable to an election to consolidate, or one of the other elections, the application of Part IVA will depend on whether subparagraph (ii) in the relevant paragraph of subsection 177C(2) applies. The subparagraph applies where the scheme is entered into or carried out for the purpose of enabling the election to be made. The test of purpose is expressed in words affected by subsection 177A(5), and therefore 'the purpose' to which it refers means the sole or dominant purpose of the scheme.

In the Commissioner's view, if a scheme is found to have a dominant purpose of enabling an election to be made, then for the purposes of subparagraph (ii), it is still necessary to undertake the analysis required by s.177D to see if the scheme was entered into or carried out for the dominant purpose of obtaining

the tax benefit. (There is no contradiction is saying that a scheme may be solely or dominantly entered into to enable an election to be made, and also solely or dominantly entered into or carried out to obtain a tax benefit, provided the election itself is made solely or dominantly to obtain a tax benefit: as, indeed, one would generally expect to be the case.)

What circumstances or state of affairs is necessary to enable a choice to consolidate to be made?

Subsection 703-50(1) provides that:

> A company may make a choice in the *approved form[4] given to the Commissioner within the period described in subsection (3)[5] that a consolidatable group is taken to be consolidated on and after a day that is specified in the choice and is after 30 June 2002, if the company was the *head company of the group on the day specified.

Put briefly, a head company is a resident, taxable company that is not a wholly-owned subsidiary of another resident, taxable company; while a consolidatable group consists of the head company and at least one wholly-owned, resident, taxable subsidiary of the head company. A company is a wholly-owned subsidiary of a head company if all the membership interests in it are beneficially owned by the head company or its other wholly-owned subsidiaries[6].

Broadly speaking, then, the circumstances to which subparagraph (ii) might apply are causing a company to be the beneficial owner of all the shares in at least one other company on a particular day, and for its own shares not to be wholly owned beneficially by another resident company on that date.

There is a distinction to be made between the circumstances necessary for an election to be made, and circumstances that extend or contract its effect. An election may be made if there is a head company in relation to at least one subsidiary, but the existence of more than one subsidiary is not necessary for an election to consolidate to be made. Hence, if a company is already a head company in relation to a consolidatable group and thus in a position to choose to consolidate that group, a scheme that merely increases (or diminishes) the number of subsidiaries in the group affected by the election to consolidate, does not seem to be one that could be entered into for the purpose of enabling the election to be made. (Insofar as a tax benefit is obtained by a taxpayer in connection with such a scheme, it may not be a tax benefit attributable to the election.)

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[4] See s.388-50 of the schedule to the Taxation Administration Act 1953 for definition. In essence, it is a declaration plus such information as the Commissioner requires.

[5] Between the specified date in the choice and the date for lodging a return for the first income year ending after the specified day.

[6] See s.703-30. Some shares are disregarded; non-share equity is also disregarded.

On the other hand, a scheme to turn a subsidiary into a head company and thereby enable it to make a choice to consolidate would go to the power to choose to consolidate. If reorganisations are made solely or dominantly to allow particular companies to become head companies that would not otherwise be head companies in respect of the group so that that particular company can make the choice for which s.703-50 provides, rather than another company, subpara (ii) will operate to ensure that there is a tax benefit under s.177C; Part IVA may then apply. All the head company's tax deductions are tax benefits, and all the amounts of assessable income its subsidiaries no longer derive are also tax benefits. (Note that subsection 170C(2) is not confined to tax benefits obtained by the taxpayer's *own* election[7].) Similarly, schemes to split a consolidatable group into a number of such groups to enable a number of new head companies to choose to consolidate their groups might be schemes to which Part IVA would apply, if the necessary purpose is present. Likewise, a company that had no subsidiaries at all, and that acquired a subsidiary dominantly to enable it to make an election to consolidate, or which arranged for itself to be acquired by a head company to enable that head company to make an election to consolidate, might have entered into and carried out a scheme to which Part IVA could apply, since these schemes bring into existence the state of affairs which must exist for the choice to be available.

It is then a question, in each of these cases, of whether there was some other purpose for the re-organization than enabling the taxpayers to obtain tax benefits. That question must be answered by reference to s.177D. That is, does the re-organization show, on its face, by reference to the manner in which it was conducted, its form and substance, its effects, and so on, that it was undertaken in that particular way to obtain those tax benefits?

Some general observations about re-organizations

The scenarios provided hereunder furnish concrete examples of what is, and is not, likely to be caught by s.177D in this way. But certain general observations are apposite.

First, in those situations where the relevant scheme includes the making of an election to consolidate the result that is achieved by the scheme in relation to the Act with respect to the head company must be compared with the result that would, but for the scheme, ensue for the separate, or differently consolidated, companies. There would not necessarily be a difference. It follows that, in itself, no great weight attaches merely to the consequence that a re-organization permits consolidation. Likewise no great weight attaches to the mere prospect, at no particular point in time, of future tax benefits of no particular character or amount flowing from consolidation. (In both cases, however, the words 'merely' and 'mere' are to be emphasised.)

Second, a re-organization of a company group may produce efficiencies, savings and conveniences, some unrelated to tax, others related to ease and cost of complying with tax laws. The achievement of efficiencies in tax

[7] Subsection 177C(2) refers to tax benefits obtained by the taxpayer attributable to an election exercised by any person.

compliance is an object of the consolidation legislation[8]. The re-organization of a company group that exhibits a purpose of permitting an election to consolidate may still be explicable by purposes other than the purpose of obtaining tax benefits.

Third, if, however, there is a conjunction of contrivance of manner in the way in which the re-organization is effected, a consequent distinction of form and substance, and a substantial tax benefit immediately in view that is not outweighed or offset by corresponding tax detriments, or by commercial advantages that could only be achieved in that particular way, then most likely Part IVA applies to the scheme.

Fourth, in particular, the distinction of form and substance is likely to be illuminating where the election to consolidate is in issue. Consolidation is legislation that puts substance before form. The premise of consolidation is this: where there is an identity of interest between companies, partnerships and trusts (as there is, when they are all owned by the same persons) there is in substance only one taxpayer, which should only be taxed once on its economic gains and benefit once only from economic losses—economic gains and losses being the gains and losses in substance, not form. The substance of the relationship between two companies is therefore a good indicator of whether the companies should, or should not, be consolidated. If there is a lack of identity of interest in companies in substance, bringing about the circumstances that enable the head company to choose to consolidate those companies may be a scheme to which Part IVA applies. If there is an identity in substance between two entities, failure to consolidate may be the outcome of a scheme to which Part IVA applies[9]. Similarly, the rules for attributing cost to assets held by a consolidated group on the basis of the costs of shares in the members are framed on the premise that in substance one is attributable to the other. Where, then, a scheme seems by its manner to be framed to attribute a value to assets that is substantially at variance with the genuine value of that asset, then that result may amount to an abuse of the Act.

Cancellation of a tax benefit

When Part IVA applies to a scheme, the Commissioner must determine, under s.177F, to cancel the tax benefits obtained in connexion with it for the Part to take effect. Although s.177F confers a discretion on the Commissioner, it is not essentially a discretion whether to apply Part IVA, but how to apply it. As the explanatory memorandum says:

> "The essential function of section 177F is to enable the Commissioner of Taxation, against the background of the other sections mentioned, to determine precisely what tax adjustments should be made in the assessments of the taxpayer concerned and of other taxpayers affected by the scheme. Sub-section (1) effectively calls on the Commissioner to make a formal determination as to how much of the amount of the identified tax benefit is to be cancelled and directs him, where he has made such a

[8] Section 700-10(c).

[9] The "all in principle" of consolidation.

determination, to take such assessing and other action as he considers necessary to give effect to it."

It is a peculiar feature of the election to consolidate that it can result in tax benefits consisting of the entirety of allowable deductions or assessable income of consolidated taxpayers. The Commissioner has power under s.177F to cancel all tax benefits obtained by taxpayers in connexion with the scheme, and not merely the tax benefit that it was the dominant purpose of some person to obtain. However, the Commissioner will generally apply Part IVA in such a way as to only remove the actual tax advantage obtained by the head company.

For example, when a company ('the loss company') has both assessable income and allowable deductions, and the allowable deductions exceed the assessable income, if an election to consolidate becomes applicable to it, the entirety of the allowable deductions of the company will be a tax benefit obtained by the head company (and the entirety of the assessable income becomes a tax benefit obtained by the loss company). The mischief of the scheme, and the actual tax advantage derived from it by the head company, was the excess of the allowable deductions over the assessable income of the loss company. It is this tax advantage that should be denied under s 177F where Part IVA has application in relation to the scheme.

One approach to achieving this outcome is to cancel the allowable deductions of the head company only to the extent of the actual tax advantage. Another approach is to disallow the whole of the tax benefit, and for the relevant taxpayer (in most instances the head company) to seek a compensatory adjustment under subsection 177F(3). Under this later approach it would still be necessary for the taxpayer to demonstrate that the adjustment was "fair and reasonable" in the circumstances. Arithmetically the consequence is the same taxable income under either approach.

Whether either of these methods is appropriate is essentially a question of fact. But the taxpayer who ventures into a scheme involving the election to consolidate takes the risk that the business of the relevant subsidiary company might be sunk in the affairs of the group so deeply that it is not possible to reliably identify the quantum of the actual tax advantage, especially for years subsequent to the scheme, with the result that the group is taxed on assessable income resulting from the scheme, but denied allowable deductions.

The following examples illustrate the Commissioner's approach to cancelling tax benefits.

Example 1

Assume:

- a parent company of a consolidatable group enters into a scheme to acquire a loss company as a wholly owned subsidiary and following acquisition of the company elects to consolidate;
- but for the application of Part IVA, the parent company as head company of the group would obtain a tax benefit from the scheme by virtue of the

operation of Part 3-90, namely access upon consolidation to the losses of the loss company; and

- the facts and circumstances of the acquisition are such as to show that the dominant purpose behind acquiring the loss company was a tax avoidance purpose;
- the loss company brings $100 worth of carry forward revenue losses into the consolidated group and the available fraction of the loss bundle is 0.5.

Variant 1

In its first income year, the head company of the consolidated group derives assessable income of $210, $40 of which was generated by the loss company. In this example, but for the application of Part IVA, the parent company has derived a tax benefit in connection with the scheme being the full amount of the revenue losses brought into the group by the loss company. However, but for the scheme the loss company would have been entitled to off set its $40 of income against $40 of its carry forward loss. The actual tax advantage to the head company is therefore not the full amount of the revenue loss. It is instead the net (that is, $60) revenue loss available to the head company to off set other assessable income derived by the head company in the relevant year. In respect of this first year the Commissioner would cancel this actual tax advantage rather than the full amount of the losses brought into the group by the loss company.

A Part IVA determination and amended assessment would issue to the parent company as head company of the consolidated group (being the relevant taxpayer).

Variant 2

As in variant 1, the head company of the consolidated group derives income of $210 in its first income year. If the objective facts are not sufficient to allow for a determination of the extent to which the income derived by the group has been generated by the loss company, the Commissioner would cancel the entire tax benefit obtained by the parent company as head company of the consolidated group in connection with the scheme, namely the full amount of the carry forward losses brought into the consolidated group by the loss company. A Part IVA determination and amended assessment would issue to the parent company as head company of the consolidated group (being the relevant taxpayer). The Commissioner would consider making compensating adjustments under subsection 177F(3) of the *Income Tax Assessment Act 1936* where the taxpayer is able to demonstrate a fair and reasonable basis for such an adjustment.

Variant 3

In its first income year the head company of the consolidated group derives $80 worth of income, all of which was generated by the loss company. Assume further that in its second income year, the parent company as head company of the consolidated group derives $40 worth of income, $10 of which was

generated by the loss company. The head company of the consolidated group has obtained a tax benefit from entering into the scheme in relation to its first income year (namely, as a result of the application of the loss fraction, $40 of carry forward loss is offset against the $80 of income). However, the head company has not obtained an actual tax advantage from the scheme. In the absence of the scheme the loss company would have been able, in the first year, to off set all of its assessable income against its carry forward loss. Since in the first year all of the assessable income of the consolidated group is generated by the loss company the Commissioner would not apply subsection 177F(1) in relation to the first income year.

However, in the second income year the head company of the consolidated group has obtained an actual tax advantage from entering into the scheme. In the absence of the scheme the loss company would have been able to off set $10 of the remaining $60 of carry forward loss against its $10 of assessable income. However, as a result of the scheme the head entity is able to off set more than that $10 against its assessable income (namely $20). The Commissioner would cancel the amount by which the carry forward loss deduction available to the head company in the second year exceeds $10. To this end, a Part IVA determination and amended assessment would issue to the head company, the relevant taxpayer.

In future years the head company would continue to have access to the remaining amount, if any, of the carry forward loss brought into the group by the loss company (for example, $50 in the third year). However, if in any future income year some or all of that loss was offset against an amount of assessable income greater than the amount of the assessable income derived by the head entity in that year as a direct consequence of the loss company being a member of the group, then the excess amount of the deduction allowed would be cancelled as a tax benefit.

Example 2

Assume:

- a non-resident parent company wholly owning an Australian corporate group enters into a scheme to interpose a company (Interposed Co) between it and the Australian resident head of the corporate group;
- Interposed Co elects to consolidate;
- but for the application of Part IVA, Interposed Co would, as a result of the scheme, be entitled to $20 more of deductions for depreciation than would have been available to the group but for the scheme. This greater entitlement to deductions results from a resetting of the tax cost of the group's assets following consolidation;
- the facts and circumstances of the acquisition are such as to show that the dominant purpose behind the introduction of Interposed Co into the corporate group was a tax avoidance purpose.

In this example, but for the application of Part IVA, the full amount of deductions (including deductions for depreciation) which accrue to Interposed Co is a tax benefit obtained in connection with the scheme. In the absence of

the scheme, Interposed Co would have had no entitlement to any of these deductions. Consequently, the tax benefit is the full amount of the deductions allowable to Interposed Co. However, the Commissioner will not cancel the entire tax benefit obtained in connection with the scheme. The Commissioner will, rather, only cancel the actual tax advantage arising to the group in connection with the scheme (most obviously, the increased entitlement to a deduction for depreciation).

Scenarios

Index to scenarios

In Summary:

- Scenarios 1-4 involve the interposition of an entity resulting in the formation of a consolidatable group;
- Scenario 5 involves the leaving out of an entity from a consolidatable group prior to the group consolidating;
- Scenario 6 involves the shifting of value out of a consolidatable group prior to consolidation;
- Scenarios 7-11 involve the disposal of an interest in a group company prior to the group consolidating;
- Scenario 12 involves the post-consolidation dissolution of a company;
- Scenarios 13-17 involve the purchase of a minority interest in a group company prior to consolidation;
- Scenario 18 involves the use by a consolidatable group of a special purpose vehicle to issue preference shares to unrelated investors while maintaining 100% ownership of its subsidiaries;
- Scenario 19 involves the use by a consolidatable group of non-share equity interests to maintain economic control over a related entity.

Relevant policy issues and legislative design principles

In considering the following scenarios it is useful to recall the following policy issues and legislative design principles of consolidation:

- At its highest level, the policy intent of the consolidation regime is reflected in section 700-10 of the *Income Tax Assessment Act 1997*. The consolidation regime seeks to benefit corporate groups through the removal of the double taxation of gains, reducing compliance costs and improving business efficiency. Consolidation also seeks to improve the integrity of the taxation of corporate groups, including through the removal of loss duplication and by ignoring intra-group transactions;
- Consolidation is optional, but once a choice to consolidate has been made by a head company, that choice is irrevocable;
- A consolidatable group cannot consist of a single company, but once a choice has been made by the head company of a consolidatable group to consolidate, subsequent changes to the group structure can result in the consolidated group consisting of a single entity member (see para 3.9 of the EM to the May 2002 Bill);

- A consolidatable group consists of a head company and all the head company's resident wholly-owned subsidiaries. A subsidiary member of a consolidatable group does not have an option not to be part of a consolidated group if the head company chooses to consolidate (the 'all in principle' – see paras 3.4 and 3.16 of the EM to the May 2002 Bill);
- In determining whether a company is a wholly owned subsidiary, regard is only had to the 'share' interests issued in that company, and debt interests are to be ignored (see para 3.6 of the EM to the May 2002 Bill). The debt/equity rules in Div 974 of the *Income Tax Assessment Act 1997* are used as a basis for identifying debt interests;
- Entry into the consolidation regime is restricted to resident Australian companies and is generally restricted to groups who have a resident holding company at the top of their structure (see para 3.4 of the EM to the New Business Tax System (Consolidation) Bill (No 1) 2002 ('the EM to the May 2002 Bill').

Policy context

Each of the scenarios includes a section that discusses the policy context that is considered relevant to the issues raised in that scenario. The discussion of policy is not intended to indicate the operation of Part IVA is determined by reference to the policy underlying a particular provision. It simply indicates that such underlying policy is part of the contextual matrix that should be considered when analyzing the potential operation of Part IVA.

Disclaimer

The application of Part IVA of the ITAA 1936 depends on a careful weighing of all the relevant circumstances of each case, and the relative weight that should be attached to each of those circumstances. The purpose of one or more of the participants in any particular arrangement is to be determined having regard the matters listed in section 177D of the ITAA 1936. Therefore, in the absence of all relevant information it is not possible to state definitively whether a particular transaction will attract the operation of Part IVA.

The scenarios do not constitute a public ruling, and are in no sense binding upon the Commissioner.

For the purposes of each of the scenarios it is assumed that the arrangements are effective under the ordinary income tax provisions. However this may not be the case in any actual arrangement. Further, no attempt has been made to discuss the impact of other provisions of the tax law which may have application in relation to the scenarios described below (for example, the value shifting provisions). Taxpayers seriously contemplating entering into a particular arrangement who wish to obtain more formal advice regarding:

- whether Part IVA has application in relation to the arrangement; and/or
- the application of other specific provisions;

may wish to approach the ATO or their professional adviser.

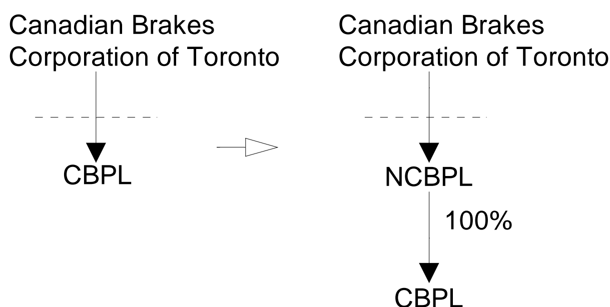
Scenario 1: Interposition of a company to form a consolidatable group

Canadian Brakes Pty Ltd (CBPL) is the only Australian subsidiary of the Canadian Brakes Corporation of Toronto as at 13 December 2002. At that date, CBPL has on its books depreciating assets such as plant and equipment (with a written down value of $200 million) and intangibles (with a written down value of $300 million). A proportion of the plant and equipment on CBPL's books was acquired prior to 21 September 1999 and was being depreciated by CBPL at accelerated rates.

CBPL has a tax year-end of 31 December 2002 and claimed $40m as a depreciation expense in its tax accounts for that year.

The group gets a briefing[10] on 13 December 2002 from its accountants on the new consolidation regime and in particular the tax cost-setting rules. The Canadian parent decides to form a consolidated group by inserting a resident company to be called New Canadian Brakes Pty Ltd (NCBPL) as the new entry point into Australia. To achieve this result, the Canadian parent first incorporates a new Australian subsidiary, NCBPL. The Canadian parent then rolls over its shareholding in CBPL to NCBPL in exchange for all of the shares in NCBPL.

The following diagram illustrates the company group structure both before and after the restructuring:



NCBPL notifies the ATO on 5 February 2003 that it is a head company and has formed a consolidated group as at 1 January 2003 with one wholly-owned subsidiary member, namely CBPL.

NCBPL chooses not to apply the consolidation regime's transitional rules regarding the setting of cost. On this basis the cost setting rules operate to reset the tax cost of CBPL's assets on entry into the consolidated group. NCBPL further chooses to reset the tax cost of the assets CBPL has previously

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[10] As was noted by the High Court in FC of T v Consolidated Press Holdings Ltd & Ors; CPH Property Pty Ltd v FC of T 'it is expected that those who participate in a complex, international, commercial transaction will be concerned about its tax implications, and will seek expert advice … In some cases the actual parties to a scheme subjectively may not have any purpose, independent of that of a professional advisor in relation to the scheme … but that does not defeat the operation of s 177D'.

been depreciating at accelerated rates and commence depreciating the assets at a rate calculated in accordance with Division 40 of the *Income Tax Assessment Act 1997* rather than continue to depreciate the assets at accelerated rates. After applying the Allocable Cost Amount (ACA) method of resetting the tax cost of assets, CBPL brings into the consolidated group depreciable assets, the tax costs of which have been reset to $400m and intangibles the tax costs of which have been reset to $100m. It has done this by allocating the ACA on the basis of the market valuation of its assets as at 1 January 2003.

Given this resetting of the assets' tax costs, NCBPL as head company of the consolidated group claims, in the year ended 31 December 2003, in relation to the assets CBPL brings into the group, a deduction for depreciation which is several million dollars more than would have been available to CBPL had it not become a member of a consolidated group. This is the result even though a deduction for depreciation available to NCBPL on some individual assets in the year ended 31 December 2003 (in particular, some of those assets that had previously been depreciated at accelerated rates) is less than the corresponding deduction that would have been available to CBPL had it continued to hold the assets.

The increase in depreciation has come about simply by the insertion of a new head company, by applying the ACA method to reset tax costs and by allocating the ACA on the basis of market values.

It is assumed for the purposes of this scenario that the legal entity CBPL held its asset register stable from 1 January 2002 to 31 December 2003 and that it had relatively minor asset acquisitions and disposals over this two year period.

The scheme

For the purposes of section 177A of the ITAA 1936, the scheme could consist of the interposition of NCBPL between CBPL and the Canadian Brakes Corporation of Toronto followed by the choice by NCBPL to consolidate.

The tax benefit

By interposing NCBPL between CBPL and the Canadian Brakes Corporation of Toronto, a consolidatable group consisting of CBPL and NCBPL is created. Upon consolidation, NCBPL obtains an uplift on the tax costs in respect of the assets held by CBPL via the consolidation cost setting rules.

In these circumstances there are a number of tax benefits under paragraph 177C(1)(b), namely the full amount of all of the various types of deductions available to NCBPL. In the absence of the scheme, that is in the absence of the creation of a situation in which NCBPL could choose to consolidate, NCBPL would not have been entitled to any deductions.

However, the actual tax advantage obtained by NCBPL is simply the difference between the amount of depreciation deductions NCBPL is entitled to and the depreciation deductions that CBPL would have been entitled to but for the

scheme. It is this amount, if any, that the Commissioner would cancel under section 177F, and not the total amount of deductions available to NCBPL.

Purpose

On the basis of the limited information set out above one might conclude that the sole reason for the interposition of NCBPL was to obtain the benefit that would follow from formation of a consolidated group, in particular, the greater deductions compared to those that would have been available had CBPL not become a member of a consolidated group.[11]

Policy context

In the absence of the interposition of NCBPL, CBPL would not be able to take advantage of the consolidation measures as, but for the scheme, there is no wholly owned Australian resident group. Further, the way in which NCBPL has been put into a position to be able to elect to consolidate and thus the manner in which it has obtained the tax benefits, is such as to show on its face a tax avoidance purpose as the prevailing reason for the interposition of NCBL. This points towards Part IVA having application. The interposition of NCBPL between CBPL and the foreign parent company solely in order to bring into existence an Australian resident group, and thereby obtain an immediate tax benefit, is inconsistent with the policy behind the consolidation regime.

Scenario 2: Interposition of a company to form a new head company of a consolidatable group

As at 13 December 2002 Australia Engines Sub Pty Ltd (AESPL) is an Australian subsidiary of Australian Engines Pty Ltd (AEPL), an Australian resident company, which in turn is a subsidiary of the US Engines Corporation of Ohio.

The group gets a briefing on 13 December 2002 from its accountants on the new consolidation regime and in particular the cost-setting rules. The accountants recommended that, prior to consolidation, a resident company be interposed between AEPL and the US Engines Corporation of Ohio. The US parent acts on this advice and incorporates a new Australian subsidiary, Head Co, and then rolls over its shareholding in AEPL to Head Co in exchange for the issuing of shares in Head Co. Head Co has no assets apart from the shares it owns in AEPL and carries on no business in its own right. The group consisting of Head Co, AEPL and AESPL subsequently consolidate.

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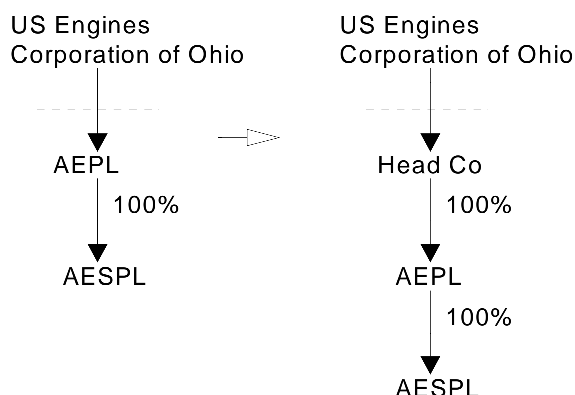
[11] A different result may follow had the facts of the scenario been altered such that the deductions for depreciation which NCBPL as head company of the consolidated group is entitled to are less in the first few years after consolidation (for example as the result of the loss of accelerated depreciation) than the deductions CBPL would have been entitled to but for the scheme, but are more in later years than the corresponding deductions CBPL would have been entitled to but for the scheme. In this variant, the net present value of the increased deductions may be such as to point towards Part IVA not having application.

The following diagram illustrates the company group structure both before and after the restructuring:



Head Co chooses not to apply the consolidation regime's transitional rules regarding the setting of cost. On this basis, the cost setting rules operate to reset the tax costs of AEPL's (and AESPL's) assets on entry into the consolidated group. Given this resetting of the assets' tax costs, in the year ended 31 December 2003, Head Co claims $70m in depreciation deductions. If Head Co had not been interposed between US Engines Corporation of Ohio and AEPL, and the group consisting solely of AEPL and AESPL had chosen to consolidate, AEPL, as the head company of this alternative consolidated group, would have been entitled to only $40m in depreciation deductions in relation to the assets it brought into the group. This follows because the head company of a consolidated group brings its assets into the group at their existing value: the head company of a consolidated group cannot reset the tax costs of its own assets.

The scheme

For the purposes of section 177A of the ITAA 1936, the scheme could consist of the interposition of Head Co between AEPL and the American Parent company.

The tax benefit

By interposing Head Co between AEPL and the American parent, a consolidatable group consisting of Head Co, AEPL and AESPL has been created. In the absence of the scheme it seems reasonable to assume that AEPL, as the potential head company of the consolidatable group comprising AEPL and AESPL, would have chosen to consolidate that consolidatable group. Consequently, in the absence of the scheme, Head Co would not have been entitled to any deductions. In these circumstances, there are a number of tax benefits, namely the full amount of all the various types of deductions otherwise allowable to Head Co, and not simply the difference between the deductions that Head Co was entitled to and what AEPL would have been

entitled to if it was the head company of the consolidated group consisting of AEPL and AESPL.[12]

However, the actual tax advantage obtained by Head Co is simply the difference between the amount of depreciation deductions Head Co is entitled to and the amount of depreciation deductions that AEPL would have been entitled to had it been the head company of a consolidated group comprising itself and AESPL. It is this amount, if any, that the Commissioner would cancel under section 177F.

Purpose

On the basis of the limited information set out above, one might conclude that the sole reason for the interposition of Head Company was to obtain the benefit that would follow from formation of a consolidated group having a company other than AEPL as its head, in particular, the greater deductions than would have been available had the group consisting solely of AEPL and AESPL consolidated.

Policy context

In the absence of the interposition of Head Co, any choice to consolidate AEPL and AESPL would result in AEPL, as the head company of the consolidated group, having to bring its assets into the group at their existing value. It is a design feature of the asset model underpinning the consolidation measure that head companies retain existing values for their assets (see, for example, paragraph 1.13 of the EM to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002). In this situation AEPL would not, but for the scheme, have been entitled to the benefit of the cost setting rules, and would not have been the beneficiary of the increase in its own assets' tax values. These considerations point towards the application of Part IVA.

Scenario 3: Interposition of a head company to form a consolidatable group

Australian Gears Pty Ltd (AGPL) is the only Australian subsidiary of the US Gears Corporation of Wisconsin as at 13 December 2002. AGPL carries on the business of the local manufacture, distribution and sale of gears, as well as the business of importing gears made overseas for sale in Australia. AGPL also has an arm which undertakes R&D activities into the design and engineering of gears. Recently AGPL further diversified its business setting up an arm which produces high quality watches using an innovative gear mechanism developed as a byproduct of the R&D activities. As at 13 December 2002, AGPL has significant depreciable assets.

[12] But for the scheme, Head Co would not have been entitled to any deductions.

AGPL has a tax year-end of 31 December 2002 and claimed $20m as a depreciation expense in its tax accounts for that year.

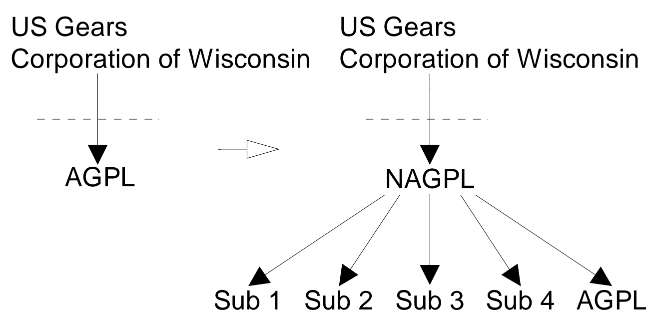
In a briefing the company's external tax advisers noted that increased deductions for depreciation, via the resetting of the tax costs of AGPL's assets, would arise from inserting a new head company to serve as the entry point into Australia.

The advisers also noted that such a restructuring provided an opportunity to split the various distinct business activities being undertaken by AGPL into separate subsidiaries, namely one subsidiary which carries on the business of manufacturing gears, another carrying on the business of distributing and selling the locally manufactured gears, a third carrying on the business of importing gears made overseas, a fourth to carry on the R&D activities of the group, and a fifth to carry on the business of manufacturing watches for sale. An objective financial analysis of this proposed restructure demonstrated that significant, non-tax, economic benefits would be achieved. In particular, the advisers emphasized that such a restructure would allow a greater focus on the management and improvement of each individual business. Finally, the advisers noted that the restructure would facilitate easy divestment of one or more of the businesses if in the future such a course of action were pursued.

The relevant board of director's minutes indicates that based on these briefings the decision was made to form a corporate group consisting of a new resident head company called New Australian Gears Pty Ltd (NAGPL) - the new entry point into Australia - with five wholly owned subsidiaries. Four of the subsidiaries are newly created companies. The fifth subsidiary is AGPL. At the end of the restructure, AGPL carries on the sole business of manufacturing gears. The four other business activities previously carried on by AGPL are rolled over into the other four subsidiaries. NAGPL as a head company has no assets apart from the shares it owns in AGPL and the other four subsidiaries and carries on no business in its own right.

NAGPL notifies the ATO on 5 February 2003 that it is a head company and has formed a consolidated group as at 1 January 2003 with five wholly-owned subsidiary members.

The following diagram illustrates the company group structure both before and after the restructuring:



NAGPL chooses not to apply the consolidation regime's transitional rules relating to the setting of cost. On this basis, the cost setting rules operate to reset the tax costs of the assets of the subsidiaries on entry into the consolidated group. Given this resetting of asset tax costs, in the year ended 31 December 2003 NAGPL, as head company of the consolidated group, claims deductions for depreciation, relating only to the assets which were owned and used by AGPL prior to the corporate restructure, that are $70 million greater than would have been available to AGPL had it not entered a consolidated group.

The scheme

For the purposes of section 177A of the ITAA 1936, the scheme could consist of the interposition of NAGPL between AGPL and the US Gears Corporation of Wisconsin followed by the election by NAGPL to consolidate.

The tax benefit

By interposing NAGPL between AGPL and the US Gears Corporation of Wisconsin and rolling over assets previously owned by AGPL into newly created subsidiaries, a consolidatable group consisting of NAGPL and its five subsidiaries is created. Given the objective non-tax economic benefits that would be obtained by re-organizing the existing company into separate companies, each carrying on a different business, it is considered reasonable to assume that in the absence of the scheme some type of re-organization would still have occurred.

For example, the re-organization could have proceeded on the basis that AGPL transfers all the assets representing each of the businesses to separate newly incorporated companies and in consideration for that transfer receives all the shares in each of those new companies. In this way AGPL would become the head company of the new group, and would not itself carry on any business. Alternatively, AGPL could have retained the assets representing the business of manufacturing gears, and transferred all the other businesses to separate new companies. Under this approach AGPL would both become the consolidated group's head company, and carry on one of its businesses.

Under either of these approaches, but for the scheme, NAGPL would not have been entitled to any deductions, including the increased deductions for depreciation. Consequently, a number of tax benefits arise in respect of the deductions allowed to NAGPL namely the full amount of all of the various types of deductions otherwise allowable to NAGPL.[13]

However, the actual tax advantage obtained by NAGPL is simply the difference between the amount of the depreciation deductions NAGPL is entitled to and the amount of the depreciation deductions that AGPL would have been entitled to had it been the head company of a consolidated group. It

[13] But for the scheme NAGPL would not have been entitled to any deductions.

is this amount, if any, that the Commissioner would cancel under section 177F. As discussed above there are at least two possible restructures that would leave AGPL as the head company: one where AGPL is simply a holding company; and a second where AGPL is both a holding company and carries on an active business. In determining the amount of the actual tax advantage obtained by NAGPL it would be necessary to determine which of these two alternative restructures is the most likely. For the purposes of this scenario it is assumed that a restructure that leaves AGPL as a pure holding company better reflects the non-tax economic reasons for the creation of a multiple entity structure.

Purpose

On the basis of the information provided it is objectively difficult to conclude that NAGPL was interposed between AGPL and the American parent company solely or dominantly to obtain a tax benefit. AGPL as a company prior to the structure carried on five distinct business activities. The restructuring enabled this distinct business to be disaggregated and rolled over into separate companies with a number of economic and commercial advantages. A move from a divisional company structure to separate businesses is not, in isolation, something from which one can infer a tax avoidance purpose.

Policy context

Absent the interposition of NAGPL, AGPL would not be able to take advantage of the consolidation measure. This is because entry into consolidation is restricted to certain corporate *groups*. However NAGPL was not interposed between AGPL and the foreign parent company solely or dominantly in order to bring into being a consolidatable group and hence an immediate tax benefit in the nature of an increased entitlement to depreciation deductions. It appears that AGPL always intended to take advantage of consolidation to restructure with all the consequent non-tax economic benefits. This points towards the general anti-avoidance rules having no application.

Scenario 4: Interposition of a new entity and restructuring to form a consolidatable group

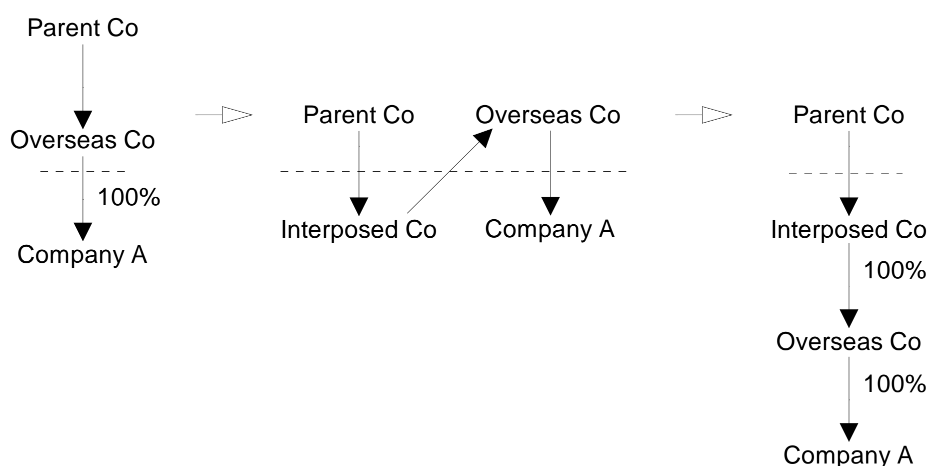
Company A, an Australian resident company, is a wholly owned subsidiary of a non-resident company (Overseas Co), which, in turn, is a wholly owned subsidiary of Parent Co, also a non-resident company. The assets of Company A are valued at $10m in its accounts. The market value of the assets is $100m. Parent Co acquires the shares in a newly incorporated Australian resident company, Interposed Co. The subscription for shares is satisfied by the issue by Parent Co of a promissory note in favour of Interposed Co with a face value of $100m. Immediately after issuing shares in its self to Parent Co, Interposed Co purchases Parent Co's shares in Overseas Co.[14] The purchase is

[14] Parent Co's shares in Overseas Co are not assets to which section 136-25 of the ITAA 1997 applies.

satisfied by Interposed Co endorsing the promissory note received from Parent Company in favour of Parent Co. This purchase makes Overseas Co a wholly owned subsidiary of Interposed Co. The interposed entity does not undertake any activities apart from issuing shares to Parent Co and purchasing, from Parent Co, Parent Co's shareholding in Overseas Co.

Through a change in residency, Overseas Co subsequently becomes an Australian resident company. The structure of the group after the change of residency is as follows: Company A is a wholly owned subsidiary of Overseas Co (now an Australian resident) which is a wholly owned subsidiary of Interposed Co (an Australian resident) which, in turn, is a wholly owned subsidiary of Parent Co (a non-resident).

The following diagram illustrates the company group structure both before and after the restructuring:



The group consisting of Interposed Co, Overseas Co and Company A consolidates allowing a 'pushdown' of the $100m paid by Interposed Co for the shares in Overseas Co. This results in the tax costs of the assets of Company A being reset in proportion to their market values. The depreciation deductions available to Interposed Co are calculated on the basis of these reset values. This results in Interposed Co being entitled to greater depreciation deductions than would have been available if the values had not been reset.

The scheme

For the purposes of section 177A, the scheme could consist of:

- the interposition of Interposed Co between Parent Co and Overseas Co;
- Overseas Co becoming an Australian resident company; and
- the election by Interposed Co to consolidate.

The tax benefit

In the absence of the scheme there was not a consolidatable group. By the interposition of Interposed Co between Parent Co and Overseas Co, and

Overseas Co becoming an Australian resident company, a consolidatable group is created. The creation of a consolidated group allows Interposed Co (the head company of the consolidated group) to obtain tax deductions that it would not have otherwise been entitled to. Consequently, a number of tax benefits arise, namely the full amount of all of the various types of deductions allowed to Interposed Co.[15]

However, the actual tax advantage obtained by Interposed Co is simply the difference between the amount of depreciation deductions Interposed Co is entitled to and the amount of depreciation deductions that company A would have been entitled to but for the scheme. It is this amount, if any, that the Commissioner would cancel under section 177F.

Purpose

The interposition of a company making use of round robin financing and the subsequent change of the residency of Overseas Co in such a way that the economic ownership of the group both before and after the restructuring is the same while the tax costs of the assets of Company A are reset yielding an immediate tax benefit indicates that the objective purpose of entering into the scheme was to obtain a tax benefit.

Policy context

As in Scenario 1, it is clear that absent the interposition of Interposed Co and the coming on shore of Overseas Co, Company A would not have been able to take advantage of the consolidation measure. This follows because, absent the scheme, the tax costs of the assets of Company A would not have been reset.[16] Accordingly, the entering into of what appears a contrived series of transactions designed to bring into being a consolidatable group, and hence create an immediate tax advantage in the nature of an increased entitlement to depreciation deductions, suggests the general anti-avoidance rules should have application.

[15] But for the scheme, Interposed Co would not have been entitled to any deductions.

[16] The consolidations legislation does contain rules which allow non-resident entities to be interposed between group members. These rules operate as a transitional measure. Assuming the conditions associated with these rules were met, a consolidatable group (consisting of Interposed Co and Company A) comes into existence even without Overseas Co becoming an Australian resident company. However, should Interposed Co elect to consolidate prior to Overseas Co coming on shore, the tax costs of Company A's assets would not be reset. This is as a consequence of the general rule that the tax costs of assets held in a transitional foreign held subsidiary cannot be reset (see paras 4.34 – 4.37 of the EM to the December Bill).

Scenario 5: Leaving out entities from a group prior to consolidation[17]

A non-resident parent company owns 100% of the shares in Company A which is a resident of Australia. Company A in turn has two wholly-owned subsidiaries Companies B and C, both of which are residents of Australia. The parent company asks its professional advisers for an analysis of all the costs and benefits of various consolidation scenarios.

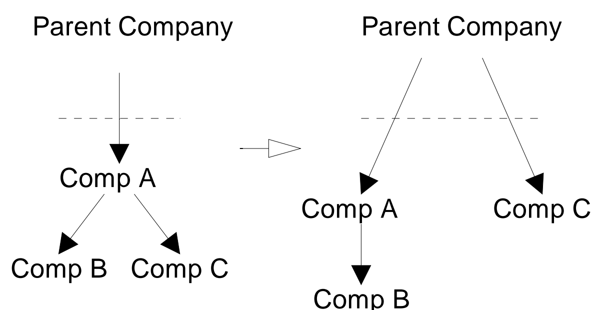
The professional advisers have provided a report that includes the following points.

- Company A has a modified market value of $10 and no losses.
- Company B has a modified market value of $100 and a loss of $100.
- Company C has a modified market value of $100 and no losses.
- If all three Australian resident companies form a consolidated group, the available fraction for Company B's loss is 100/210 = 0.476. The available fraction is the proportion that the loss entity's modified market value at the joining time bears to the adjusted market value of the group at that time. It is a proxy for determining the proportion of the group's income generated by the loss entity.
- However, if Company C is left outside the consolidated group, the available fraction will be 100/110 = 0.909.
- It is predicted that Company A and Company B will have between them sufficient assessable income in the first year of consolidation to benefit from the higher available fraction.
- Excluding Company C from the consolidated group will therefore allow the group to utilise the $100 loss at a faster rate than had Company C been part of the consolidated group.

The non-resident parent decides to only consolidate companies A and B. In order to give effect to this decision, the non-resident parent purchases all of the shares in Company C owned by Company A. The purchase price paid by the non-resident parent is equal to the CGT cost base of the shares owned by Company A ($10). CGT rollover relief is available and claimed under Division 126-B of the *Income Tax Assessment Act 1997*.

[17] For the purposes of this scenario, the available fractions are worked out on the basis that the value donor concession rules are not available. It is further assumed that section 707-325(2) does not have application; this may not be the case.

The following diagram illustrates the company group structure both before and after the restructuring:



After the restructuring is complete, Company A elects to consolidate. The available fraction in respect of Company B's loss bundle is 100/120 = 0.833. The difference between this available fraction and that calculated by the professional advisers arises from the fact that Company A has received $10 as consideration for the sale of the shares in company C, while the original calculation proceeded on the basis that there was no such consideration.

The scheme

For the purposes of section 177A, the scheme could consist of the purchase by the parent company of all the shares owned by Company A in Company C.

The tax benefit

As a result of the disposal by Company A of all of the shares it owns in Company C to the parent company, the available fraction in respect of Company B's loss bundle within the consolidated group consisting of Companies A and B is increased relative to what the available fraction would have been had Companies A, B and C consolidated. This increase in the available fraction means the losses brought into the group by Company B can be utilised at a faster rate than they could have been had Companies A, B and C consolidated. That is, Company A, as the head company of the consolidated group, is entitled in the first year after consolidation to a greater deduction than would have been the case but for the scheme. The tax benefit obtained by Company A is the difference between the amount of the loss deduction allowable in the first year to Company A and the amount of the loss deduction that it would have been entitled to in that year if the scheme had not occurred. It is this amount, if any, that the Commissioner would cancel under section 177F.[18]

[18] Company A also obtains an omitted income tax benefit from the scheme: but for the scheme, Company C would have been a subsidiary member of a consolidated group consisting of Companies A, B and C. That is, but for the scheme, the income generated by Company C would have been the assessable income of Company A as head company of the consolidated group. If the omitted income benefit is cancelled under section 177F, then Company A may be entitled to a compensating adjustment under section 177F(3) in respect of some or all of the

Purpose

No purpose other than the obtaining of a tax benefit suggests itself having regard to the terms of the scheme. Therefore, on the basis of the information provided, it is reasonable to conclude that the sole purpose of the restructuring was to enable the consolidated group to obtain greater allowable deductions through greater access to Company B's losses than would have been available had Companies A, B and C consolidated.

Policy context

It is a design feature of the consolidation measure that wholly owned Australian resident subsidiaries of a foreign resident company will not be prevented from forming a consolidated group where the foreign resident has more than one strand of investment into Australia. Moreover, each 'entry level' entity within each strand of investment is free to choose to group with other 'entry level' entities and form a multiple entry consolidated (MEC) group, form a consolidated group or remain unconsolidated (see paragraph 4.3 of the EM to the New Business Tax System (Consolidation) Bill (No 1) 2002). This approach was designed to meet the operational needs of certain foreign owned groups which operate their subsidiaries on an autonomous basis.

The present scenario does not present the case of a group which can, without restructuring, take advantage of these choices available to wholly owned Australian resident subsidiaries of a foreign resident company. Further, the facts of the present scenario point towards the restructuring having been undertaken solely in order for the group to avoid the consequences of the 'all in principle' and bring itself within the scope of the operation of the MEC rules with their attendant advantages.[19] From a policy position, this suggests that the general anti-avoidance rules should have application.

More generally, arrangements, including group restructures, entered into to manipulate available fractions or otherwise increase the rate of loss utilisation by a consolidated group are not consistent with the intended policy outcome. The potential application of Part IVA in these situations was referred to in paragraph 8.102 of the EM to the May 2002 Bill.

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deductions that would have been allowable to it but for the scheme (that is, but for Company C remaining outside the consolidated group).

[19] Note however that in being left out of the consolidated group, Company C misses out on the compliance benefits associated with grouping with Companies A and B and further forgoes the opportunity of having the cost of its assets reset.

Scenario 6: Shifting of value out of a consolidatable group prior to consolidation[20]

A non-resident parent company owns 100% of the shares in Company X which is a resident of Australia. Company X in turn has two wholly-owned subsidiaries Companies Y and Z, both of which are residents of Australia. Company X has a modified market value of $10 and no losses. Company Y has a modified market value of $100 and a tax loss of $100. Company Z has a modified market value of $100 and no tax losses.

Company Z declares a franked dividend of $70 in favour of Company X. Company X in turn declares a franked dividend of $70 in favour of the non-resident parent company.

Subsequent to the declaration of dividends, the group consisting of Companies X, Y and Z consolidate.

The scheme

For the purposes of section 177A, the scheme could consist of the declaration of a dividend by Company Z in favour of Company X followed by the declaration of a dividend by Company X in favour of the non-resident parent company.

The tax benefit

As a result of the declaration of the dividends, the modified market value of Company Z has decreased from $100 to $30. The modified market value of Company X remains unchanged as the value of its new assets (the dividend declared by Company Z) is offset by its new liability (the dividend declared by Company X in favour of the non-resident parent). The reduction in the modified market value of Company Z results in the available fraction in respect of the loss bundle Company Y brings into the group increasing from 100/210 = 0.476, to 100/140 = 0.714. Assuming that the consolidated group has sufficient assessable income in the first year of consolidation to benefit from the higher available fraction, the increase in the available fraction means the losses brought into the group by Company Y can be utilised at a faster rate than they could have been had $70 of the value in Company Z not been 'shifted' to the parent company by way of a dividend. That is, Company X, as the head company of the consolidated group, is entitled to a greater deduction than would have been the case but for the scheme. This is a tax benefit obtained in connection with the scheme. The amount of the tax benefit obtained by Company X is the difference between the amount of the loss deduction allowable in the first year to Company X and the amount of the loss deduction that it would have been entitled to in that year if the scheme had not occurred. It is this amount, if any, that the Commissioner would cancel under section 177F.

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[20] For the purposes of this scenario, the available fractions are worked out on the basis that the value donor concession rules are not available.

Purpose

Given that the scheme consists solely of the payment of dividends by Companies Y and Z, and that there are no additional relevant facts, it is difficult to posit objectively that the dominant purpose of entering into the scheme is to enable Company X, as the head company of the consolidated group, to obtain a tax benefit. There are many commercial reasons which may explain why a chain of dividends was declared for the benefit of the non-resident parent company, the ultimate economic owner of the group[21]. These points suggest that Part IVA will not have application.

This conclusion could well, however, be different if further matters bearing on the manner of carrying out the scheme and its form and substance indicated that that the dividend was a distribution in form only. Should, for example, there be evidence that the declared dividends remain unpaid or are loaned back by the non-resident parent to the group; or were immediately recapitalised by an issue of shares, or the like; or that the company could not in commercial prudence make a distribution in the circumstances, a different conclusion might follow. Similarly, the conclusion may be different if Company Z had previously had a policy over a lengthy period of not paying dividends (that is, a 100% profit retention policy), or the dividend declared by Company Z represented all of the pre-dividend market value of the company, thereby rendering Company Z essentially valueless.

Scenario 7: Disposal of a minority interest in a group company prior to the group consolidating[22]

A non-resident parent company owns 100% of the shares in Company L which is a resident of Australia. Company L in turn has two wholly-owned subsidiaries, Companies M and N, both of which are residents of Australia. Company L has a modified market value of $10 and no losses. Company M has a modified market value of $100 and a tax loss of $100. Company N has a modified market value of $100 and no tax losses.

Prior to consolidating, the group undergoes the following restructure:

- Company L disposes of 5% of its shareholding in Company N to a third party for $5;
- Company L then rolls over the remaining 95% of its shareholding in Company N to Company M and claims CGT rollover relief;
- Company L receives additional shares in Company M in return for the transfer of the shares in Company N to Company M.

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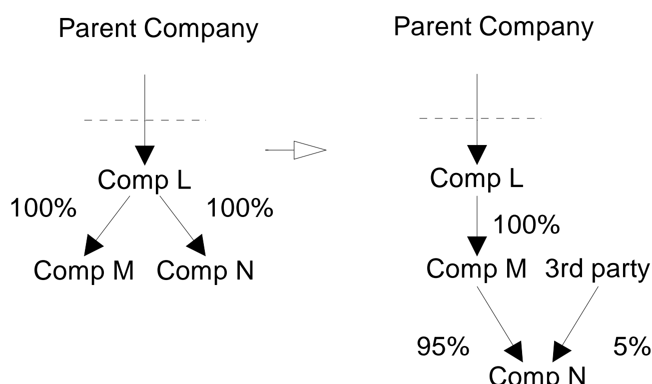
[21] By way of contrast with the situation in Scenario 6, Scenario 7 does not present a situation in which the 'all in principle' has been offended.

[22] For the purposes of this scenario, the available fractions are worked out on the basis that the value donor concession rules are not available. It is further assumed that section 707-325(2) does not have application; this may not be the case.

The following diagram illustrates the company group structure both before and after the restructuring:



Subsequent to the restructure, Companies L and M consolidate.

The scheme

For the purposes of section 177A, the scheme could consist of:

- the disposal by Company L of 5% of its shareholding in Company N for valuable consideration;
- the disposal by Company L of the remaining 95% of its shareholding in Company N to Company M; and
- the claiming of CGT rollover relief in relation to the disposal.

The tax benefit

As a result of the scheme, the available fraction in respect of the loss bundle Company M brings into the group has increased from 100/210 = 0.476 to 195/210 = 0.929. This increase in the available fraction reflects the fact that the modified market value of Company M has increased from $100 to $195 as a result of the scheme (the modified market value of Company M includes the amount attributable to its membership interest in Company N, a non-member company of the consolidated group ($95)).

Assuming that the consolidated group has sufficient assessable income in the first year of consolidation to benefit from the higher available fraction, the increase in the available fraction means the loss bundle brought into the group by Company M can be utilised at a faster rate than they could have been had Companies L, M and N consolidated. That is, Company L, as the head company of the consolidated group, is entitled to a greater deduction than would have been the case but for the scheme. The tax benefit obtained by Company L is the difference between the amount of the loss deduction allowable in the first year to Company L and the amount of the loss deduction that it would have been entitled to in that year if the scheme had not occurred.

It is this amount, if any, that the Commissioner would cancel under section 177F.[23]

Purpose

In substance, by a combination of:

- a sale by Company L of a relatively small percentage of its equity interest in Company N to a third party; and
- rolling over the remainder of its interest to Company M,

the group has maintained an effective economic control of Company N while increasing substantially the rate at which it can access the losses Company M brings into the group. On the basis of the information provided, the manner in which the scheme has been carried out is contrived and has no obvious commercial justification. This points towards the application of Part IVA.

Policy context

Similarly to Scenario 5, the facts of Scenario 7 point towards the restructuring having been undertaken in order to avoid the consequences of the 'all in principle'. However, in this example, the consequences of the 'all in principle' are not simply avoided. In addition, the value of the company excluded from the group increases the modified market value of Company M. This increase in the modified market value of Company M ultimately results in an increase in the rate at which the group can access the losses brought into the group by Company M.[24] From a policy position, these considerations suggest that the general anti-avoidance rules should have application.

More generally, as noted in relation to Scenario 5, arrangements, including group restructures, entered into to manipulate available fractions or otherwise increase the rate of loss utilisation by a consolidated group are not consistent with the intended policy outcome. The potential application of Part IVA in these situations was referred to in paragraph 8.102 of the EM to the May 2002 Bill.

[23] Company L also obtains an omitted income tax benefit from the scheme: but for the scheme, Company N would have been a subsidiary member of a consolidated group consisting of Companies L, M and N. That is, but for the scheme, the income generated by Company N would have been the assessable income of Company L as head company of the consolidated group. If the omitted income benefit is cancelled under section 177F, then Company L may be entitled to a compensating adjustment under section 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Company N remaining outside the consolidated group).

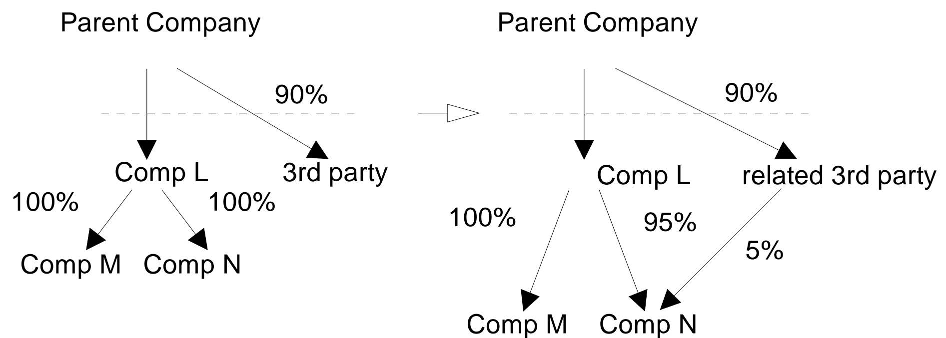
[24] Note however that in being left out of the consolidated group, Company N misses out on the compliance benefits associated with grouping with Companies L and M and further forgoes the opportunity of having the cost of its assets reset.

Scenario 8: Disposal of a minority interest in a group company prior to the group consolidating[25]

A non-resident parent company owns 100% of the shares in Company L which is a resident of Australia. Company L in turn has two wholly-owned subsidiaries, Companies M and N, both of which are residents of Australia. Company L has a modified market value of $10 and a tax loss of $100. Company L has no available capital losses. Company M has a modified market value of $100 and no tax losses. Company N has a modified market value of $100 and no tax losses.

Prior to consolidating, Company L disposes of 5% of its shareholding in Company N to a related third company for $5 triggering a capital gains tax liability. This related third company could not become part of the consolidated group comprising Company L, Company M and Company N, nor could it form a MEC group with Companies L, M and N, as the non-resident parent only owns 90% of its shares, the other 10% being owned by non-related Australian residents.

The following diagram illustrates the company group structure both before and after the restructuring:



Subsequent to the restructure, Companies L and M consolidate.

The scheme

For the purposes of section 177A, the scheme could consist of the disposal by Company L of 5% of its shareholding in Company N for valuable consideration.

The tax benefit

As a result of the scheme, the available fraction in respect of the loss bundle Company L brings into the group has increased from 10/210 = 0.048 to 110/210 = 0.524. This increase in the available fraction reflects the fact that

[25] For the purposes of this scenario, the available fractions are worked out on the basis that the value donor concession rules are not available. It is further assumed that section 707-325(2) does not have application; this may not be the case.

the modified market value of Company L has increased from $10 to $110 as a result of the scheme (the modified market value of Company L includes the amount attributable to its membership interest in Company N, a non-member company of the consolidated group ($95) and the consideration of $5 received for disposal of the membership interests in Company N to the related third party).

Assuming that the consolidated group has sufficient assessable income in the first year of consolidation to benefit from the higher available fraction, the increase in the available fraction means the losses brought into the group by Company L can be utilised at a faster rate than they could have been had Companies L, M and N consolidated. That is, Company L, as the head company of the consolidated group, is entitled to a greater deduction than would have been the case but for the scheme. The tax benefit obtained by Company L is the difference between the amount of the loss deduction allowable in the first year to Company L and the amount of the loss deduction that it would have been entitled to in that year if the scheme had not occurred. It is this amount that, if any, the Commissioner would cancel under section 177F.[26]

Purpose

As in Scenario 7, in substance as a result of the sale by Company L of a relatively small percentage of its equity interest in Company N to a third party, the economic group, including the non-resident parent company, has maintained an effective economic control of Company N while increasing substantially the rate at which it can access the losses Company L brings into the group. On the basis of the information provided, the manner in which the scheme has been carried out is contrived and has no obvious commercial justification. This points towards the application of Part IVA. The fact that the shares in Company N were sold to a related third party ultimately controlled by the non-resident parent of Company L increases the likelihood that Part IVA will apply.

However, the transaction as implemented triggers a potential capital gain for Company L. The size of this potential net capital gain arising from the scheme must be taken into consideration when determining a participant's sole or dominant purpose in entering into the scheme. For example, if the expected net capital gain is greater than Company L's expected tax benefit in the first year, then there may be doubts as to whether the dominant purpose of any participant in entering into the scheme was to obtain the tax benefit in that first year. Alternatively, further evidence may suggest that the dominant purpose of a participant in entering into the scheme was to obtain a tax benefit

[26] Company L also obtains an omitted income tax benefit from the scheme: but for the scheme, Company N would have been a subsidiary member of a consolidated group consisting of Companies L, M and N. That is, but for the scheme, the income generated by Company N would have been the assessable income of Company L as head company of the consolidated group.

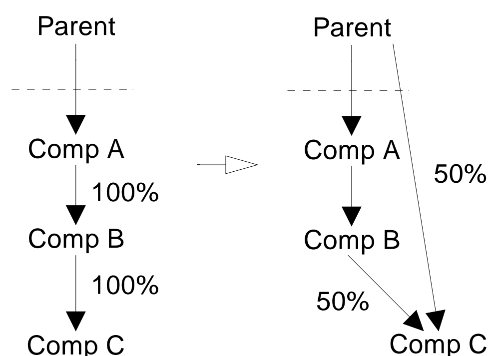
in the first year, notwithstanding the capital gain arising in that year. In any case, one of the participants in the scheme may still have a dominant purpose of allowing Company L to obtain a tax benefit (in the form of greater loss deductions) in the second or a subsequent year.[27]

Scenario 9: Disposal of an interest in a group company prior to the group consolidating[28]

A non-resident parent company owns 100% of the shares in Company A which is a resident of Australia. Company A has a resident wholly-owned subsidiary, Company B, which in turn has a resident wholly owned subsidiary, Company C. Company A has a modified market value of $10 and no tax losses. Company B has a modified market value of $100 and a tax loss of $100. Company C has a modified market value of $100 and no tax losses.

Prior to consolidating, Company B disposes of 50% of its shareholding in Company C to the non-resident parent for $50. Company B claims rollover relief in respect of this disposal.

The following diagram illustrates the company group structure both before and after the restructuring:



Subsequent to the restructure, Companies A and B consolidate.

The scheme

For the purposes of section 177A, the scheme could consist of the disposal by Company B of 50% of its shareholding in Company C for valuable consideration.

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[27] In this situation, the tax benefit obtained in the first year could still be cancelled being a tax benefit obtained in connection with the scheme for the purposes of subsection 177F(1) of the ITAA 1936.

[28] For the purposes of this scenario, the available fractions are worked out on the basis that the value donor concession rules are not available. It is further assumed that section 707-325(2) does not have application; this may not be the case.

The tax benefit

As a result of the scheme, the available fraction in respect of the loss bundle Company B brings into the group has increased from 100/210 = 0.476 to 200/210 = 0.952. This increase in the available fraction reflects the fact that the modified market value of Company B has increased from $100 to $200 as a result of the scheme (the modified market value of Company B includes the amount attributable to its membership interest in Company C, a non-member company of the consolidated group ($50) and the consideration of $50 received in respect of the disposal).

Assuming that the consolidated group has sufficient assessable income in the first year of consolidation to benefit from the higher available fraction, the increase in the available fraction means the losses brought into the group by Company B can be utilised at a faster rate than they could have been had Companies A, B and C consolidated. That is, Company A, as the head company of the consolidated group, is entitled to a greater deduction than would have been the case but for the scheme. The tax benefit obtained by Company A is the difference between the amount of the loss deduction allowable in the first year to Company A and the amount of the loss deduction that it would have been entitled to in that year if the scheme had not occurred. It is this amount, if any, that the Commissioner would cancel under section 177F.[29]

Purpose

In this scenario, Company B has sold a large percentage of its equity interest in Company C, but the sale is to the ultimate parent of the group. As a consequence, the group has maintained total economic control of Company C while increasing substantially the rate at which it can access the losses Company B brings into the group. On the basis of the information provided, the manner in which the scheme has been carried out is contrived and has no obvious commercial justification. This points towards the application of Part IVA.

Scenario 10: Disposal of a minority interest in a group company prior to the group consolidating

A holding company immediately before 1 July 2002 owns all the shares in a number of subsidiaries, including a finance subsidiary. The finance subsidiary lent a substantial amount in a previous year of income to Debtor Co, another of the group's subsidiaries. The loan was lent in the ordinary course of its business of lending money to group companies. No part of the loan to Debtor

[29] Company A also obtains an omitted income tax benefit from the scheme: but for the scheme, Company C would have been a subsidiary member of a consolidated group consisting of Companies A, B and C. That is, but for the scheme, the income generated by Company C would have been the assessable income of Company A as head company of the consolidated group.

Co was repaid by the due date. The finance company has a strong expectation that the debt will become bad in the near future. Post consolidation any bad debt owed by one group member of the consolidated group to another group member would not be taken into account in calculating the head company's taxable income.

Subsequent to the realisation that Debtor Co was unlikely to be able to repay any of the loan, but before a choice is made to consolidate the group, the finance subsidiary issues a 1% shareholding to an unrelated third party for valuable consideration. The remaining 99% of the issued shares are retained by the holding company. The amount raised from this share issue is substantially less than the potential reduction in the tax payable that may arise as a consequence of the finance subsidiary being able to obtain a bad debt deduction for the loan made to Debtor Co.

Soon after this issue of shares by the finance subsidiary, the holding company elects for the wholly owned group of which it is the head company to consolidate. As the finance company is no longer a wholly owned subsidiary of the holding company, the finance company does not become a member of the consolidated group. Subsequently, the finance company writes off the debt owed to it by Debtor Co. The finance company claims a deduction for the amount of the debt under section 25-35 of the ITAA 1997.[30]

The scheme

For the purposes of section 177A, the scheme could consist of the issue by the finance company of shares in itself to the third party.

The tax benefit

In these circumstances the tax benefit under paragraph 177C(1)(b) is the full amount of the deductions available to the finance company. But for the scheme, it is reasonable to assume that the finance company would not have issued shares to the third party. Rather, the finance company would have remained a wholly owned subsidiary of the holding company and become a member of the consolidated group. It follows that but for the scheme, no deductions would have been allowable to the finance company: as a result of the single entity principle, the bad debt would not be recognised.[31]

However, the actual tax advantage obtained by the finance company is simply the difference between the deductions the finance company is entitled to as an entity outside the consolidated group, and those deductions that the head

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[30] For the purposes of this scenario, it is assumed that the commercial debt forgiveness provisions contained in Schedule 2C to the ITAA 1936 have no application.

[31] The holding company also obtains an omitted income tax benefit from the scheme: but for the scheme, the finance subsidiary would have been a subsidiary member of a consolidated group consisting of the holding company and its 100% wholly owned subsidiaries. That is, but for the scheme, the income generated by the finance subsidiary would have been the assessable income of holding company as head company of the consolidated group.

company would have been entitled to as a consequence of the finance company being a member of the consolidated group. It is this amount, if any, that the Commissioner would cancel under section 177F, and not the total amount of deductions available to the finance company.

Purpose

In the absence of anything indicative of a non-tax related purpose for the issue of a small shareholding to a third party which raises comparatively little capital for the finance company, the facts objectively suggest the dominant, if not sole purpose, of the scheme is to obtain a tax benefit in the form of a deduction that would not be available but for the scheme.

Policy context

The facts of this scenario point towards the share issue having been undertaken in order for the group to avoid the consequences of the 'all in principle' and the 'single entity principle'. While the issue of shares in the finance company to a third party results in the finance company remaining outside the consolidated group with the consequent tax advantages, the group effectively gives up very little economic ownership of the company. Furthermore, under the compulsory acquisition rules contained in the *Corporations Act 2001*, the group could, subject to the statutory limitations on the exercise of the power, compulsorily acquire the third party's interest in the finance company at a later time, bringing the finance company into the group. This suggests that the general anti-avoidance rules should have application.

Scenario 11: Disposal of a minority interest in a group company prior to the group consolidating

Assume the same facts as in Scenario 10 with the following modifications. The finance company is lacking in funds and needs to raise capital. Rather than issuing a 1% shareholding to the third party, the company instead issues a 20% shareholding to the third party. Also assume that the amount raised from this share issue is substantially more than the potential reduction in the tax payable that may arise as a consequence of the finance subsidiary being able to obtain a bad debt deduction for the loan made to Debtor Co. The rights attaching to the shares issued to the third party provide that party with rights equivalent to those attaching to the shares owned by the holding company. Finally, assume that the issue of the shareholding to the third party occurs three days prior to the holding company electing to consolidate.

The scheme and the tax benefit

As in Scenario 10, the finance company obtains a tax benefit (the deductions not otherwise available, including the bad debt deduction) in connection with a scheme (the issue by the finance company of shares in itself to the third party).

Purpose

However, in contrast to Scenario 10, on the facts of Scenario 11 it would be difficult to posit that the objective purpose of entering into the scheme is to obtain of the tax benefit. The arrangement does not appear to be dominantly 'tax driven'. The manner in which the shares are issued is unremarkable; the form and substance of the scheme correspond—it is a capital raising in a way that gives a significant and meaningful economic interest in itself to the third party. The scheme is explicable by the purpose of raising capital. The fact that the issue of the shareholding in the finance subsidiary occurred only three days prior to the holding company electing to consolidate points, of itself, only weakly towards the possible application of Part IVA.

Policy context

In contrast to Scenario 10, the group has in reality suffered a significant reduction of its economic interest in the finance subsidiary. The arrangements do not appear to have been entered into for the purpose of getting around the 'all in principle'. Rather shares in the finance company were issued in order to raise needed capital. These considerations suggest that the general anti-avoidance provisions should not have application.

Scenario 12: Post consolidation dissolution of a company

Airline Co owns all the shares in Zeppelin Co, a failed airline. Zeppelin Co, purchased some years earlier, has no assets, no longer has any (commercial) goodwill attached to its name, and has been wound up. The only step remaining is the deregistration and dissolution of the company. Zeppelin Co has a large mixture of capital and revenue losses from a crash that occurred two years after its acquisition by Airline Co. The group has not been able to fully recoup these losses. A decision to transfer all of Zeppelin's assets, business operations and staff, and then wind up Zeppelin Co on the grounds that its continued existence served no commercial purpose was made six months before 1 July 2002, and, with the exception of deregistration, carried out. After 1 July 2002, the group consisting of Airline Co and Zeppelin Co consolidate. Zeppelin Co satisfies the relevant loss transfer tests and its losses are transferred into the consolidated group. Zeppelin Co is then deregistered on 31 December 2003.

Airline Co has other subsidiaries and would have been able to consolidate even if Zeppelin Co had been deregistered.

The scheme and purpose

The course of action of continuing to conduct the company's affairs, such as they are, amounts to a scheme (as is the winding up itself). The plan to deregister the company only after electing to consolidate is also a scheme. But for the scheme, the original proposal to wind the company up would have been carried out in full, and the company deregistered. The time at which the scheme was entered into and the length of the period during which it was

carried out, together with the manner in which the scheme is carried out, would be the deciding factors. While no inference of a dominant purpose of obtaining a tax benefit could be made merely from allowing a company that existed prior to consolidation to continue to exist after consolidation, nor from the mere fact that deregistration did not occur at the earliest possible time, a long delay in deregistration would be difficult to explain on non-tax commercial grounds. A winding up entered into for non-tax reasons may be carried out in an abnormal way to obtain a tax benefit from losses and for that dominant purpose. However, in this case, the short period of time involved does not support that inference. These points suggest that Part IVA will not have application.

Scenario 13: Purchase of minority interests in a group company prior to consolidation

Parent Co owns 99% of the issued shares in Sub Co. The remaining 1% of the issued shares are held by the directors of Sub Co as directors' qualifying shares; these shares do not attract the operation of subsection 703-35(4) (regarding employee shares). Sub Co has generated a large amount of losses from its business activities. Following a change to the constitution of Sub Co removing the requirement for directors of Sub Co to hold shares in the company, Parent Co acquires the remaining shares in Sub Co from Sub Co's directors making Sub Co a wholly owned subsidiary of Parent Co. Sub Co and Parent Co subsequently consolidate. Sub Co satisfies the relevant loss transfer test enabling it to bring its losses into the consolidated group. In the absence of this share purchase neither Parent Co, nor Sub Co, could become members of a consolidatable group.

The scheme

For the purposes of section 177A, the scheme could consist of the purchase by Parent Co of the remaining shares in Sub Co making Sub Co a wholly owned subsidiary of Parent Co followed by the election of Parent Co to consolidate.

The tax benefit

As a result of the scheme, Parent Co is entitled to a number of separate deductions that Sub Co would otherwise have been entitled to in the absence of the scheme. Parent Co is also entitled to a deduction in respect of the carry forward losses that Sub Co brings into the consolidated group. In these circumstances, a number of different tax benefits arise. Those tax benefits are the difference between the full amount of a deduction having a particular character that is allowable to Parent Co as head company of a consolidated group that includes Sub Co as a member, and the amount of the deduction of that character that Parent Co would have been entitled to in the absence of the scheme. [32] [33]

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[32] Sub Co obtains an omitted income tax benefit from the scheme. But for the scheme Sub Co would not have been a subsidiary member of a consolidated group, and the income generated

Purpose

Since Sub Co was the only subsidiary of Parent Co, the purpose of the scheme, it might be inferred, was to enable the Parent Co to choose to consolidate. Consequently, subsection 177C(2) will not apply. The question is whether it might also be inferred from the scheme that the purpose for purchasing the shares was to obtain a tax benefit for losses. The scheme might also be explicable as a result of the elimination of the directors' shareholding requirement for other reasons, or by reference to the cost advantages of consolidation. The small number of shares, and relatively minor non-tax effects derived from purchasing them, make the case on or near the borderline. Effects point to the purpose of obtaining a tax benefit. However, there is nothing in the manner of the scheme, as described, that particularly indicates a prevailing purpose of tax avoidance, and the form and substance of the scheme correspond. Duration of the scheme, assuming the shares are to be held indefinitely, will assist the taxpayer. The circumstances in which Sub Co was acquired as a subsidiary and in which the loss arose are not included in the scheme, and therefore cannot point to a purpose of tax avoidance. If closer examination of the facts did not reveal material adverse to the taxpayer, one would not conclude that the dominant purpose of the scheme was to obtain a deduction for losses.

Policy context

As a matter of policy, there is no mischief in the mere acquisition of minority interests owned by a third party in a group subsidiary by the group prior to consolidation. However, if the original owners of the minority interests retain an economic interest in the subsidiary post disposing of their shares to the group the position would be different from a policy perspective, and the conclusion under section 177D might also be different.

Scenario 14: Purchase of minority interests in a group company prior to consolidation

Parent Co owns 85% of the issued shares in Sub Co. The remaining 15% of the issued shares are held by a number of parties. Sub Co has generated a large amount of losses from its business activities. Parent Co has other subsidiaries, and would be able to consolidate even if Sub Co was not a wholly owned subsidiary. Parent Co acquires the remaining shares in Sub Co for the full market value of those shares, and the previous minority owners retain no legal or economic interest in Sub Co. The share acquisition makes Sub Co a wholly

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by Sub Co would have been its assessable income and not that of the head company of the consolidated group. Sub Co may be entitled to a compensating adjustment under subsection 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Sub Co becoming a member of the consolidated group).

[33] Parent Co may be entitled to a compensating adjustment, under subsection 177F(3) in respect of some, or all, of the assessable income that is generated by Sub Co's activities that Parent Co derives as a consequence of being consolidated with Sub Co.

owned subsidiary of Parent Co. Parent Co elects to form a consolidated group and Sub Co becomes a member of the consolidated group. Sub Co satisfies the relevant loss transfer test enabling it to bring its losses into the consolidated group.

The scheme

For the purposes of section 177A, the scheme could consist of the purchase by Parent Co of the remaining shares in Sub Co, making Sub Co a wholly owned subsidiary of Parent Co.

The tax benefit

As a result of the scheme, Parent Co is entitled to a number of separate deductions that Sub Co would otherwise have been entitled to in the absence of the scheme. Parent Co is also entitled to a deduction in respect of the carry forward losses that Sub Co brings into the consolidated group. In these circumstances, a number of different tax benefits arise. Those benefits are the difference between the full amount of a deduction having a particular character that is allowable to Parent Co as head company of a consolidated group that includes Sub Co as a member, and the amount of the deduction of that character that Parent Co would have been entitled to in the absence of the scheme. [34] [35]

Purpose

Objectively speaking it is difficult to conclude on the basis of the facts of this scenario that the dominant purpose of Parent Co in purchasing the remaining shares in Sub Co was to obtain a tax benefit, being deductions attributable to the access by Parent Co of the losses of Sub Co. In the absence of unusual features, a real outlay of money for a substantial stake in a company would ordinarily be explained by reference to a purpose of deriving income from holding the shares.

Policy context

As noted in relation to Scenario 13, as a matter of policy, there is no mischief in the mere acquisition of minority interests owned by a third party in a group subsidiary by the group prior to consolidation if the original owners of the minority interests do not retain an economic or legal interest in the subsidiary post disposal of the shares to the group. The mere buying out of a minority

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[34] Sub Co obtains an omitted income tax benefit from the scheme. But for the scheme Sub Co would not have been a subsidiary member of a consolidated group, and the income generated by Sub Co would have been its assessable income and not that of the head company of the consolidated group. Sub Co may be entitled to a compensating adjustment under subsection 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Sub Co becoming a member of the consolidated group).

[35] Parent Co may be entitled to a compensating adjustment, under subsection 177F(3) in respect of some, or all, of the assessable income that is generated by Sub Co's activities that Parent Co derives as a consequence of being consolidated with Sub Co.

interest in order to consolidate is consistent with the desired policy outcome that groups will consolidate to access the intended benefits of the consolidation regime and will then be necessarily subject to the improved integrity aspects of the regime.

Scenario 15: Purchase of minority interests in a group company prior to consolidation

Parent Co, the parent company of a corporate group, owned 85% of the issued shares in Sub Co that was deregistered a number of years after having ceased to carry on any business activities. Prior to deregistration, the remaining 15% of the issued shares were held by a number of parties. At the time of deregistration, Sub Co was carrying a large amount of losses that the group had not been able to access under the income tax loss grouping provisions. Parent Co has other subsidiaries, and would be able to consolidate. Parent Co applies to the court to have Sub Co reinstated and the court makes an order for the reinstatement of the company. Parent Co subsequently acquires the remaining shares in Sub Co for the full market value of those shares. The previous minority owners retain no legal or economic interest in Sub Co. The share acquisition makes Sub Co a wholly owned subsidiary of Parent Co. Parent Co elects to form a consolidated group and Sub Co becomes a member of the consolidated group. Sub Co satisfies the relevant loss transfer test enabling it to bring its losses into the consolidated group.

The scheme

For the purposes of section 177A, the scheme could consist of the application by Parent Co for the reinstatement of Sub Co followed, after the company's reinstatement, by the purchase by Parent Co of the remaining shares in Sub Co making Sub Co a wholly owned subsidiary of Parent Co.

The tax benefit

As a result of the scheme, Parent Co is entitled to a deduction via its access to the losses Sub Co brings with it into the consolidated group.[36] But for both the reinstatement of Sub Co, and the purchase by Parent Co of the remaining shares in Sub Co, Parent Co would not have been able to access Sub Co's losses. The entitlement of Parent Co to a deduction is a tax benefit obtained in connection with the scheme.

Purpose

Scenario 15 illustrates a situation where the presence of unusual facts points to a conclusion that what is a real outlay for a substantial stake in a company nonetheless is objectively not explicable by reference to a purpose of deriving income from the holding of shares but rather the purpose of obtaining a tax benefit. Sub Co, but for the scheme, had ceased to exist. Furthermore, prior to

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[36] It is assumed that Sub Co has a non-zero, albeit very small, modified market value.

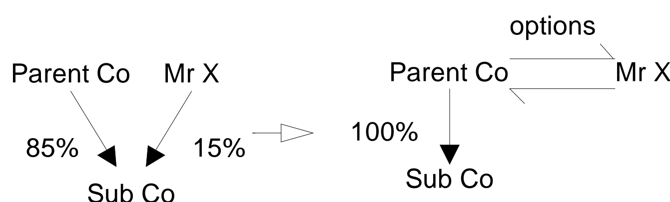
deregistration of the company, Sub Co was a 'dormant' company: Sub Co had not carried on any business activities for a number of years prior to deregistration. All these facts point to the application of Part IVA.

Scenario 16: Purchase of minority interests in a group company prior to consolidation

Parent Co owns 85% of the issued shares in Sub Co. The remaining 15% of the issued shares are held by Mr X, an individual taxpayer. Parent Co has other subsidiaries, and would be able to consolidate even if Sub Co was not a wholly owned subsidiary. Sub Co has generated a large amount of losses from its business activities. Parent Co acquires the remaining shares in Sub Co making Sub Co a wholly owned subsidiary of Parent Co, subject, however, to a call option issued by Parent Co in favour of Mr X, and a put option issued by Mr X in favour of Parent Co over the shares. The put and call options cannot be exercised for a period of three years. Under an enforceable collateral arrangement between all the parties it is agreed that Sub Co will not pay distributions to shareholders during the three years following the transfer of the shares from Mr X to Parent Co. The difference between the price paid by Parent Co for Mr X's 15% share holding, and the price payable by Mr X for a 15% shareholding under either the put or call options, is approximately 50% of the net present value of the expected reduction in tax payable by Parent Co as a result of the losses brought into the group by Sub Co.

It is expected that all of the losses that Sub Co brings to the consolidated group will be utilised within three years. Sub Co and Parent Co subsequently consolidate. Sub Co satisfies the relevant loss transfer test enabling it to bring its losses into the consolidated group.

The following diagram illustrates the key aspects of the scheme:



The scheme

For the purposes of section 177A, the scheme could consist of:

- the purchase by Parent Co of the remaining shares in Sub Co making Sub Co a wholly owned subsidiary of Parent Co; and
- the granting of a call option by Parent Co in favour of Mr X, and the granting of a put option by Mr X in favour of Parent Co over the shares.

The tax benefit

As a result of the scheme, Parent Co is entitled to a number of separate deductions that Sub Co would otherwise have been entitled to in the absence of the scheme. Parent Co is also entitled to a deduction in respect of the carry forward losses that Sub Co brings into the consolidated group. In these circumstances, a number of different tax benefits arise. Those benefits are the difference between the full amount of a deduction having a particular character that is allowable to Parent Co as head company of a consolidated group that includes Sub Co as a member, and the amount of the deduction of that character that Parent Co would have been entitled to in the absence of the scheme. [37] [38]

Purpose

Objectively speaking, the fact that Parent Co as the head of the consolidated group has obtained access to the losses of Sub Co via consolidation, while Mr X who originally owned the 15% shareholding bought by Parent Co has retained a significant economic interest in the shareholding (by way of the put and call options), suggests that the dominant purpose of Parent Co in entering the scheme was to obtain a tax benefit from the scheme.

Policy context

In contrast to Scenarios 13 and 14, this scenario is not one of a mere acquisition of minority interests prior to consolidation. By acquiring 100% of the issued shares in Sub Co subject to put and call options issued over a substantial fraction of its shareholding in the subsidiary, Parent Co is effectively seeking to gain access to the advantages offered by consolidation in a situation where, in substance, Sub Co is not economically its wholly owned subsidiary. The manner in which the scheme is carried out, and the lack of congruence between form and substance point to the scheme having been entered into in that particular way dominantly to obtain tax benefits. The result also offends the design principle underlying consolidation that the consolidation regime is only available to a head company and its wholly owned subsidiaries.

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[37] Sub Co obtains an omitted income tax benefit from the scheme. But for the scheme Sub Co would not have been a subsidiary member of a consolidated group, and the income generated by Sub Co would have been its assessable income and not that of the head company of the consolidated group. Sub Co may be entitled to a compensating adjustment under subsection 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Sub Co becoming a member of the consolidated group).

[38] Parent Co may be entitled to a compensating adjustment, under subsection 177F(3) in respect of some, or all, of the assessable income that is generated by Sub Co's activities that Parent Co derives as a consequence of being consolidated with Sub Co.

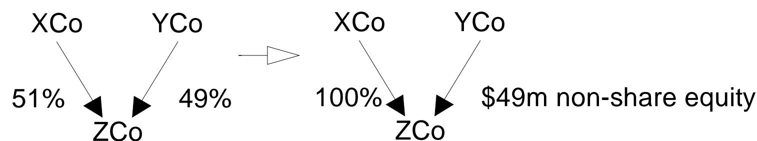
Scenario 17: Purchase of minority interests in a group company prior to consolidation

Xco owns 51% of the shares in Zco. Yco owns the remaining 49% of the shares. The market value of a 49% shareholding in Zco is $49,000,000.

Zco has a large amount of carry forward losses.

Xco buys all of the shares in Zco held by Yco for $1. At the same time Zco issues $49,000,000 of debt instruments (notes) to Yco. These notes are a form of 'synthetic shares' under which the amount of interest payable on each note is equal to the amount of dividend paid by Zco to its actual shareholder (namely Xco) during the year. The notes are only redeemable when Zco is wound up. The redemption amount is the higher of either the face value of the notes, or 49% of the market value of Zco's net assets (after taking into account amounts owed to other creditors). The synthetic shares do not count as membership interests for the purposes of the consolidation measure. The synthetic shares are, however, treated as equity under Div 974 of the ITAA 1997 and can support the payment of frankable non-share dividends. Xco subsequently chooses to form a consolidated group with Zco.

The following diagram illustrates the key aspects of the scheme:



The scheme

For the purposes of section 177A, the scheme could consist of:

- the purchase by Xco of the shares Yco owns in Zco for nominal consideration;
- the issue by Zco of non-share equity interests in itself to Yco with face value equal to the market value of Yco's previous shareholding in Zco; and
- the choice by Xco to consolidate.

The tax benefit

As a result of the scheme, Xco is entitled to all the current year deductions that Zco would otherwise have been entitled to. Xco is also entitled to deductions in respect of the losses that Zco brings into the consolidated group. But for the purchase of the shares by Xco it would not have been eligible to form a consolidated group. In these circumstances, a number of separate tax benefits arise. Those benefits are the difference between the full amount of the various deductions allowable to Xco as head company of a consolidated group that

includes Zco as a member, and the deductions, if any, of that type that Xco would have been entitled to in the absence of the scheme. [39] [40]

Purpose

The facts of this scenario point towards the objective dominant purpose of entering into the scheme being the obtaining of a tax benefit by Xco. In particular, the purchase by Xco of Yco's shareholding in Zco for nominal consideration followed immediately by the issue by Zco of non-share equity interests in itself to Yco objectively appears to be solely for the purpose of allowing Yco to retain an economic interest in Zco comparable to that which it owned prior to the purchase of its shareholding by Xco while also allowing Zco to enter a consolidated group with Xco. This indicates that Part IVA should have application.

Policy context

As with Scenario 16, this scenario is not one of a mere acquisition of minority interests prior to consolidation. By acquiring 100% of the issued shares in Zco in circumstances where, immediately after the share acquisition, Zco issues non-share equity interests in itself to Yco, Xco is effectively seeking to gain access to the advantages offered by consolidation in a situation where, in substance, Zco is not economically its wholly owned subsidiary. It is a design feature of the consolidation regime that non-share equity interests are ignored for the purpose of determining whether one entity has a membership interest in another entity. However, the present scenario does not present the case of a group which could, but for the scheme, take advantage of this design feature. Instead, the facts of the present scenario point towards the scheme having been undertaken in order for the group to avoid the consequences of the principle that only wholly owned subsidiaries of a head company are able to become members of a consolidated group and bring itself within the scope of the exclusion from the definition of membership interests of non-share equity. Indeed, prior to the scheme being carried out, there was in fact no consolidatable group. The manner in which the scheme is carried out, and the lack of congruence between form and substance point to the scheme having been entered into in that particular way predominantly in order to obtain tax benefits. This suggests the general anti-avoidance rules should have application.

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[39] Zco obtains an omitted income tax benefit from the scheme. But for the scheme Zco would not have been a subsidiary member of a consolidated group, and the income generated by Zco would have been its assessable income and not that of the head company of the consolidated group. Zco may be entitled to a compensating adjustment under subsection 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Zco becoming a member of the consolidated group).

[40] Xco may be entitled to a compensating adjustment, under subsection 177F(3) in respect of some, or all, of the assessable income that is generated by Zco's activities that Xco derives as a consequence of being consolidated with Zco.

Scenario 18: The use of a special purpose vehicle to issue preference shares to unrelated investors

Parent Co is the head company of an Australian corporate group. Subco, a wholly owned subsidiary of Parent Co, is the holding company of a wholly owned subgroup. Sub Co is only one of a number of subsidiaries wholly owned directly by Parent Co. The sub-group of which Sub Co is the holding company has considerable losses which cannot presently be fully utilised by other members of the corporate group.

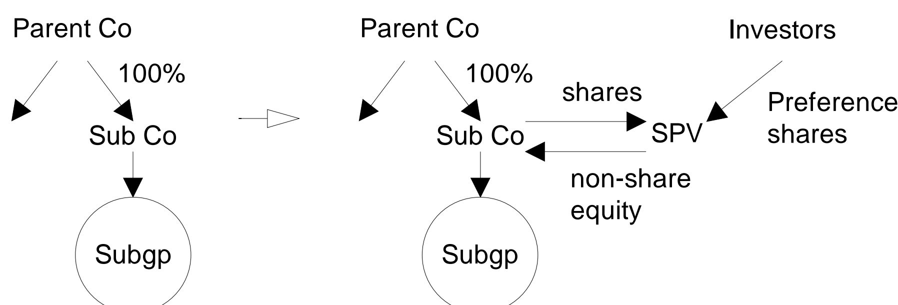
For commercial reasons, Sub Co wishes to issue preference shares to certain unrelated investors.

If Sub Co was itself to issue preference shares, the company and the subgroup which it heads would not be able to consolidate with the remainder of the corporate group.[41] Instead, the following arrangement is entered into:

- A special purpose vehicle is incorporated;
- Sub Co subscribes for all the issued shares in the special purpose vehicle;
- The special purpose vehicle issues preference shares to the investors. The shares are equity interests within the meaning of Div 974 of the ITAA 1997;
- Sub Co simultaneously issues an equivalent number of notes to the special purpose vehicle. The special purpose company uses the proceeds from issuing the preference shares to fund the purchase of the notes. The notes do not constitute membership interests under the consolidation legislation but are non-share equity interests within the meaning of Div 974 of the ITAA 1997 and can support the payment of frankable non-share dividends;
- The rights attaching to the preference shares owned by the investors in the special purpose vehicle are substantially the same as the rights attaching to the non-share equity interests owned by the special purpose vehicle in Sub Co;
- The special purpose vehicle does not undertake any activities other than the issuing of the preference shares to the investors and the subscribing for notes in Sub Co;
- Franked distributions on the notes are paid by Sub Co to the special purpose vehicle. The special purpose vehicle pays an equivalent franked distribution on the preference shares to the investors.

[41] Sub Co could, nonetheless, form a consolidated group with its subsidiaries as group members.

The following diagram illustrates the company group structure both before and after the restructuring:



Parent Co elects to consolidate. Each of the members of the subgroup headed by Sub Co, being wholly owned subsidiaries of Parent Co, become members of the consolidated group. The special purpose vehicle is not a member of the consolidated group as the preference shares are treated as membership interests when determining if the special purpose vehicle is wholly owned.

The scheme

For the purposes of section 177A, the scheme could consist of:

- the incorporation of the special purpose company;
- the purchase by Sub Co of all the issued shares in the special purpose company;
- the issue by the special purpose company of preference shares to external investors; and
- the simultaneous purchase by the special purpose company of non-share equity interests in Sub Co.

The tax benefit

But for the use by Sub Co of an interposed special purpose vehicle to issue preference shares to the external investors Sub Co would not have been eligible to enter a consolidated group with Parent Co. Based on normal commercial practice it would be reasonable to assume that in the absence of the scheme Sub Co would have issued preference shares in itself directly to the external investors, and hence would have ceased to be a wholly owned subsidiary of Parent Co.

In these circumstances a number of separate tax benefits are obtained by Parent Co. Those benefits are the full amount of all of the various types of deductions available to Parent Co as a result of Sub Co being a member of the group[42]. In the absence of the scheme Parent Co would not have been entitled to any of those deductions.[43]

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[42] Sub Co obtains an omitted income tax benefit from the scheme. But for the scheme Sub Co would not have been a subsidiary member of a consolidated group, and the income generated by Sub Co would have been its assessable income and not that of the head company of the

Purpose

The facts of this scenario suggest that the objective dominant purpose of entering into the scheme was the obtaining of a tax benefit by Parent Co. For example, while the form of the scheme is that of an issue of notes by Sub Co and a simultaneous issue of preference shares by the special purpose company, in substance Sub Co has undertaken all the commercial risk associated with funding the preference shares. The changes in the financial positions of the relevant persons and the other commercial consequences of the scheme will be substantially the same as the changes that might reasonably have been expected to flow if the scheme had not been carried out.

Policy context

It is a design feature of consolidation that non-share equity interests are ignored for the purpose of determining whether one entity has a membership interest in another entity. However, analogously with Scenario 17, the facts of the present scenario point towards the creation and interposition of the special purpose vehicle having been undertaken in order for the group to avoid the consequences of the principle that only wholly owned subsidiaries of a head company are able to become members of a consolidated group and bring itself within the scope of the exclusion from the definition of membership interests of non-share equity. The manner in which the scheme is carried out, and the lack of congruence between form and substance point to the scheme having been entered into in that particular way dominantly to obtain tax benefits. This suggests the general anti-avoidance rules should have application.

Scenario 19: The use by a consolidatable group of non-share equity interests to maintain economic control over a related entity

Parent Co is the parent company of an Australian resident corporate group. As part of a plan to diversify the business activities conducted by the group, Parent Co wishes to incorporate a new company. It is expected that this newly incorporated company will produce losses of approximately $10 million over the first three years of the company's existence before starting to produce a profit. Parent Co does not expect that the group would be able to make significant use of these losses during that three year period.

Y Co, an unrelated third party, is expected to produce significant trading profits over the next few years. Y Co does not have access to any losses.

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consolidated group. Sub Co may be entitled to a compensating adjustment under subsection 177F(3) in respect of some or all of the deductions that would have been allowable to it but for the scheme (that is, but for Sub Co becoming a member of the consolidated group).

[43] Parent Co may be entitled to a compensating adjustment, under subsection 177F(3) in respect of some, or all, of the assessable income that is generated by Sub Co's activities that Parent Co derives as a consequence of being consolidated with Sub Co.

Y Co incorporates a new company - X Co - which then carries on the new business that Parent Co had intended to establish. All of the directors of X Co are directors of Parent Co, and X Co's officers are former officers of Parent Co. Yco pays $7 million for all the A class shares in X Co. No other shares are issued by X Co. The amount paid by Y Co for its shareholding in X Co is roughly equivalent to the discounted value of the losses X Co is expected to make over three years. Parent Co subscribes for $100 million worth of convertible notes issued by X Co. The convertible notes do not count as membership interests for the purposes of the consolidation measure but are non-share equity interests for the purposes of Div 974 of the ITAA 1997. The convertible notes are convertible one for one into B class shares in X Co three years after the date of issue. Under the constitution of X Co rights of A class shareholders are subordinated in all respects to the rights of B class shareholders. For example, there is no requirement to pay a dividend on A class shares, and A class shareholders only receive a nominal amount per share upon winding-up. In economic effect once the convertible notes are exercised, Y Co will not be able to participate in any profits X Co may make.

Y Co chooses to form a consolidated group with X Co.

The scheme

For the purposes of section 177A, the scheme could consist of:

- the purchase by Y Co of A class shares in X Co;
- the issue by X Co of convertible notes convertible into B class shares and the purchase by Parent Co of these issued notes; and
- the choice by Y Co to consolidate.

The tax benefit

As a result of the scheme, Y Co, a third party unrelated to the group, is entitled to all the deductions that arise as a consequence of the carrying on of the business by X Co. It is only the fact that X Co issues non-share equity interests in itself to Parent Co rather than ordinary shares that allows Y Co to consolidate with X Co. In the absence of the scheme it seems reasonable to assume that the $100 million in funding actually provided by Parent Co would have been provided via a subscription for shares rather than convertible notes. That is, but for the scheme it seems reasonable to assume that Y Co would not have wholly owned X Co. In fact it seems reasonable to assume that but for the scheme Y Co would not have acquired shares in X Co. The tax benefit is therefore the full amount of the deductions that Y Co obtains as a consequence of being in a consolidated group with X Co.[44]

[44] Y Co may be entitled to a compensating adjustment, under subsection 177F(3) in respect of some, or all, of the assessable income that is generated by X Co's activities that Y Co derives as a consequence of being consolidated with X Co.

Purpose

The facts of this scenario point towards the objective dominant purpose of the scheme being the obtaining of a tax benefit by Yco. In particular, the facts of the scenario suggest that the arrangement has been structured in this particular way solely for the purpose of allowing Parent Co to own a long term controlling economic interest in X Co while also allowing Y Co to utilise the losses made by X Co during the start up phase.

Note: a similar conclusion as to purpose would be likely to follow if, rather than being subordinated to the rights of the B class shareholders, the class A shares carried substantive rights and Parent Co had a call option which, when exercised, would allow it to purchase Y Co's shareholding for fair market value.

Policy context

By acquiring 100% of the issued shares in X Co in circumstances where, immediately after the share acquisition, X Co issues convertible notes in itself to Parent Co, Y Co is effectively seeking to gain access to the advantages offered by consolidation in a situation where, in substance, X Co is not economically its wholly owned subsidiary. As noted in relation to Scenario 17, it is correct to state that it is a design feature of consolidation that non-share equity interests are ignored for the purpose of determining whether one entity has a membership interest in another entity. However, the present scenario does not present the case of a group which could, but for the scheme, take advantage of this design feature underpinning the legislation. Instead, as with Scenario 17 and 18, the facts of the present scenario point towards the scheme having been undertaken in order for the group to avoid the consequences of the principle that only wholly owned subsidiaries of a head company are able to become members of a consolidated group and to bring itself within the scope of the exclusion from the definition of membership interest of non-share equity. Indeed, as with Scenario 17, prior to the scheme being carried out, there was in fact no consolidatable group. Further, prior to the scheme being carried out, Y Co had no economic interest in X Co and, in the longer term, it can be expected that Y Co will have no meaningful economic interest in X Co. The manner in which the scheme is carried out, and the lack of congruence between form and substance point to the scheme having been entered into in that particular way dominantly to obtain tax benefits. This suggests the general anti-avoidance rules should have application.

Revision history

Section C9-1-220 first included in the *Consolidation reference manual* 3 December 2003.