Worked example

Single entity treatment – deductibility of interest

Description

This example shows how, under the single entity rule, the basis of deductibility of interest paid by a holding company for funds on-lent to a subsidiary may differ from the situation applying outside consolidation (although the result may be the same).

Commentary

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

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

Where a holding company borrows money to lend to a subsidiary, the basis of deductibility of interest paid by the holding company differs in consolidated and non-consolidated situations, although the result may be the same. In a consolidated group, intragroup transactions have no income tax consequences. The deductibility of interest paid to a non-member is determined by looking at the economic substance for the group as a whole of the purpose of the loan and the use to which it is put – that is, income tax law applies to the interest as if the head company was a single company undertaking the borrowing.

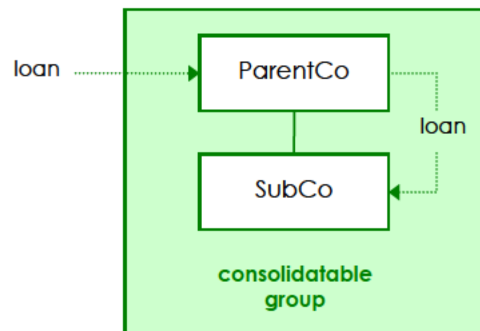
Example

Facts

ParentCo and its wholly-owned subsidiary, SubCo, form a consolidatable group (figure 1). Prior to consolidation, ParentCo borrows money to make a loan to SubCo for the purpose of making SubCo commercially feasible and promoting generation of income by SubCo – and thence ultimately by ParentCo.

The group subsequently consolidates.

Figure 1: Funds on-lent by ParentCo to SubCo



Analysis

Prior to consolidation, the interest paid by ParentCo on the monies loaned is deductible to ParentCo under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) as it is incurred in producing ParentCo's assessable income and carrying on its business.

Following consolidation, the single entity rule means the loan between ParentCo (as head company) and SubCo is ignored for the purposes of working out ParentCo's income tax position. The interest paid by ParentCo on the loan is therefore no longer deductible on the basis that the monies are loaned to its subsidiary for the purposes of making the latter commercially feasible and promoting the ultimate generation of income by ParentCo.

Under the single entity rule, SubCo is treated as a part, or division, of ParentCo. The deductibility of the interest paid by ParentCo is therefore determined according to the normal principles applying to a single company. The use to which SubCo puts the loaned funds is attributed to ParentCo – that is, the relevant transactions are treated according to their economic substance for the group as a whole.

The deductibility of the interest payments is determined under the tests in section 8-1 on this basis. The interest is deductible if the borrowed monies are used in gaining or producing assessable income, or necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income *for the group* (represented by the head company).

References

Income Tax Assessment Act 1997, section 8-1

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

Revision history

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