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

Description

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

Commentary

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

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

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

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

The transaction with the outside party is treated according to its economic substance for the group as a whole, without regard to internal transactions. From this perspective, the asset is treated as if it is newly created when sold or assigned outside the group. The asset may therefore be treated (for the purposes of working out the head company's income tax) as something different from its legal form for non income tax purposes.

Note

Sale of membership interests

Special rules apply where membership interests in a subsidiary member are sold to a non-member by the head company.

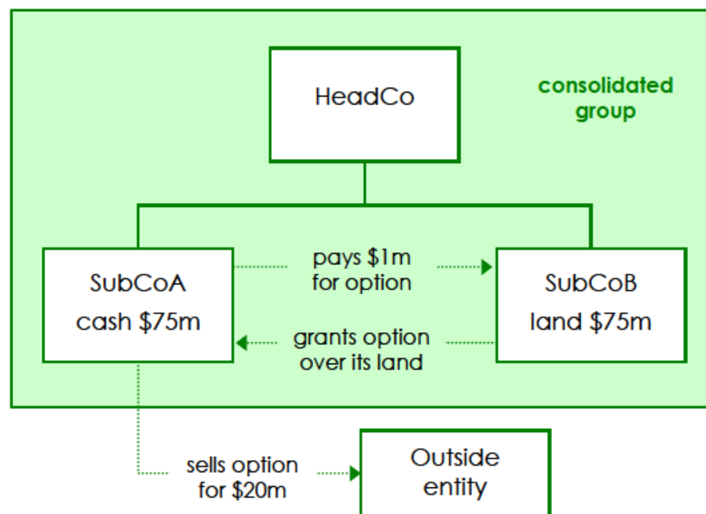
Example – sale of option

Facts

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

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

Figure 1: Sale of intragroup option outside group



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

As a result:

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

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

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

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

Calculation

In legal form, SubCoA has sold an option. Outside consolidation this transaction would attract CGT event A1 (disposal of a CGT asset). However, as the transaction with the third party is treated in accordance with its economic substance from the point of view of the group as a whole, without regard to the internal transaction (which has no tax consequences – the intragroup option never gave rise to an asset in the hands of HeadCo), the group has not disposed of an existing asset.

Thus, while the sale price to the third party is less than the purchase price to SubCoA, the consolidated group has not made an economic loss from the assignment of the option to the third party for market value. The economic effect of the transaction for the group is that it has granted an option to a third party and received $0.8 million as payment.

For the purposes of working out the head company's income tax position, the transaction is treated according to its economic substance from the point of view of the group as a single entity. That is:

- the head company has granted an option to an entity outside the group
- the group has received capital proceeds of $0.8 million from the transaction
- CGT event D2[1] (granting of an option) is triggered, resulting in a capital gain of $0.8million – the difference between the amount received for the option ($0.8 million) and the costs incurred by the group (nil), and
- the cost base for the land remains $75 million, which will be available on disposal of the land (if the option is exercised or otherwise).

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

Example – sale of interest stream

Facts

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

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

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

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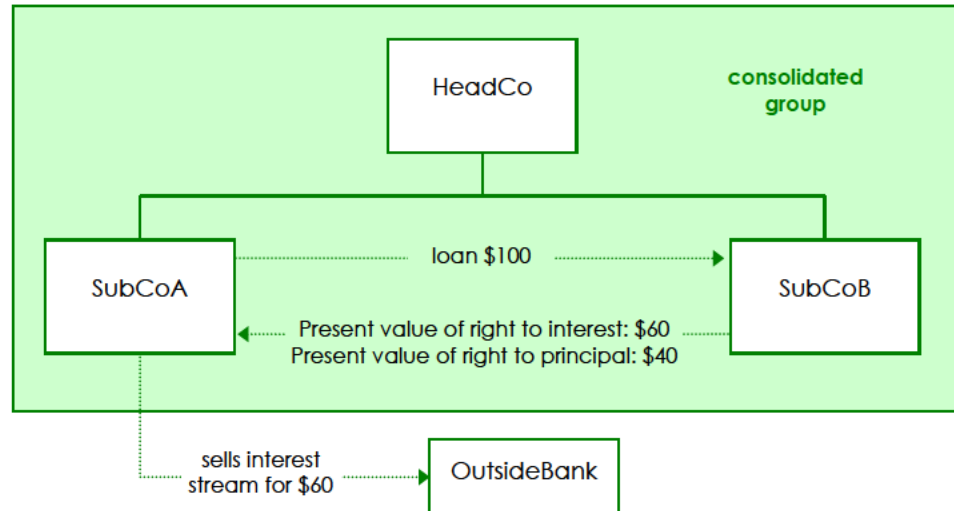
[1] Section 104-40 ITAA 1997.

Figure 2: Sale of intragroup income stream outside group



Calculation

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

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

Example – sale of debt

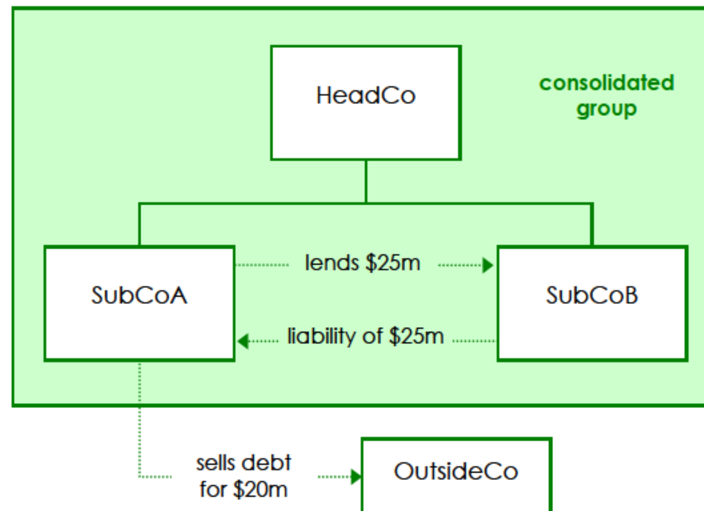
Facts

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

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

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

Figure 3: Sale of debt outside group



Calculation

The assignment of the intragroup debt is treated, in accordance with its economic substance for the group, as if HeadCo is entering into a new loan. This does not constitute a CGT event[2]. Therefore there are no income tax consequences for the group as a result of the transaction. This accords with the income tax treatment of a single company undertaking the same transaction and is consistent with the single entity rule.

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

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

References

Income Tax Assessment Act 1936, Division 16E

Income Tax Assessment Act 1997, section 8-1

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

Revision history

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

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