Tax sharing agreements

In a consolidated group, the head company is responsible, on behalf of the group, for the payment of income tax related liabilities (the group liability). If the head company fails to discharge in full its obligation to pay the group's tax liability by the time the tax is due (the head company's due time), subsidiary members (contributing members) that were part of the group for whole or part of the liability period become jointly and severally liable for the group liability.

Contributing members can, however, avoid this liability by entering into a tax sharing agreement (TSA) before the head company's due time. A TSA is an agreement between the head company and one or more contributing members that allows the group liability to be apportioned between group members according to a methodology set out in the agreement. Note that the liability of the head company for the total debt continues whether a TSA exists or not.

These guidelines provide an overview of the provisions relating to TSAs, and should be read in conjunction with 'Collection of Consolidated Group Liabilities' in the *ATO Receivables Policy* → see 'References' at the end of this section. However, a company director should always seek independent professional advice when deciding whether to enter into a TSA and what the form and content of that agreement should be.

Note

The following information is based on the assumption that the group liabilities relate to the period after the head company has lodged the first consolidated return, and that the Tax Office has issued the head company with a consolidated group PAYG instalment rate. The head company is therefore responsible for lodging the group's annual income tax return and reporting the group's consolidated PAYG instalments in a single quarterly activity statement.

Legislative background

Division 721 of the *Income Tax Assessment Act 1997* (ITAA 1997) deals with the liability for payment of tax when the head company fails to pay on time. It establishes:

- how consolidated groups can apportion the group's tax liabilities through TSAs
- how subsidiary companies can effect a clear exit from a consolidated group through the use of a valid TSA, and
- the circumstances in which TSAs are considered valid for the purposes of Division 721.

Subsection 265-45(2) of the *Taxation Administration Act 1953* (TAA 1953) provides for a right of contribution when persons are jointly liable for a tax-related liability. If a group member pays all or part of a debt for which it is jointly liable, it may be able to seek a contribution towards that amount from other members who are also jointly liable.

Group liability

In accordance with the single entity rule, the head company is responsible for a consolidated group's income tax liabilities.

→ 'Consolidation – key points and pathway', B0-1; ''Glossary', A2

A list of group liabilities is set out in subsection 721-10(2) of the ITAA 1997. When the head company fails to satisfy a group liability by the due time, each contributing member becomes jointly and severally liable, with the head company, for the outstanding amount, unless:

- that member is prohibited by the effect of an Australian law from entering into arrangements that would subject it to joint and several liability, or
- the group liability was covered by a valid TSA that allocates the liability between the members of the group on a reasonable basis.

Valid tax sharing agreements

The members of a consolidated group may avoid the consequences of joint and several liability by entering into a valid TSA with the head company. A TSA is an agreement between the head company and subsidiary members (contributing members). It can be used to allocate a group liability among a number of contributing members, provided that allocation is a 'reasonable allocation'.

Each contributing member covered by a valid TSA is liable for the amount determined under that agreement. A TSA may make a contributing member liable for all, part, or none of a group liability.

Under section 721-25, a group liability will only be covered by a TSA if:

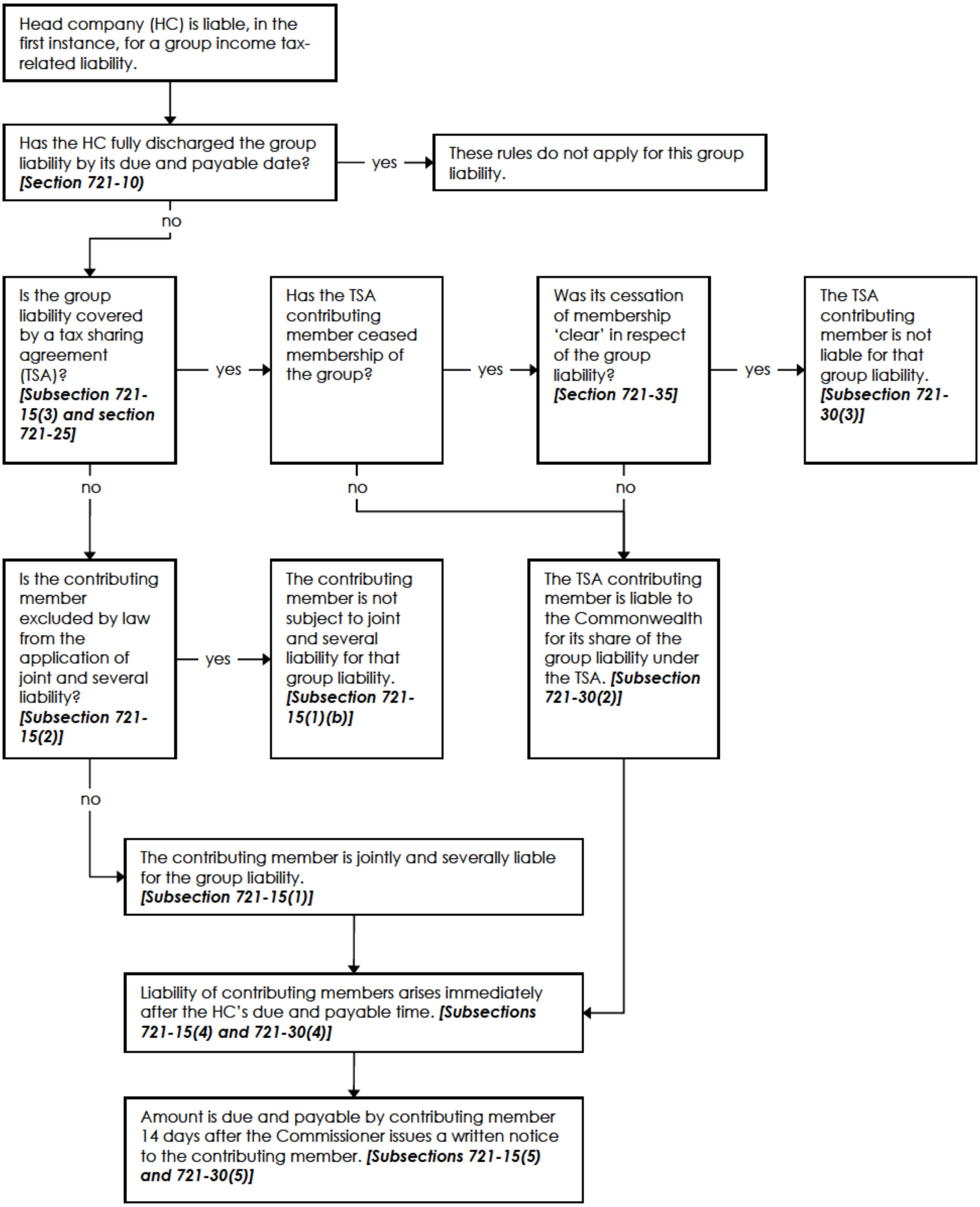
- the agreement between the head company and contributing members exists immediately before the head company's due time
- the agreement determines how the relevant group liability is to be allocated to the contributing members (the contribution amount)
- the allocation of the contribution amounts between the head company and contributing members is a reasonable allocation and accounts for the entire group liability, and
- the agreement complies with any requirements set out in the regulations (currently, there are no relevant regulations).

A TSA is not considered valid if:

- the agreement was entered into as part of an arrangement, a purpose of which was to prejudice the Tax Office's recovery of some or all of the group liability, or
- the Commissioner serves a notice on the head company requesting a copy of the TSA in the approved form and it is not provided within 14 days.

Diagram 11.1 from the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 illustrates the application of TSAs to group liabilities.

Diagram 11.1



Head company (HC) is liable, in the first instance, for a group income tax-related liability.
Has the HC fully discharged the group liability by its due and payable date? *[Section 721-10)*
yes
These rules do not apply for this group liability.
no
Is the group liability covered by a tax sharing agreement (TSA)? *[Subsection 721-15(3) and section 721-25]*
yes
Has the TSA contributing member ceased membership of the group?
yes
Was its cessation of membership 'clear' in respect of the group liability? *[Section 721-35]*
yes
The TSA contributing member is not liable for that group liability. *[Subsection 721-30(3)]*
no
no
no
Is the contributing member excluded by law from the application of joint and several liability? *[Subsection 721-15(2)]*
yes
The contributing member is not subject to joint and several liability for that group liability. *[Subsection 721-15(1)(b)]*
The TSA contributing member is liable to the Commonwealth for its share of the group liability under the TSA. *[Subsection 721-30(2)]*
no
The contributing member is jointly and severally liable for the group liability. *[Subsection 721-15(1)]*
Liability of contributing members arises immediately after the HC's due and payable time. *[Subsections 721-15(4) and 721-30(4)]*
Amount is due and payable by contributing member 14 days after the Commissioner issues a written notice to the contributing member. *[Subsections 721-15(5) and 721-30(5)]*

Subsection 721-25(3) states that a copy of a TSA must be given to the Commissioner, on request, in the 'approved form'. Because a TSA is an agreement between the head company and other members of the group, a specific TSA form does not exist, but the Commissioner has specified the minimum requirements that a TSA must comply with in order to be produced in the 'approved form'. The requirements outlined in 'Collection of Consolidation Group Liabilities' in the *ATO Receivables Policy* stipulate that the TSA must:

- be in writing
- show the date of execution
- specify what group liability or group liabilities it covers
- provide for a reasonable allocation of at least one *entire* group liability (i.e. not just part of a liability)
- be executed by the head company and each TSA contributing member that is a party to the agreement
- include any executed deeds of assumption and/or deeds of release in relation to the relevant group liability, and
- either
  - by reference only to the TSA and to the amount of the group liability be capable of allowing a particular amount (the contribution amount) to be determined by the Commissioner for each TSA contributing member in relation to the group liability, or
  - show, when produced to the Commissioner, the quantum of the group liability (the contribution amount) for each TSA contributing member in relation to the group liability as determined by applying the TSA to the group liability. Accordingly, when produced, the TSA may occasionally need to include an attachment showing the liability as determined (e.g. copy of, or extract from, working papers used to complete a BAS or income tax return if that is the basis for allocating the liability).

A new TSA may be necessary if there are changes in the consolidated group's structure (because of the entry or exit of members), or changes to an individual member's operations.

Reasonable allocation

The contribution amounts for each of the contributing members must represent a reasonable allocation of the total group liability.

→ paragraph 721-25(1)(c)

This manual cannot cover all possible methods for achieving a reasonable allocation of a group liability, but examples of reasonable allocations include:

- allocations based on the percentage share of the group accounting profit for the preceding income year
- allocations based on the percentage share of the group accounting profit for the current income year, or

- allocations based on each member's ability to pay the liability.

An example of an unreasonable allocation would be one that allocated the group liability based on the percentage share of the group profit, while excluding members that were major contributors to that profit. The ultimate determination of what is a 'reasonable allocation' will of course rest with the courts.

Formal notice requesting a copy of a TSA

If the Tax Office decides to pursue one or more members for an unpaid group liability, it may issue a notice to the head company under subsection 721-25(3). The head company has 14 days after service of the notice to produce a copy of the relevant TSA in the approved form. If the TSA is not produced, the group liability will be considered never to have been covered by a TSA, and all contributing members will be jointly and severally liable for the group liability. (Note that if a TSA does not exist at the head company's due time, the contributing members' liability arises just after that time, not at the time of any later non-production of the TSA.)

The Commissioner may defer the time for lodgment of a TSA under section 388-55 of the TAA 1953. As a TSA must exist before the head company's due time to be valid, such a deferral would only be granted in exceptional circumstances. → *ATO Receivables Policy*, 'Deferral of the Due Date for Lodgment and Suspension of Lodgment Action'

Actions prejudicial to recovery

Under subsection 721-25(2), a group liability is not covered by a TSA if the TSA was entered into as part of an arrangement, a purpose of which was to prejudice the recovery of some or all of the group liability by the Tax Office. Actions that might lead to such a determination include:

- disposing of interests in solvent or asset-rich members of a group (while retaining control) to the extent that they are no longer considered to be part of the consolidated group
- allocation of a liability to a member when its likely inability to pay is foreseeable (e.g. because of litigation in progress), or
- uncommercial sale of assets.

Amended liabilities

Generally, a liability resulting from an amendment or revision is considered to be covered by a TSA if the TSA refers to the underlying liability to which the amendment or revision relates. For example, a reference to the group liability for income tax relating to the 2002–03 income year would cover any amendment to that liability, provided the TSA did not specify fixed amounts in relation to the original liability.

Depending on the method used, some groups may wish to consider inserting a clause into their TSAs that provides for any increase in the group liability arising from an amendment or revision to be allocated to the entity or entities responsible for the understatement.

It is important to note that the due date for payment of an amended income tax assessment or revised PAYG instalment is the same as the date on which the original liability was payable. Because the original and amended due dates are the same, the TSA methodology must remain unchanged – though the Commissioner may require the production of an attachment to the TSA to disclose the new allocations to members arising from the amended or revised liability.

Tax Office review of TSAs

The Tax Office cannot provide a binding view on the validity of a TSA, but it will regularly update guidelines.

If the Tax Office has received a copy of a TSA – whether informally or through a request under subsection 721-25(3) – and has not taken further action, this does not imply that it considers the TSA to be valid or has determined that it provides a reasonable allocation of the relevant group liability.

Clear exit

Under section 721-35, a contributing member can leave a group clear of a specific group liability if:

- it ceases to be a member of the group before the due date of the group liability
- before the leaving time, it pays to the head company an amount equal to the contribution amount or, if that amount cannot be determined at that time, a reasonable estimate of that amount, and
- the member's exit from the group is not part of an arrangement, a purpose of which was to prejudice the recovery of all or part of the group liability by the Tax Office.

A contributing member cannot have a clear exit if there is a group liability not covered by a valid TSA or if the group liability is due and payable before it ceases to be a member of the group. Note that the due date for payment of an amended income tax assessment or revised PAYG instalment is the same as the date the original liability was payable.

Reasonable estimate of contribution amount

When a leaving entity wishes to leave a group clear of a particular group liability, and its contribution amount under the TSA cannot be determined before the leaving time, paragraph 721-35(c) provides that a reasonable estimate of that contribution amount must be made. This reasonable estimate must be based on the TSA. Depending on the particular TSA's methodology, actual income figures or projected cash flows may be used.

Payment of contribution

Documentary evidence that the leaving member has paid the contribution amount, or a reasonable estimate of that amount, to the head company must be retained by the leaving entity in case it is later needed to prove that it left the group clear of a particular group liability. Standard commercial documentation is generally sufficient.

A mere book entry is not sufficient as a form of payment. Any book entry must result from a clear contractual arrangement establishing a debt between the parties.

Actions prejudicial to recovery

A contributing member will not leave the group clear of a particular group liability if its exit was part of an arrangement, a purpose of which was to prejudice the Tax Office's recovery of some or all of the group liability. This might apply, for example, if the exiting entity is sold for less than its market value.

Amended liabilities

Most group liabilities have a fixed statutory due date for payment. Any increase in these liabilities following an amendment or revision will be due for payment on the same date as the original liability. As a result, an amended or revised group liability may affect an entity that has left the group by:

- requiring it to make a further payment towards a debt that is deemed to have been due before the entity left the group, or
- affecting whether an amount already paid by the leaving entity is considered reasonable, given the revised or amended group liability.

A TSA could be used to limit a leaving entity's exposure to that part of an increased group liability, relating to a period in which it was a contributing member, that resulted from its own activities.

Issues for contributing members

Contributing members need to consider their statutory and common law responsibilities before becoming a party to a TSA. Issues they need to consider may include:

- *the need for a TSA*:
  - creditors or potential purchasers of the company may wish to examine the terms of the TSA
  - there could be a serious impact on the company's solvency if it does not enter into a TSA (in the event that the Tax Office takes recovery action against it under the joint and several liability provisions)
  - a company can only make a clear exit from a group if it is a party to a TSA
- *time for preparation:* the TSA must be drafted and executed before the head company's liability becomes due and payable
- *regular revision:* TSAs may need to undergo regular revisions as members are purchased by interests outside the consolidated group, or new members are brought into the group – such changes may affect the reasonableness of TSA allocations of group liability, and
- *other matters to be included in the TSA*: other related issues may be addressed in a TSA provided they do not invalidate its prime purpose – such as, for example, subvention payments or contributions by members to ongoing tax payments.

References

Income Tax Assessment Act 1997, Division 721; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, and *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 14

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 11.12, diagram 11.1

Taxation Administration Act 1953, subsection 265-45(2)

The Tax Office has published guidelines for TSAs in the *ATO Receivables Policy*, available on the Legal Database page of its website, **www.ato.gov.au**