Worked example

Tax sharing agreement based on percentage of profit methodology

Description

This example shows what happens, under the tax sharing agreement (TSA) rules, when the head company of a consolidated group receives an assessment, which it pays, and later receives an amended assessment, on which it defaults.

→ 'Tax sharing agreements', C9-7-110

Commentary

Division 721 of the *Income Tax Assessment Act 1997* (ITAA 1997) provides that the primary liability for a consolidated group's tax liability rests with the head company. If, however, the head company fails to discharge this obligation, the subsidiary members of the group could become jointly and severally liable for the group's tax liability.

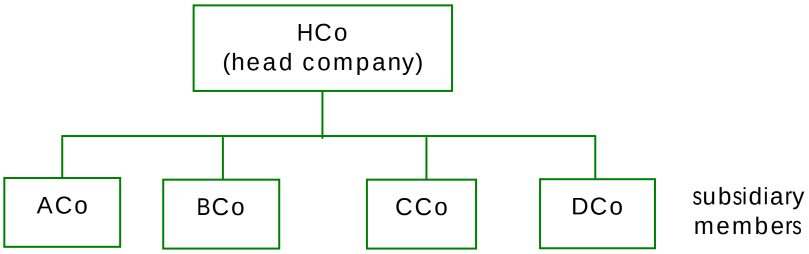
Subsidiary members may decide to limit their individual liability by entering into a tax sharing agreement (TSA) with the other entities in the group. The TSA allows subsidiary members (contributing members) to apportion the group tax liability among themselves, subject to the statutory requirement that any allocation needs to be reasonable. (If the group liability is for income tax for an income year, the group may choose to apportion among its contributing members the amount of the group liability less the PAYG instalment credits to which the head company is entitled for that income year. → subsection 721-25(1A), ITAA 1997.)

Directors and managers of entities considering entering into a TSA need to be aware that other aspects of tax administration, such as the amended assessment provisions, can continue to apply to their obligation under any TSA. Consequently they should seek professional advice on both the application of the law and the content of any agreement.

Example

Facts The example is based on the group structure shown in figure 1.

Figure 1: Group structure



The example focuses on the group's liability for income tax in respect of the year ending 30 June 2006 and, in particular, on the non-payment of part of that group liability relating to an amended assessment. PAYG instalments for the year ending 30 June 2006 are included.

Head company HCo has a standard 30 June year for income tax purposes and has previously chosen to form a consolidated group. Because it received its initial head company instalment rate before 1 July 2005 (i.e. before the start of the 30 June 2006 income year), HCo will be responsible for the group's PAYG instalment liabilities for the year ending 30 June 2006.

The example assumes the PAYG instalments for the 2006 income year are $50 each quarter. (In practice, the amount will be likely to vary because of movements in instalment income and the probable issuance of an updated PAYG instalment rate in the second or third quarter following lodgment of the 30 June 2005 return.)

The group liability for PAYG instalments is allocated under the TSA on the basis of each contributing member's share of group accounting profit for the year ending 30 June 2005 (the preceding year). The example assumes that the group has chosen to allocate among its contributing members its total liability for income tax (rather than that amount reduced by the PAYG instalment credits the head company is entitled to).

The TSA allocates the group liability for income tax in respect of the 2006 income year (→ section 204, *Income Tax Assessment Act 1936*) on the basis of each contributing member's share of group accounting profit for the year ending 30 June 2006 (the current year). The group operates a tax contribution arrangement using the same calculation basis.

HCo returns taxable income for the year ending 30 June 2006 of $1,200 (accounting profit of $1,140 plus tax adjustments) resulting in assessed income tax of $360 (30% of $1200). After credit for PAYG instalments, tax of $160 is payable on 1 December 2006.

The subsidiary members contribute their allocated amounts to HCo, and HCo pays the $160 tax on the due date.

Following an audit of the group, the Tax Office issues an amended assessment in September 2010, which increases the group liability for income tax from $360 to $400. The extra assessable income ($133) relates solely to a transaction undertaken by HCo.

HCo fails to pay the additional $40 and recovery action therefore commences.

The Tax Office issues a notice to HCo requiring a copy of the TSA in the approved form within 14 days → subsection 721-25(3), ITAA 1997. HCo provides the Tax Office with a copy of the TSA as well as a worksheet (indicating the allocation of the group liability in dollars, based on the TSA) within the required period. The worksheet (see table 1) is prepared after receipt of the notice from the Tax Office, as part of providing the TSA in the approved form.

The Tax Office reviews the material provided, considering:

- whether the TSA allocation is reasonable → paragraph 721-25(1)(c)
- whether it complies with the relevant regulations → paragraph 721-25(1)(d), and
- the purpose of the arrangement → subsection 721-25(2),

and concludes that the group liability (income tax assessed for the year ending 30 June 2006) is covered by a TSA under subsection 721-25(1). Because there is a valid TSA, the contributing members are not jointly and severally liable and section 721-30 applies. The Tax Office may proceed with recovery action against contributing members within the limits of the share of group liability allocated to them under the TSA.

For the sake of simplicity, the example ignores the general interest charge (GIC) on the unpaid tax. In practice, however, a TSA should address the allocation of the GIC, including a late GIC for the group liability. TSAs should also provide for the allocation of any penalties resulting from the amendment or revision of a group liability.

Table 1: TSA allocations within HCo's group

	Consolidated group (HCo acting as single entity)	TSA allocations					Notes
		HCo	ACo	BCo	CCo	DCo	
PAYG instalment group liabilities – 2006							
Accounting profit – year ending 30.6.05	$1,000	$50	$400	$150	$300	$100	
% of accounting profit – year ending 30.6.05	100%	5%	40%	15%	30%	10%	
PAYG instalments – year ending 30.6.06	(paid by HCo)						
Quarter 1 – 21.10.05	$50	$2.50	$20	$7.50	$15	$5	TSA allocations of PAYG group liabilities.
Quarter 2 – 21.1.06	$50	$2.50	$20	$7.50	$15	$5	
Quarter 3 – 21.4.06	$50	$2.50	$20	$7.50	$15	$5	
Quarter 4 – 21.7.06	$50	$2.50	$20	$7.50	$15	$5	
(each instalment is a group liability)							
Income tax group liability – 2006							
Accounting profit – year ending 30.6.06	$1,140	$60	$540	$120	$480	($60)	
% of accounting profit* – year ending 30.6.06	100%	5%	45%	10%	40%	0%	
Income tax assessed – year ending 30.6.06 (section 204, ITAA 1936)							
Group liability	$360						
less PAYG instalments raised	($200)						
= tax payable	$160						$160 paid by HCo
TSA allocation of group liability	$360	$18	$162	$36	$144	$0	TSA allocations
Amended income tax assessment issued September 2010 in respect of the year ending 30.6.06 (section 204, ITAA 1936)							
Group liability	$400						
less PAYG instalments raised	($200)						
less tax paid	($160)						
= tax outstanding	$40						$40 not paid – default
TSA allocation of increased group liability	$400	$20	$180	$40	$160	$0	TSA allocations

*The figure on which the percentage is calculated is $1,200, being the total accounting profit of HCo, BCo and CCo, and excluding the $60 loss of DCo.

Calculation

Percentage of profit methodology

The percentage of accounting profit approach is one method that can be used to produce a reasonable allocation of the relevant group liability for the purposes of section 721-25 of the ITAA 1997.

In this example, the preceding year accounting profits are used to allocate PAYG group liabilities, and current year accounting profits are used to allocate the final income tax group liability. Although actual instalment income and taxable income on an entity by entity basis may be different to the result obtained under a percentage of profit allocation, this does not in itself mean the methodology breaches the reasonable allocation requirements in section 721-25.

Under the percentage of profit method, it is not necessary to eliminate intragroup transactions from the accounting profits to ensure the group liability is reasonably allocated (though certain intragroup transactions, such as intragroup dividends, can be eliminated under certain circumstances).

A TSA allocated contribution cannot be a negative amount. Because DCo has an accounting loss of $60, it is allocated a nil amount.

Parties to the TSA

For the TSA to be valid, the allocation of the total group liability among the head company and the subsidiary members that are party to the agreement (the 'TSA contributing members') must be reasonable. There must only be one TSA for each group liability, although one TSA can cover more than one group liability. All members of a consolidated group do not need to be party to a TSA under the current law, provided the TSA represents a reasonable allocation. However, it may be prudent for all subsidiary members to be party to the TSA for due diligence and other commercial reasons.

In this example there are five group liabilities: four PAYG instalments (each instalment is a separate group liability) and the income tax for the 2006 year. These could be dealt with in five separate TSAs or in one or perhaps two (income tax and PAYG) TSAs.

Timing issues

The TSA must be in place before the relevant group liability is due and payable. In this case, therefore, the TSAs for each of the PAYG instalments must be in place before 21 October 2005, 21 January 2006, 21 April 2006 and 21 July 2006 respectively. The TSA for the income tax for the 2006 income year needs to be in place before 1 December 2006.

Note

Due and payable date

For income tax assessments for 2003-04 and earlier years, amended assessments become due and payable on the same date as that applying to the original assessment. The debts in both original and amended assessments relate to the same liability, and must therefore be covered by the same TSA. 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.

For income tax assessments for 2004-05 and later years, the due date for amended assessments is 21 days from when the taxpayer is notified of the amendment. Although the due date for an amended assessment for these years is later than that of the original assessment, the debts in both original and amended assessments relate to the same liability, and therefore must also be covered by the same TSA. The TSA must be in place – and all its requirements met – before the due time of the original assessment. The TSA methodology must also remain unchanged.

Worksheets providing specific allocation details may be required if the Tax Office asks for a copy of the TSA, but they are not part of the TSA itself and therefore do not necessarily need to be prepared until that time. Preparation of the worksheets on a more regular basis would, however, help to reduce the amount of work required to be performed within the 14-day notice period.

TSA methodology and contribution arrangements

The TSA only becomes relevant if the head company defaults on a group liability. Contributions between group members to facilitate the funding and payment of group liabilities are contractual matters for the group and are not relevant to the collection of a group liability by the Tax Office.

Although, in this example, the contribution arrangements are on a similar basis to the TSA, this is not a requirement of a valid TSA. The TSA percentage of profit methodology could be considered a reasonable allocation even if the group's contribution arrangements were totally different (if they were based, for example, on stand-alone tax calculations and included, in effect, subvention payments for losses).

It should be noted that the TSA contribution amounts need to be able to be determined at the head company's due time. This does not *require* the TSA to specify a 'particular amount'. Depending on the methodology of the TSA it could show each TSA contributing member's contribution amount as:

- a fixed or variable percentage of the group liability
- an amount based on the 'notional' contributions to taxable income, or
- an amount based on some other formula.

However, if the TSA does not show each TSA contributing member's contribution amount as a specified sum, a schedule will need to be produced with a copy of the TSA, if and when required, showing the contribution amount for each TSA contributing member as determined by applying the method provided in the TSA relating to that group liability.

Group liability

If HCo defaults, the maximum amount of the group liability that the Tax Office can collect from each contributing member is the reasonable allocation amount under a valid TSA. If the amounts allocated under the TSA exceed the outstanding debt, the total amount the Tax Office can collect is limited to the amount of the outstanding debt, but it can choose which member it collects from.

The group liability as defined in section 204 is the total tax assessed *before* credit for PAYG instalments.

The group liability for income tax to be allocated is the tax assessed for one income year. The amount of the group liability may be modified by amended assessments, but the original assessment and any amended assessments are *not* separate group liabilities.

Thus, in this example, there is in effect a part payment ($360) of the tax assessed of $400. The group liability that must be allocated under the TSA is the tax assessed ($400), not the net tax payable ($40). The amount allocated to member subsidiaries is $380 (excluding the $20 allocated to HCo). Because the allocated amount exceeds the outstanding debt, the Tax Office can collect the $40 from ACo, BCo or CCo – or any combination of them. It cannot however collect any amount from DCo, since its allocation is capped at $0.

Note that, even though it was an HCo transaction that gave rise to the amended assessment, the TSA allocation methodology spreads the adjustment across all members of the group. This does not jeopardise the reasonableness of the allocation.

If the TSA allocation methodology in this example was more sophisticated – if it sought to allocate the entire increase in the group liability to those entities whose allocations under the original assessment were understated – the Tax Office would generally respect the intent behind the TSA. Even though the additional $40 is not a separate group liability with its own separate TSA allocation, the Tax Office would only seek payment of the outstanding amount related to the amended assessment from the entities that contributed to the understatement.

As the liability is for the 2006 income year, and the amended assessment is issued in September 2010, a contributing member that leaves the consolidated group after 1 December 2006 (the due and payable date for the original assessment) and before the date of issue of the amended assessment *may* still achieve a clear exit in relation to the amount of the amended assessment, provided all the requirements under section 721-35 are met → 'Clear exit', in C9-7-110. This is because the due and payable date for the amended assessments for the 2005 and later income years is prospective, being 21 days from when the taxpayer is given notification of the amendment. → subsection

204(2), ITAA 1936. A clear exit can be achieved in this case if the entity makes a payment of its (anticipated) post-amendment contribution amount, or a reasonable estimate of the amount, to the head company, before leaving.

→ 'Clear exit' in C9-7-110.

References

Income Tax Assessment Act 1936, section 204

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, *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 14, and *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2, Part 10

Revision history

Section C9-7-510 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
23.4.04	Revisions to sections on who should be party to a TSA and methodology and contribution arrangements (pp. 4 and 5).	For clarification.
14.7.04	Note on recent changes to consolidation rules.	Legislative amendments.
26.10.05	Extensive changes.	Legislative amendments.
15.11.06	Changes to requirements for TSAs, p, 6.	Change to practice statement.
	Change to text on circumstances for clear exit, p. 8	
30.6.09	Changes to note on due and payable date, p, 6, and text on requirements for a clear exit, p. 8.	To align with changes to *ATO Receivables Policy*.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

044 CRMUR - Scanlan amend methc

103 CRMUR Mark insert alerts Karen C

130 CRMUR - Tax sharing - Lian-Chin Ti

148 CRMUR - ATO Receivables align - 03