



Taxation Determination

Income tax: can Division 16E of Part III of the *Income Tax Assessment Act 1936* apply to a head company of a consolidated group where an intra-group income stream is assigned by a member of the group to a non-member?

Preamble

*The number, subject heading, date of effect and paragraph 1 to paragraph 2 of this document are a 'public ruling' for the purposes of Part IVA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner.*

1. Yes.
2. Where a member of a consolidated group assigns an income stream owed to it by another member to a third party which is not a member of the group, the arrangement will be treated as the issue by the head company of a 'security' under subsection 159GP(1) of the *Income Tax Assessment Act 1936* (ITAA 1936). Applying the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997), the head company will be taken to be the issuer of the security once the member assigns the right to the income stream to an entity outside of the group. The head company will be entitled to claim deductions on an annual accruals basis under Division 16E of Part III (Division 16E) of the ITAA 1936 if the security satisfies the conditions for a 'qualifying security' under subsection 159GP(1) of the ITAA 1936 at the time of the deemed issue by the head company and the conditions under section 159GT of the ITAA 1936 are otherwise satisfied.

Application of the Single Entity Rule

3. Section 701-1 of the ITAA 1997 provides that if an entity is a subsidiary member of a consolidated group for any period, it and any other subsidiary member of the group are taken for the core purposes (stated in subsections 701-1(2) and (3)) to be parts of the head company of the group, rather than separate entities, during that period ('the single entity rule').
4. The core purposes are, in brief, to work out the amount of the head company and subsidiary member's liability for income tax and the amount of a loss for a relevant period. They include all matters relevant and incidental to those calculations. In practical terms, this rule ensures that intra-group transactions between members of a consolidated group have no income tax consequences for the head company.

5. Under the single entity rule, an arrangement between members of a consolidated group is taken to be an arrangement between parts of the head company. Where such an arrangement involves a right to income, the obligations and payments will not be recognised and the income tax law, including Division 16E, cannot apply to them, as the head company is notionally both the debtor and the creditor as long as the arrangement subsists within the group.

6. If a right to income held by the member creditor is subsequently assigned to an entity outside of the consolidated group ('non-member entity'), income tax consequences can arise for the consolidated group. Those consequences are viewed from the perspective of the head company as a result of the single entity rule. Notwithstanding that under the single entity rule the head company did not recognise the intra-group transaction between the members of the group for the purposes of working out its own income tax, this underlying agreement may still be relevant in determining what rights and obligations the head company is taken (because of the single entity rule) to have entered into with the non-member entity.

Application of Division 16E

7. Division 16E of the ITAA 1936 deals with the income tax treatment of certain discounted and deferred interest securities. Broadly, income and deductions from these securities are spread over the term of the security on a basis which reflects the economic gains and losses which have accrued at any point in time. Nevertheless, the question of whether Division 16E applies to a particular arrangement is determined by reference to the terms of the provisions contained within the Division.

8. More specifically, section 159GT of the ITAA 1936 provides that the issuer of a 'qualifying security' is entitled to a deduction if certain conditions are satisfied.

9. Before section 159GT can apply to the head company in relation to the assignment of an income stream, it is necessary to establish:

- the existence of a 'security', as defined by subsection 159GP(1) of the ITAA 1936;
- that the head company is the 'issuer' of the security, as defined by subsection 159GP(1); and
- that the security is a 'qualifying security', as defined by subsection 159GP(1).

'Security'

10. 'Security' is defined in subsection 159GP(1) of the ITAA 1936. Included within the definition are a secured or unsecured loan (paragraph (c)); and any other contract (whether or not in writing) under which a person is liable to pay an amount or amounts, whether or not the liability is secured (paragraph (d)).

11. Depending on whether the arrangement between the head company and the non-member can be characterised as a loan, at least one of these two paragraphs will be satisfied.

'Issue' of the security

12. Subsection 159GP(1) of the ITAA 1936 defines the 'issue' of a security (apart from a security that is a bill of exchange) to be the creation of the liability to pay an amount or amounts under the security. 'Issuer' is defined in that subsection to be the person who would be liable to pay the amount or amounts under the security (apart from a security that is a bill of exchange) if the amount or amounts payable were due and payable at the time.

13. The assignment of the income stream will give rise to what is effectively a borrowing of money by the head company from a non-group entity. This will be treated as a creation of contractual rights under the income tax laws and therefore involves an 'issue' of a security for the purposes of Division 16E of the ITAA 1936. After the assignment of the income stream to a non-member, the 'issuer' of the security for the purposes of Division 16E will be the head company because of the effect of section 701-1 of the ITAA 1997.

'Qualifying security'

14. 'Qualifying security' is defined in subsection 159GP(1) of the ITAA 1936 as any security:

- that is issued after 16 December 1984;
- that is not a prescribed security within the meaning of section 26C of the ITAA 1936;
- that is not part of an exempt series (as provided for in subsection 159GP(9A));
- the term of which, ascertained as at the time of issue of the security will, or is reasonably likely to, exceed 1 year;
- that has an eligible return; and
- where the precise amount of the eligible return is able to be ascertained at the time of issue of the security – in relation to which the amount of the eligible return is greater than 1½% of the amount ascertained by multiplying the amount of the payment or the sum of the payments (excluding any periodic interest) liable to be made under the security by the number (including any fraction) of years in the term of the security,

but does not, except as provided by subsection 159GP(10), include an annuity.

15. In determining whether Division 16E of the ITAA 1936 applies to the arrangement entered into between the head company of the consolidated group and the non-member on assignment of the income stream, the following elements are likely to be critical:

- whether the term of the security will or is reasonably likely to, exceed 1 year;
- whether there is an 'eligible return'; and
- where the amount of the eligible return can be precisely ascertained at the time the security is issued, whether that amount is greater than 1½% of the figure obtained by multiplying the total payments (excluding periodic interest) liable to be made under the security by the number of years in the term of the security.

16. The particular facts and circumstances of a given case will determine whether these elements are satisfied.

'Periodic interest'

17. The question of whether any part of the payments made to the non-member entity can be characterised as interest is crucial in determining whether there is an 'eligible return' and, if there is one that can be precisely ascertained at the time of issue, what the amount of the 'eligible return' is. This is because 'periodic interest payments' are not taken into account in determining whether there is an eligible return under subsection 159GP(3) of the ITAA 1936.

18. Subsection 159GP(6) provides that, for the purposes of Division 16E, 'where an amount of interest is payable under a security, the amount shall be taken to be periodic interest if the period between the commencement of the period in respect of which the interest is expressed to be payable and the time at which the interest is payable is less than or equal to one year'. An amount must be interest in form, and thus cannot be economically equivalent to interest, for it to be periodic interest – see paragraph 13 of Taxation Ruling TR 96/3.

19. In *Federal Commissioner of Taxation v. Firth* (2002) 120 FCR 450; 2002 ATC 4346; (2002) 50 ATR 1, Hill J stated at FCR 454; ATC 4349; ATR 5:

Interest is the price of money which is borrowed. It is 'the return or consideration or compensation for the use or retention by one person of a sum of money belonging to, in a colloquial sense, or owed to another.': *Re Farm Security Act 1944 of the Province of Saskatchewan* [1947] SCR 394 at 411-412... It is, referable to a sum borrowed or agreed to be borrowed. Without a borrowing (or agreement to borrow) there can be no interest.

20. A borrowing connotes a loan and thus involves a temporary transfer of an asset, usually funds, to a borrower (*Butterworths Business and Law Dictionary*, 2nd edn, p. 303) in return for repayment at some time and under some circumstances (*Re Southern Brazilian Rio Grande Do Sul Railway Co Ltd* [1905] 2 Ch 78 at 83). Further, in determining whether a particular arrangement can be characterised as a loan, it has been said 'that what matters is the real *legal* nature of the transaction and not its economic nature, and the courts will not go behind the actual agreement made unless there is evidence that the parties did not intend the relationship between them to be governed by the ostensible agreement which they have made' (*Chitty on Contracts: Vol. 2*, 28th edn., para. 38-225).

21. The enquiry is, therefore, whether there has been a contribution of money (or another asset) by one entity in consideration for a promise from the entity to which the money (or other asset) is lent to repay the money (or return the asset). The answer to this enquiry will depend on the facts and circumstances of each individual case.

22. Subsection 159GP(6) of the ITAA 1936 also requires interest to be *expressed* as payable under the arrangement before it can be considered periodic interest.

Example 1**Facts**

23. *Aerial Co (Aerial) and Brilliant Co (Brilliant) are members of a consolidated group, the head company of which is Heavy Co (Heavy). The group consolidated on 1 July 2002. On that date, Aerial entered into a loan agreement with Brilliant under which Aerial would lend Brilliant \$25 million at 10% pa interest (\$2.5 million pa), repayable in 5 years.*

24. *On 1 July 2003, Ordinary Co (Ordinary), a non-member, pays Aerial \$8 million for the assignment of the interest stream under the loan.*

Application of the single entity rule

25. As the original loan between Aerial and Brilliant is an intra-group transaction and not recognised for income tax purposes, there are no tax consequences arising from the intra-group debt.

26. On assignment of the interest stream outside of the group, Heavy is taken for income tax purposes as having received \$8 million in return for the obligation to pay \$2.5 million per year to a non-member entity (Ordinary) over 4 years. Given that Heavy has only assumed the obligation to make the payments for tax purposes on 1 July 2003, it is at that time that the transaction results in income tax consequences for the consolidated group.

Application of Division 16E in light of the single entity rule

27. The incurring of the obligation to make the payments by the head company to a non-member will bring the arrangement within the terms of Division 16E of the ITAA 1936.

28. Under subsection 159GP(1) of the ITAA 1936, the arrangement existing between Heavy and Ordinary can be classified as a 'security' under paragraph (d) of that definition, as there is a contract under which a person is liable to pay an amount or amounts.

29. The security is taken to be issued at the time of assignment and Heavy is taken to be the issuer of the security.

30. In determining whether the security is a 'qualifying security', it is noted that the security is issued after 16 December 1984, is not a prescribed security within the meaning of section 26C of the ITAA 1936 and is not part of an exempt series as provided in subsection 159GP(9A) of the ITAA 1936.

31. The term of the security, as ascertained at the time of issue of the security, will or is reasonably likely to, exceed 1 year. In this case, the term of the security is 4 years.

32. Under subsection 159GP(3), there is an 'eligible return' given that at the time that the security is issued, it is reasonably likely for the sum of all payments (other than periodic interest) under the security to exceed the issue price of the security. This is because the total payments under the arrangement (excluding periodic interest) will be \$10 million, compared to the issue price of \$8 million. There is no periodic interest as there is no interest expressed to be payable in respect of the arrangement. The amount of the eligible return will be \$2 million, that is, \$10 million less \$8 million.

33. The precise amount of the eligible return is therefore able to be ascertained at the time of issue of the security. Accordingly, that amount must be greater than 1½ % of:

$$\text{Sum of payments liable to be made under the security} \times \frac{\text{Number of years in the term of the security}}{\text{Number of years in the term of the security}}$$

This amount is: \$10 million $\times$ 4 years = \$40 million.

34. The eligible return (\$2 million) is greater than 1½% of \$40 million [1½% of \$40 million = \$0.6 million].

35. Accordingly, the arrangement between Heavy and Ordinary will be treated as a 'qualifying security' following the assignment of the interest stream by Aerial to Ordinary and Heavy will be the issuer of that qualifying security for the purposes of Division 16E of the ITAA 1936.

36. A deduction is only allowable to Heavy under section 159GT of the ITAA 1936 if Heavy would also be entitled to a deduction under section 8-1 of the ITAA 1997 in respect of payments under the security (not being redemption payments, partial redemption payments or periodic interest payments) – see subsection 159GT(2) of the ITAA 1936. For the purposes of these examples, it is assumed that subsection 159GT(2) will not deny Heavy a deduction under section 159GT.

Example 2

Facts

37. The facts are as in Example 1 except that Aerial also entered into a 5 year agreement with Brilliant under which Aerial would lease property to Brilliant in return for yearly rental payments of \$100,000 per year.

38. On 1 July 2003, Ordinary Co pays Aerial \$350,000 for the assignment of the remaining rental payments under the lease. All other rights and obligations under the lease agreement between Aerial and Brilliant, for example the right to use the property, are retained within the group.

Application of the single entity rule and Division 16E

39. Apart from the calculation of the eligible return, the outcome in this example is identical to that in Example 1. On assignment of the rental payment stream outside of the group, Heavy is taken for income tax purposes as having received \$350,000 in return for the obligation to pay \$100,000 per year to a non-member entity over 4 years. This arrangement between the Heavy and Ordinary can be classified as a 'security' under paragraph (d) of that definition in subsection 159GP(1) of the ITAA 1936, as there is a contract under which a person is liable to pay an amount or amounts, which is 'issued' by Heavy at the time of the assignment.

40. In this case, the 'eligible return' is \$50,000, as this is the amount by which the sum of the amounts payable under the security ($4 \times \$100,000$) exceeds the issue price (\$350,000). As the precise amount of the eligible return is able to be ascertained at the time of issue of the security, that amount must be greater than $1\frac{1}{2}\%$ of:

Sum of payments liable to be made under the security $\times$ Number of years in the
term of the security

This amount = $\$400,000 \times 4 \text{ years} = \1.6 million .

41. The eligible return (\$50,000) is greater than $1\frac{1}{2}\%$ of \$1.6 million [$1\frac{1}{2}\%$ of \$1.6 million = \$24,000].

42. Accordingly, the arrangement between Heavy and Ordinary will be treated as a 'qualifying security' following the assignment of the rental payment stream by Aerial to Ordinary and Heavy will be the issuer of that qualifying security for the purposes of Division 16E of the ITAA 1936.

Date of Effect

43. This Determination applies to years commencing both before and after its date of issue. However, it does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Commissioner of Taxation

15 December 2004

Previous draft:

TD 2004/D47

Related Rulings/Determinations:

TR 92/20; TR 96/3

Subject references:

- consolidation – tax liabilities
- deferred interest security
- discounted security
- eligible return
- periodic interest
- qualifying security
- single entity rule

Legislative references:

- TAA 1953 Pt IVA
- ITAA 1936 26C
- ITAA 1936 Pt III Div 16E
- ITAA 1936 159GP(1)
- ITAA 1936 159GP(3)
- ITAA 1936 159GP(6)
- ITAA 1936 159GP(9A)
- ITAA 1936 159GP(10)

- ITAA 1936 159GT

- ITAA 1936 159GT(2)

- ITAA 1997 8-1

- ITAA 1997 701-1

- ITAA 1997 701-1(2)

- ITAA 1997 701-1(3)

Case references:

- Federal Commissioner of Taxation v. Firth (2002) 120 FCR 450; 2002 ATC 4346; (2002) 50 ATR 1
- Re Farm Security Act 1944 of the Province of Saskatchewan [1947] SCR 394
- Re Southern Brazilian Rio Grande Do Sul Railway Co Ltd [1905] 2 Ch 78

Other references:

- Beale, H. G (ed.), Chitty on Contracts: Vol. 2, 28th edn, Sweet & Maxwell Limited, London
- Butterworths Business and Law Dictionary, 2nd edn, LexisNexis Butterworths, Chatswood

ATO references

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