TD 2004/D40 - Income tax: consolidation: can the head company of a consolidated group claim a deduction under section 8-1 of the Income Tax Assessment Act 1997 for interest paid on funds borrowed before consolidation and on-lent interest-free to a subsidiary member of the consolidated group?

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Draft Taxation Determination

Income tax: consolidation: can the head company of a consolidated group claim a deduction under section 8-1 of the *Income Tax Assessment Act 1997* for interest paid on funds borrowed before consolidation and on-lent interest-free to a subsidiary member of the consolidated group?

Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of ***Part IVAAA of the Taxation Administration Act 1953****. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

1. Yes, provided the interest expense continues to satisfy the requirements of section 8-1.

2. Before consolidation, a parent company may have been able to claim a deduction for interest on monies borrowed which were on-lent to a subsidiary interest-free. A basis for the deduction would have been that the loan was to promote the profitability of the subsidiary in the expectation of a subsequent receipt of assessable income by a head company in the form of dividends. (Refer to Income Tax Ruling No. IT 2606 and *Federal Commissioner of Taxation v Total Holdings (Aust.) Pty Ltd* (1979) 79 ATC 4279, 9 ATR 885 (*Total Holdings*)).

3. The single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) treats subsidiary members of a consolidated group as parts of the head company rather than as separate entities. As a consequence, arrangements such as an intra-group loan are taken to be arrangements between parts of the head company.

4. On the same basis, when a dividend is paid by one member of a consolidated group to another, the transaction is treated for income tax purposes as a movement of funds between two parts of the same entity (the head company) rather than the payment of a dividend. See, for example, the Explanatory Memorandum to the *New Business Tax System (Consolidation) Bill (No. 1) 2002* at paragraph 2.18.

5. Where an interest-free, intra-group loan exists between the head company and a subsidiary member of a consolidated group the prospect of future dividends, which was a rationale for interest deductibility under section 8-1 accepted in *Total Holdings* and in

IT 2606, cannot now be the relevant basis for the continued availability of a deduction for the head company's interest expense.

6. As a consequence, the deductibility of interest paid on the funds initially on-lent interest-free to the subsidiary member must now be determined having regard to the purpose of the borrowing and the use to which the borrowed funds are put by the head company (as the relevant entity and on behalf of the consolidated group).

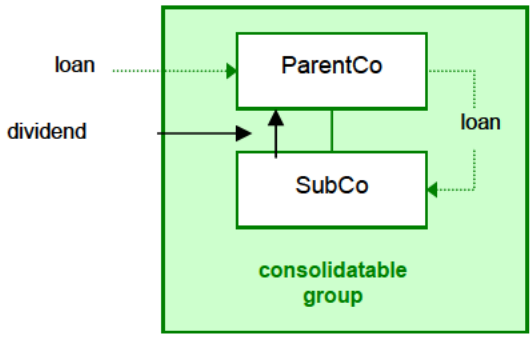
7. The general principles governing the deductibility of interest are applied to the head company as if it were a single entity. These principles are set out in Taxation Ruling TR 95/25 at paragraphs 2 and 3, with a further explanation for companies provided at paragraphs 12 to 17. Addendum 1 to TR 95/25 amends the Ruling in relation to the 1997-98 and later income years by inserting a reference to section 8-1 of the *Income Tax Assessment Act 1997*. Taxation Ruling TR 2004/4 also discusses the deductibility of interest and specifically so in relation to interest incurred prior to the commencement or after the cessation of the relevant income-producing activities.

Example 1:

8. *ParentCo and its wholly-owned subsidiary, SubCo, are members of a consolidatable group (figure 1). Prior to consolidation, ParentCo borrows money to make a loan to SubCo to finance SubCo's income-producing activities which returns income to ParentCo in the form of dividends.*

9. *The group subsequently consolidates. Prior to consolidation, the interest paid by ParentCo on the borrowed monies is deductible under section 8-1 of the ITAA 1997 as it is incurred in producing ParentCo's assessable income.*

Figure 1:



10. Following consolidation, the application of the single entity rule means that neither the inter-group loan nor any payment of dividends between ParentCo (as head company) and SubCo is recognised for the purposes of working out ParentCo's income tax position. This means that the previous rationale for allowing a deduction to ParentCo, that is, the monies are loaned to its subsidiary for the purposes of financing the subsidiary's income-producing activities and ultimately returning income to ParentCo, is no longer available.

11. *ParentCo must now apply the tests in section 8-1 on the single entity basis. The interest will be deductible on the borrowed monies having regard to the purpose of the borrowing and the use to which the borrowed funds are put.*

Date of Effect

12. When the final determination is issued, it is proposed to apply from 1 July 2002. However, this Determination is not to apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Your comments

13. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date.

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Commissioner of Taxation
21 July 2004

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
IT 2606; TR 92/20; TR 95/25; TR 2004/4

Legislative references:
- ITAA 1997 8-1
- ITAA 1997 Pt 3-90
- ITAA 1997 701-1
- ITAA 1997 Div 974

Case references:
- Federal Commissioner of Taxation v. Total Holdings (Aust.) Pty Ltd (1979) 79 ATC 4279; 9 ATR 885

Other references:
- ATO ID 2003/841
- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002

ATO references
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