


***TD 2005/D30 - 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 from outside the group by it or a subsidiary member to buy shares in another subsidiary member of the group?***

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This document has been finalised by TD 2006/48.



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## Draft Taxation Determination

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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 from outside the group by it or a subsidiary member to buy shares in another subsidiary member of the 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 satisfies the requirements of section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997).
2. During consolidation the single entity rule (SER) in section 701-1 of the ITAA 1997 treats subsidiary members of a consolidated group as parts of the head company rather than as separate entities, for the head company's and subsidiary members' income tax purposes.
3. This means that if a subsidiary member borrows funds from outside the group it is the head company that is taken to have borrowed the funds under the SER. The test for interest deductibility is viewed from the perspective of the head company. This is also the case where the head company borrows the funds.
4. The deductibility of interest on the funds borrowed must be determined having regard to all the facts (taking account of the effect of the SER) and considering the connection between the interest expense and the gaining of the head company's assessable income or the carrying on of the head company's business for the purpose of producing assessable income.
5. This will include having regard to the use to which the borrowed funds are put, or taken to be put, by the head company. This may require looking at the flow of funds within the group and the use to which those funds are ultimately put. The use of funds will often result in an outgoing to a non-group member, for example, a payment to a non-group member for assets or for expenses.

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6. The general principles governing the deductibility of interest are applied to the consolidated group as if it were a single entity. These principles are set out in Taxation Ruling TR 95/25 at paragraphs 2 and 3. Paragraphs 12 to 17 of that Ruling provide further guidance on how these principles apply to companies.

7. However, when determining whether the head company of a consolidated group can claim a deduction for interest, it is important to recognise that the SER can affect how certain actions and transactions are to be viewed for income tax purposes. For example, outside consolidation a company may be able to claim a deduction for interest on funds borrowed which are used to buy shares in another company on the basis that the shares are bought with the expectation of receiving assessable income in the form of dividends (refer to paragraph 9 of Taxation Ruling IT 2606).

8. However, because of the SER, 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 as the payment of a dividend.

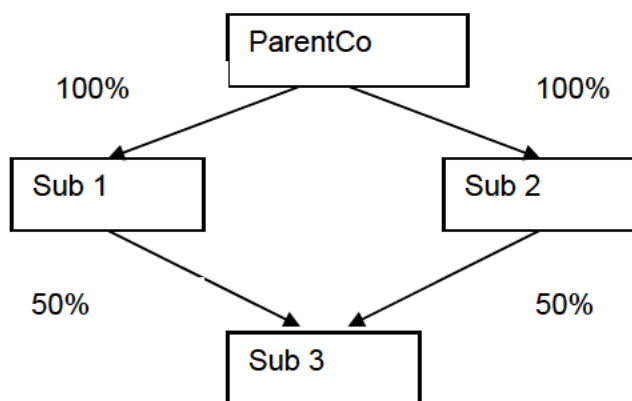
9. Accordingly, the prospect of dividends cannot be a basis for the head company of the consolidated group deducting interest expense where a group member borrows funds that are used to buy shares in another subsidiary member.

10. Another effect of the SER is that the assets of an existing subsidiary member are taken to be those of the head company (excluding intra-group assets). As a result, where the head company or a subsidiary member borrows funds and uses those funds to buy shares in another subsidiary member, there is no change in the assets held by the head company or in its sources of assessable income.

11. In these circumstances it is not open to the head company to argue that the interest is deductible on the basis that the borrowed funds were used to acquire income producing assets or an additional source of assessable income. The head company's income producing assets both before and after the relevant share purchase transaction are exactly the same.

**Example 1**

12. *ParentCo has two wholly owned subsidiaries, Sub 1 and Sub 2, each of which has a 50% share in Sub 3. The group consolidates and ParentCo (the head company) decides to restructure by purchasing Sub 3 from its other subsidiaries.*

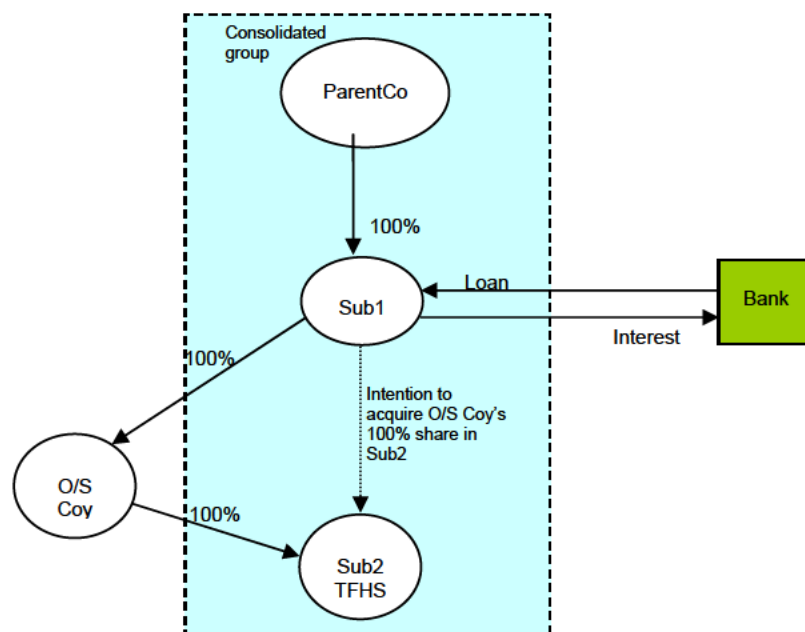


13. ParentCo takes out a loan from a non-group member for \$100,000 and purchases the shares in Sub 3 from Subs 1 and 2. Under the SER the membership interests in Sub 3 and this transaction are not recognised for the group's income tax purposes.

14. Sub 1 and Sub 2 use the funds they receive from ParentCo to purchase additional assets (from a non-group entity) which they use for the purpose of producing assessable income.

15. ParentCo, as the head company of the consolidated group, must apply section 8-1 of the ITAA 1997 on a single entity basis to determine the deductibility of the interest paid on the borrowed funds. From ParentCo's point of view, the borrowed funds were used to acquire the additional assets from the non-group entity which are used to produce assessable income rather than the shares in Sub 3. Consequently, the interest is deductible under section 8-1 of the ITAA 1997.

## Example 2



16. ParentCo, Sub1, O/S Coy & Sub2 are all members of a wholly-owned group. ParentCo, Sub1 and Sub2 are Australian resident companies, whereas O/S Coy is an overseas resident company.

17. ParentCo, Sub1 & Sub2 form a consolidated group prior to 1 July 2004, with ParentCo as the head company and Sub2 as a Transitional Foreign-Held Subsidiary (TFHS) (defined in section 701C-20 of the Income Tax (Transitional Provisions) Act 1997). O/S Coy is ineligible to be a member of the consolidated group as it fails to meet the residency test.

18. Sub1 owns 100% of the shares in O/S Coy which owns 100% of the shares in Sub2.

19. On 1 July 2004 Sub1 decides to acquire the shares in Sub2. To facilitate this purchase, Sub1 borrows money from a bank at commercial rates and is liable for regular interest payments.

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20. *With the borrowed funds, Sub1 purchases all of O/S Coy's shares in Sub2. The parties deal with each other at arm's length.*
21. *For ParentCo's income tax purposes it is considered to have borrowed the money and to be liable for repayments including interest.*
22. *ParentCo, as the head company of the consolidated group, must apply the tests in section 8-1 of the ITAA 1997 to determine the deductibility of the interest paid on the borrowed funds.*
23. *In this case the borrowed funds were paid to O/S Co, a company outside the consolidated group, for the shares in Sub2. However, from ParentCo's perspective the assets it held before and after the purchase of shares in Sub2 are unchanged. There is no additional source of assessable income for the group. The borrowed funds have not been used by ParentCo in the gaining of its assessable income or the carrying on of its business for the purpose of producing assessable income. Section 8-1 is not satisfied.*

## Date of Effect

24. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not 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

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

**Due date:** 9 September 2005

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*Previous draft:*

Not previously issued as a draft

- single entity rule

*Legislative references:*

*Related Rulings/Determinations:*

IT 2606; TR 92/20; TR 95/25

- TAA 1953 Pt IVAAA

- ITAA 1997 8-1

- ITAA 1997 701-1

- IT(TP)A 1997 701C-20

*Subject references:*

- consolidation

- interest

ATO references

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