


TD 2005/D31 - Income tax: consolidation: can the gross proceeds or profit on the disposal of membership interests in a subsidiary member of a consolidated group be income?

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This document has been finalised by TD 2006/36.



Draft Taxation Determination

Income tax: consolidation: can the gross proceeds or profit on the disposal of membership interests in a subsidiary member of a consolidated group be income?

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 IVA of the **Taxation Administration Act 1953**. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

1. Yes, the gross proceeds or profit on the disposal of membership interests in a subsidiary member of a consolidated group can be income according to ordinary concepts, depending on the facts of the particular case.

Consolidation

2. The consolidation provisions allow certain groups of entities to be treated as single entities for their income tax purposes. Under the single entity rule (SER) in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997), the subsidiary members of a consolidated group are taken to be parts of the head company of the group, rather than separate entities. All of the assets of the subsidiary members (with the exception of intra-group assets) are taken to be owned by the head company. Assets can move within the group, but such intra-group transactions do not have any income tax consequences.

3. While a subsidiary member continues to be a member of the group, the membership interests in that subsidiary are not recognised for income tax purposes. However, once the group disposes of those membership interests, the subsidiary ceases to be a member of the group and the group must consider if the gross proceeds or profit on the disposal of the membership interests is income.

4. Due to the operation of the SER, the head company is the only taxpayer recognised for income tax purposes. The head company is taken to have disposed of the membership interests and any gross proceeds or profit on the disposal will be assessed to it, even though the membership interests may have actually been sold by a subsidiary member of the group (the legal owner). Where the membership interests were acquired by a subsidiary before it became a member of the group, the entry history rule in section 701-5 of the

ITAA 1997 supports the SER by attributing to the head company everything that happened in relation to each subsidiary before it became a member of the group.

5. When the subsidiary member ceases to be a member of the group, the tax cost of the membership interests in the subsidiary is set at the tax cost setting amounts (TCSA) (see subsection 701-15(3) of the ITAA 1997). Under subsection 701-55(5) of the ITAA 1997 the TCSA becomes the cost base of each membership interest for the purpose of determining any capital gain under Part 3-1 or 3-3 of the ITAA 1997. Under subsection 701-55(6) of the ITAA 1997 the TCSA becomes the cost of each membership interest for the purpose of any provisions not specifically mentioned in section 701-55 of the ITAA 1997. This would include section 6-5 of the ITAA 1997 where the gross proceeds or profit on disposal is income.

Characterisation

6. Existing principles in characterising the gross proceeds or profit from a transaction also apply in a consolidated environment. Paragraph 2.28 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 (the EM) states:

The income tax character of a transaction undertaken by a consolidated group will continue to be a question of fact to be determined in light of all the relevant circumstances.

7. Paragraph 2.29 of the EM adds:

Transactions under consolidation are subject to the same scrutiny for the purposes of characterisation as those involving a single taxpayer.

Ordinary income under section 6-5

8. Whether the gross proceeds or the profit from the disposal of the membership interests would be assessable as ordinary income under section 6-5 of the ITAA 1997 depends on the circumstances of each case.

9. Based on existing principles, where the acquisition and disposal of the membership interests is part of the ordinary business of the head company, the gross proceeds or the profit will be ordinary income and included in the assessable income of the head company under section 6-5 of the ITAA 1997.

10. Where the acquisition and disposal of the membership interests is not part of the ordinary business of the head company, the principles regarding isolated transactions outlined in Taxation Ruling TR 92/3 'Income tax: whether profits on isolated transactions are income' provide guidance.

11. TR 92/3 refers to the intention or purpose of the taxpayer in entering into the transaction. Where the transaction involves simply the acquisition and disposal of the membership interests, the intention or purpose of the taxpayer in acquiring the membership interests needs to be determined. Where the membership interests were not acquired by a group member (for example, where the head company of a consolidated group incorporates a new subsidiary member), or where there are substantial changes made to the subsidiary member prior to the disposal of the membership interests, it is the intention or purpose of entering into the entirety of the transaction that generated the profit that will be relevant.

12. Paragraph 7 of TR 92/3 states:

The relevant intention or purpose of the taxpayer (of making a profit or gain) is not the subjective intention or purpose of the taxpayer. Rather it is the taxpayer's intention or purpose discerned from an objective consideration of the facts and circumstances of the case.

13. In determining the head company's intention or purpose, where the head company did not itself acquire the membership interests, an objective consideration of all the facts and circumstances may include a consideration of everything that happened in relation to a subsidiary member that acquired the interest prior to when it became a member of the group. In determining the head company's intention or purpose, the SER does not operate to prevent consideration of intra-group transactions or dealings.

Note: Any capital gains on the disposal of the membership interests in the subsidiary member under Parts 3-1 or 3-3 of the ITAA 1997 may be reduced by section 118-20 of the ITAA 1997 if the gross proceeds or profits for the disposals are assessable as ordinary income under section 6-5 of the ITAA 1997.

Example 1

14. *H Co is the head company of a consolidated group. It carries on a business of producing DVDs.*

15. *On 1 January 2004 X Co is acquired by the group as part of a long term business strategy and it becomes a subsidiary member. The group continues to operate X Co's business of distributing DVDs in the same way as X Co had before the acquisition.*

16. *The group carries on the distribution business until December 2007 when X Co is sold. At the time of sale the assets of X Co relate solely to the distribution business. The sale occurs because the group wishes to retreat from its earlier business strategy and to concentrate solely on its manufacturing business.*

17. *H Co makes a capital gain under Part 3-1 of the ITAA 1997 on the sale of the shares in X Co. The gross proceeds or profit from the sale are not assessable as ordinary income under section 6-5 of the ITAA 1997.*

Example 2

18. *SubCo, a member of a consolidated group, has been carrying on a business of manufacturing and retailing furniture for a number of years.*

19. *The group now wants to concentrate on the manufacture of furniture and decides to sell its retail operation as a going concern.*

20. *To facilitate the sale, a new subsidiary member of the group is incorporated and all of the assets and liabilities relating to the retail operation are transferred to the newly incorporated entity.*

21. *The head company of the consolidated group will make a capital gain on the sale of the shares in the newly incorporated entity under Part 3-1 of the ITAA 1997. The gross proceeds or profit from the sale are not assessable as ordinary income under section 6-5 of the ITAA 1997.*

TD 2005/D31**Date of Effect**

22. 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

23. 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

10 August 2005

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 92/3; TR 92/20

Subject references:

- consolidated groups
- entry history rule
- membership interests
- single entity rule

Legislative references:

- TAA 1953 Pt IVA
- ITAA 1997 6-5

- ITAA 1997 Pt 3-1
- ITAA 1997 Pt 3-3
- ITAA 1997 118-20
- ITAA 1997 701-1
- ITAA 1997 701-5
- ITAA 1997 701-15(3)
- ITAA 1997 701-55
- ITAA 1997 701-55(5)
- ITAA 1997 701-55(6)

Other references:

- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002

ATO references

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