



TD 2007/D5 - Income tax: consolidation: does the single entity rule in section 701-1 of the Income Tax Assessment Act 1997 apply in determining whether distributions by the liquidator of a head company represent 'income derived' by the head company for the purposes of section 47 of the Income Tax Assessment Act 1936?

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 The Tax Office is consulting with Treasury in relation to this issue. TD 2007/D5 will not be finalised while this consultation is occurring. TD 2007/D5 will not be withdrawn and still represents the Tax Office view of the law.



Draft Taxation Determination

Income tax: consolidation: does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* apply in determining whether distributions by the liquidator of a head company represent ‘income derived’ by the head company for the purposes of section 47 of the *Income Tax Assessment Act 1936*?

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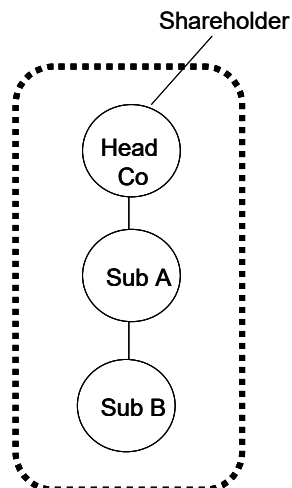
Ruling

1. No. The single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) applies only for the head company core purposes and entity core purposes described in that section. For other purposes of the income tax law, such as the application of section 47 of the *Income Tax Assessment Act 1936* (ITAA 1936)¹ to determine the income tax liability of a shareholder of a head company, the single entity rule does not apply.

¹ All legislative references are to the ITAA 1936 unless otherwise indicated.

Example 1

2. Shareholder, an individual, owns all the shares in Head Co. Head Co, Sub A, and Sub B are members of a consolidated group. All membership interests are post-CGT interests.



3. Sub B is placed in voluntary liquidation. At the end of its winding up, the liquidator makes a distribution of \$100 to Sub A, representing a return of paid up share capital of \$50, and pre-consolidation untaxed retained earnings of \$50.

4. For the purposes of working out Sub A's income tax liability, the SER applies and the distribution is ignored. However, for the purpose of ultimately working out the income tax liability of the shareholder of Head Co, section 47 operates in the normal way as this is not a core purpose. Sub A is regarded as having received a return of share capital of \$50, and a dividend out of profits of Sub B of \$50 because the retained earnings represent income derived by Sub B.

5. Sub A is subsequently liquidated. At the end of its winding up, the liquidator makes a distribution of \$150 to Head Co, representing a return of share capital of \$100 and the \$50 profits received from the winding up of Sub B.

6. For the purpose of working out Head Co's income tax liability, the SER applies and the distribution is ignored. For the purpose of working out the ultimate shareholder's income tax liability, section 47 applies. Head Co is regarded as having received a return of share capital (\$100) and a dividend of \$50 out of profits of Sub A because the dividend deemed to be paid by Sub B represents income derived by Sub A pursuant to subsection 47(1A). That is, although no amount forms part of Sub A's assessable income for the purposes of determining its income tax liability, the SER does not apply for other purposes such as determining the liability of the ultimate shareholder. For those purposes, therefore, the deemed dividend will represent an amount included in Sub A's assessable income in terms of subsection 47(1A).

7. Head Co is subsequently liquidated. At the end of its winding up, the liquidator makes a distribution of \$150 to Shareholder representing a return of paid up share capital of \$100 and the \$50 profits received from the winding up of Sub A.

8. For the purpose of working out Shareholder's income tax liability, section 47 applies. Shareholder is regarded as having received a return of share capital of \$100 and a dividend of \$50 out of profits of Head Co because the dividend deemed to be paid by Sub A represents income derived by Head Co pursuant to subsection 47(1A) (refer to the explanation in paragraph 6 of this Determination).

Example 2

9. Shareholder, an individual, owns all the shares in Head Co. Head Co, Sub A, and Sub B are members of a consolidated group. Sub B had brought a pre-CGT asset into the group and subsequently disposed of that asset. Sub B pays a dividend of \$50 to Sub A out of profits on disposal of the pre-CGT asset. For the purposes of working out Sub A's income tax liability, the SER applies and the dividend is ignored. For the purpose of working out the ultimate shareholder's income tax liability pursuant to section 47, the dividend is not ignored and represents income in the hands of Sub A.

10. Sub A then pays a dividend of \$50 to Head Co. The SER applies for the purposes of working out Head Co's income tax liability, and the dividend is ignored. For the purpose of working out Head Co's shareholder's income tax liability pursuant to section 47, the dividend is not ignored and represents income in the hands of Head Co.

11. Head Co is subsequently liquidated. At the end of its winding up, the liquidator makes a distribution of \$150 to Shareholder, representing a return of share capital of \$100, and the dividend of \$50 paid to Head Co by Sub A.

12. For the purpose of working out Shareholder's income tax liability, section 47 applies. Under section 47, Shareholder is deemed to have received a dividend of \$50 out of profits which is the extent to which the distribution represents income derived by Head Co.

Example 3

13. Shareholder, an individual, owns all the shares in Head Co. Head Co, Sub A, and Sub B are members of a consolidated group. Sub B has a retained profit of \$50 made on the disposal of a pre-CGT asset before the consolidated group was formed.² Sub B is liquidated and the liquidator makes a distribution to Sub A representing a return of paid up share capital and the profit on disposal of the pre-CGT asset. For the purposes of working out Sub A's income tax liability, the SER applies and the distribution is ignored. For the purpose of ultimately working out the income tax liability of Shareholder, section 47 would apply as this is not a core purpose.

14. However, in this case, no part of the distribution by the liquidator of Sub B would be deemed to be a dividend paid out of profits because no part of the distribution represents income derived by Sub B (that is, the profit on disposal of the pre-CGT asset would not be assessable to Sub B and therefore would not constitute income derived by Sub B under subsection 47(1A) for the purposes of applying section 47 to Shareholder). If Sub A and Head Co are subsequently liquidated and the liquidator's distributions only represent a return of paid up share capital and the profit on disposal of the pre-CGT asset by Sub B, then section 47 would not apply to deem a dividend as no part of the distributions would represent income derived by Sub A or Head Co.

² Note that the outcome in this example would be the same if the circumstances in Example 2 applied (that is, Sub B had brought the pre-CGT asset into the consolidated group and subsequently disposed of it).

TD 2007/D5

Date of effect

15. 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 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

11 April 2007

Appendix 1 – Explanation

❶ ***This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.***

Explanation

Subsection 47(1)

16. Subsection 47(1) provides:

Distributions to shareholders of a company by a liquidator in the course of winding up the company, to the extent to which they represent income derived by the company (whether before or during liquidation) other than income which has been properly applied to replace a loss of paid-up share capital, shall, for the purposes of this Act, be deemed to be dividends paid to the shareholders by the company out of profits derived by it.

17. The effect of section 47 is to treat certain distributions by a liquidator as dividends paid out of profits when they otherwise would have been treated as capital.³

The single entity rule

18. Transactions between members of a consolidated group that might otherwise produce assessable income are not recognised, or are ignored, for 'head company core purposes' and 'entity core purposes' under the single entity rule (SER) in section 701-1 of the ITAA 1997.⁴ Income derived by subsidiary members will be taken to have been derived by the head company of the group under the SER for the same purposes. This is because the SER deems the subsidiary members of the group to be parts of the head company for those purposes. The core purposes are, broadly, working out a liability for income tax or working out a loss for the head company or an entity that is a subsidiary member of the consolidated group.

Income derived by a head company for the purpose of section 47

19. Funds from which a liquidator makes a distribution to shareholders of a consolidated group may represent 'income derived' by the head company for the purposes of section 47 even if that income was derived through intra-group transactions that would not be recognised under the SER. This is because the SER only applies for head company core purposes and entity core purposes. For purposes other than the core purposes, such as the application of section 47 to determine the liability for income tax of shareholders of a head company, the SER does not apply.

³ See *IRC v. Burrell* (1924) 2 KB 52 and *FCT (NSW) v. Stevenson* (1937) 59 CLR 70: a liquidator's distribution, whether or not it encompasses amounts that were income in the hands of the company, will have the character of capital in the hands of the shareholder.

⁴ For the ATO view on the SER, see Taxation Ruling TR 2004/11 Income tax: consolidation: the meaning and application of the single entity rule in Part 3-90 of the *Income Tax Assessment Act 1997*, in particular paragraphs 8(d), 10 and 32.

20. Thus, transactions within the consolidated group are not ignored for the purpose of determining whether a distribution ultimately made by the liquidator of a head company represents income derived by the head company for the purposes of section 47. If the distribution represents income derived by the head company then the distribution will be deemed to be a dividend paid out of profits of the head company under section 47.

21. A distribution by a liquidator of a subsidiary member of a consolidated group is an intra-group transaction that would be recognised for purposes other than core purposes. In these circumstances, section 47 will apply to deem the distribution to be a dividend out of profits to the extent that the distribution represents income derived by the subsidiary member.

22. For the purposes of a subsequent application of section 47 to the liquidation of the company that receives the distribution, the deemed dividend will represent income in the hands of that company because of the extension of the meaning of 'income' in subsection 47(1A). This provision extends the meaning to include an amount that is included in the assessable income of a company. For purposes other than core purposes, the deemed dividend out of profits will be taken to be an amount included in the assessable income of the company that receives the distribution.

Appendix 2 – Alternative views

❶ *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.*

Alternative view

23. An alternative view is that, in the context of section 47, the question of whether a distribution by a liquidator represents income derived by a head company must be answered by reference to the SER.

24. For the purpose of determining a head company's liability under the income tax law, the question of whether it has derived income is answered having regard to the SER. It is natural, then, that references in the income tax law to 'income derived' by a head company should be taken to mean income derived in the context of the application of the SER.

25. This approach therefore should be the basis for determining whether a distribution represents income derived by a company for the purpose of section 47 if the relevant company is a head company.

26. The Tax Office does not accept this view because the SER in section 701-1 of the ITAA 1997 is clearly expressed to apply only for the core purposes outlined in that section. The determination of whether a distribution by a liquidator represents income derived by a head company under section 47 of the ITAA 1936 does not relate to core purposes but, rather, it relates to the income tax liability of shareholders of the head company. Therefore, the question of whether a distribution represents income derived by a head company must be determined without regard to the SER.

27. Another alternative view is that, although it may be accepted that intra-group transactions are recognised for the non-core purposes described in this Determination, the statutory extension of the meaning of 'income' in subsection 47(1A) does not apply in the circumstances where a distribution by a liquidator of a subsidiary member has been deemed to be a dividend paid out of profits to another company in the consolidated group. That is, contrary to the position put in paragraph 22 of this Determination, the operation of the SER means that the deemed dividend will not be included in the assessable income of the other company and, therefore, it will not represent income for the purposes of applying section 47 to the subsequent liquidation of that company.

28. The Tax Office does not accept this view. Although the effect of the SER is that no amount is included in the assessable income of the other company for the purposes of determining its income tax liability, the deemed dividend is still taken to be included in the assessable income of the company for other purposes.

Appendix 3 – Your comments

29. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date. (Note: the Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

Due date: 11 May 2007

Contact officer details have been removed.

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2004/11; TR 2006/10

Subject references:

- company
- consolidated group
- consolidation - exiting
- consolidation - tax liabilities
- leaving entity
- leaving time
- liquidation
- member of a group
- ownership, interests, control & rights
- pre-CGT shares
- provisional liquidation

- single entity rule
- subsidiary company
- subsidiary member of a consolidated group
- voluntary liquidation
- wholly owned
- wholly owned subsidiary

Legislative references:

- ITAA 1936 47
- ITAA 1936 47(1)
- ITAA 1936 47(1A)
- ITAA 1997 701-1

Case references:

- IRC v. Burrell (1924) 2 KB 52
- FCT (NSW) v. Stevenson (1937) 59 CLR 70

ATO references

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Income Tax ~~ Consolidation ~~ single entity rule