


***TR 2004/D5 - Income tax: whether the exclusion under subsection 721-15(2) of the Income Tax Assessment Act 1997 can extend to a participant in a licensed financial market or licensed CS facility***

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This document has been finalised by TR 2004/12.



## Draft Taxation Ruling

Income tax: whether the exclusion under subsection 721-15(2) of the *Income Tax Assessment Act 1997* can extend to a participant in a licensed financial market or licensed CS facility

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### **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 Rulings that represent authoritative statements by the Australian Taxation Office.*

## What this Ruling is about

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1. This Draft Ruling deals with the extent of the exclusion from joint and several liability that arises under subsection 721-15(2) of the *Income Tax Assessment Act 1997* (ITAA 1997). It considers whether a subsidiary member of a consolidated group that is a participant in a financial market or clearing and settlement (CS) facility licensed under the *Corporations Act 2001* would be within the subsection 721-15(2) exclusion because of a prohibition in the operating rules of the licensee of the market or facility. In particular it considers whether a Participant in the financial market of the Australian Stock Exchange Ltd (ASX) or the CS facility of the Australian Clearing House Pty Ltd (ACH) could come within the subsection 721-15(2) exclusion.

## Date of effect

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2. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. The final Ruling would be administratively binding on the Commissioner and would apply to protect a subsidiary member of a consolidated group that comes within the terms of the Ruling from recovery action for a group liability (section 721-15 of the ITAA 1997). However creditors of other entities that are members of that consolidated group and other subsidiary members of the consolidated group would not be bound by the final Ruling.

## Ruling

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3. Subsection 721-15(2) of the ITAA 1997 can exclude a subsidiary member of a consolidated group from being jointly and severally liable for a group liability. The exclusion would apply when at the head company's due time the subsidiary member was '... prohibited according to the effect of an Australian law ...' from entering into an arrangement under which it would become subject to such a joint and several liability.
4. The subsection 721-15(2) exclusion would apply to a subsidiary member that was a participant in a financial market or CS facility licensed under Parts 7.2 or 7.3 of the *Corporations Act 2001*, if at the time that the group liability became due and payable, the operating rules of the market or facility prohibited the subsidiary member from entering into any arrangement under which it would become subject to a joint and several liability.
5. ASX Participants are subject to ASX Market Rules, which are the operating rules of a financial market under Part 7.2 of the *Corporations Act 2001*. ACH Participants are subject to ACH Clearing Rules, which are the operating rules of a CS facility under Part 7.3 of the *Corporations Act 2001*. Under both the ASX Market Rules and the ACH Clearing Rules, Participants have to comply with one of three capital regimes; the Risk Based Capital Requirements, the Net Tangible Assets Requirements or the Other Capital Regime. Which capital regime applies to a Participant depends on the transactions it has trading permission for and/or the clearing authority it has. ASX and ACH Participants that are subject to the current version of the Risk Based Capital Requirements may only give a guarantee or indemnity in limited circumstances and are prohibited from giving a cross guarantee. It is accepted that such a prohibition for practical purposes is tantamount to a prohibition on becoming subject to a joint and several liability and that it arises '...according to the effect of an Australian law' for the purposes of subsection 721-15(2).

## Explanation

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6. Section 721-15 of the ITAA 1997 provides that in the absence of a valid tax sharing agreement (TSA) the head company and the subsidiary members of a consolidated group are jointly and severally liable for the payment of a group liability where the head company does not pay on time. The imposition of joint and several liability by this section effectively amounts to the subsidiary members of a consolidated group becoming guarantors of the group liability. Paragraph 56 of Urgent Issues Group, Abstract 52, Income Tax Accounting under the Tax Consolidation System (December 2003) issued by the Australian Accounting Standards Board confirms that:

... Wholly-owned subsidiaries in a tax-consolidated group have contingent liabilities as a result of their joint and several liability, which is in effect a guarantee by the subsidiaries.

7. However, an exclusion applies in respect of a subsidiary member that is prohibited, as an effect of an Australian law, from entering into an arrangement under which it would become subject to a joint and several liability. Subsection 721-15(2) of the ITAA 1997 provides that:

... a contributing member is excluded by this subsection if it is, at the head company's due time, prohibited according to the effect of an Australian law from entering into any arrangement under which the entity becomes subject to a liability referred to in subsection (1).

8. A subsidiary member that is a participant in a financial market or CS facility such as those operated by the ASX or ACH may be prohibited by the operating rules regulating that market or CS facility from giving a cross guarantee and becoming subject to such a joint and several liability. An issue arises as to whether such a prohibition arises as an effect of an Australian law.

9. Under the *Corporations Act 2001* the Minister has the main responsibility for regulating financial markets and CS facilities operating in Australia. The Australian Securities and Investments Commission (ASIC) advises the Minister about applications for market and CS facility licences, changes in operating rules and other matters in respect of financial markets and CS facilities including matters in respect of which the Minister has a discretion under Parts 7.2 and 7.3 of the *Corporations Act 2001*. The Minister has the power at any time to impose conditions or additional conditions on an Australian market license or an Australian CS facility licence or to vary or revoke the conditions imposed on such a license (sections 796A and 825A of the *Corporations Act 2001*). The purposes of this market regulation are to protect market users and enhance market integrity and financial system stability.

10. The ASX is a market licensee regulated by Part 7.2 of the *Corporations Act 2001*. The ACH is a clearing and settlement facility licensee under Part 7.3 of the *Corporations Act 2001*. Under Parts 7.2 and 7.3 licensees are required to have operating rules for the supervision of their markets or CS facilities including rules for monitoring the conduct of participants. These operating rules are made by the market or CS facility licensee or are contained in the licensee's constitution. The authority and obligation of the licensee to properly regulate the market or facility by making and enforcing operating rules arises under the *Corporations Act 2001*. The operating rules have to deal with the matters prescribed in the *Corporations Regulations 2001*.

11. Written notice of a change to the operating rules including the text of the change, the date that it was made and the reason for the change has to be lodged with ASIC (sections 793D and 822D of the *Corporations Act 2001*). ASIC is then required to send a copy of the notice to the Minister, who has the power to disallow all or part of a change (sections 793E and 822E of the *Corporations Act 2001*).

12. Under sections 793B and 822B of the *Corporations Act 2001* the operating rules of licensed markets and licensed CS facilities are given force and effect as a statutory contract under seal between both the licensee and each participant in the market or facility and between the participants themselves. The ability to make an application in respect of a breach of the operating rules is not limited to these parties (sections 793C and 822C of the *Corporations Act 2001*). A court may make certain orders in respect of a contravention of the operating rules under section 1101B of the *Corporations Act 2001*. Changes to the rules made by the licensee can be disallowed by the relevant Minister.

13. An ASX Participant (other than a Participant who is only a Principal Trader that is not registered as a Market Maker in respect of one or more Derivative Trading Platform products) is required by ASX Market Rules to hold an Australian financial services licence (AFSL) under Part 7.6 of the *Corporations Act 2001*. An ACH Participant is also required by the ACH Clearing Rules to hold an AFSL. It is a condition of such a licence that the Participant complies with the relevant Risk Based Capital requirements prescribed in the ASX Market Rules and the ACH Clearing Rules.

14. Under ASX Market Rule S1A.2.6 in Schedule 1A:

A Market Participant may only give a guarantee or indemnity:

- (a) for the purposes of these Rules, the ACH Clearing Rules or the ASTC Settlement Rules;
- (b) in the ordinary course of the conduct of its securities or derivatives business;
- (c) outside the ordinary course of its securities or derivatives business if a maximum liability is specified in the guarantee or indemnity at the time it is entered into; or
- (d) to settle legal proceedings that have been threatened or issued against it;

and must not give a cross guarantee.

ACH Clearing Rule S1.2.6 in Schedule 1 of the ACH Clearing Rules is identical to ASX Market Rule S1A.2.6 except that the reference to 'Market Participant' becomes 'Participant' and the reference to 'ACH Clearing Rules' changes to 'ASX Market Rules'.

15. The reason for these Rules is concern that if participants were not prohibited from entering into cross guarantees, they could become liable for the debts of other unregulated group entities. The imposition of minimum capital requirements by the ASX Group provides a level of protection to investors and to other market participants against the default of a participant.

16. While the prohibition is contained in the operating rules rather than a statute, those operating rules are required by the *Corporations Act 2001* to be made by the financial market or CS facility licensee and are given force by that statute. The word 'effect' in the expression 'according to the effect of an Australian law' in subsection 721-15(2) would be satisfied because while the proximate cause of the prohibition would be the operating rules the making, operation and enforcement of those operating rules are themselves effects of the legislative regime imposed by the *Corporations Act 2001*. The prohibition is a downstream effect of an Australian law. The connection between the statute and the prohibition is sufficient for the subsection 721-15(2) exclusion to apply.

## Alternative views

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17. A restriction or prohibition in the operating rules on a participant giving a guarantee or cross guarantee would not amount to a total prohibition on entering into an arrangement under which it would become subject to a joint and several liability. The subsection 721-15(2) exclusion should be restricted to where there is such a total prohibition. While the concepts of joint and several liability, guarantee and suretyship overlap they are not co-extensive.

18. Even if the operating rules did prohibit entry into a joint and several liability, such a prohibition would only arise from the operating rules made by a market licensee rather than as an effect of an Australian law. The connection with the prohibition and the Australian law is too remote for the purposes of subsection 721-15(2). The prohibition has to arise from an Australian law which means a law of the Commonwealth, a State or a Territory (subsection 995-1(1) of the ITAA 1997).

19. The prohibition on cross guarantees does not arise from the *Corporations Act 2001* itself but only from operating rules made by companies that have licenses to operate financial markets or CS facilities. For example the ASX Market Rules are made and promulgated under Article 13.2(f) of the ASX's Constitution. Under Article 14 the administration and control of these Market Rules is with the directors of ASX who have the power to alter, repeal and replace the Rules subject to Ministerial non-disallowance. While these rules are given force and effect as a statutory contract between both the licensee and each participant in the market and between the participants themselves, it can equally be said that the constitution of any company also has force and effect as a statutory contract between the company and each member and the members themselves by virtue of subsection 140(1) of the *Corporations Act 2001*.

20. In any case the relevant operating rules of the ASX and ACH as currently drafted only prohibit participants from 'giving' cross guarantees or indemnities. If a head company elects to form a consolidated group with the consequence that the subsidiary members risk becoming jointly and severally liable for a group liability just after the head company's due time, the joint and several liability arises from the election of the head company and not from the giving of a guarantee by the Participant.

21. While each of these alternative views has considerable merit when considered in isolation, it is considered that the preferred views are more consistent with a purposive construction of the subsection 721-15(2) exclusion, and in particular the need to achieve an appropriate balance between the ability to collect tax and the need for efficient and effective prudential regulation of financial markets and CS facilities.

## **Ramifications for other creditors**

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22. The Commissioner can decide not to sue an ASX or ACH Participant that is a subsidiary member of a consolidated group because he takes the view that the Participant comes within the subsection 721-15(2) exclusion. If this view is ultimately found to be incorrect as a matter of law, the creditors of other subsidiary members of the consolidated group could be disadvantaged relative to the creditors of the Participant.

23. However this risk would be ameliorated to the extent that the other subsidiary members of the consolidated group who have paid an amount of the group liability would have a right of contribution under section 265-45 of Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953) against the Participant that was not sharing the burden for which it was jointly and severally liable as a matter of law. For example, a consolidated group consists of a head company (Hco) and two subsidiary members, a company called Aco and a Participant covered by this Draft Ruling. The head company fails to pay a group liability of \$1 million by the due time. Aco pays the group liability of \$1 million for which it is jointly and severally liable 14 days after being given written notice by the Commissioner. Aco can then seek a contribution from the Participant for so much of the debt paid of \$1 million as a court of competent jurisdiction considers just and equitable (subsection 265-45(2) of Schedule 1 to the TAA 1953). Whether or not the Participant comes within the subsection 721-15(2) exclusion would be a matter for the court to determine.

24. This statutory right would operate in addition to any common law rights of contribution. The fact that the joint and several liability was not assumed voluntarily but arose from a revenue law would not preclude a right of contribution from also arising under equitable principles (*Armstrong v. Commissioner of Stamp Duties* (1967) 69 SR (NSW) 38; 86 WN (Pt 2) (NSW) 259). Of course the risk of joint

and several liability would not arise in the first place if the group liability was covered by a tax sharing agreement (subsection 721-15(3) of the ITAA 1997).

## Your comments

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

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**Contact officer:** Sophia Savva  
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## Detailed contents list

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*Subject references:*

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- joint and several liability
- joint liability
- legal liability
- several liability
- subsidiary member of a consolidated group
- subsidiary member of a MEC group
- tax sharing agreement
- valid tax sharing agreement

*Legislative references:*

- TAA 1953 Pt IVA
- TAA 1953 Sch 1 265-45
- TAA 1953 Sch 1 265-45(2)
- ITAA 1997 721-15
- ITAA 1997 721-15(1)
- ITAA 1997 721-15(2)
- ITAA 1997 721-15(3)

- ITAA 1997 995-1(1)
- Corporations Act 2001 Pt 7.2
- Corporations Act 2001 Pt 7.3
- Corporations Act 2001 Pt 7.6
- Corporations Act 2001 140(1)
- Corporations Act 2001 793B
- Corporations Act 2001 793C
- Corporations Act 2001 793D
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- Corporations Act 2001 796A
- Corporations Act 2001 822B
- Corporations Act 2001 822C
- Corporations Act 2001 822D
- Corporations Act 2001 822E
- Corporations Act 2001 825A
- Corporations Act 2001 1101B
- Corporations Regulations 2001

*Case references:*

- *Armstrong v. Commissioner of Stamp Duties* (1967) 69 SR (NSW) 38; 86 WN (Pt 2) (NSW) 259

*Other references:*

- ACH Clearing Rule S1.2.6 Schedule 1
- ASX Market Rule S1A.2.6 Schedule 1A
- ASX Constitution Article 13.2(f)
- ASX Constitution Article 14
- UIG Abstract 52

## ATO references

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