


TD 2005/D29 - Income tax: consolidation: can the head company of a multiple entry 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 an existing eligible tier-1 company of the group?

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This document has been finalised by TD 2006/47.



Draft Taxation Determination

Income tax: consolidation: can the head company of a multiple entry 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 an existing eligible tier-1 company 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. No. The interest expense does not satisfy 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 multiple entry consolidated (MEC) group as parts of the head company rather than as separate entities, for the head company's and subsidiary members' income tax purposes. (A MEC group is described in section 719-5 of the ITAA 1997.)
3. This means that if a subsidiary member borrows funds from outside the MEC 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 are 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 MEC 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. When determining whether the head company of a MEC 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 MEC 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.

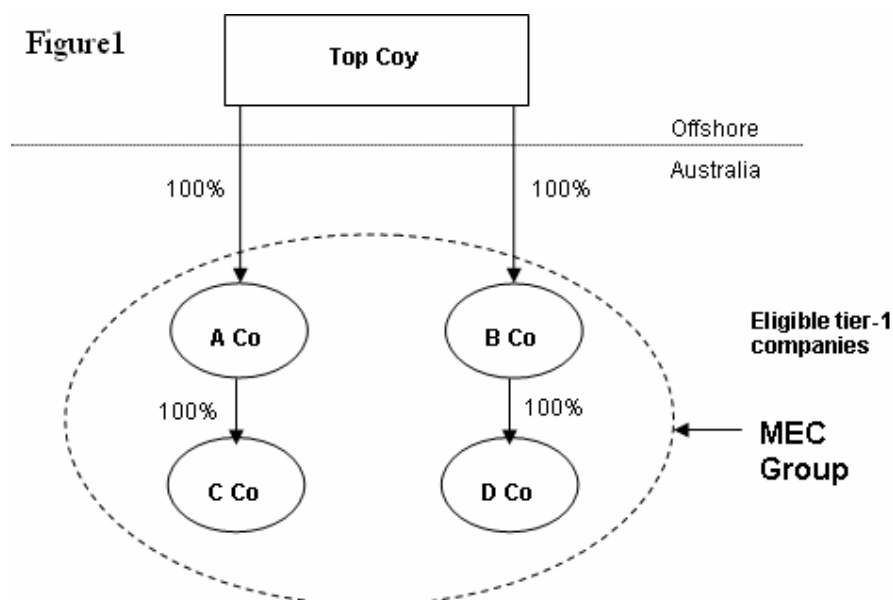
9. Accordingly, the prospect of dividends cannot be a basis for the head company of the MEC group deducting interest expense where a group member borrows funds that are used to buy shares in an existing eligible tier-1 (ET-1) company. (An ET-1 company is described in section 719-15 of the ITAA 1997.)

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 an existing ET-1 company, 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.

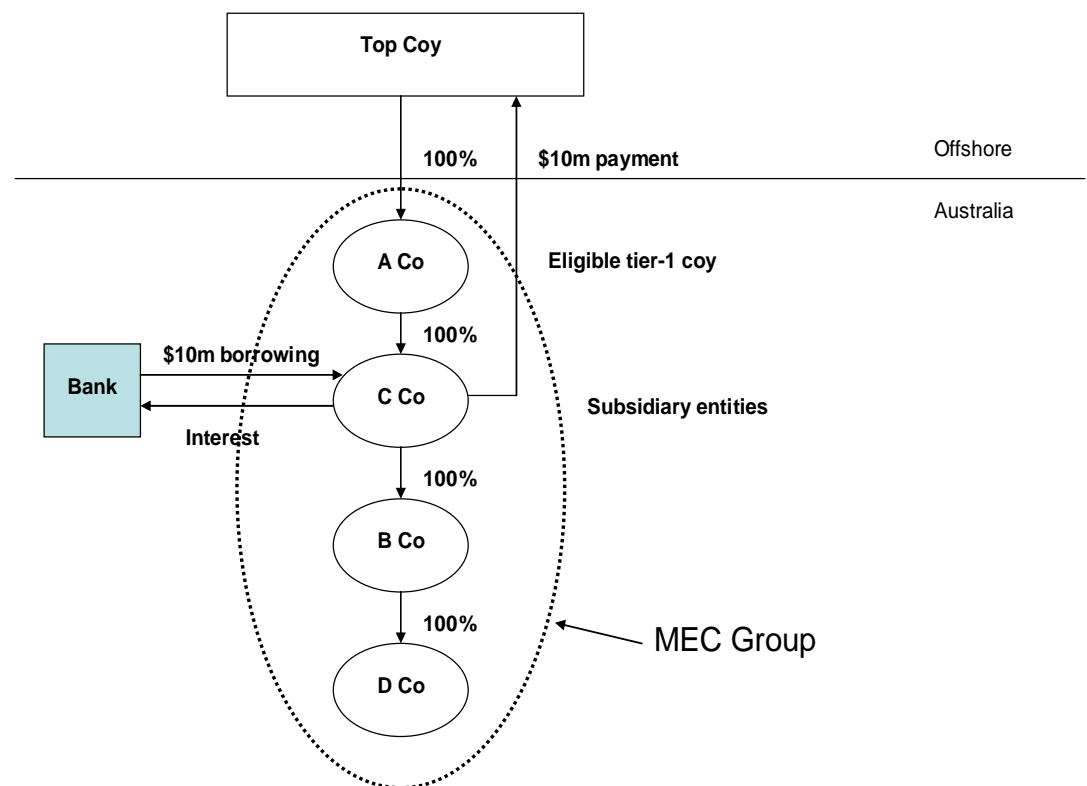
Example

12. **Figure 1:** A MEC group consists of head company A Co, another ET-1 company B Co as a subsidiary member and subsidiary members C Co and D Co.



13. C Co purchases the shares in B Co from Top Coy for market value being \$10m. To fund the purchase, C Co borrows \$10m from a bank.

14. **Figure 2:** The MEC group continues with A Co as head company and subsidiary members C Co, B Co and D Co. The impact within the MEC group is that B Co is no longer an ET-1 company (it is a subsidiary member) and C Co and D Co are subsidiary members. A Co is taken to have incurred the interest payable by C Co in respect of the \$10m borrowing.



15. A Co, as the head company of the MEC group, must apply the tests in section 8-1 of the ITAA 1997 on a single entity basis. The deductibility of interest paid on the borrowed funds must be determined by reference to the use to which the borrowed funds are taken to be put by A Co.

16. In this case the borrowed funds were paid to Top Coy, a company outside the consolidated group, for the shares in B Co. However, from A Co's perspective the assets it held before and after the purchase of shares in B Co are unchanged. There is no additional source of assessable income for the MEC group. The borrowed funds have not been used by A Co 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.

TD 2005/D29**Date of Effect**

17. 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

18. 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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Commissioner of Taxation

10 August 2005

<p><i>Previous draft:</i></p> <p>Not previously issued as a draft</p> <p><i>Related Rulings/Determinations:</i></p> <p>IT 2606; TR 92/20; TR 95/25</p> <p><i>Subject references:</i></p> <ul style="list-style-type: none"> - consolidated groups - deductibility of interest - MEC groups 	<ul style="list-style-type: none"> - membership interests - single entity rule <p><i>Legislative references:</i></p> <ul style="list-style-type: none"> - TAA 1953 Pt IVAAA - ITAA 1997 8-1 - ITAA 1997 701-1 - ITAA 1997 719-5 - ITAA 1997 719-15
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ATO references

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