


***TD 2006/36 - Income tax: consolidation: can the profit received on the disposal of membership interests in a subsidiary member of a consolidated group be income according to ordinary concepts?***

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# Taxation Determination

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Income tax: consolidation: can the profit received on the disposal of membership interests in a subsidiary member of a consolidated group be income according to ordinary concepts?

**❶ This publication provides you with the following level of protection:**

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*. A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

## Ruling

1. Yes, the profit received 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.
2. The views expressed in the Taxation Determination apply equally to a multiple entry consolidated (MEC) group where appropriate.

## Date of effect

3. This Determination applies both before and after its date of issue. However, the Determination does 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.

## Appendix 1 – Explanation

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

### Explanation

4. The consolidation provisions allow certain groups of entities to be treated as a single entity for 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 for income tax purposes. As a consequence the subsidiary members cease to be recognised as separate entities for income tax purposes with the head company of the group being the only entity recognised for these purposes. The meaning and application of the SER is explained in Taxation Ruling TR 2004/11.

5. If the membership interests in a subsidiary member are disposed of to a non-group entity, the subsidiary ceases to be a member of the group and the head company is taken to have disposed of the membership interests in that entity.

6. Taxation Determination TD 2004/40 provides that CGT Event A1 in section 104-10 of the ITAA 1997 happens to the head company of a consolidated group when a contract is made to sell a membership interest in a subsidiary member to a purchaser outside the group. It is also possible that the profit received on disposal of the membership interests may also give rise to ordinary income assessable under section 6-5 of the ITAA 1997. Whether 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 facts of each case.

**Note:** Any capital gain worked out under section 104-10 of the ITAA 1997 on disposal of membership interests in a subsidiary member would be reduced by section 118-20 of the ITAA 1997 to the extent the profit is assessable as ordinary income under section 6-5 of the ITAA 1997.

7. Where the disposal of the membership interests in a subsidiary member occurs in the ordinary course of carrying on a business by the head company, then based on existing principles, the profit will be included in ordinary assessable income.

8. Where the disposal of the membership interests does not occur in the ordinary course of carrying on a business by the head company, the principles outlined in Taxation Ruling TR 92/3 'Income tax: whether profits on isolated transactions are income' provides guidance. Paragraph 6 of TR 92/3 states:

...a profit from an isolated transaction is generally income when both of the following elements are present:

- (a) the intention or purpose of the taxpayer in entering into the transaction was to make a profit or gain; and
- (b) the transaction was entered into, and the profit was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction

9. Where the disposal of membership interests does not occur in the ordinary course of carrying on a business by the head company, the head company's intention or purpose (of making a profit) in entering into the transaction may need to be determined.

10. The time at which the transaction is entered into may be the time at which the membership interests were acquired or created or some later time. Determining whether the head company had a profit making purpose at the relevant time will require determining when the membership interests were acquired or created and whether the profit making purpose existed at this or at a later time (that is, whether there has been any change in purpose).

11. Paragraphs 26 to 28 of TR 2004/11 state that the SER does not set out specific mechanisms to determine how the rule applies for each provision of the income tax law. Rather, when considering transactions or dealings the correct use of the SER is to indicate when, and for what purposes, transactions or parts of transactions are to be regarded or disregarded in determining the income tax position of the head company of the consolidated group. For this reason the way the SER applies will depend on the purpose for which a transaction is being considered.

12. Where the transaction involves the disposal of membership interests in a subsidiary member and the purpose for which it is being considered is to determine whether the profit from the disposal is assessable as ordinary income of the head company under section 6-5 of the ITAA 1997, the head company must consider the entire factual matrix or context surrounding the derivation of the profit.

13. As noted at paragraph 10, this may require determining when the membership interests were acquired or created and whether a profit making purpose existed at this or at a later time (that is, whether there has been any change in purpose). This may require a consideration of things that happen to or in relation to the membership interests before or during consolidation or things that happen to or in relation to the subsidiary member in which the membership interests are held at these times. The entry history rule in section 701-5 of the ITAA 1997 may assist the head company in this process if required.

14. No single factor, such as the nature of the underlying assets (for example trading stock) that form part of the tax cost setting amount for the membership interests worked out under section 711-15 or section 711-55 of the ITAA 1997 will determine whether the profit on disposal is assessable as ordinary income under section 6-5 of the ITAA 1997. The character of the profit will be determined after an assessment of all relevant evidence by the head company. Facts such as the purpose for which the membership interests were originally acquired or created (either before or during consolidation) or the way the underlying assets have been held by the consolidated group, as well as any change in the foregoing, (including changes involving intra-group transactions and dealings) may be facts relevant to this process.

### **Example 1**

15. *H Co is the head company of a consolidated group in the business of selling cars (motor vehicle retailer). The motor vehicle retailing business is carried out through a subsidiary group member Car Sales Co.*

16. *Car Sales Co receives an order from a customer, Customer Co, for the supply of 300 cars. On the request of Customer Co, Car Sales Co incorporates a new subsidiary group member, Fleet Subco. All the shares in Fleet Subco are legally owned by Car Sales Co. Just after the incorporation of Fleet Subco, Car Sales Co transfers trading stock of 300 cars into Fleet Subco and then following this intra group transaction disposes of all the shares in Fleet Subco to Customer Co.*

17. *H Co will include the profit on the sale of the Fleet Subco shares in its assessable income under section 6-5 of the ITAA 1997. An assessment of all the evidence shows that the shares in Fleet Subco were created for the purpose of profit making by sale and that the transaction (comprising the creation of Fleet Subco, the transfer of 300 cars into Fleet Subco from Car Sales Co and the sale of all the shares in Fleet Subco) although not within the ordinary course of the business of selling cars comes within the course of that business activity.*

**Note:** *if Fleet Subco was a unit trust instead of a company, the outcome would be the same.*

### **Example 2**

18. *H Co is the head company of a consolidated group in the business of producing DVDs.*

19. *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. H Co continues to operate X Co's business of distributing DVDs in the same way as X Co had before the acquisition.*

20. *H Co 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 and include trading stock, debtors and goodwill. The sale occurs only because the group wishes to retreat from its earlier business strategy and to concentrate solely on its manufacturing business.*

21. *H Co makes a capital gain under Part 3-1 of the ITAA 1997 on the sale of the shares in X Co.*

22. *The proceeds from the sale will not give rise to ordinary income assessable under section 6-5 of the ITAA 1997. An assessment of all the evidence shows that X Co was not acquired for the purpose of profit making by sale, there has been no change in that purpose since acquisition and that the transaction is not made in the course of carrying on a business by H Co.*

### **Example 3**

23. *H Co is the head company of a consolidated group carrying on the business of manufacturing and retailing furniture. The group has been in this business for many years.*

24. *H Co now wants to concentrate on the manufacture of furniture and decides to sell its retail operation as a going concern. To facilitate the sale, H Co incorporates a new subsidiary member, Retail Co, and all of the assets relating to the retail operation, including trading stock, debtors and goodwill and associated liabilities are transferred to Retail Co.*

25. *H Co will make a capital gain on the sale of the shares in Retail Co under Part 3-1 of the ITAA 1997.*

26. *The proceeds from the sale of the shares will not give rise to ordinary income assessable under section 6-5 of the ITAA 1997. An assessment of all the evidence shows that Retail Co was not created for the purpose of profit making by sale (but rather for the purpose of realising a capital asset to best advantage) and that the transaction is not made in the course of carrying on a business by H Co.*

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## References

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*Previous draft:*

TD 2005/D31

*Related Rulings/Determinations:*

TR 92/3; TR 2004/11; TD 2004/40

*Subject references:*

- consolidated groups
- entry history rule
- membership interests
- profits on isolated transactions
- single entity rule
- trading stock

*Legislative references:*

- TAA 1953
- ITAA 1997 6-5
- ITAA 1997 Pt 3-1
- ITAA 1997 104-10
- ITAA 1997 118-20
- ITAA 1997 701-1
- ITAA 1997 701-5
- ITAA 1997 711-15
- ITAA 1997 711-55

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*ATO references*

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