


TD 2006/47 - 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 after formation of the MEC group 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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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 after formation of the MEC group 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 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 head company of a MEC (multiple entry consolidated) group will be able to claim a deduction provided that it can demonstrate that the essential character of the interest is expenditure that has a sufficient connection with the operation or activities which more directly gain or produce the head company's assessable income or is necessarily incurred in carrying on a business for that purpose and provided that the expenditure is not of a capital, private or domestic nature.
2. The refinancing principle (as explained in paragraphs 17 to 20 of this Determination) may be used to demonstrate that such a connection exists.

Example**3. Facts**

- A MEC group comprises A Co (head company) and subsidiary members B Co (eligible tier-1 company), C Co and D Co.
- A Co borrows \$10 million from a bank and purchases the shares in B Co from Top Coy for \$10 million.
- The parties deal with each other at arm's length. The \$10 million reflects the market value of the net assets of B Co. The accounts of B Co show that the market value of the net assets are represented by \$5 million share capital originally subscribed by Top Coy, \$4 million in retained earnings and \$1 million in an unrealised asset revaluation reserve.
- The MEC group continues with A Co as head company and subsidiary members B Co, C Co and D Co.

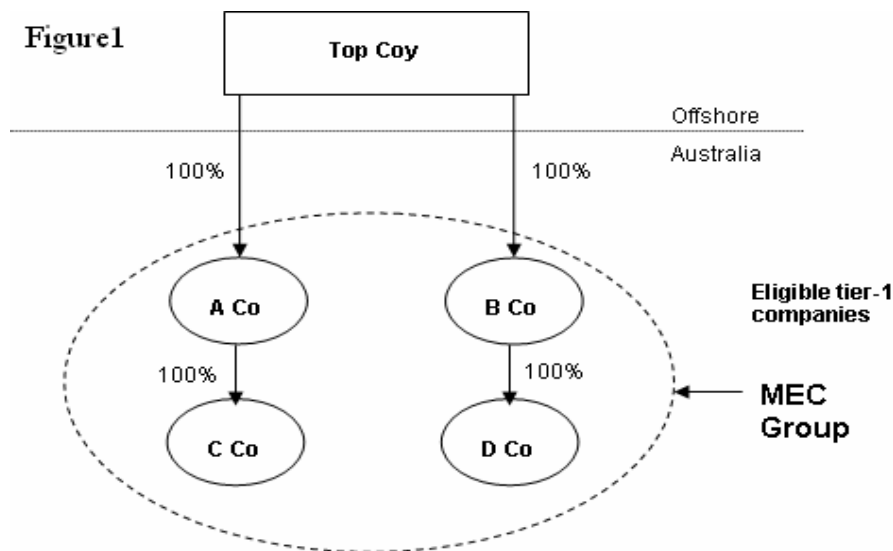
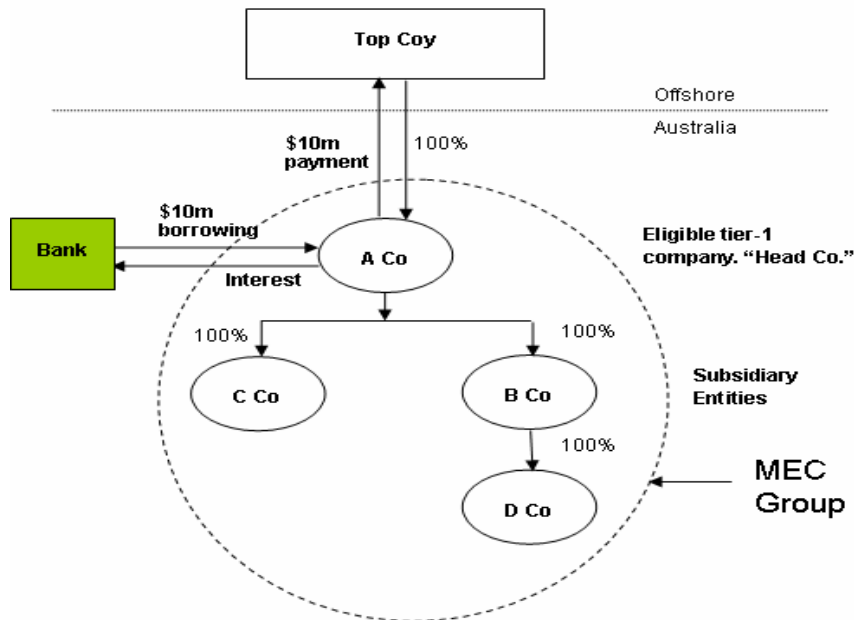
Figure 1: MEC group structure before sale of shares in B Co

Figure 2: MEC group structure after sale of shares in B Co**Figure 2**

4. As the head company of the MEC group, A Co must determine if the interest paid on the funds borrowed to acquire the shares in B Co is deductible under section 8-1 of the Income Tax Assessment Act 1997 (ITAA 1997) after taking into account the operation of the SER.

5. Tracing the use of the funds shows that they have been paid out of the group for the shares in B Co. However, the shares in B Co are not recognised as an asset of A Co (that is they are an intra-group asset) while B Co remains a subsidiary member in the MEC group. Also dividends paid by B Co will not be assessable income to the head company and as such can not be used as a basis for finding that the borrowing has the necessary connection to the head company's income producing or business activities carried on for the purpose of producing assessable income.

6. As discussed below at paragraphs 17 to 20 it can be argued that from the head company's perspective the borrowed funds have been used, at least in part, to replace the capital or working capital used in the business that the head company of the MEC group is taken to carry on for income tax purposes. To the extent that the \$10 million represents the replacement of funds employed as capital or working capital of the head company's business, interest paid on the funds will be deductible to A Co. In this example, based on the principles outlined in paragraphs 12 to 17 of Taxation Ruling TR 95/25, A Co would be able to deduct interest to the extent that it relates to the \$5m capital originally subscribed by Top Coy and the \$4 million relating to the retained earnings, as these amounts effectively replace funds employed in the business of A Co. However interest relating to the \$1 million represented by the unrealised asset revaluation reserve would not be deductible (see paragraph 16 of TR 95/25).

7. It is, however, still open to the head company of the MEC group to show that all of the interest expense has a sufficient connection with the assessable income earning activity, or business, carried on by the head company.

TD 2006/47

Date of effect

8. This Determination applies to years commencing both before and after its date of issue. However, this 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.

Commissioner of Taxation

26 July 2006

Appendix 1 – Explanation

① *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

9. The general principles governing the deductibility of interest are applied to the consolidated group as if it were a single entity. These principles are set out in 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.

10. The deduction for interest on the funds borrowed must be determined having regard to all the facts (taking into account the effect of the single entity rule (SER) contained in section 701-1 of the ITAA 1997) 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. Section 719-2 of the ITAA 1997 extends the application of the SER to the head company of a MEC group and section 719-25 of the ITAA 1997 stipulates that the remaining members of the MEC group are subsidiary members.

11. When determining whether the head company of a MEC group can claim a deduction for interest it is important to recognise that, for income tax purposes, the SER can affect how certain actions and transactions are to be viewed. Under the SER subsidiary members of a MEC group are taken to be parts of the group's head company rather than separate entities while they are members of the group. Accordingly, if a subsidiary member borrows funds and pays interest on those borrowings it is the head company that is taken to have borrowed the funds and to have incurred the interest expense (see subparagraph 8(a) of Taxation Ruling TR 2004/11). It is the head company that may be entitled to claim a deduction under section 8-1 of the ITAA 1997 in respect of the interest payment.

12. Where the shares in an existing ET-1 company are acquired by another member of the MEC group the operation of the SER also means that, for income tax purposes:

- Dividends paid on the ET-1 company shares acquired will not be assessable income in the hands of the MEC group's head company. This is because dividend payments between members of a MEC or consolidated group are treated as the movement of funds between two parts of the same entity, being the head company (see TR 2004/11, paragraph 10).
- The acquisition of the ET-1 company shares by the head company does not result in additional income producing assets being owned by the head company. The shares in the existing ET-1 company are not recognised as an asset of the head company (that is intra-group assets such as membership interests in other group members are not recognised for income tax purposes – see TR 2004/11 subparagraph 8(c)). Nor does the acquisition increase the income producing assets owned by the head company as the ET-1 company was already a member of the MEC group and its assets were already taken to be those of the head company (see TR 2004/11 subparagraph 8(b)).

13. As a consequence of the SER, the prospect of receiving assessable dividends on the shares acquired in the ET-1 subsidiary member (see Taxation Ruling IT 2606, paragraph 9) can no longer be the basis for allowing the interest deduction to the head company.

14. In this case, it is not apparent that tracing the use of the borrowed funds will establish a sufficient connection between the interest expenditure and the head company's production of assessable income or business carried on for that purpose. This is because the borrowed funds have been used to pay the non-resident entity for the shares in the existing ET-1 company.

15. Under the SER, the head company is already taken to own the assets of the existing ET-1 subsidiary member whose shares were acquired. Although the assets of the MEC group have been preserved, this will not of itself result in the interest being deductible.¹

16. However, it is still open to the head company of the MEC group to show that the interest expense has a sufficient connection with the assessable income earning activity, or business, carried on by the head company. The general principles for determining interest deductibility set out in TR 95/25 provide the following guidance (at paragraph 3(b)):

The character of interest on money borrowed is generally ascertained by reference to the objective circumstances of the use to which the borrowed funds are put by the borrower. However, regard must be had to all the circumstances, including the character of the taxpayer's undertaking or business, the objective purpose of the borrowing, and the nature of the transaction or series of transactions of which the borrowing of funds is an element. In some cases, the taxpayer's subjective purpose, intention or motive may be relevant in deciding the deductibility of interest.

The refinancing principle

17. Paragraphs 12 to 17 of TR 95/25 consider the implication for companies of the Full Federal Court decision in *FC of T v. Roberts; FC of T v. Smith* 92 ATC 4380; (1992) 23 ATR 494 (*Roberts and Smith*). Interest may be deductible under the 'refinancing principle' where borrowed funds are used to fund a repayment of share capital to the shareholders in circumstances where the repaid capital was employed as capital or working capital in the business carried on by the company for the purpose of deriving assessable income.

18. Under the SER the subsidiary members of a MEC group are taken to be parts of the group's head company for the purpose of working out the head company's liability to income tax or determination of a loss. In this context, the money or property used by the head company in gaining or producing its assessable income or in carrying on business for that purpose should be treated as capital or working capital of the head company. The 'refinancing principle' may apply where such capital or working capital is replaced by funds sourced from other than shareholder funds.

19. The membership interests held in the ET-1 by the non-resident entities represent funds that may be seen as capital or working capital that has been employed to the produce the head company's assessable income.

20. In the context of the *Roberts and Smith* decision, from the head company's perspective, the payment for the shares in the ET-1 company is therefore like a repayment of the head company's share capital. Where borrowed funds are used to buy the shares, those funds are effectively seen as a replacement for a source of funding that was previously used in the business of the head company of the consolidated group. Therefore, the head company may be allowed a deduction for interest paid on those funds subject to the limitations expressed in TR 95/25 (for example, the limitations in paragraph 16).

¹ See paragraph 3(e) of TR 95/25.

References

Previous draft:

TD 2005/D29

Related Rulings/Determinations:

IT 2606; TR 95/25; TR 2004/11

Subject references:

- consolidation
- interest
- single entity rule

Legislative references:

- TAA 1953
- ITAA 1997 8-1
- ITAA 1997 701-1
- ITAA 1997 719-2
- ITAA 1997 719-25

Case references:

- FC of T v. Roberts & Smith 92 ATC 4380; (1992) 23 ATR 494

ATO references

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