The single entity rule: the need to clarify the effect and limits of the cornerstone of Australia's tax consolidation regime

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Abstract

The single entity rule ('SER') is the cornerstone of Australia's consolidation regime, which was introduced almost 20 years ago. However, significant uncertainty remains regarding the role and scope of the SER. There are numerous gaps in legislative and administrative guidance as to how the SER interacts with other provisions in the tax acts. The recent Federal Court decision of Davies J in the 2019 Glencore transfer pricing case (subject to appeal), which echoes the comments of Pagone J (and Davies J) in the 2015 Channel Pastoral decision have created further uncertainty on a more fundamental level. These cases cast doubt on the long-accepted position that Australia's consolidation system is a full absorption model of consolidation under which subsidiaries of a head company cease to exist for tax purposes, as opposed to a pooling system as found in many similar advanced economies. This article reviews the current state of uncertainty as to the operation of the SER and recommends legislative amendments to confirm the role of the SER as part of a full absorption model of consolidation and clarify and explain how the SER interacts with other provisions of the tax acts.

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1 Introduction

The single entity rule (SER) is an ostensibly simple principle underpinning Australia's consolidation regime. At a high level, it provides that members of an income tax consolidated group are treated as parts of the head company that represents the group for the purposes of determining the tax liabilities and losses of the group. However, owing to its principles-based drafting the SER does not provide clear guidance on its application and interaction with other provisions. This lack of precise legislative guidance as to the scope and effect of the SER has resulted in significant uncertainty for taxpayers.

This paper considers first the background to Australia's consolidation regime in Pt 3-90 of the ITAA 1997 and in particular the SER.[1] This analysis reveals the clear intention for Australia's consolidation regime to be a strong 'absorption' model as opposed the more popular 'pooling' system.[2]

Second, the judgments of Pagone and Davies JJ and Allsop CJ in *Channel Pastoral Holdings Pty Ltd and Another v Federal CoT* (*Channel Pastoral*)[3] and the recent decision of Davies J in *Glencore Investment Pty Ltd v CoT* (*Glencore*) (subject to appeal),[4] which promote a pooling interpretation of the SER, will be considered. It is argued that such a view is inconsistent with the policy objectives of the system as being an 'absorption' system, based on the explanatory materials and the scheme of Pt 3-90 of the ITAA 1997 itself, particularly key features such as cost setting.

Finally, the continuing uncertainty regarding the scope of the SER and its interaction with other provisions in the Acts will be considered. This part focuses on provisions that turn on defining a relation between entities, using demerger relief and the associate test in the debt parking rules as case studies.[5] It will be shown that although the Commissioner of Taxation (Commissioner) has produced significant guidance on various interactions, the guidance is inconsistent and gaps remain.[6]

A proposed solution to the address the current uncertainty would be legislative change to:

- more definitively describe the SER as forming part of an absorption system;
- outline specific exceptions to the SER where it would defeat the purpose of other provisions, particularly those that turn on defining relationships with third parties.

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1 Note: legislative references are to the *Income Tax Assessment Act 1997* (ITAA 1997), the *Income Tax Assessment Act 1936* (ITAA 1936), or the *Taxation Administration Act 1953* (TAA), or collectively the Acts, as relevant.

2 See Part 2 below.

3 (2015) 232 FCR 162.

4 [2019] FCA 1432. Re appeal, see NSD 1636, 1637 and 1639 of 2019 <https://www.comcourts.gov.au/file / Federal/P/NSD1636/2019/actions>.

5 ITAA 1997, s 245-36.

6 See for example the summary in the table in Appendix 1 of Des Maloney and Peter Walmsley, 'ATO Perspective on Consolidation – Unravelling the Mysteries of the Single Entity Rule', (Conference Paper, Tax Institute of Australia, 1 May 2009).

2 Background to the SER

Australia's tax consolidation system, and the SER, are based on the findings and recommendations in the 1999 Report into Business Taxation (Ralph Report).[7] Most importantly, the Ralph Report recommended an asset-based model of consolidation under which the tax values for assets of a joining entity are aligned with the tax values for the membership interests – necessitating the cost setting exercise.[8] This asset based or 'absorption' model was ultimately adopted by the Government.[9]

There are a number of approaches Australia could have taken when developing a full consolidation model. The purpose of this section is not to critique Australia's decision[10] but to provide context. Three broad approaches that Australia could have taken to grouping entities in a consolidation regime with the effect of treating the group as a single entity include:[11]

- Pooling – where group members calculate their tax position as separate entities, with the results aggregated and often adjusted for intragroup transactions, to arrive at a net position for the group. Pooling is the predominant approach taken by similar countries to Australia, including France, Japan, New Zealand and the US.
- Attribution – where assets, liabilities and activities of group members are attributed to the parent, but the members continue to be treated as separate entities for tax purposes, which is important in relation to the application of tax treaties.[12]
- Absorption (or asset based) – under which members of the group are treated as divisions of the head company (i.e. not as separate entities for tax purposes) and all assets and liabilities are deemed to be assets and liabilities of the head company.

The most important consequences, for the purposes of this paper, of the strong 'absorption' approach taken by Australia, and those which generate the bulk of the complexity[13] in the system are:

- subsidiary asset ownership is collapsed into one level of ownership for the head company, necessitating the cost setting of assets of joining subsidiaries;[14]
- consequently, the cost of interests in exiting subsidiaries must also be reset;[15] and

7 Ralph, John: Review of Business Taxation 'A Taxation System Redesigned More certain, equitable and durable' Report, 1999.
8 Ralph Report, Recommendation 15.5.
9 See discussion in Maloney and Walmsley, (n 6) 6 and ff.
10 For a critique, see Anthony Ting, 'The Unthinkable Policy Option? Key Design Issues Under a System of Full Consolidation', (2011) 59(3) *Canadian Tax Journa*l 421; Maloney and Walmsley, above n 6; Anthony Ting, 'Australia's consolidation regime: a road of no return?' (2010) 2 *British Tax Review* 162.
11 See Ting 2011 (n 10) 432-434.
12 Ibid, 433.
13 See generally, Ting 2010 (n 10).
14 ITAA 1997, Div 705.
15 ITAA 1997, Div 711.

- the 'disappearance' of joining subsidiaries and the 're-emergence' of exiting subsidiaries necessitates entity history rules and rules regarding the ownership of tax attributes.[16]

Importantly, these consequences also drive the need for a SER under which the subsidiaries cease to exist while they are members of the group.[17]

2.1 The SER defined

The SER is contained in s 701-1 of the ITAA 1997, which relevantly provides (emphasis added):

> Single entity rule
>
> (1) If an entity is a * subsidiary member of a * consolidated group for any period, it and any other subsidiary member of the group are taken *for the purposes covered by subsections (2) and (3) to be parts of the * head company of the group, rather than separate entities*, during that period.
>
> Head company core purposes
>
> (2) The purposes covered by this subsection (the *head company core purposes*) are:
>
> (a) working out the amount of the * *head company's liability* (if any) for income tax calculated by reference to any income year in which any of the period occurs or any later income year; and
>
> (b) working out the amount of the *head company's loss* (if any) of a particular * sort for any such income year.
>
> Entity core purposes
>
> (3) The purposes covered by this subsection (the *entity core purposes*) are:
>
> (a) working out the amount of the *entity's liability* (if any) for income tax calculated by reference to any income year in which any of the period occurs or any later income year; and
>
> (b) working out the amount of the *entity's loss* (if any) of a particular * sort for any such income year.
>
> …

Section 701-85 ostensibly limits the SER. It provides:[18]

> The operation of each provision of this Division is subject to any provision of this Act that *so requires, either expressly or impliedly*.

The explanatory materials provided the following examples of the intended scope of s 701-85, 'the inherited history rules will be affected by the rules covering the treatment of losses

16 Eg, ITAA 1997, ss 701-5 and 707-120.
17 Maloney and Walmsley (n 6) 6.
18 The Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, [2.81].

and franking credits',[19] an outcome which is arguably clear from the specific rules dealing with losses and franking credits.

On the face of it, the SER sets out an apparently simple principle that underpins the operation of the consolidation rules. The SER is an example of principles-based drafting and therefore has the advantage of setting out a clear purpose but, to its detriment, lacks the precision needed for such a fundamental provision,[20] as illustrated in this paper.

2.2. The purpose of the SER

The SER was introduced by the New Business Tax System (Consolidation) Bill (No. 1) 2002, the explanatory memorandum to which (2002 EM) explained (emphasis added):[21]

> The income tax treatment of a consolidated group flows from the rule that an entity is treated as part of the head company while it is a subsidiary member of a consolidated group. *Actions of the subsidiaries are treated as actions of the head company, as this is the only entity the income tax law recognises for the purposes of working out the income tax liability or losses of a consolidated group*…

The 2002 EM also explains some of the consequences of the SER applying,[22] importantly in relation to the ownership of assets and liabilities, it states (emphasis added):[23]

> The *assets, liabilities*, etc. of the subsidiary member are *treated for income tax purposes as if they were owned by the head company*, as this is the only entity the income tax law recognises.

However, the long-accepted characterisation of Australia's consolidation rules as an absorption as opposed to a pooling system has been thrown into doubt by recent Federal Court decisions, discussed in Part 3 below.

2.3 The Commissioner's general position on the SER

The primary document setting out the Commissioner's views as to the meaning, scope and impact of the SER is TR 2004/11.[24] In TR 2004/11 the Commissioner strongly supports the 'absorption' and 'divisional' construction of the SER thereby producing results in relation to transactions that would occur for a single company that operates by division. The Commissioner summarises in TR 2004/11 (emphasis added):[25]

> the SER ensures that the income tax laws will apply to a consolidated group on the basis that the group is a single entity with all of the actions and transactions undertaken by the subsidiary members of the group being *imputed to the head company*. This allows for the proper administration of the income tax laws to the consolidated group. The SER, broadly speaking, *allows for parity between the income tax position of a consolidated group, treated as a single entity, and of a company carrying on business in divisions*.

19 See for example, ITAA 1997, Division 707 (about losses).
20 Maloney and Walmsley (n 6) 9.
21 At [2.12].
22 2002 EM, from [2.17].
23 2002 EM, [2.20].
24 See also the Consolidation Reference Manual.
25 [35].

Accordingly, the Commissioner's view is that subsidiaries effectively cease to exist for tax purposes upon formation of the group.[26]

The Commissioner's views in TR 2004/11 on the impact of the SER are broadly consistent with the explanatory materials and the policy objectives of the SER outlined above. However, as set out below, upon examination of the Commissioner's various rulings it is apparent that the Commissioner's interpretation of the SER is much more fluid when it comes to specific applications of the rule.

In relation to the interaction of the SER with other provisions of the Acts, the Commissioner states in TR 2004/11 (emphasis added):[27]

> 26. With the single entity rule Parliament, has expressed its intended policy outcome in broad and simple language, in this case by equating a consolidated group with a single entity. A necessary feature of this drafting approach is the omission of statutory mechanisms for effecting the policy for each provision of the income tax law (although in some cases they are provided). In construing a rule drawn this way, like in all cases of statutory interpretation, the fundamental object is to ascertain the legislative intent by reference to the language of the instrument as a whole…
>
> 27. Accordingly, relying on these established approaches to statutory interpretation, (and notwithstanding the operation of section 701-85 – itself an interpretive directive), interactions with other provisions in the Income Tax Assessment Acts need to be taken into account in applying the SER. For example, a mechanical application of the SER should not defeat the policy underpinning the SER by producing results in relation to transactions that would not occur for a single company that operates by division.

Accordingly, instead of relying on s 701-85, which ostensibly deals with overlap scenarios, the Commissioner prefers an approach based on a purposive interpretation of the provisions. The Commissioner has consistently given s 701-85 a narrow interpretation and there are no examples of rulings where the Commissioner has accepted that s 701-85 can in fact limit the operation of the SER.[28] The issues with such an approach are highlighted in Part 4 below.

3 Questioning the orthodoxy: *Channel Pastoral* and *Glencore*

There is little judicial guidance on the SER. The first serious examination of the SER was undertaken in the '*Mongoose*' cases, in particular *Federal Commissioner of Taxation v Macquarie Bank Ltd*[29] (*Mongoose*). *Mongoose* considered the interaction of the consolidation provisions with Pt IVA of the ITAA 1936. The result in *Mongoose* was an orthodox divisional interpretation of the SER[30] and a loss for the Commissioner.

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26 At [7]-[8].
27 [26]-[28].
28 See Part 4 generally and TD 2004/81 for example. Further, no private rulings the author is aware of rely on s 701-85.
29 (2013) 210 FCR 164.
30 See *Mongoose*, [42]; [130].

The more significant result of *Mongoose* is that it prompted the Commissioner to find a test case in order to clarify the operation of Pt IVA in a consolidation context following *Mongoose*. That case was *Channel Pastoral*.

However, instead of clarity, the *Channel Pastoral* case has created greater uncertainty and has brought into question the long accepted 'divisional' interpretation of the SER as a result of the decisions of Pagone and Davies JJ and Allsop CJ in that case. While the Commissioner has attempted to address the doubt created by *Channel Pastoral*,[31] the recent decision of Davies J in *Glencore* has created further doubt that will, subject to appeal, be more difficult for the Commissioner to manage.

3.1 Channel Pastoral

The key facts of *Channel Pastoral* were:

- Channel Cattle Company Co Pty Ltd (CCC) owned agricultural assets with a tax cost that was significantly lower than market value (at the date of consolidation).
- In January 2008 CCC joined Channel Pastoral Holdings Pty Ltd (CPH) to create a consolidated group (Group) with CPH as the head company. The tax cost of the assets was increased significantly in the cost setting process.
- Almost immediately after consolidation, the Group sold the assets to a third party. As a result of the uplift to tax costs under the cost setting on consolidation there was no net gain on disposal.

Being a test case, key factual findings necessary for the operation of s 177D were agreed, such as whether it was the 'sole or dominant purpose' of the scheme to obtain a 'tax benefit'.[32] The Court in *Channel Pastoral* was only asked three specific questions regarding which entity (CPH or CCC) could be the subject of a Pt IVA determination and which entity could be assessed based on that determination. The three reserved questions were whether, by reason of Div 701 of Pt 3-90 of the ITAA 1997, the Commissioner was not authorised to:[33]

- Reserved Question 1 – make a Pt IVA determination in respect of CCC and, in order to give effect to this, assess CPH;
- Reserved Question 2 – make a Pt IVA determination in respect of CPH and assess CPH on the basis of the determination; or
- Reserved Question 3 – make a Pt IVA determination in respect of CCC and assess CCC on the basis of the determination.

Notwithstanding the Commissioner's apparent hope for clarity regarding the operation of Pt IVA and the consolidation rules, the outcome of *Channel Pastoral* is anything but clear. In short:[34]

- The plurality found that CCC should be the relevant entity that is the subject of the assessment and the determination (Reserved Question 3).

31 See Part 4 below.
32 Additionally, the 'scheme' was not attacked on other bases that were arguably open on the facts.
33 *Channel Pastoral*, [63].
34 For a detailed analysis see Clint Harding and Peter Scott, 'Part IVA and consolidated groups: grazing on uncertainty' (2015) 50(3) *Taxation in Australia* 132.

- Pagone and Davies JJ dissented on the other two alternatives, holding that CCC/CPH or CPH/CPH could also be the subject of determinations/assessments (Reserved Questions 1 and 2).
- The majority (Edmond and Gordon JJ, Allsop CJ agreeing) held that the determinations/assessments under Reserved Questions 1 and 2 were not open to the Commissioner.

It is difficult to find any satisfactory or particularly useful guidance from *Channel Pastoral*. However, it does now seem to be the case that the Commissioner can (assuming a 'tax benefit' is found, which was agreed in this case), successfully challenge schemes that produce a tax benefit under the cost setting rules in Division 701 under Pt IVA. While determinations and assessments to CCC were the only mechanism accepted by all judges, the reasoning of the Court was not unified. More importantly for present purposes, the decision creates significant confusion regarding the operation of the SER.

The interaction of Pt IVA and the consolidation rules was considered by all judges and it was agreed that Pt IVA was superior in priority to Pt 3-90 on the basis of s 701-85[35] (extracted above) and s 177B(1) which provides that '*Nothing in the following limit the operation of this Part: (a) the provisions of this Act (other than this Part)* …'.

However, Edmonds and Gordon JJ (with whom Allsop CJ agreed) found that, regardless of the operation of s 177B(1), s 701-30 allowed for the making of determinations and assessments in respect of CCC, which would promote 'harmonious goals'.[36] Accordingly, the scope and purpose of the SER was not explored in any significant detail by the majority.[37]

Notably, Allsop CJ stated that 's 701-1 does not remove or destroy the existence of an entity in the group, but makes it a part of the head company',[38] which suggests some agreement with the position put forward by Pagone J.

Pagone J (Davies J agreeing) answered no to all reserved questions (allowing all determinations and assessments). The underlying reason for doing so was not only the priority of Pt IVA (which was relevant) but more fundamentally, their Honours' construction of s 701-1 and the interpretation of the SER requiring a pooling approach to determining tax liabilities of a consolidated group.

Pagone J describes the 'single entity rule' as a mechanism to calculate group liability under, apparently, a form of pooling approach (emphasis added):[39]

> The effect of Div 701 has been described as creating a statutory fiction but it may be more helpful, and more accurate, to describe its effect as a *statutory direction concerned with the calculation of a composite liability*. The statutory direction in s 701-1(1) is not that a subsidiary of a consolidated group is to be treated as non-existent, or that it ceases to be a taxpayer or that it does not derive or make assessable income or gains, or does not incur losses or outgoings. *The statutory direction, rather, contemplates the continued existence of a subsidiary of a consolidated group but directs that for the limited purposes of determining "liability" or "losses" of the members of the group, the subsidiary is to be treated as part of the head company* …

35 *Channel Pastoral*, [20] (Allsop, CJ); [82] and [92] (Edmonds and Gordon JJ); [135] Pagone J; [141] (Davies J).
36 *Channel Pastoral*, [82].
37 See *Channel Pastoral*, [80], [109], [102] (Edmonds and Gordon JJ); [8] (Allsop CJ).
38 *Channel Pastoral*, [8] (Allsop CJ).
39 *Channel Pastoral*, [119] (Pagone J).

> Division 701 does not alter the points of derivation or incurrence (or other such relevant fiscal events) which arise by force of the ITAA 1997 or of the ITAA 1936 or by general principle. The liability or loss of the head company to be worked out as required by s 701-1 contemplates that there have been fiscal events by the group members. The function of the individual group members in the working out required by Div 701 is for their *individual fiscal amounts to be taken into account in the calculation of the one final composite liability or loss of the whole through the head company*. The single entity rule is a statutory direction which removes the need, which had previously existed under the former grouping provisions, for separate returns and assessments, *but the rule does not create a general statutory fiction that the individual parts of the consolidated group do not continue to have an existence or that their individual existence is not specifically relevant in the working out of the liability ultimately falling upon the head company*. On the contrary, it is plain from s 701-1 itself that each continues to have a fiscal function by their individual contributions to the working out of the liability of the head company in its particular capacity as head company of the group.

Pagone J went on to explain the operation of the SER under his 'pooling' approach:[40]

> The fiscal character and consequences of the sale for the group are given to it by the subsidiary, and it is the subsidiary as an entity (rather than its assessable income or losses) which by s 701-1 is taken to be "part of" the head company of the group. In other words, *the provisions assume*, as will be the fact, that it is the subsidiary that acts in the ordinary way and that it will attract the operation of the ordinary taxing provisions, *but that the subsidiary is to be taken to be part of the group for the purposes of working out liability and losses.*

His Honour then went on to consider the findings of the Full Court in *Mongoose*. In particular, Pagone J found that the *Mongoose* decision rested on a mistaken 'absorption' interpretation of the SER.[41]

Therefore, under Pagone J's analysis, calculating the ultimate tax position of a head company first requires a calculation of the tax position of subsidiaries as standalone entities. This view is in contrast with the more orthodox view of the SER, which requires the treatment of a subsidiaries in a consolidated group as divisions within a single taxpayer.

Davies J agreed with the reasons and conclusions of Pagone J.[42]

3.2 The Commissioner's reaction to Channel Pastoral views

The Commissioner has been slow to address the minority views in *Channel Pastoral*. In 2015 the Commissioner promised a decision impact statement in *Taxation Determination* TD 2015/18EC.[43] However, it was only in January 2019 that the Commissioner provided a response the comments of Pagone J with the addition of a new appendix to *Taxation Ruling* TR 2004/11. The Commissioner confirmed that (emphasis added):[44]

40 [120]-[121].
41 *Channel Pastoral*, [125] and ff.
42 *Channel Pastoral*, [136].
43 A compendium to TD 2015/18.
44 [42K]-[42L].

> The interpretation and consequences of the SER as described at paragraphs 119 to 121 of the judgment of Pagone J are *not consistent with the Commissioner's view* of the SER as expressed in this Ruling.
>
> The answers given to the reserved questions by the majority of the Court are based on an understanding that the SER operates in a way consistent with the description given at paragraph 80 of the joint judgment of Edmonds and Gordon JJ. Conversely, Pagone J's 'statutory direction' interpretation of the SER informed His Honour's answers to the reserved questions (that is, 'no' to each) and, as a result, his reasoning in reaching those answers does not form part of the ratio decidendi of the majority that is binding authority on the interpretation and application of the SER.

The Commissioner concluded that he would continue to the apply the SER in accordance with the views set out in the *Taxation Ruling* TR 2004/11. That is, the Commissioner will continue to adopt the orthodox 'divisional' approach to s 701-1 as a 'statutory fiction'. However, the Commissioner's reasons for rejecting Pagone J's approach do not provide a technical legal basis for the rejection (on the substantive question).

3.3 Glencore

Pagone J departed the Federal Court on 31 March 2018. However, His Honour's decision in *Channel Pastoral* received further support from Davies J in the recent Federal Court decision in *Glencore*, handed down on 3 September 2019.

The *Glencore* decision concerned the application of the transfer pricing rules (both the former Div 13 and the new Subdiv 815-A). In short:

- the taxpayer was the head company of a multiple entry consolidated group;[45]
- a subsidiary member of the group, CMPL, entered into an arrangement with the ultimate foreign parent entity, GIAG; and
- the Commissioner argued that a transfer pricing adjustment should apply in respect of the arrangement.

The Commissioner was unsuccessful. The decision is primarily based on the application of transfer pricing principles that are outside the scope of this paper. However, the taxpayer also argued that (emphasis added):[46]

> … Div 13 did not apply to it because the relevant international agreement was *between GIAG and CMPL* and, although in accordance with the single entity rule in s 701-1 of the ITAA 1997 CMPL is taken to be part of the taxpayer, being the head company of the taxpayer's MEC group, for the purposes of working out amounts of income tax liability and losses of the taxpayer, *the single entity rule does not deem an international agreement under s 136AD(1) to have been entered into by a head company when it was in fact entered into by a subsidiary member of the relevant tax group*.

45 For the purposes of this paper, the differences between a MEC group and an income tax consolidated group are not relevant.

46 *Glencore*, [399].

This argument was ostensibly based on the comments of Pagone J at [119] in *Channel Pastoral* (extracted above), with emphasis added to the final sentence.[47] Davies J rejected the taxpayer's argument, stating:[48]

> the single entity rule operates as a "statutory direction" that, for the limited purposes of determining "liability" or "losses" of the members of the group, the subsidiary is to be treated as part of the head company, rather than as a separate entity, and for that purpose, *the actions and transactions of the subsidiary member are treated as having been undertaken by the head company*. The single entity rule does not have the effect that a subsidiary of a consolidated group is to be treated as non-existent, or that it ceases to be a taxpayer or that it does not derive or make assessable income or gains, or does not incur losses or outgoings. *For the purposes of the application of Div 13 the relevant "taxpayer" is still CMPL and so too for the purposes of Subdiv 815-A, the relevant "entity" is CMPL*. There is no inconsistency between these provisions and the single entity rule.

Accordingly, Davies J found that although (in the view of Pagone J) the SER means the relevant taxpayer examined first is the actual legal person (the subsidiary), for the purposes of giving effect to the transfer pricing adjustment the actions of the subsidiary (CMPL) are deemed to have been undertaken by the head company (the taxpayer).

It is possible that the Full Federal Court may comment on this aspect of the reasons of Davies J when it determines an appeal from her Honour's decision, which was commenced in late 2019.[49]

3.4 Are they right?

It is argued that the position of Davies and Pagone JJ, Alsop CJ, and now Davies J in *Glencore* set out above (the pooling view) is inconsistent with the basis of Australia's 'absorption' and 'divisional' model of consolidation – long accepted by the Commissioner and taxpayers.

As set out in Part 2 above, Australia's consolidation regime is intended to be a system under which subsidiaries are completely 'absorbed' into the head company such that they no longer (while members of the group) have an identity for income tax purposes and are instead treated as divisions of the head company. Such a regime sits in stark contrast to the more popular 'pooling' systems,[50] under which subsidiaries retain their identity and must calculate their tax position (generally with adjustments for intragroup transactions), which is then pooled with other members to arrive at a net position for the group.

The pooling view requires that taxing provisions apply directly to group members as 'taxpayers' and then, for the purposes of determining the ultimate tax position of the group, a deemed application of the provisions to the head company. The pooling view reads into the SER a two-step requirement in determining the tax position of consolidated groups that is not supported by the legislation. As explained above, the scheme of Pt 3-90 is based on the assumption that joining subsidiaries ceased to be recognised for tax purposes as separate entities (even though they continue to exist as legal persons for general legal purposes). For example, the cost setting of assets of joining entities required

47 See (n 39).
48 *Glencore*, [400].
49 See (n 4).
50 See Part 2.

under s 701-10(4) is based on the assumption that the joining entity ceases to exist and therefore cost setting is required to calculate what the head company 'paid' for the assets. Another example would be the rules that turn off any potential tax consequences 'disposal' of assets of a subsidiary to the head company when it joins a tax consolidated group,[51] which are inconsistent with Pagone J's construction of the consolidation rules in *Channel Pastoral* extracted above.[52]

Under the pooling view no cost setting would be required because assets would be disposed of by the subsidiary for tax purposes:

- the subsidiary would calculate the tax effect of a disposal based on its tax cost; and
- under a 'statutory direction', the transaction would be deemed to have occurred in respect of the head company for the 'core purpose' of calculating the tax liability or loss of the group.

It is clear from this example that the pooling view does not address the practical implications of a pooling approach in the context of the legislative framework of Pt 3-90.

The pooling view focuses on one aspect of consolidation, the scope of the SER, and ignores the mechanical aspects of consolidation (such as cost setting) which exist for a purpose that is inconsistent with the basis of the pooling view.

It is argued that the pooling view is incorrect and not supported by the explanatory materials, the scheme of Pt 3-90 of the ITAA 1997 itself, or the Commissioner's views in TR 2004/11. The purpose of the SER is to provide the necessary statutory fiction (as opposed to a mere direction) for the consolidation rules to apply as intended within a full absorption scheme of consolidation.

3.5 Where to now?

Subject to any developments in principle arising from the *Glencore* appeal, taxpayers may now attempt to pick and choose whether to apply *Taxation Ruling* TR 2004/11 or the pooling view supported to some extent by three Federal Court judges, depending on which suits them.

Although the Commissioner has sought to sidestep the pooling view comments of Pagone J in *Channel Pastoral*, dealing with the comments of Davies J in *Glencore* will not be as simple because *Glencore* was a single judge decision and the comments in paras [399]-[400] address an issue the Court was asked to address.

The current status of the judicial authority on the SER, and the inconsistency with the orthodox view of the Commissioner, is untenable and should be clarified by legislative amendment. As was illustrated in *Channel Pastoral*, it may be unwise simply to wait for a clarifying decision of the Full Federal Court or the High Court to confirm what is commonly understood to be the case.

51 ITAA 1997, ss 701-25 and 701-35.
52 [120]-[121].

4 The scope of the SER

There are clearly a significant number of circumstances in which the SER could potentially apply. If we focus on scenarios that do not necessarily turn on the entry or exit of a member from the group, there are broadly two scenarios that can apply:

1. typical transactions between subsidiaries and third parties, such as buying and selling stock; and
2. transactions where the tax consequences depend on the relationship that the relevant subsidiary member has with another entity.

Under 'type 1' transactions, such as the sale of goods by a subsidiary to a customer, it is wholly consistent with the SER objectives that the sale is, for tax purposes, deemed to have been from the head company to the customer. The Commissioner has provided a significant amount of guidance on these typical transactions.[53]

This paper will focus on 'type 2' transactions. That is, transactions that for tax purposes first require an analysis of a particular relationship. The tax laws contain multiple examples of provisions that turn on the existence of a particular relationship that an entity has with another entity before the provision is enlivened. For example, the controlled foreign company rules test control on an associate inclusive basis,[54] the small business concessions turn on affiliate inclusive thresholds,[55] and the market value substitution rules turn on the relationship between buyer and seller being at 'arm's length'.[56] This paper will examine the interaction of the SER with the demerger relief and debt parking rules.

It is argued that these relationship-driven provisions present a significant challenge under the SER because, while these provisions will often affect net income of the head company (i.e. a core purpose), the operation of the provisions solely because of the SER may conflict directly with the underlying purpose of the taxing provision.

The following two examples, one which the Commissioner has provided guidance on and one on which he has not, highlight the complications that a strict application of the SER can create.

4.1 Rollover relief: Demergers

Division 125 of the ITAA 1997 provides for 'demerger relief' where, broadly a subsidiary of a company is demerged by transferring the shares in the subsidiary to the shareholders of the head company.[57] The effect of demerger relief is, subject to integrity rules,[58] to effectively disregard or treat as non assessable any capital gain for the company[59] and any dividend[60] and/or capital gain[61] for shareholders.

53 See for example, the table in Appendix 1 of Maloney and Walmsley (n 6).
54 ITAA 1936, Pt X.
55 ITAA 1997, Div 152.
56 Eg, ITAA 1997, s 112-20.
57 ITAA 1997, s 125-55.
58 ITAA 1936, s 45B.
59 ITAA 1997, s 125-155.
60 ITAA 1936, s 44(4).
61 ITAA 1997, s 125-55.

The purpose of Division 125 is to provide 'an overall benefit to the economy and enhance the competitiveness of Australia's business sector through greater opportunities to increase shareholder value by creating more efficient business structures' through 'genuine demergers'.[62]

A core requirement of Division 125 is the existence of a 'demerger group', being a head entity and any one or more 'demerger subsidiaries'.[63] Although 100% ownership is not necessarily required[64] for an entity to be a demerger subsidiary, this will often be the case. In the context of publicly-listed groups, a demerger subsidiary will generally be a 100% subsidiary of the head entity and a member of a head company's tax consolidated group. For example, prior to the recent demerger of Coles by Wesfarmers,[65] Coles was a wholly owned subsidiary, although just prior to the demerger Wesfarmer's ownership dropped to 85%.[66] In any case, for the purposes of defining the 'demerger group', under the Commissioner's current approach to demerger relief the testing time would be at the start of the 'restructuring', being the first step of the demerger process.[67]

Accordingly, if the SER were to apply such that Coles were taken to be a division of one single entity for tax purposes, Wesfarmers, then the threshold requirement for the existence of a 'demerger group' and 'demerged entity' that is a member of that group would not be met. Such an outcome is clearly at odds with the purpose of demerger relief, particularly in the context of the primary target of demerger relief, being listed groups (that are generally tax consolidated).[68] The Commissioner has long acknowledged this anomalous outcome.

In *Taxation Determination* TD 2004/48 the Commissioner states that the SER does not mean you can never have a demerger group, stating:

> 5. However, *the single entity rule does not apply to defeat a clearly intended outcome under provisions outside the consolidation rules* ... In such cases, intra-group interests, or legal entities that are part of the head company for consolidation purposes, *require a level of recognition in applying provisions that have regard to such interests and entities* (for example, in determining eligibility for a concession). Paragraphs 8(c) and 26 to 28 of Taxation Ruling TR 2004/11 explain the Commissioner's view that reading the Act as a whole achieves this outcome (and without the need to rely on section 701-85 of the ITAA 1997).
>
> 6. *In our view, the single entity rule does not prevent recognition of the demerged entity, and the group's membership interests in the demerged entity, just before the relevant CGT event happens*. The head company can meet the requirements of a demerging entity in subsection 125-70(7) of the ITAA 1997. That is, the demerger group consists of the head company and the demerged subsidiary, even if there are other interposed subsidiary members. This is consistent with CGT events in relation to the demerger happening to the head company under the single entity rule.

62 Second reading speech.
63 ITAA 1997, s 125-65(1).
64 ITAA 1997, s 125-65(6).
65 CR 2018/59, [14].
66 CR 2018/59, [15].
67 TD 2019/D1, [2]; see also CR 2007/111 (PBL class ruling).
68 See Recommendation 19.4 of the Ralph Review which restricted the demerger relief to widely held entities but no such restriction was ultimately included in Div 125.

It is notable that the Commissioner relies on a broad interpretation of the tax act as a whole rather than the specific overlap provision in section 701-85 (extracted above). It would appear to be implied in the requirements of Div 125 that the SER should have no part to play in the defining of a demerger group. However, the Commissioner instead relies on a purposive interpretation (also relying on the assumption that it could not be intended that the SER has any application under section 125-70) of the provisions to achieve the same objective.

The starting point in interpreting the statutory provisions is the words of the provisions themselves. If the words are clear and unambiguous then the legislature should be taken to have intended what is clearly expressed.[69] Where necessary, alternative approaches to interpretation may be employed, such as a purposive approach, which is supported by the common law[70] and the *Acts Interpretation Act 1901*[71] in circumstances where applying the ordinary and grammatical meaning would give the statute an operation which obviously was not intended.[72]

As noted, a failure of the requirements for demerger relief on account of the SER tends to produce an absurd outcome. However, it is not clear that a court would so readily adopt the Commissioner's approach in *Taxation Determination* TD 2004/48, based on paragraphs 26 to 28 of *Taxation Ruling* TR 2004/11 (extracted above).[73] Given that the Divisions 125 and 701 were introduced at almost the same time,[74] in the absence of a clear overlap rule (such as section 701-85, see below), a court may be unwilling to read into the words of Div 701 and 125 a priority for Div 125 to apply. Therefore, the Commissioner's approach is an unsatisfactory solution.

4.2 The associate test and debt parking

One of the many areas where the Commissioner has not provided clear guidance on the scope of the SER is in respect of the question of the relevant test entity when applying provisions using the 'associate test' in s 318 of the ITAA 1936. Section 318 is an extremely broad provision, which treats entities as 'associates' based on the characteristics of the test entity's (primary entity) relationship with other entities, either by assuming control or looking for actual control.[75] It is outside the scope of this paper to consider exhaustively the operation of s 318. But it should be noted that that the provision is complicated and can produce surprising results. For example, a primary entity company will be associate of an entity that:

- holds the majority of its voting interests (regardless of whether they can be controlled or in fact exercised);[76] or
- 'sufficiently influences' it.[77]

The defined term 'associate' is utilised in over 250 provisions in the ITAA 1997, ITAA 1936 and TAA. While not all of these provisions may be affected by the SER, many may be.

69 *Sussex Peerage Case* (1844) 11 Cl & Fin 85; 8 ER 1034 at 143 (Lord Tindall CJ).
70 *Cooper Brookes (Wollongong) v FCT* (1981) 147 CLR 297 (Cooper), 320-321 per Mason and Wilson JJ.
71 Section 15AA.
72 *Cooper* (n 70).
73 Part 2.
74 Acts 68 and 90 of 2002.
75 ITAA 1936
76 ITAA 1936, ss 318(2)(d)(ii) and 318(6)(c). See *Commissioner of Taxation v Linter Textiles Australia Ltd (in liquidation)*, [63]-[64] (not disturbed on appeal) regarding the hypothetical nature of the test.
77 ITAA 1936, ss 318(2)(d)(i) and 318(6)(b), see *BHP Group Ltd v Commissioner of Taxation* [2020] HCA 5.

Where a transaction is entered into by a subsidiary in a tax consolidated group, the application of the associate test may produce different results depending on whether the 'primary entity' is taken to be the subsidiary or the head company. Usually, the outcome should not differ, given that the head company would usually control the voting interests in a wholly owned subsidiary. Accordingly, if the head company is an 'associate' of another entity then the subsidiary would also be expected to be an associate.[78] However, in the context of an insolvent group, where certain members may be subject to voluntary administration, deeds of company arrangement, liquidation or receivership, the 'primary entity' tests may alter whether an associate relationship exists with a third party.

An example of where the correct application of the 'associate test' as a precondition to the application of another provision is the debt parking rule in s 245-36 of ITAA 1997, which relevantly provides (emphasis added):

> A debt is forgiven if and *when* the *creditor assigns* the right to receive payment of the debt to *another entity* (the new creditor) and the following conditions are met:
>
> (a) either the new creditor is the *debtor's * associate* or the assignment occurred under an arrangement to which the new creditor and debtor were parties;
>
> ....

Where s 245-36 applies, the tax attributes of the debtor company will be eroded pursuant to the waterfall in Subdivision 245-E to the extent of any 'net forgiven amount' under the steps in Subdivision 245-C and D (again, outside the scope of this paper).

The purpose of s 245-36 is to deem a debt forgiveness to have occurred where an 'associate' relationship exists (or where the creditor is a party), which warrants the assumption that the debt will not be recovered.[79]

The following example illustrates the potentially different outcomes under the associate test (and therefore s 245-36) depending on the extent to which the SER applies:

- Shareholder A is a majority shareholder of HeadCo.
- HeadCo wholly owns SubCo 1.
- SubCo 1 wholly owns SubCo 2 (debtor).
- A mid-sized creditor of SubCo 2 assigns its debt to Shareholder A (new creditor).

In this example, Shareholder A would be considered an associate of SubCo 2 (debtor) as it would be expected to exert sufficient influence over, and control the casting of majority voting interests of, SubCo 2.[80] Alternatively, if the HeadCo group is an income tax consolidated group and the SER applies, the relationship to be tested is between new creditor and HeadCo, resulting in the same outcome.

However, as noted above, in an insolvency context the relationship testing under s 318 becomes more complicated and influence and control may not be assumed. If each of HeadCo and the SubCos are subject to external administration, ignoring the SER, it may be that the debtor and Shareholder A would no longer be considered associates due to the

78 Pursuant to s 318(2)(f) or potentially (e) depending on the scenario.
79 Explanatory memorandum to the *Taxation Laws Amendment Act (No. 2) 1996*, [6.25].
80 ITAA 1936, s 318(2)(d)(i) and (ii).

lack of control or influence a shareholder has in respect of a company subject to external administration.[81] However, if the SER were applied, then the influence/voting control the new creditor has over HeadCo would likely mean the debtor and new creditor are associates pursuant to s 318 and accordingly s 245-36 should apply.

While the consequences in s 245-E should apply to HeadCo if s 245-36 applies to the group, if the actual debtor is not an associate of the creditor under the threshold test then the provisions should have no application at all. This is essentially the same argument on which TD 2004/48, in relation to Div 125, is based (see above).

It is implicit in s 245-36 that the focus of the provision is on the relationship between the debtor and new creditor. The explanatory materials support the purpose of the provision as targeting relationships where an effective forgiveness should be assumed. In the insolvency context above it should not be assumed any forgiveness would apply – it should be assumed that the new creditor will exercise its rights as a creditor to the fullest extent possible, particularly where there are multiple competing creditor claims against the group. Accordingly, s 245-36 would not operate 'correctly' (based on its purpose) where, under the SER, the true debtor is ignored and s 318 is applied in relation to the HeadCo as a precondition to the application of s 245-36.

Accordingly, the SER should apply subject to s 245-36 for the purposes of determining the threshold question of whether debtor and creditor are associates pursuant to s 701-85. Alternatively, but to the same end, a purposive interpretation should be afforded to s 245-36, as endorsed by the Commissioner in TD 2004/48.

The above issues are complex. However, similar issues do arise in practice regularly and the current level of uncertainty is problematic. Legislative change is required to clarify the interaction of the SER with other provisions of the Acts, particularly those that turn on the testing of relationship between entities.

3 Conclusion

The cornerstone of Australia's consolidation regime, the SER, requires legislative clarification to accurately and clearly define its effect and scope. The notion of Australia's consolidation regime set out in Pt 3-90 of the ITAA 1997 as a pooling system as opposed to an absorption system should be overtly rejected by legislative amendment. At the same time, the SER's interaction with other provisions of the should be clarified to provide certainty to taxpayers.

Opinions may differ as to the best method for legislating a full consolidation regime.[82] However, given that Australia has now ventured down the 'absorption' approach and the

81 The purpose of this example is to illustrate that it is unclear how the SER would operate in this scenario and not to provide a detailed examination of the interaction of s 318 of the ITAA 1936 and s 245-36 of the ITAA 1997. As to the potential for shareholders to control the voting power of a company in liquidation, see *Commissioner of Taxation v Linter Textiles Australia Ltd (In Liquidation)* [2005] HCA 20, [83]-[84] (Gleeson CJ, Gummow, Hayne, Callinan and Heydon JJ); [176] (McHugh J), which supports the view that control vests in the liquidators. Other types of external administration, such as a deed of company administration, would generally be expected to result in a similar outcome based on the usual terms of a deed of company administration granting a high level of control to the deed administrator.

82 See Ting 2010 (n 10).

cost of any change,[83] Australia should at least clarify and define the scope of the rules, specifically the SER.

83 Ibid.