‘PURPOSE IN TAX CONSOLIDATION – NO MORE PURPOSE?’

I INTRODUCTION

The characterisation of a gain or loss on disposal of an asset as income or capital continues to be one of the most challenging areas in tax law. In the case of the disposal of a company, the characterisation of the gain or loss depends on the method of sale. Where the disposal is by way of a sale of the underlying assets in the company, it is the nature of those assets which characterizes the gain or loss. On the other hand, where the disposal of the company is effected through the sale of the company’s shares, it is the characterisation of those shares which determines the nature of the gain or loss arising and not, the nature of the underlying assets. Very broadly, that characterization is dependent on the taxpayer’s purpose in acquiring or holding the shares.

Tax consolidation was introduced in Australia with effect from 1 July 2002. One of the key benefits of the tax consolidation regime is that any income tax consequences arising out of transactions between members of a tax consolidated group are disregarded. As such, tax consolidated groups are able to restructure their operations prior to disposal of a subsidiary member without tax consequence. This presents taxpayers with the opportunity to structure their affairs in such a way so that a gain or loss is converted from income to capital or vice versa. The purpose approach is inadequate in dealing with this situation and accordingly, is considered inappropriate in determining whether a gain or loss on disposal of the shares of a subsidiary member of a tax consolidated group is of a capital or income nature. This paper proposes that in this limited context, the purpose approach should be eschewed and such gains be characterized as being exclusively capital in nature through legislative amendment.

The next section discusses in further detail the current approach to characterizing the nature of a gain or loss on sale of shares, including a discussion as to why the distinction remains relevant. Section III introduces the reader to the tax consolidation rules in Australia and discusses the particular problems which arise for the characterisation issue as a result of consolidation. Finally, Section IV proposes that the issue be dealt with by legislative amendment, deeming the gain or loss on sale of a subsidiary member of a consolidated group to be exclusively on capital account. By way of comparison, the analysis also considers the US treatment of such gains.
II  INCOME VERSUS CAPITAL

The astute reader may question whether there is any great significance in distinguishing between income amounts or capital gains as the two amounts are subject to the same income tax rate, being 30 percent for corporate taxpayers. Further, corporate taxpayers cannot tax advantage of the concessions on capital gains introduced in 1999 whereby trusts and individuals can reduce their notional capital gain on certain assets by 50 percent. However, a significant difference does still arise due to the differing treatment of losses. Revenue losses may be utilised to offset both revenue and capital gains whereas capital losses can only be utilised against capital gains. Therefore, taxpayers in a gain position would prefer to establish that a gain is capital in nature in order to soak up capital losses quicker whereas taxpayers incurring a loss would of course argue that the loss was a revenue loss to prevent the loss being quarantined. For example, assume that a corporate taxpayer has carry-forward revenue losses of $4,000 and carry-forward capital losses of $3,000. Also assume that the taxpayer makes a gain from the sale of an asset of $10,000. If the gain was classified as a revenue amount, the $3,000 of carry-forward capital losses cannot be utilised against the $10,000 gain and only the $4,000 of revenue losses may be offset against the gain resulting in tax payable of $1,800 (30 percent of $6,000). On the other hand, if the gain was classified as capital in nature, the $3,000 of carry-forward capital losses would be applied in the first instance to reduce the net capital gain to $7,000 which would then be reduced further to $3,000 by applying the $4,000 of carry-forward revenue losses. As a result, the taxpayer has a tax liability of only $900 (30 percent of $3,000) arising from the same gain of $10,000.

The utilization of prior year losses (whether revenue or capital) by corporate taxpayers is subject to the satisfaction of two loss recoupment tests and corporate taxpayers would therefore prefer to utilise the losses quicker in order to prevent future wastage. Broadly, the company must have the same majority owners from the start of the income year in which the loss was incurred to the end of the income year in which the loss is to be utilised in order to do apply the losses against any gains. Failing that, the company must be operating the same business during the loss recoupment year as it did just prior to failing the continuity of ownership test. The need to utilise prior year losses sooner rather than later is now of greater significance due to the changes to the loss recoupment tests introduced late in 2005 which remove the secondary same business test for

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1 Explanatory Memorandum, New Business Tax System (Integrity and Other Measures) Bill 1999, 11.22.
businesses with a turnover in excess of $100 million. This is especially a problem for consolidated groups as the $100 million threshold applies to the group as a whole. It is therefore imperative for consolidated groups that any gains be classified as capital in nature while any losses are classified on revenue account to maximize the rate of utilization of current and prior year losses, minimizing income tax payable.

III CURRENT TREATMENT

A gain or loss on the sale of shares is generally presumed to be on capital account unless the individual facts indicate otherwise. For example, where the buying and selling of shares is part of the taxpayer’s ordinary course of business, the shares can be treated as trading stock and any gains or losses arising on disposal will be of an income nature. Further, through the decisions of Whitfords Beach and Myer Emporium, the Australian courts have recognized that isolated or extraordinary share sale transactions may also give rise to an income amount rather than a capital gain or loss. This paper is only concerned with income amounts arising in this manner and not with taxpayers that are in the business of share trading.

The basic test outlined in Whitfords Beach and followed in subsequent cases such as Myer Emporium and Westfield is that a profit or gain arising from an isolated or extraordinary transaction would constitute income where the taxpayer entered into the transaction with a profit-making purpose. Where the transaction involves the sale of property, it is generally accepted that the requisite profit-making purpose must have existed at the time the taxpayer acquired the property. The courts have also accepted that in some cases, the taxpayer may not have had a profit-making purpose at the time of acquiring the property but developed such a purpose at a later time. In such cases, the change of purpose in holding the asset would be sufficient to satisfy the test.

From case law, it is evident that the relevant purpose is an objective one and not the taxpayer’s subjective purpose. The taxpayer’s objective purpose is to be ascertained by looking at all of the facts and circumstances of each individual case and making a conclusion based on that
information. In Taxation Ruling TR 92/3, the Commissioner suggests a number of factors as being relevant in determining the taxpayer’s objective purpose.

This paper is solely concerned with corporate taxpayers and it is therefore important to note that in the case of companies, the purpose of the company may be imputed from the purposes of those who control it. It should also be noted that the profit-making purpose need not be the sole or dominant purpose but rather only a significant purpose of the taxpayer.

IV TAX CONSOLIDATION

Tax consolidation was introduced in Australia with effect from 1 July 2002. Under the new regime which is optional (but irrevocable) for all qualifying corporate taxpayers, wholly-owned Australian corporate groups can choose to be treated as a single entity for income tax purposes. As a result, only the head company of the consolidated group files an income tax return reporting the group’s tax liability, with each individual subsidiary member being treated as a branch of the head company. The regime is expected to significantly reduce compliance costs for corporate taxpayers as well as promoting business efficiency by facilitating intra-group transactions and restructuring as all income tax consequences arising from intra-group transactions are disregarded.

The tax consolidation system is based on one fundamental rule, the single entity rule. Under the single entity rule, the subsidiary members of a consolidated group are treated as parts of the head company of the consolidated group for income tax purposes. The rule applies for the purposes of working out the head company and subsidiary member’s liability for income tax or the amount of a loss for the income year. The single entity rule has the effect that:

- The actions and transactions of a subsidiary member are treated as having been undertaken by the head company;

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7 *FCT v Whitfords Beach Pty Ltd* (1982) 150 CLR 355 at 370.
8 See for example, *FCT v Cooling* (1990) 90 ATC 4472 at 4484; *Moana Sands Pty Ltd v FCT* (1988) 88 ATC 4897; *AGC Investments Ltd v FCT* (1991) 91 ATC 4180.
- The assets of a subsidiary member of the group are taken to be owned by the head company (with the exception of intra-group assets) while the subsidiary member remains a member of the consolidated group;
- Assets where the rights and obligations are between members of a consolidated group (intra-group assets) are not recognized for income tax purposes during the period they are held within the group whether or not the asset, as a matter of law, was created before or during the period of consolidation; and
- Dealing that are solely between members of the same consolidated group (intra-group dealings) will not result in ordinary or statutory income or a deduction to the group’s head company.

The single entity rule is supported by the entry history rule which provides that everything that happened to a subsidiary member prior to joining a consolidated group is taken to have happened to the head company of the consolidated group for the purpose of working out the head company’s tax liability or tax losses post consolidation. For example, the pre CGT status of assets that are brought into a consolidated group by an entity that becomes a subsidiary member of the group will be preserved as a consequence of the entry history rule.

In a consolidated environment the shares in a subsidiary member of the consolidated group (known as “membership interests” for the purposes of consolidation) are ignored under the single entity rule. However, the sale of such membership interests to a third party outside the tax consolidated group will trigger CGT Event A1 happening to the head company of the consolidated group. More importantly for the purposes of this paper, the gain or loss arising from the sale of the membership interests may also give rise to a revenue gain or loss under ordinary income principles, as discussed in the previous section. The fact that the profit received on the disposal of membership interests in a subsidiary member of a consolidated group can be income according to ordinary concepts was confirmed in Taxation Determination TD

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14 Australian Taxation Office, Taxation Determination TD 2004/40 ‘Income Tax: Consolidation: Capital gains: Does CGT event A1 in section 104-10 of the Income Tax Assessment Act 1997 happen to the head company of a consolidated group when a contract is made to sell a membership interest in a subsidiary member of the group to a purchaser outside the group?
15 Where the profit on disposal constitutes ordinary income, the capital gain would be reduced accordingly, as per section 118-20 of the Income Tax Assessment Act 1997.
2006/36,\textsuperscript{16} i.e., tax consolidation does not alter the existing approach to determining the character of a gain or loss on disposal of an asset.

\textbf{A The Determination of Purpose in a Tax Consolidated Environment}

This section discusses the application of the purpose approach in a tax consolidation context and the unique problems which potentially arise in this situation.

The first issue requiring clarification is the relevant taxpayer for determining purpose. In a tax consolidated group, the relevant taxpayer in all income tax matters is the head company of the group following the single entity rule as discussed above. As such, it is the purpose of the head company of the consolidated group in holding the shares that is of relevance. This would be the case even where the shares in the subsidiary member are not held directly by the head company of the consolidated group but indirectly through another subsidiary member of the group. In this situation, the entry history rule would ensure that everything that happened to a subsidiary member prior to consolidation is taken to have happened to the head company upon consolidation. Therefore, the single entity rule, in conjunction with the entry history rule, ensures that the head company’s purpose encompasses the purpose of its subsidiary member’s actions.

The question then turns to the appropriate approach for determining the purpose of the head company, including that of any relevant subsidiary members. The basic approach outlined above is unaltered in a consolidated environment and the characterisation of the transaction will be a question of fact, determined in accordance with all relevant circumstances.\textsuperscript{17} It is considered that this approach places too onerous a burden on consolidated groups as it requires the head company to “consider the entire factual matrix or context surrounding the derivation of the profit”.\textsuperscript{18} This approach contemplates “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”.\textsuperscript{19} As discussed earlier, the purpose of a company is to be imputed from the intentions of a majority of its board of directors.

\textsuperscript{16} Australian Taxation Office, Taxation Determination TD 2006/36 ‘Income tax: consolidation: can the profit received on disposal of membership interests in a subsidiary member of a consolidated group be income according to ordinary concepts?’ (2006).

\textsuperscript{17} Explanatory Memorandum New Business Tax System (Consolidation) Bill. No.1 (2002) para. 2.28.

\textsuperscript{18} TD 2006/36 para 12.

\textsuperscript{19} TD 2006/36 para 13.
In a consolidated context, this is likely to involve more than one board of directors potentially making it even more difficult to ascertain the relevant purpose. Further, it is not inconceivable that companies may form a tax consolidated group to realize the benefits of tax consolidation discussed above but not operate as a group commercially, potentially acting at cross-purposes and further complicating the determination of purpose. The determination of purpose is burdensome not only due to the volume of information that requires consideration but also the number of times that need to be considered. As discussed in TD 2006/36, it is necessary to determine if the head company had a profit-making purpose at the time of entering into the transaction. That time may be when the membership interests were acquired, when they were created or some later time when there has been a change in purpose.  

Finally, it is considered that continuing to apply a purpose approach in this context defeats one of the fundamental reasons for introducing tax consolidation, the ability of group members to transact with one another and restructure group operations without income tax consequences under the single entity rule. This includes the ability to transfer assets between group members without ordinary income or capital gain consequences. However, it is likely that taxpayers will have to continue tracking and documenting the transfer of assets between group members as it will be relevant to the determination of purpose upon the disposal of membership interests in the relevant subsidiary member. TD 2006/36 clearly states that the nature of the underlying assets in a subsidiary member is not the only relevant factor in determining the character of the profit on disposal of the membership interests. However, the Determination does consider “the way the underlying assets have been held by the consolidated group, as well as any change in the foregoing (including … intra-group transactions)” to be relevant in determining purpose. Further, the ability of group members to transfer assets between themselves without tax consequence potentially makes it even more difficult to objectively ascertain the taxpayer’s purpose. For example, assume that a head company has long-held shares in a subsidiary company. Any gain arising from the sale of these shares would generally be presumed to be on capital account. However, assume that due to a series of intra-group transactions over a period of time, the only assets of the company are trading stock. It is no longer obvious that the gain on sale of the shares should be on capital account but it could be depending on all of the surrounding facts. Many such scenarios are possible, either by accident or by design, and hence it is considered that the purpose

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20 TD 2006/36 para.10.
approach is inadequate in a consolidated environment due to the added complication of group members being able to transfer assets free of income tax consequences. Example 1 in TD 2006/36 contemplates intra-group restructuring prior to the disposal of shares but the fact scenario used presents a clear answer which is unlikely in practice where transactions are not exactly black and white and more likely to fall within the shades of grey.

V The US Approach

The United States provides an interesting comparison on the issue of characterizing a gain on sale of an asset for the purposes of this paper as it employs an approach which used to incorporate a determination of purpose but since the Supreme Court’s decision in 1988 in Arkansas Best,\(^{22}\) the taxpayer’s purpose in acquiring the asset is now considered irrelevant. The US approach to characterisation differs to the Australian approach firstly because it is more prescriptive and based on a legislative definition rather than the Australian approach which has emerged from case law. In the US, a gain (or loss) on the sale of an asset is on capital account where the asset disposed of is a capital asset. US legislators attempted to provide further guidance by defining a capital asset as follows:\(^{23}\)

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\begin{align*}
&\ldots \text{property held by the taxpayer (whether or not connected with his trade or} \\
&\text{business), but does not include -} \\
&\text{(1) stock in trade of the taxpayer or other property of a kind which would} \\
&\text{properly be included in the inventory of the taxpayer if on hand at the close of the} \\
&\text{taxable year, or property held by the taxpayer primarily for sale to customers in} \\
&\text{the ordinary course of his trade or business;} \\
&\text{(2) property, used in his trade or business, of a character which is subject to the} \\
&\text{allowance for depreciation provided in section 167, or real property used in his} \\
&\text{trade or business;} \\
&\text{(3) a copyright, a literary, musical, or artistic composition, a letter or} \\
&\text{memorandum, or similar property, held by -} \\
&\text{(A) a taxpayer whose personal efforts created such property,} \\
&\text{(B) in the case of a letter, memorandum, or similar property, a taxpayer} \\
&\text{for whom such property was prepared or produced, or}
\end{align*}
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\(^{22}\) Arkansas Best Corp. v Commissioner 108 S.Ct. 971, 973-4 (1988).

\(^{23}\) Internal Revenue Code (US) section 1221.
(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by -

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A);

(6) any commodities derivative financial instrument held by a commodities derivatives dealer, unless -

(A) it is established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a dealer, and

(B) such instrument is clearly identified in such dealer's records as being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe);

(7) any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); or

(8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.
The legislative definition of capital asset does not in any way appear to incorporate a determination of purpose but in the 1955 case Corn Products Refining Co. v Commissioner, the Supreme Court established what has become known as the Corn Products doctrine. Under this doctrine, the determination as to whether an asset is a capital asset or not is dependant upon the taxpayer’s purpose in purchasing the asset. An asset purchased for a business purpose without any substantial investment purpose is an ordinary asset, the sale of which would give rise to ordinary gains or losses whereas an asset purchased with a substantial investment purpose would be a capital asset and its disposal would give rise to capital gains or losses.

The Corn Products and Arkansas Best cases concerned hedge transactions and the fact scenarios involved are not directly relevant to this paper and are therefore not discussed here. However, some of the comments arising in and out of those cases in relation to the determination of purpose are of interest. Firstly, it should be noted that the court in Arkansas Best primarily rejected a purpose test on the basis that the definition of capital asset extracted above does not contemplate such an interpretation. However, the Corn Products doctrine had been in existence for thirty years prior to Arkansas Best without interference by Congress and therefore it is arguable that this reasoning is not the sole basis for the change of direction in Arkansas Best. It is considered more likely that given the complexity of transactions in business today, the court found it too burdensome on the Internal Revenue Service to make a determination as to the taxpayer’s purpose in holding an asset each time a gain or loss required characterisation. Following Corn Products, US courts applied the doctrine in many cases establishing a number of reasons why shares may be acquired for a business purpose thereby giving rise to ordinary gains or losses. Such reasons included ensuring a source of supply, purchasing customers, acquiring the underlying assets, securing a reliable distribution channel and protecting the reputation of the business. However, where the taxpayer had a substantial investment motive in acquiring the shares, they would be capital assets regardless of the existence of a predominantly business motive. Hence, a secondary ‘substantial investment motive’ test developed which proved to be problematic when applied to a holding company’s shares in a subsidiary company. The situation did not arise until 1984 when two such cases went to court. In the first, Campbell Taggart, the court found that shares held by a holding company could be ordinary assets where the taxpayer

26 Ibid. See especially discussion at fn.63.
had a business purpose in acquiring the shares. The second case which we are already familiar with, Arkansas Best, rejected the application of the Corn Products doctrine to such situations in the first instance, finding that shares held by a holding company are always capital assets and ultimately led to a rejection of the purpose test when the case reached the Supreme Court. These two cases illustrate the difficulty of determining purpose in relation to a holding company’s share holding in subsidiary companies. While the Australian position is not exactly the same as that in the US, it is considered that for the reasons outlined in the previous section, the determination of a profit-making purpose in a consolidated environment will become increasingly difficult, if not impossible, and therefore it is time for us to also consider abolishing the purpose test in this context.

VI The Way Forward

The question then turns to the appropriate treatment of gains or losses arising from the sale of shares in a subsidiary company of a tax consolidated group. The alternatives are that the gains or losses could always be on capital account, always on revenue account or something in between depending on the amount of time the shares have been held for. Another alternative is that the taxpayer could make an election when acquiring or creating the shares whether they are to be on capital or revenue account, with no possibility of changing that characterisation in the future. As stated in the beginning, this paper proposes that the appropriate treatment for such gains or losses is that they always be on capital account. The reason for this choice is solely based the goal of increasing simplicity in the Australian tax system. The essential criteria for assessing a tax system have long been held to be equity, efficiency and simplicity. The alternatives considered here are likely to be neutral with respect to equity, may have some differences in relation to promoting efficiency but would most significantly differ with respect to achieving simplicity. The last alternative, providing taxpayer’s with a choice is likely to afford taxpayers the opportunity to manipulate their transactions in order to achieve the most favourable tax outcome thereby decreasing the efficiency of the tax system. Further, this alternative would require either the Australian Taxation Office or the taxpayer to maintain records in relation to the election made at the time the shares are acquired or issued, creating an unnecessary compliance burden. Characterizing the gain or loss depending on the length of holding of the asset has traditionally been a popular option. For example, access to the capital gains concessions for individuals and trusts is dependant on the asset being held for a period of at least 12 months. In the US, the

previous definition of capital asset included time-based criterion which was later removed. The introduction of a minimum holding period to access capital treatment is not considered appropriate because it creates an artificial line in the sand which leads taxpayers to either dispose of assets sooner or later than intended purely to achieve the desired tax outcome. This results in inefficiency in the tax system. Therefore, there are ultimately two possible options – treat all gains and losses on ordinary account or capital account with no room for manipulation between the two. Either alternative would promote simplicity in the tax system by providing taxpayers with greater certainty and reduce the compliance burden on taxpayers and the tax office as there is no need to undertake extensive investigations in order to determine the tax characterisation of shares. As between the two alternatives, the choice is likely to depend ultimately on which option provides the most revenue for the government. In this paper, the capital option is selected on the basis firstly that shares are generally held on capital account and the majority of cases applying the current test would be on capital account. Secondly, promotion of investment particularly by corporate taxpayers continues to be one of the key objectives of the government for the good of the national economy. Affording capital account treatment to all investments in shares in a subsidiary company is likely to promote investment as taxpayers generally undertake investment on the basis that they will realize a gain and this option offers them the certainty that all such gains will be treated on capital account. While it may be possible to argue that the proposed amendment may result in companies acquiring 100 percent of the shareholding of a company rather than some lesser amount in order to bring the company into the consolidated group and take advantage of the capital gain treatment on disposal, it is considered that such change in decision-making is unlikely due to the responsibilities that accrue to the head company upon bringing a new company into the tax consolidated group.

On a final note, it should be reiterated that the appropriate avenue for such an amendment is through legislative intervention. Taxpayers require certainty in their dealings and this should be provided to them sooner rather than later. It will take years before an appropriate case is heard in the High Court and more importantly, it should not be for the courts to create an exception such as that considered in this paper. Many issues of uncertainty arising out of the tax consolidation regime have been dealt with through the public rulings system of the Australian Taxation Office but it is not the place of rulings to introduce what would effectively be new law. Therefore, legislative amendment is the most appropriate solution.