Part IVA & consolidation: *Channel Pastoral*

The Full Federal Court decision in *Channel Pastoral Holdings Pty Ltd v Commissioner of Taxation* [2015] FCAFC 57 (*Channel Pastoral*) re-visited the interaction between Part IVA and the tax consolidation rules as considered on appeal by the Full Federal Court in *Federal Commissioner of Taxation v Macquarie Bank Ltd* (2013) 210 FCR 164 (*Mongoose*). Importantly, all 5 judges agreed that Part IVA can apply in a tax consolidated group formation context – a question left somewhat open following *Mongoose* – although there was disagreement in relation to how, and in particular to which entity, it applies. In this regard, the decision largely relates to mechanics – how can the law be interpreted to operate adequately so that tax can be assessed when the 2 regimes interact. However, the conclusion that the Commissioner can give effect to a Part IVA determination by issuing an assessment to a subsidiary member of a tax consolidated group is likely to raise a number of additional difficulties as it is in sharp contrast to previous understandings of the operation of the single entity rule.

**Issue**

The questions considered by the Court relate to how Part IVA applies where a subsidiary member of a consolidated group obtains a tax benefit as a result of joining the group. For example:

- an entity has assets with a market value of $100 but a cost base of $10;
- as a result of joining the group, the cost base of the assets is reset to their $100 market value (and tax is not payable on transfer of the shares in the entity, for example because it is a non-land rich entity owned by non-residents or the shares are pre-CGT assets as was the case in *Channel Pastoral*); and
- the entity subsequently sells the assets for $100 and does not make a taxable gain.

In this scenario, if the sole or dominant purpose of a party to the scheme, being the subsidiary member joining the group, was to secure the cost base step up and associated tax benefits, can Part IVA be applied to assess the $90 gain that would have arisen had the assets been sold without the entity joining the group?

In *Channel Pastoral*, a full bench of 5 judges was specifically asked to consider whether the Commissioner was authorised to tax the gain under 3 different combinations of Part IVA determinations and income tax assessments:

1. **head company via subsidiary approach**: a Part IVA determination made to a subsidiary member given effect by assessing the head company;
2 head company only approach: a Part IVA determination made to the head company given effect by assessing the head company; or

3 subsidiary only approach: a Part IVA determination made to the subsidiary member given effect by assessing the subsidiary member.

Background – the decision in Mongoose

The interaction between Part IVA and tax consolidation in these circumstances was previously considered by the Full Federal Court in Mongoose where the majority (Middleton and Robertson JJ, Emmett J dissenting) essentially held that:

- as a result of the single entity rule, a subsidiary member cannot be directly assessed; and
- a head company cannot be assessed where under the counterfactual the subsidiary member, and not the head company, would make the gain.

The High Court refused the Commissioner’s application for special leave to appeal that decision (Commissioner of Taxation v Macquarie Bank Limited [2013] HCATrans 185). However, that refusal was influenced by the unanimous conclusion reached in the Full Court that the taxpayer did not have a sole or dominant purpose of obtaining a tax benefit. The Commissioner would have therefore been unlikely to succeed on appeal even if his technical arguments regarding the interaction of Part IVA and the tax consolidation rules were upheld by the High Court.

How to apply Part IVA in a tax consolidation context – Channel Pastoral

Highlighting the importance of this issue, Channel Pastoral was heard by a full bench of 5 judges, and the Court was only asked to consider 3 specific questions which concerned whether, in the circumstances described above, the Commissioner was authorised to issue, and give effect to, a Part IVA determination applying each of the 3 approaches outlined above.

The case was stated under Part 38 of the Federal Court Rules 2011 which allows the Court to determine reserved questions on the basis of an agreed statement of facts. Accordingly, the Court did not undertake a fact finding exercise and was not asked to consider the ‘tax benefit’ or ‘dominant purpose’ aspects of Part IVA. The taxpayer and Commissioner had entered into a settlement prior to the trial such that their dispute would be fully resolved by the Court’s determination of the reserved questions.

The Court delivered 4 separate judgments. Gordon and Edmonds JJ (with whom Allsop CJ agreed although he gave slightly different reasons) held that the subsidiary only approach was the only option available to the Commissioner. That is, the Commissioner was authorised to issue a Part IVA determination to the subsidiary member and give effect to that determination by issuing an assessment to the subsidiary member, notwithstanding the single entity rule. The reasoning is essentially that:

- the Part IVA determination must be issued to the entity that obtained the tax benefit – the subsidiary member who would have derived the gain under the counterfactual;
- the application of Part IVA proceeds on the basis of the counterfactual – under the counterfactual the subsidiary member is not a member of the group for part of the relevant tax year because the counterfactual involves the subsidiary member not joining the group, or joining the group later; and
- the ability to assess a subsidiary member of a consolidated group that was not a member of the group for part of the income year is expressly provided for in section 701-30 and section 701-30 applies in this scenario because, under the counterfactual, the subsidiary is not a member of the group at the time it obtains the tax benefit.
The reasoning in the majority decision in relation to section 701-30 is somewhat difficult to follow because section 701-30 only applies where an entity is a subsidiary member of a group for some but not all of an income year. Therefore section 701-30 cannot apply under a counterfactual that involves the subsidiary member not being a member of the group at any time in the relevant year.

The majority held that reliance on section 701-85 (which states that the operation of the core consolidation rules is subject to any provision of the 1936 or 1997 Acts) was not necessary because the application of Pt IVA proceeds on the basis that the subsidiary member is not a subsidiary member of the consolidated group at the time the gain was realised and therefore conflict between Part IVA and the single entity rule does not arise.

The minority considered that the Commissioner was able to assess a subsidiary member of a consolidated group on the basis of section 177B which prevents any section of the 1936 Act or 1997 Acts from overriding the operation of Part IVA and section 701-85.

In the view of the majority:

- the head company via subsidiary approach is not available because assessing the head company would not ‘give effect to’ the determination issued to the subsidiary member, because the head company does not obtain any tax benefit as compared to the counterfactual; and
- the head company only approach is not available because the head company does not obtain any tax benefit as compared to the counterfactual and therefore the Commissioner cannot issue a Part IVA determination based on that counterfactual to the head company.

It is somewhat surprising that Edmonds J joined in this judgment given his conclusion in his first instance decision in Mongoose that none of the 3 approaches are available. On the subsidiary only approach, he said in Mongoose ‘[i]n my view, [it] is just not possible [to issue an assessment to Mongoose] on the facts of the present case where Mongoose is a subsidiary member of the Macquarie Bank consolidated group and, as such, is not a separate entity liable to tax.’

Pagone J’s dissenting judgment (with which Davies J agreed) concluded differently. In his view, each of the 3 approaches was open to the Commissioner, but the need to utilise the subsidiary only approach would only arise if neither the head company via subsidiary approach, nor the head company only approach, were available. That is, Pagone J preferred either of the 2 approaches that resulted in the head company being assessed – a view that, perhaps, results from a more principled application of the single entity rule (although his interpretation of the limitations of the single entity rule may go too far).

Implications of Channel Pastoral

The majority’s conclusion that a subsidiary member can be directly assessed under Part IVA, (a conclusion also reached by the minority though on a more limited basis) raises a number of additional difficulties that will need to be addressed. For example:

- How is the subsidiary member’s taxable income calculated? Does it include only the gain that constitutes the Part IVA tax benefit or is it adjusted for income derived and expenses incurred by the subsidiary member during the period which, under the counterfactual, it is not a member of the consolidated group? Is the subsidiary member able to utilise tax losses it incurred before joining the consolidated group which, in fact, were transferred to the head company at the joining time? And, if so, how do the mechanics of the Act operate appropriately to prevent the head company from utilising those same losses?
- How are the reset cost bases of any assets retained by the subsidiary member calculated? For example, is the calculation and allocation of the joining allocable cost amount (or ACA) determined?
by reference to the assets and liabilities of the subsidiary member at the actual joining time or at the joining time presumed under the counterfactual, i.e. after the assets have been sold?

- If the subsidiary member is assessed and pays tax in respect of the gain, how will the mechanics of the Act operate appropriately to ensure that the resulting franking credits are included in the franking account of the head company?

In addition, a particularly concerning aspect of the decision is that if (as was the case in Channel Pastoral) the assessment issued to the subsidiary member is a new assessment rather than an amended assessment (i.e. because subsidiary members do not lodge tax returns while they are members of a consolidated group), the general 4 year amendment period will not apply. That is, in order to start the 4 year amendment period, should subsidiary members now lodge nil tax returns while they are members of consolidated groups?

Obviously none of the above issues were considered in the judgment. Further, the difficulties would not arise if, as the minority decided, the Commissioner could issue a Part IVA determination to the subsidiary member and give effect to that determination by assessing the head company.

The taxpayer will almost certainly seek special leave to appeal the decision to the High Court. Given the potential impacts of the decision for all consolidated groups, developments should be closely monitored.

The potential implications of the decision (and any appeal) extend beyond the interaction between the consolidation rules and Part IVA and may even impact the application of the single entity rule in other circumstances. In particular, Pagone J’s comments about the single entity rule operating as a ‘statutory direction concerned with the calculation of a composite liability’ rather than as a ‘statutory fiction … that a subsidiary of a consolidated group is to be treated as non-existent’ could have significant consequences, for example, in relation to the treatment of intra-group assets, being a perplexing issue that has also previously been the subject of extended consideration by the Board of Taxation.
For further information, please contact

Melbourne

Narelle McBride
narelle.mcbride@greenwoods.com.au
phone +61 3 9288 1715

Ken Spence
ken.spence@greenwoods.com.au
phone +61 3 9288 1451

Ryan Leslie
ryan.leslie@greenwoods.com.au
phone +91 3 9288 1441

Sydney

Tony Frost
tony.frost@greenwoods.com.au
phone +61 2 9225 5982

Tim Kyle
tim.kyle@greenwoods.com.au
phone +61 2 9225 5934

Perth

Nick Heggart
nick.heggart@greenwoods.com.au
phone +61 8 9211 7593

G&HSF document ID 51059375

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Greenwoods & Herbert Smith Freehills Pty Limited (ABN 60 003 146 852)

www.greenwoods.com.au

Sydney        ANZ Tower, 161 Castlereagh Street, Sydney NSW 2000 Australia
              Ph +61 2 9225 5955, Fax +61 2 9221 6516
Melbourne     101 Collins Street, Melbourne VIC 3000, Australia
              Ph +61 3 9288 1881 Fax +61 3 9288 1828
Perth         QV.1 Building, 250 St Georges Terrace, Perth WA 6000, Australia
              Ph +61 8 9211 7770 Fax +61 8 9211 7755