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Part IVA and consolidated groups: grazing on uncertainty

by Clint Harding, CTA, Partner, and Peter Scott, ATI, Lawyer, Arnold Bloch Leibler

Abstract: The decision of the Full Court of the Federal Court in Channel Pastoral Holdings Pty Ltd v FCT was the second of two decisions which have considered the interaction of Pt IVA (the general anti-avoidance provision) of the Income Tax Assessment Act 1936 and the tax consolidation regime (the first was FCT v Macquarie Bank Ltd). In Channel Pastoral, the court held that Pt IVA could apply to a scheme or an arrangement involving the formation of a tax consolidated group, and that the correct entity to which to issue a determination and corresponding assessment (or amended assessment) is the group member which would have derived the tax benefit had the consolidated group not been formed. This article examines the case in detail, outlines a number of implications, and argues that there is still confusion as to who should be the subject of a determination and an assessment in these situations.

Introduction
Following the Full Federal Court decision in FCT v Macquarie Bank Ltd (Mongoose), it was unclear whether the Commissioner could ever apply Pt IVA of the Income Tax Assessment Act 1936 (Cth) (ITAA36) to a scheme or an arrangement involving the formation of a tax consolidated group. That uncertainty has now been removed by the same court in its decision in Channel Pastoral Holdings Pty Ltd v FCT (Channel Pastoral), where it held that Pt IVA can apply in this context.

Once the underlying proposition is accepted, then the question becomes one of application. How should the Commissioner go about applying Pt IVA in such circumstances? The Full Federal Court’s decision in Channel Pastoral is by no means uniform in this regard, with four separate decisions being handed down. However, how the Commissioner applies Pt IVA in this context is an important point of law and can have a significant impact on the existing laws applying to income tax consolidated groups (ITCGs).

The facts and issues

The facts of Channel Pastoral were agreed and the court was restricted to determining only three questions. Importantly, the court was not required to determine whether there was a “scheme or arrangement”, a “tax benefit”, or to form a view on the “dominant or sole purpose” of the taxpayer. The three questions all relate to determining how the Commissioner should apply Pt IVA in the context of a scheme involving the formation of a consolidated group.

It is worth simplifying the facts of Channel Pastoral as follows:

- Channel Cattle Co Pty Ltd (Subco) owned a CGT asset, which had a cost base that was significantly lower than the market value (at the date of consolidation);
- in January 2008, Subco joined Channel Pastoral Holdings Pty Ltd (Headco) to create a consolidated group (group), with Headco as the head company;
- this had two key consequences:
  - the group would henceforth be treated as a single entity; and
  - the cost base of the CGT assets was reset to the market value at the date of consolidation; and
- in February 2008 (almost immediately after consolidation), the group sold the assets to another party at market value and, because the cost base of the assets had been reset to market value, there was no capital gain — in fact, there was a capital loss.

Under Pt IVA, the Commissioner can assess a taxpayer on the basis of what the Commissioner believes would have happened, but for the clear tax benefit of consolidating before selling the asset — this is called the counterfactual. The Commissioner can do this where the taxpayer cannot disprove that the consolidation was done for the sole or dominant purpose of obtaining the tax benefit — as opposed to some other commercial benefit.

In Channel Pastoral, the Commissioner’s counterfactual was that Subco would not have joined the group prior to selling its assets and therefore would have sold the assets with a lower cost base, giving rise to a significant capital gain. This was the “tax benefit” that the Commissioner alleged resulted from consolidation and which the Commissioner sought to assess. The Commissioner also sought to assess tax benefits in relation to trading stock values and capital losses resulting from the consolidation process.

The Commissioner, seeking to navigate the inter-relationship between the consolidation provisions and the general anti-avoidance provision, made a number of alternative determinations.
and assessments, effectively taking a "scattergun approach" to applying Pt IVA. This approach ultimately proved to be a wise course of action.

Because the above facts were agreed, the court was only asked to decide the correct way to determine and assess the tax benefit from the following three possibilities (the reserved questions):

1. (option 1) a Pt IVA determination is made in respect of Subco and, in order to give effect to this, Headco is assessed;
2. (option 2) a Pt IVA determination is made in respect of Headco and Headco is then assessed on the basis of the determination; or
3. (option 3) a Pt IVA determination is made in respect of Subco and Subco is then assessed on the basis of the determination.

The three questions posed for the court were all concerned with determining the mechanics of how the Commissioner can apply Pt IVA where a tax benefit is said to have been obtained in connection with a scheme which involves the formation of a consolidated group.

The key provisions

The key legislative provisions considered by the court in answering the above questions were:

- s 177F ITAA36 which allows the Commissioner to effectively cancel a tax benefit by assessing the taxpayer on the benefit;
- s 177B(1) ITAA36 which provides that Pt IVA is not limited by any other provisions in the Act (which includes the Income Tax Assessment Act 1997 (Cth) (ITAA97));
- the "single entity rule" in s 701-1 ITAA97 which provides that subsidiaries are to be treated as members of the consolidated group and not as separate taxpayers; and
- s 701-30 ITAA97 which allows an entity to be assessed as a separate taxpayer for periods during an income year in which it is not part of a consolidated group.

The decision

In a majority judgment (Edmonds and Gordon JJ, Allsop CJ agreeing), it was held that the only available option was for the Commissioner to make the determination and assessment in respect of Subco. The findings of their Honours are summarised in Table 1.

Mongoose

Similar issues were considered in Mongoose. However, in contrast to the majority in Channel Pastoral, the majority in Mongoose held (as relevant here) that:

- a subsidiary could not be directly the subject of a determination and assessed on this on the basis of the single entity rule, meaning that it could not be treated as a separate taxpayer; and
- a head company could not be assessed (whether the assessment is made in relation to the head company or subsidiary) on the basis of a counterfactual that assumes that the subsidiary never joined the group.

The Commissioner argued that the decision in Mongoose was incorrect and the court agreed.

The reasoning

Edmonds and Gordon JJ

The leading judgment of Edmonds and Gordon JJ turns the analysis of the reserved questions on its head and they effectively made a decision that, because the tax benefit can be determined and assessed in respect of Subco (option 3), there is no need to use options 1 and 2. They held that this approach is more consistent with the purposes of the consolidation provisions. Options 1 and 2 were nevertheless considered and ultimately rejected.

Option 1: Edmonds and Gordon JJ accepted that there may be scenarios where one taxpayer can be assessed on the basis of a determination made in respect of another taxpayer. However, their Honours held that any assessment must be consistent with the counterfactual on which the determination is based. Because the Commissioner’s counterfactual assumes that Subco never joined the group, or at least joined after selling its main assets, Headco could never be said to make a gain on which it can be assessed. Their Honours stated:

“In our view, any assessment to give effect to an anterior s 177F determination to include an amount in the assessable income of a taxpayer must be consistent, in all material respects, with the postulate upon which that determination is predicated, whether the assessment is issued to the taxpayer referred to in the determination or a different taxpayer.”

Interestingly, their Honours also stated that, if the counterfactual and the assessment were consistent and therefore Headco could be assessed, then option 1 still should not happen. Rather, option 3 should prevail because such an outcome leads to “harmonious goals”. This reasoning relies on the finding in respect of option 3 — that Subco can be assessed. Their Honours held that it could not be the intention of the Act that the Commissioner would therefore be able to tax the same gain.

Table 1

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<th>Reserved question</th>
<th>Determination</th>
<th>Assessment</th>
<th>Decision</th>
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<td>Option 1</td>
<td>Subco</td>
<td>Headco</td>
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<td>Edmonds and Gordon JJ x</td>
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<td>Davies J ✓</td>
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<td>Option 2</td>
<td>Headco</td>
<td>Headco</td>
<td>Allsop CJ x</td>
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<td>Option 3</td>
<td>Subco</td>
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twice, particularly because the intention of the consolidation provisions was to prevent double taxation.

Option 2: Their Honours also held that option 2 was not available to the Commissioner. This was because the Commissioner’s counterfactual was that Subco never joined the group and therefore Headco could never obtain a tax benefit, a determination and therefore an assessment based on this determination can never be made in respect of Headco. To this end, their Honours cited Edmonds J in Macquarie Bank Ltd v FCT (Mongoose (primary decision)).

“The same conclusion [that option 3 is available to the Commissioner] is reached if one approaches the issue through the prism of Pt 3-90, rather than through the unlimited operation of s 177B of Pt IVA. Part 3-90 actually contemplates that, as a matter of fact, there may be periods in the income year when an entity is not part of the group: see s 701-30 in [68] above. It further provides for how the entity’s taxable income (if any) is to be worked out for what is called ‘the non-membership period’: see s 701-30(3) …

In the present case, the application of Pt IVA proceeds on the basis that [Subco] is not a subsidiary member of the group for part of the 2008 income year. The fact that [Subco] is not a member of the [Headco] consolidated group for part of the 2008 income year is the basis for the alternative determination. The Commissioner then is required to, and did, give effect to that determination by issuing the alternative assessment to [Subco]: s 177F(1)(a). The ability to issue an assessment to a subsidiary member of a consolidated group that was not a member for part of the income year is expressly provided for by s 701-30. That section does not ignore the single entity rule in Pt 3-90. It recognises, as was the fact, that there will be instances where a subsidiary member is not part of the consolidated group for the whole income year. Section 701-30 provides a method of working out how the entity core rules apply to the entity for periods in the income year when the entity is not part of the group. The method involves treating each period separately with no netting off between them.”

The above reasoning with respect to, and reliance on, s 701-30 is difficult to follow. The primary purpose of s 701-30 is to provide for circumstances where an ITCG is formed part-way through an income tax year. It is not immediately clear how the provision provides a basis for somehow extending the non-consolidated period of a tax year by reference to the Commissioner’ counterfactual in a Pt IVA context, which is what their Honours seem to suggest.

Allsop CJ

Allsop CJ agreed with Pagone, Davies, Edmonds and Gordon JJ that the Commissioner could make determinations and assessments under Pt IVA in the context of consolidations, in particular under option 3, stating that:

“To the extent that the decision of the majority of the Full Court in [Mongoose] may be taken to decide to the contrary of the availability of a determination under s 177F(1) concerning an entity that is part of a group contemplated by Pt 3-90 in circumstances such as the present, in my respectful view, it is wrong and should not be followed.” (emphasis added)

While Allsop CJ accepted the supremacy of the Pt IVA provisions over the consolidation provisions (and therefore options 1 and 2 are theoretically available), his Honour agreed with Edmonds and Gordon JJ that this would result in the unsatisfactory outcome that both Headco and Subco could be assessed in respect of the same tax benefit, stating:

“One is therefore left with the position, on this hypothesis, of Pt IVA and Pt 3-90 authorising the assessment to two taxpayers [Subco] and [Headco] where the assessment to one [Subco] would be giving effect to the terms of the determination and the factual postulates in connection therewith, and the assessment to the other [Headco] would not be giving effect to the terms of the determination and the factual postulates in connection therewith, but Pt 3-90 could be seen to permit the assessment to [Headco] as the now responsible head company for the liability of [Subco] (as its ‘part’) to tax.

Once, however, one recognises that the objectives of Pt 3-90 are as set out in s 700-10 (to prevent double taxation of the same economic gain, to prevent a double tax benefit from an economic loss, and to provide a systematic solution to prevent such double taxation and double tax benefit), and once one accepts that Pt 3-90 cannot prevent an assessment to [Subco] to give effect to the determination concerning it, one is drawn to the conclusion that the context, general purpose and policy of Pt 3-90 and its consistency and fairness are a sure guide that an assessment to [Headco], absent a prohibition on the assessment to [Subco], does not fall within the intended reach of the words of s 701-1, in circumstances where (as here) such assessment would not otherwise give effect to the terms of the determination to [Subco].”

The minority

The minority decision of Pagone J (with whom Davies J agreed) rested heavily on the primacy of Pt IVA, meaning that the consolidation provisions did not in any way prevent a determination and an assessment being made in respect of the Headco or Subco and therefore all options were available to the Commissioner.

Pagone J

Option 1: Pagone J construed the single entity rule as a statutory direction concerned with the calculation of a composite liability, which in any case could not take precedence or limit the operation of Pt IVA by virtue of s 177B.
His Honour nevertheless considered the findings of the court in *Mongoose* in relation to the interaction of Pt IVA and the consolidation provisions. In particular, regard was had to the view that a head company could not be assessed in respect of a determination made to a subsidiary and/or in relation to a counterfactual where consolidation never occurs. Pagone J stated in relation to this:⁸

“In my view the decision of the majority in *Mongoose* was manifestly or plainly wrong and should not be followed. The decision, in my respectful opinion, rests upon a mistaken view of the operation of s 701-1 … The analysis which their Honours … should have asked whether the provisions of Part IVA, on their terms, authorised the making of a determination to the subsidiary … Their Honours did not consider whether an assessment to the head company would give effect to a determination made to the subsidiary within the meaning of s 177F(1). The reasons of the majority have two strands; namely, (a) that the assessment to the subsidiary is an impermissible step in light of their Honours construction of Part 3-90 of the 1997 Act (see at [132]) and, (b) that the assessment to the head company could not be sustained because it could not have obtained the tax benefit hypothesized by the Commissioner … Neither strand dealt with whether an assessment to the head company could give effect to a determination if validly made to either a subsidiary or the head company. Neither strand allowed for the subsidiary to have a role, as ‘part of’ the consolidated group, in working out the liability of the head company in its capacity, not as a separate company, but as the head company of the consolidated group. The final liability may fall upon the head company by force of Div 701 but it does so only by taking into account the amounts otherwise assessable or allowable of, and through, the parts which make up the consolidated group as an aggregated whole.” (emphasis added)

Pagone J ultimately agreed with the dissenting judgment of Emmett J in *Mongoose*, holding that:⁹

“An assessment to [Headco] in this case is, to adopt the words used by Emmett J at [33] [in *Mongoose*], ‘appropriate and adapted for giving effect to a determination issued’ to [Subco] (especially where that which produced the tax benefit was so intimately involved with the creation and joining of the consolidated group which were necessarily steps for the tax benefit to be obtained by the group member). The assessment to [Headco], in its capacity as the head company of a consolidated group, in my view, is not factually inconsistent with the hypothesis upon which the determination was predicated because the assessment would be to [Headco] as the group entity which is made liable for the determination which was made to a member of the group. Accordingly, the answer to the first question is ‘no’; in other words, that the Commissioner is permitted to make a determination to [Subco] and to give effect to that determination by an assessment to [Headco] consistently with the provisions in Div 701 of the 1997 Act.” (emphasis added)

Therefore, Pagone J emphasised that, in light of the circumstances, the most practical way to give effect to the determination in respect of Subco was to assess Headco.

“… the most practical way to give effect to the determination in respect of Subco was to assess Headco.

**Option 2:** Pagone J also held that Headco could be the subject of a determination in respect of the tax benefit and assessed on this — again, taking a pragmatic approach. His Honour held that:¹⁰

“… although it is true in point of fact that [Headco] could never itself (as a separate entity) have obtained the tax benefit but for the scheme, the operation of Div 701 requires the subsidiary to be taken to be part of the head company for the purpose of working out their liability. The effect of Div 701 is, in other words, to put [Headco] ‘in the shoes of’ the subsidiary for that purpose. On this reasoning the relevant inquiry may more practically be understood by posing the question as being whether that part of the head company which formed part of the consolidated group obtained the tax benefit, rather than whether the head company without the relevant subsidiary had obtained the tax benefit. On that reasoning a determination to [Headco] can be seen as the formal mechanism contemplated by s 701-1 to include in the liability of the group the tax benefit obtained by a member of the group, namely by [Subco]. In this way the determination made to the head company (not as a separate company but in its capacity as the head company which is taken to include all of its parts) is the means by which the tax benefit is included in the relevant part of the consolidated group.”

**Option 3:** Pagone J’s analysis in respect of option 3 relies heavily on s 177B, providing that Pt IVA is not limited in any way. His honour stated:¹¹

“Part IVA must be applied according to its terms … and by, s 177B, overrides any provisions to the contrary. Section 177B provides that nothing in the provisions in the Act, apart from an exception not presently relevant, shall be taken to limit its operation … Section 701-85 in Part 3-90, in turn, also provides that the provisions of Div 701 are subject to any provision that so requires either expressly or impliedly. Division 701, therefore, does not prevent the Commissioner from making determinations to [Subco] under s 177F(1), and the power to give effect to such determinations by assessments to [Subco] under the assessing powers in ss 168 and 169 are within the power of s 177F(1) as a means by which determinations to [Subco] may be given effect by assessments directly to [Subco]. The operation of ss 168 and 169, through s 177F, override any contrary provision in Div 701 because of s 177B of the 1936 Act and s 701-85 of the 1997 Act. Accordingly, I would also answer ‘no’ to question 3; that is, that s 701 does not prevent the Commissioner from making alternative determinations and assessments.”

Davies J agreed with Pagone J and made some additional observations, which generally acceded with that of Pagone J.

**Implications and observations**

**Implications**

The majority’s conclusion in *Channel Pastoral* has the following potential implications, none of which were considered in *Channel Pastoral*:

- In *Channel Pastoral*, Subco was the subject of a *new assessment* and not an amended assessment because it was part of a consolidated group and therefore it had not lodged a return which might be amended. The absence of an assessment, and therefore an assessment date, has the unfortunate implication that the general four-year amendment period will not apply. In order to ensure that there is an assessment date from which a four-year amendment period can apply, it may now be prudent for subsidiaries to lodge nil tax returns.

- Should tax-sharing agreements and tax funding agreements now contemplate
the possibility of a Pt IVA determination and assessment being made in respect of a group member? If so, how does this impact on the reasonable allocation of the group liability for which the tax-sharing agreements must provide?

- Does the decision impact on a subsidiary’s ability to achieve a “clear exit” from a consolidated group?
- Where the subsidiary is assessed, will the franking credits flow to the head company or be lost in the subsidiary?
- Are the reset cost bases of assets remaining within the subsidiary to be recalculated by reference to the consolidation date under the counterfactual or from the actual date of consolidation?
- Under a Channel Pastoral-type assessment, how is a subsidiary supposed to recalculate its taxable income? In particular, can the subsidiary reduce gains by using capital losses incurred prior to the actual consolidation or are those losses trapped within the head company by virtue of consolidation?

Additional observations

Arguably, there is still confusion as to who should be the subject of a determination and an assessment in Channel Pastoral and Mongoose situations.

From a practical point of view, it may be the case that the Commissioner will continue to adopt a scattergun approach to issuing determinations and alternate assessments, as it was clearly a successful approach in Channel Pastoral. This outcome is likely to create a lot of confusion for taxpayers who will have to deal with several determinations and assessments, and still raises questions as to where the liability really sits.

The most commonsense approach to these scenarios is option 1. Clearly, the counterfactual is inconsistent with the assessment of Headco. However, taking a big picture view of the whole arrangement, this is the most practical way to tax the benefit alleged as it accepts the reality that Subco is now a member of a consolidated group. In this way, option 1 is the most appropriate and adapted way to give effect to the determination. Option 1 also largely avoids the undesirable implications identified above.

The authors understand that the decision has not been appealed. It is likely, given some of the uncertainties remaining and referred to above, that the issue will again come before the courts and perhaps it will then be resolved in a manner satisfactory to both the taxpayers and the ATO.

Taxpayers looking to consolidate should be aware of the implications of Channel Pastoral and the clear potential for Pt IVA to apply in the context of consolidations, and should also have regard to the potential implications for a subsidiary leaving a consolidated group.

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