CONSOLIDATION AND IMPUTATION

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This article examines the overlap and interaction between the new consolidation regime and the new simplified imputation regime. Both these regimes were introduced, with general effect, from 1 July 2002 and comprise an intricate web of provisions that span well over 100 pages of legislation. The article focuses on the special ways in which the franking account and exempting account rules apply to a consolidated group. The article analyses the technical operation of the new rules and explains why various modifications to the general franking and exempting account provisions were required as a consequence of the introduction of the consolidation regime. In particular, the article provides several specific illustrations of how the regimes interact and outlines certain opportunities that potentially arise under the rules.

1. INTRODUCTION

Arguably, the most revolutionary of all the Review of Business Taxation's tax reform recommendations was the proposal to introduce a regime that would allow groups of wholly-owned resident entities to "consolidate" their income tax affairs.[1] Although the government was quick to accept this recommendation,[2] the consolidation regime is a recent measure that only commenced operation from 1 July 2002.

The consolidation regime is principally contained in Pt 3-90 of the *Income Tax Assessment Act 1997* (Cth) ("ITAA97"), comprising

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[1] Review of Business Taxation, *A Tax System Redesigned* (1999) 517 (Recommendation 15.1).

[2] Treasurer, *Press Release No 58* (21 September 1999).

Div 700 to Div 719. Within these Divisions are hundreds of complex provisions. These provisions are based around a set of "core rules", but also contain numerous important "modifications" to those rules. The relevant provisions are extensively cross-referenced to each other and designed to integrate with the general income tax provisions located elsewhere in the tax legislation. Ultimately, the new rules represent one of the most intricate regimes that currently exist under the income tax law.

Given the recent nature of the reforms, their technical complexity and the fact that they were introduced in stages through a package of major amending Bills,[3] it is not surprising that both the professional and academic literature in this area has, so far, largely only covered general aspects of the regime. The purpose of this article is not to replicate any of this general discussion.[4] Rather, its aim is to focus in detail on one specific aspect of the new rules, namely the way in which the consolidation regime interrelates with the new simplified imputation system contained in Pt 3-6 of the ITAA97, which was also introduced with effect from 1 July 2002.[5]

2. KEY CONSOLIDATION PRINCIPLES

The fundamental aim of the consolidation regime is to allow a wholly-owned group of resident entities to consolidate their tax position rather than be treated as separate entities. The regime

[3] The relevant Bills were: the New Business Tax System (Consolidation) Bill No 1 2002 (released on 16 May 2002); the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002 (released on 27 June 2002): the New Business Tax System (Consolidation) Bill No 1 2002 (released on 16 May 2002); the New Business Tax System (Consolidation and Other Measures) Bill (No 1) 2002 (released on 26 September 2002); and the New Business Tax System (Consolidation and Other Measures) Bill (No 2) 2002 (released on 12 December 2002).

[4] For a general overview of the basic aspects of the consolidation rules, see: A Carey, *Consolidation — The Adviser's Guide* (2002); and R Woellner, S Barkoczy, S Murphy and C Evans, *Australian Taxation Law* (2002) 1,196-1,218.

[5] For a general discussion of the simplified imputation rules, see: CCH Australia Ltd, *Australian Master Tax Guide* (34th ed, 2003) 123-153; R Deutsch, M Friezer, I Fullerton, M Gibson, P Hanley and T Snape, *Australian Tax Handbook* (2003) 980-1,016; and Woellner et al, above n 4, 1,121-1,151.

operates exclusively in the income tax arena and therefore does not impact upon other tax regimes, such as the GST or FBT systems. Furthermore, it does not have any general corporate law implications.

2.1 Consolidated Group

The consolidation regime operates in respect of a "consolidated group". A consolidated group consists of a "head company" and all its "subsidiary members".[6] These concepts are defined by reference to a table in s 703-15.[7] Essentially, a "head company" is a resident company[8] that is not a subsidiary member of a consolidated or "consolidateble" group.[9] A "subsidiary member" is an entity (namely, a resident company,[10] a resident trust described in s 703-25, or a partnership) that is a "wholly-owned subsidiary" of the head company.[11] According to s 703-30, an entity is a "wholly-owned subsidiary" of another entity (the "holding entity") if all of the "membership interests"[12] in the entity are beneficially owned[13] by either the holding entity, one or more wholly-owned subsidiaries of

[6] ITAA97, s 703-5(3).
[7] The table operates subject to ITAA 1997, s 703-20 which excludes certain entities from being either head companies or subsidiary members (eg pooled development funds, film licensed investment companies, entities that are exempt from tax under Div 50 ITAA97 and superannuation entities).
[8] The company must be subject to the general corporate tax rate.
[9] ITAA97, s 703-10 and s 703-15. The object of this rule is to ensure that the head company is always the highest resident company in a chain of wholly-owned entities.
[10] Again, the company must be subject to the general corporate tax rate.
[11] If any entities are interposed between the subsidiary and the head company, the requirements of ITAA97, s 703-45 must also be satisfied.
[12] Defined in ITAA97, s 960-130 and s 960-135.
[13] Special tracing rules allow ownership to be traced through non-fixed trusts: ITAA97, s 703-40.

the holding entity, or a combination of the holding entity and one or more of its wholly-owned subsidiaries.[14]

2.2 Choice to Consolidate

A consolidated group comes into existence from the date specified by the head company in a written choice that it makes under s 703-50.[15] In other words, consolidation is not mandatory.[16] However, once a choice to consolidate has been made, the consolidated group generally continues to exist until the head company ceases to be a head company (eg it is taken over by another consolidated group).[17]

2.3 Single Entity Rule

To ensure that the consolidation regime is based on a consistent set of principles, it is underpinned by a set of "core rules". For the purposes of this article, the most important core rule is the "common rule" contained in s 701-1, which is known as the "single entity rule". This rule provides that the subsidiary members of the group are treated as parts of the head company, rather than separate entities during the period of consolidation.

Some of the important income tax implications that flow from the operation of the single entity rule are outlined below:

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[14] Note that in determining whether a company is a wholly-owned subsidiary, minor shareholdings under employee share arrangements are disregarded under ITAA97, s 703-35 (see 7.1). This allows consolidated groups to he formed in cases where small portions of shares are held outside the group by employees.
[15] ITAA97, s 703-5(1).
[16] While consolidation is not mandatory, it is important to realise that various forms of corporate group relief (such as the CGT group roll-over relief under ITAA97, Div 126-B and the tax loss and net capital loss transfer rules in ITAA97, Subdivs 170-A and 170-B) will not be available from 1 July 2003. The removal of this relief, may therefore operate as a significant factor in encouraging corporate groups to consolidate.
[17] ITAA97, s 703-5(2).

- The head company is primarily liable for the income tax related liabilities of the consolidated group.[18] The head company is therefore required to lodge a single income tax return based on the taxable income or loss of the group for the relevant accounting period.[19]
- The head company is treated as the tax owner of the assets and liabilities of the group during the period of consolidation (even though actual ownership of the assets and responsibility for liabilities may remain with the subsidiary members under the general law). This means, for example, that it is the head company which must recognise any capital gain that arises in respect of a CGT event happening to a CGT asset and which is entitled to claim a deduction for the decline in value of a depreciating asset, irrespective of which entity in the group actually owns the asset.
- All membership interests held by the head company and its subsidiary members in group entities are ignored during the period of consolidation. Consequently, it is only when an entity ceases to be a member of a group that the membership interests held in such an entity need to be recognised.
- All intra-group transactions that occur between the members of the group during the period of consolidation are ignored. This means, for example, that dividends paid between group members and asset transfers that occur between them do not have any income tax effect. Likewise, a similar principle applies to intra-group reconstructions, such as share buy-backs, capital reductions and liquidations that take place in relation to the subsidiary members of the group.

3. SPECIAL FRANKING AND RELATED RULES

[18] Note, however, that ITAA97, Div 721 contains special provisions for the recovery of these liabilities from "contributing members" where the head company fails to pay a group liability by the time it becomes due and payable.

[19] The accounting period for a group will be based on the head company's accounting period, even though its subsidiary members may have previously balanced on different dates.

In order to ensure that the single entity rule is reflected in the way in which the imputation system interrelates with the consolidation regime, ITAA97, Subdiv 709-A contains special rules, which require the head company of a group to maintain a single "pooled" franking account on behalf of the group. Consistent with this principle, there is also a requirement that the franking accounts of subsidiary members are rendered inoperative during the time that they are members of the group. More specifically, as stated in s 709-55, the aim of Subdiv 709-A is to ensure that:

- there is a nil balance in the franking accounts of entities that become subsidiary members of a group;
- the franking accounts of those subsidiary members do not operate while they are subsidiary members;
- debits or credits that would otherwise arise in the franking accounts of the subsidiary members arise instead in the franking account of the head company of the group; and
- the head company is the only member of the group that can frank distributions.

It is important to realise that the special franking account rules in Subdiv 709-A do not replace the general franking account rules in Pt 3-6 of the ITAA97. Rather, they are superimposed on these rules and the relevant provisions must therefore be read in conjunction with each other.

The remainder of this article is divided into three main parts:

1. The first part focuses on examining how the special franking account rules in Subdiv 709-A operate (see 4 to 7).
2. The second part discusses two related issues, namely:
   - the operation of ITAA97, Div 709-B which modifies the way in which the "exempting entity" and "former exempting entity" provisions in ITAA97, Div 208 apply in relation to consolidated groups (see 8); and

- the operation of s 177EB of the *Income Tax Assessment Act 1936* (Cth) ("ITAA36"), which is a new anti-avoidance provision specifically targeted at franking credit trading schemes involving consolidated groups (see 9).

3. The third part examines a specific franking opportunity that arises under the consolidation rules (see 10).

4. CREATING A NIL BALANCE IN THE FRANKING ACCOUNT OF A JOINING ENTITY

Special franking credit and franking debit entries arise under Subdiv 709-A where an entity joins a consolidated group as a subsidiary member and it has either a franking surplus or a franking deficit in its franking account immediately before the joining time. The aim of these rules is to create a nil balance in the joining entity's franking account and to either transfer any surplus to the head company or have the joining entity make up for any deficit by paying franking deficit tax. The specific way in which the rules operate is discussed at 4.1 and 4.2.

4.1 Franking Surplus

If the joining entity has a franking surplus in its franking account immediately before the joining time, the surplus is cancelled and transferred to the head company. This is achieved by way of the following franking entries arising under s 709-60(2):

(a) a debit equal to the franking surplus arising at the joining time in the joining entity's franking account; and

(b) a credit equal to the franking surplus arising at the joining time in the head company's franking account.

Example 1

H Co is the head of a consolidated group. On 1 May 2003, H Co acquired all the shares in J Co, which became a subsidiary member of the group on this date. Assume that immediately before acquiring the shares in J Co, H Co had a franking surplus in its franking account of $3m and J Co had a franking surplus in its franking account of $1m.

As a consequence of the consolidated franking account rules, a $1m debit would arise in J Co's franking account and a corresponding $1m credit would arise in H Co's franking account at the joining time. This is illustrated by the following entries:

J Co's franking account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/5/03	Balance just before joining time			$1m
1/5/03	Franking surplus transferred to H Co (s 709-60(2)(a))	$1m		Nil

H Co's franking account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/5/03	Balance just before joining time			$3m
1/5/03	Franking surplus received from J Co (s 709-60(2)(b))		$1m	$4m

The transferring of a joining entity's franking surplus to the head company ensures that the group can benefit from any credits that were generated by the joining entity prior to it joining the group. These credits would have arisen under the ordinary franking account rules in ITAA97, Div 205 (eg as a result of payments of tax and PAYG instalments by the joining entity and its receipt of franked distributions).

4.2 Franking Deficit

If the joining entity has a franking deficit in its franking account immediately before the joining time, the deficit is also cancelled. This is achieved by way of a credit equal to the franking deficit arising at the joining time in the joining entity's franking account: s 709-60(3)(a). The joining entity is also liable to pay franking deficit tax as if the joining entity's franking year had ended just before the joining time: s 709-60(3)(b). However, the joining entity is not entitled to credit its franking account in relation to its franking deficit tax liability (as would ordinarily be the case in accordance with item 5 of the table in s 205-15): s 709-60(3)(c). This is because it has already credited its franking account under s 709-60(3)(a).

Example 2

If in Example 1, J Co had a $1m deficit in its franking account rather than a $1m surplus, a $1m credit would arise in its franking account at the joining time and it would be required to pay franking deficit tax of $1m. There would not be any corresponding credit in H Co's franking account. Accordingly the only relevant franking entries are as follows:

J Co's franking account

Date	Details	Debit	Credit	Balance
1/5/03	Balance just before joining time			($1m)
1/5/03	Cancellation of franking deficit (s 709-60(3)(a))		$1m	Nil

5. SUBSIDIARY MEMBERS FRANKING ACCOUNTS DO NOT OPERATE DURING CONSOLIDATION

Consistent with the principle that the head company must maintain a single franking account on behalf of a consolidated group, is the rule contained in s 709-65 which provides that an entity's franking account is rendered inoperative from the time just after it becomes a subsidiary member of a group until the time that it leaves the group. In other words, no entries can arise in an entity's franking account during the period that it is a subsidiary member of a group since that account is effectively suspended during this period.

On leaving the group, the entity's franking account is re-activated. However, the leaving entity is not entitled to take any part of the head company's franking surplus (assuming it has one) with it. This is the case, even though the entity may have transferred its franking surplus to the head company on joining the group. As a result, the "re-opening balance" in the leaving entity's re-activated franking account will always be nil.

6. TREATMENT OF HEAD COMPANY'S FRANKING ACCOUNT DURING CONSOLIDATION

Since a head company is a "corporate tax entity",[20] it will need to maintain its own franking account for imputation purposes.[21] A head company will generate credits and debits in its franking account in accordance with the general franking rules in ITAA97, Div 205. In particular, a head company will generate credits in its franking account in the circumstances outlined in the table in s 205-15 and it will generate debits in its franking account in the circumstances outlined in the table in s 205-30. For example, a head company will credit its franking account when it pays tax or PAYG instalments and it will debit its franking account when it pays franked distributions to its members or receives tax refunds.

[20] Defined in ITAA97, s 960-115.
[21] ITAA97, s 205-10.

There is also a general rule that a head company will register credit and debit entries in its franking account whenever credit and debit entries would otherwise arise in the franking accounts of its subsidiary members if not for s 709-65 (see 5): s 709-70(1) and (2) and s 709-75(1) and (2). In other words, events which would have affected the franking accounts of subsidiary members of a group if those accounts had not been rendered inoperative, will be attributed to the head company's franking account. The amount of such entries correspond to the credit and debit amounts that would otherwise have arisen in the subsidiary members' franking accounts: s 709-70(3) and s 709-75(4). The object of this rule is to obviously preserve any franking credits and debits that relate to a subsidiary member in the hands of the head company under the single franking account rule.

Example 3

S Co joined a consolidated group that has H Co as its head company on 1 July 2003. On 5 August 2003, S Co received a $3m refund of tax relating to a tax dispute in respect of its 2000/01 year of income. Ignoring the consolidation rules, this refund would ordinarily result in a franking debit of $3m arising in S Co's franking account on 5 August 2003. However, since S Co is now a member of a consolidated group, a franking debit of $3m arises in H Co's franking account at such time.

There are two exceptions to the general rule outlined above:

- The first exception relates to the credit that arises in the subsidiary member's franking account as a consequence of s 709-60(3)(a) — namely, the credit that cancels a joining entity's franking deficit (see 4.2): s 709-70(4).
- The second exception relates to the debit that arises in the subsidiary member's franking account under s 709-60(2)(a) – namely the debit that cancels a joining entity's franking surplus (see 4.1): s 709-75(4).

A head company will not generate credit and debit entries in its franking account in relation to the above entries as they have already been taken into account for the purposes of cancelling the joining entity's franking deficit or franking surplus. The exceptions therefore prevent an unwarranted duplication of credit and debit entries from arising under the general rule.

7. FRANKABLE DISTRIBUTIONS MADE BY SUBSIDIARY MEMBERS TREATED AS DISTRIBUTIONS BY THE HEAD COMPANY

Ordinarily a subsidiary member of a group will only make frankable distributions to members of the group. Due to the single entity rule, these intra-group distributions are ignored (see 2.3). There are, however, a limited set of circumstances in which a subsidiary member of a consolidated group may make frankable distributions to entities that are not group members. Essentially, this may arise where distributions are made in respect of eligible employee shares and where distributions are made in respect of non-share equity interests. It is therefore necessary to have special franking account rules that apply in these circumstances. These rules are discussed at 7.1 and 7.2.

7.1 Frankable Distributions in Respect of Eligible Employee Shares

As a general rule, for a company to be a subsidiary member of a consolidated group, all the shares in the company must be beneficially owned by members of the group (see 2.1). There are, however, special rules contained in s 703-35 to ensure that a company is not prevented from being a subsidiary member of a consolidated group just because minor shareholdings in the company were acquired under eligible employee share acquisition arrangements. Essentially, provided such shares do not exceed 1% of the ordinary shares in the company, they are disregarded for the purposes of applying the grouping rules. Consequently, it is therefore possible for a subsidiary member of a group to have shareholders that are not group members.

By virtue of s 709-80, where a subsidiary member of a consolidated group makes a frankable distributions in respect of eligible employee shares to a relevant shareholder,[22] the distribution is treated as a frankable distribution made by the head company to a member of the head company. This rule applies for all franking purposes under Pt 3-6 of the ITAA97. As a consequence, the head company must debit its franking account to the extent to which the distribution is franked[23] and it must also issue a distribution statement to the shareholder.[24] In addition, it is the head company's "benchmark franking percentage" for the particular franking period that is relevant for the purposes of applying the "benchmark rule" in ITAA97, Div 203. Accordingly, if this rule has been breached, it is the head company which must pay overfranking tax[25] or which must generate a franking debit in its franking account[26] under s 203-50.

Example 4

Elly is an employee of S Co, which is a subsidiary member of the H Co group. Elly acquired shares under an eligible employee share scheme arrangement in S Co. If S Co makes a frankable distribution to Elly (eg pays her a dividend), the distribution is treated as if it was made by H Co to one of its members. In order not to breach the benchmark rule, H Co should ensure that the distribution is franked to the same franking percentage as its benchmark franking percentage for the franking period. On this basis, H Co should debit its franking account appropriately and it should issue a distribution statement to Elly.

[22] Or to another entity, because the shareholder owns the shares.
[23] This is done in accordance with item 5 in the table in ITAA97, s 205-30.
[24] This statement is issued in accordance with ITAA97, s 202-75.
[25] Overfranking tax applies where the "franking percentage" for the distribution exceeds the "benchmark franking percentage".
[26] A franking debit arises where the "franking percentage" for the distribution is less than the "benchmark franking percentage".

7.2 Frankable Distributions in Respect of Non-Share Equity Interests

Only "membership interests" in an entity are taken into account in determining whether the entity is a subsidiary member of a group. Membership interests are defined in s 960-135 and do not include "non-share equity interests" (defined in s 995-1 as "equity interests"[27] that are not shares). Accordingly, non-share equity interests in a subsidiary member of the group may be held by entities that are not members of the group.

Distributions in respect of non-share equity interests are referred to as "non-share distributions". To the extent that a non-share distribution is a "non-share dividend",[28] it is a frankable distribution in accordance with s 202-40(2). By virtue of s 709-85, where such a distribution is made by a subsidiary member of a group to an entity that is not a member of the group, the distribution is treated as a frankable distribution by the head company to a member of the head company. The effect of this rule is therefore the same as that under s 709-80 in respect of frankable distributions relating to eligible employee shares (see 7.1).

Example 5

X Co holds a non-share equity interest in S Co which is a subsidiary member of the H Co group. X Co is not a member of the group. If S Co makes a non-share dividend payment to X Co, this payment is treated as if it was a frankable distribution made by H Co to one of its members. H Co will therefore confront the same franking issues as those outlined in Example 4.

[27] Defined in ITAA97, Subdiv 974-C.
[28] Defined in ITAA97, s 974-120.

8. MODIFICATIONS TO THE "EXEMPTING ENTITY" AND "FORMER EXEMPTING ENTITY" RULES IN DIVISION 208

The imputation provisions dealing with the effect of receiving franked distributions are located in ITAA97, Div 207. Among other things, the Division contains the general "gross up and credit" rule, which applies where an entity receives a franked distribution.[29] The Division also contains special rules that operate where an entity receives franked distributions "indirectly" (ie via partnerships and trusts).[30] Importantly, these rules operate subject to a number of specific "internal" and "external" constraints. For example, the general rule operates subject to the operation of various Subdivisions located within Div 207. These include Subdiv 207-C and Subdiv 207-E which, in simple terms, usually requires that, in order to benefit from the gross up and credit mechanism, the recipient of a franked distribution must be a resident and must not to be exempt from tax.[31]

An important external constraint on the operation of Div 207 is found in Div 208, which contains special rules designed to prevent "franking credit trading schemes". Subdivision 709-B contains some important modifications to the way in which Div 208 operates in the context of a consolidated group (see 8.2). In order to appreciate these modifications, it is first necessary to briefly explain the fundamental role of Div 208, which is, in itself, a quite distinct and complex statutory regime (see 8.1).

8.1 Role of Division 208

Division 208 is superimposed on the general imputation rules and applies to two kinds of corporate tax entities, namely "exempting entities" and "former exempting entities".

Exempting entities are essentially corporate tax entities that are "effectively owned" by "prescribed persons" (ie broadly, nonresidents and tax exempt entities).[32] In simple terms, Div 208 is targeted at these entities since prescribed persons are generally not entitled to any of the franking benefits available under Div 207 in relation to franked distributions that are paid to them. As a result, these entities are therefore theoretically more likely to enter into schemes under which the benefit of franking credits are transferred to those entities that could otherwise use them (ie taxable residents). To discourage this occurring, s 208-195 deems that, subject to the exceptions in Subdiv 208-G,[33] Div 207 does not apply to franked distributions paid by exempting entities. The obvious consequence of this rule is that taxable resident entities (who would otherwise benefit from receiving franked distributions because of the gross up and credit mechanism) cannot usually benefit from franking credits allocated to franked distributions that are paid to them by exempting entities.

Exempting entities that cease to be effectively owned by prescribed persons are known as "former exempting entities".[34] Division 208 contains separate rules relating to these entities. These rules require that, on becoming a former exempting entity, an entity is required to "quarantine" its franking account by converting it into an "exempting account" and to open a new franking account.[35] In this regard, Subdiv 208-F contains special "exempting credit" and

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[32] ITAA97, s 208-20 and s 208-40 (see also s 208-45). Broadly, an entity is effectively owned by prescribed persons at a particular time if not less than 95% of the "accountable membership interests" (defined in s 208-30) or "accountable partial interests" (defined in s 208-35) are held by, or held indirectly for the benefit of, prescribed persons: s 208-25(1)(a). Alternatively, an entity is also effectively owned by prescribed persons at a particular time if it would be reasonable to conclude (pursuant to s 208-25(2)) that, at that time, the risks involved in, and the opportunities resulting from, holding accountable membership interests, or accountable partial interests, in the entity that are not held by, or directly or indirectly for the benefit of, prescribed persons are substantially borne by, or substantially accrue to, prescribed persons: s 208-25(1)(b).

[33] The exceptions relate to distributions made by exempting entities to other exempting entities and to employees that acquired their shares under eligible employee share schemes.

[34] ITAA97, s 208-50.

[35] ITAA97, s 208-110.

"exempting debit" rules, which relate to a former exempting entity's exempting account.[36] The Subdivision also contains special franking credit and franking debit rules, which arise as a consequence of an entity becoming a former exempting entity.[37] Most importantly, these rules require that immediately after an entity becomes a former exempting entity, any franking surplus or franking deficit in its franking account must be cancelled and posted to its exempting account. This is achieved under a two step process. First, a franking debit entry (equal to the amount of any franking surplus) or a franking credit entry (equal to the amount of any franking deficit) must be made to the entity's franking account under item 1 in the table at s 208-145 or item 1 in the table at s 208-130. Secondly, the amount of the franking surplus or franking deficit then becomes an exempting credit or exempting debit in the former exempting entity's exempting account under item 1 in the table in s 208-115 or item 1 in the table at 208-120.

While a former exempting entity can frank distributions using its exempting credits, it is important to realise that s 208-225 performs a similar role in relation to former exempting entities to that which s 208-195 performs in relation to exempting entities. Specifically, it deems that, subject to the exceptions in Subdiv 208-H,[38] Div 207 does not apply to distributions franked with "exempting credits".[39] As a result, unless a specific exception applies to a former exempting entity's taxable resident shareholders, they would not obtain any franking benefits in relation to distributions that are franked with exempting credits.

8.2 Subdivision 709-B Modifications

[36] ITAA97, s 208-115 and s 208-120.
[37] ITAA97, s 208-130 and s 208-145.
[38] The exceptions relate to distributions made by exempting entities to other exempting entities or former exempting entities, to employees that acquired their shares under eligible employee share schemes and to "eligible continuing substantial members" (defined in s 208-155).
[39] Defined in ITAA97, s 208-60.

In the consolidation context, Div 208 is applied to the head company of a group to determine whether the group is an exempting entity or former exempting entity.[40] However, as alluded to above, the rules in Div 208 are modified by additional rules contained in Subdiv 709-B. The relevant modifications are contained in s 709-160 to s 709-175.[41] Essentially, the way in which the special rules operate differs depending on whether the head company and its subsidiary members are exempting entities or former exempting entities at the "joining time". Importantly, in determining the status of these entities for the purposes of applying the special rules, Div 709-B contains its own internal "testing rules". The effect of these testing rules is that Div 208 is applied to determine the status of the head company, before the special rules in s 709-160 to s 709-175 are applied.[42] Furthermore, Div 208 is applied to subsidiary members just after they join a group based on the assumption that they were not members of the group at such time.[43]

The specific ways in which the Div 709-B modifications to Div 208 operate are discussed in detail at 8.2.1 to 8.2.6 and the broad effect of the rules is summarised at 8.2.7.

8.2.1 Head Company is Neither an Exempting Entity Nor a Former Exempting Entity and Subsidiary is an Exempting Entity: s 709-160

If the head company of a consolidated group is neither an exempting entity nor a former exempting entity, and a corporate tax entity which becomes a subsidiary member of the group is an exempting entity at the joining time, then the head company becomes a former exempting entity at such time.[44] In these circumstances, the head company has both a franking account and an exempting account[45] and the subsidiary member's franking account is rendered

[40] ITAA97, s 709-155(1).
[41] ITAA97, s 709-155(2).
[42] ITAA97, s 709-155(3)(a).
[43] ITAA97, s 709-I55(3)(b).
[44] ITAA97, s 709-160(1) and (2) (item 1 in the table).
[45] ITAA97, s 709-160(2) (item 2 in the table).

inoperative while it is a member of the group.[46] Any franking surplus in the subsidiary member's franking account is cancelled and transferred to the head company's exempting account rather than its franking account under s 709-60(2) (see 4.1).[47] This is achieved by a franking debit equal to the surplus arising in the subsidiary member's franking account and a corresponding exempting credit arising in the head company's exempting account at the joining time.[48] If the subsidiary member has a deficit in its franking account at the joining time, it will be liable for franking deficit tax.[49] Because of these special rules, the franking credit and debit and exempting credit and debit entries in item 1 of each of the tables in ss 208-115, 208-120, 208-130 and 208-145 (see 8.1), which ordinarily operate as a consequence of a company becoming an exempting entity, do not apply to the head company.[50]

Example 6

H Co is the head company of a consolidated group and is neither an exempting entity nor a former exempting entity. J Co, which is an exempting entity, joins the group on 1 August 2003. Assume that at the joining time, H Co has a $3m franking surplus in its franking account and J Co has a $1m franking surplus in its franking account.

According to s709-160, H Co becomes a former exempting entity on 1 August 2003 and it is required to maintain both a franking account and exempting account. H Co's franking account retains its $3m franking surplus. However, J Co's $1m franking surplus is transferred to H Co's new exempting account in accordance with the following entries:

[46] ITAA97, s 709-65 (see 5).
[47] ITAA97, s 709-160(2) (item 4 in the table).
[48] ITAA97, s 709-160(2) (item 3 in the table).
[49] ITAA97, s 709-60(3).
[50] ITAA97, s 709-160(2) (items 5 to 8 in the table).

J Co's franking account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Franking surplus at joining time			$1m
1/8/03	Franking surplus transferred to H Co's exempting account (s 709-160)	$1m		Nil

H Co's exempting account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Opening balance at joining time			Nil
1/8/03	Franking surplus received from J Co (s 709-160)		$1m	$1m

8.2.2 Head Company is Neither an Exempting Entity Nor a Former Exempting Entity and Subsidiary is a Former Exempting Entity: s 709-165

If the head company of a consolidated group is neither an exempting entity nor a former exempting entity, and a corporate tax entity which becomes a subsidiary member of the group is a former exempting entity at the joining time, then the head company becomes a former exempting entity at such time.[51] In these circumstances, the

[51] ITAA97, s 709-165(2) (item 1 in the table).

head company has both a franking account and an exempting account[52] and the subsidiary's franking account and exempting account are rendered inoperative while it is a member of the group.[53] Any exempting surplus in the subsidiary member's exempting account at the joining time is transferred to the head company's exempting account. This is achieved by an exempting debit equal to the surplus arising in the subsidiary member's exempting account and a corresponding exempting credit arising in the head company's exempting account at the joining time.[54] Where the subsidiary member has an exempting deficit in its exempting account at the joining time, the deficit is cancelled by a credit entry arising in its exempting account at the joining time. A corresponding franking debit equal to the exempting deficit also arises in its franking account just before the joining time.[55] Any surplus in the subsidiary's franking account at the joining time is transferred to the head company's franking account.[56] Correspondingly, if the subsidiary's franking account is in deficit at such time, the subsidiary is required to pay franking deficit tax.[57] Again, because of these special rules, the franking credit and debit and exempting credit and debit entries in item 1 of each of the tables in ss 208-115, 208-120, 208-130 and 208-145 (see 8.1) do not apply to the head company.[58]

[52] ITAA97, s 709-165(2) (item 2 in the table).
[53] ITAA97, s 709-65 (see 3) and s 709-165(2) (item 5 in the table).
[54] ITAA97, s 709-165(2) (item 3 in the table).
[55] ITAA97, s 709-165(2) (item 4 in the table).
[56] ITAA97, s 709-60(2) (see 4.1).
[57] ITAA97, s 709-60(3) (see 4.2).
[58] ITAA97, s 709-165(2) (items 6 to 9 in the table).

Example 7

H Co is the head company of a consolidated group and is neither an exempting entity nor a former exempting entity. J Co, which is a former exempting entity, joins the group on 1 August 2003. Assume that at the joining time, H Co has a $3m franking surplus in its franking account and J Co has a $1m franking surplus in its franking account and a $2m exempting surplus in its exempting account.

According to s 709-165, H Co becomes a former exempting entity on 1 August 2003 and it is required to maintain both a franking account and exempting account. H Co retains its $3m franking surplus in its franking account and J Co's $1m franking surplus is transferred to this account. At the same time, J Co's $2m exempting surplus is cancelled and transferred to H Co's new exempting account. The following entries illustrate this:

J Co's franking account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Franking surplus at joining time			$1m
1/8/03	Franking surplus transferred to H Co's franking account (s 709-60(2)(a))	$1m		Nil

H Co's franking account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Franking surplus at joining time			$3m
1/8/03	Franking surplus received from J Co (s 709-60(2)(b))		$1m	$4m

J Co's exempting account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Exempting surplus al joining time			$2m
1/8/03	Exempting surplus transferred to H Co's exempting account (s 709-165)	$2m		Nil

H Co's exempting account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Opening balance at joining time			Nil
1/8/03	Exempting surplus received from J Co (s 709-165)		$2m	$2m

8.2.3 Head Company is an Exempting Entity and Subsidiary is an Exempting Entity: s 709-170

If the head company of a consolidated group is an exempting entity and a corporate tax entity which becomes a subsidiary member of the group at the joining time, is also an exempting entity at that time, then the status of the head company does not change.[59] In these circumstances, the general rules discussed earlier on in this article relating to franking accounts operate. Accordingly, if the subsidiary member has a franking surplus, it must transfer this to the head

[59] ITAA97, s 709-170.

company's franking account[60] and if it has a franking deficit, it will be liable for franking deficit tax.[61] Also, in accordance with the general rule, the subsidiary member's franking account does not operate while it is a member of the group.[62]

Example 8

H Co is the head company of a consolidated group and is an exempting entity. J Co, which is also an exempting entity, joins the group on 1 August 2003. Assume that at the joining time, H Co has a $3m franking surplus in its franking account and J Co has a $1m franking surplus in its franking account.

According to s 709-170, there is no change in the status of H Co on 1 August 2003 (ie it remains an exempting entity). H Co's franking account retains its $3m franking surplus and J Co's $1m franking surplus is transferred to H Cos franking account in accordance with the following entries:

J Co's franking account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Franking surplus at joining time			$1m
1/8/03	Franking surplus transferred to H Co's franking account (s 709-60(2)(a))	$1m		Ni

60 ITAA97, s 709-60(2) (see 4.1).
61 ITAA97, s 709-60(3) (see 4.2).
62 ITAA97, s 709-65(3) (see 5).

H Co's franking account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Franking surplus at joining time			$3m
1/8/03	Franking surplus received from J Co (s 709-(0(2)(6))		$1m	$4m

8.2.4 Head Company is a Former Exempting Entity and Subsidiary is an Exempting Entity: s 709-175(1) and (2)

If the head company of a consolidated group is a former exempting entity and a corporate tax entity, which becomes a subsidiary member of the group at the joining time, is an exempting entity at that time, then the status of the head company does not change.[63] In these circumstances, any franking surplus in the subsidiary member's franking account at the joining time is transferred to the head company's exempting account. This is achieved by a franking debit equal to the surplus arising in the subsidiary member's franking account and a corresponding exempting credit arising in the head company's exempting account at the joining time.[64] As a consequence of this transfer, there is no transfer under s 709-60(2) (see 4.1).[65] If the subsidiary member's franking account is in deficit, it will be liable for franking deficit tax.[66] Again, pursuant to the general rule, the subsidiary member's

[63] ITAA97, s 709-175(2) (item 1 in the table).
[64] ITAA97, s 709-175(2) (item 2 in the table).
[65] ITAA97, s 709-175(2) (item 3 in the table).
[66] ITAA97, s 709-60(3) (see 4.2).

franking account is rendered inoperative during the period that it is a member of the group.[67]

Example 9

H Co is the head company of a consolidated group and is a former exempting entity. J Co, which is an exempting entity, joins the group on 1 August 2003. Assume that at the joining time, H Co has a $3m franking surplus in its franking account and a $2m exempting surplus in its exempting account and J Co has a $1m franking surplus in its franking account.

According to s 709-175(1) and (2), there is no change in the status of H Co on 1 August 2003 (ie it remains a former exempting entity). H Co's franking account retains its $3m franking surplus. Likewise, H Co's exempting account retains its exempting surplus of $2m and J Co's $1m franking surplus is transferred to this account. The following entries illustrate this:

J Co's franking account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Franking surplus at joining time			$1m
1/8/03	Franking surplus transferred to H Co's exempting account (s 709-175(2))	$1m		Nil

H Co's exempting account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Exempting surplus at joining time			$3m
1/8/03	Franking surplus received from J Co (s 709-175(2))		$1m	$4m

[67] ITAA97, s 709-65 (see 5).

8.2.5 Head Company is a Former Exempting Entity and Subsidiary is a Former Exempting Entity: s 709-175(3) and (4)

If the head company of a consolidated group is a former exempting entity and a corporate tax entity, which becomes a subsidiary member of the group at the joining time, is also a former exempting entity at that time, then the status of the head company does not change.[68] Any exempting surplus in the subsidiary member's exempting account at the joining time is transferred to the head company's exempting account. This is achieved by an exempting debit equal to the surplus arising in the subsidiary member's exempting account and a corresponding exempting credit arising in the head company's exempting account at the joining time.[69] If the subsidiary member's exempting account has an exempting deficit at the joining time, the deficit is cancelled by an exempting credit and a debit equal to the deficit arises in the subsidiary member's franking account just before the joining time.[70] If the subsidiary member's franking account is in deficit, it will be liable for franking deficit tax.[71] The subsidiary member's franking account and exempting account do not operate while it is a member of the group.[72]

Example 10

H Co is the head company of a consolidated group and is a former exempting entity. J Co, which is a former exempting entity, joins the group on 1 August 2003. Assume that at the joining time, H Co has a $3m franking surplus in its franking account and a $5m exempting surplus in its exempting account and J Co has a $1m franking surplus in its franking account and a $2m exempting surplus in its exempting account.

According to s 709-175(3) and (4), there is no change in the status of H Co on 1 August 2003 (ie it remains a former exempting entity). H Co retains its $3m franking surplus in its franking account and its $5m exempting surplus in its exempting account. J Co's $1m franking surplus is transferred to H Co's franking account and its $2m exempting surplus is transferred to H Co's exempting account. The following entries illustrate this:

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68 ITAA97, s 709-175(4) (item 1 in the table).
69 ITAA97, s 709-175(2) (item 2 in the table).
70 ITAA97, s 709-175(2) (item 3 in the table).
71 ITAA97, s 709-60(3) (see 4.2).
72 ITAA97, s 709-65 and s 709-175(2) (item 4 in the table).

J Co's franking account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Franking surplus at joining time			$1m
1/8/03	Franking surplus transferred to H Co's franking account (s 709-175(2))	$1m		Nil
H Co's franking account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Franking surplus at Joining time			$3m
1/8/03	Franking surplus received from J Co (s709-175(2))		$1m	$4m
J Co's exempting account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Exempting surplus at joining time			$2m
1/8/03	Exempting surplus transferred to H Co's exempting account (s 709-175(2))	$2m		Nil

H Co's exempting account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Exempting surplus at joining time			$5m
1/8/03	Exempting surplus received from J Co (s 709-175(2))		$2m	$7m

8.2.6 Head Company is a Former Exempting Entity and subsidiary is Neither an Exempting Entity Nor a Former Exempting Entity: s 709-175(5)

If the head company of a consolidated group is a former exempting entity and a corporate tax entity, which becomes a subsidiary member of the group at the joining time, is neither an exempting entity nor a former exempting entity at that time, then the status of the head company does not change.[73] If the subsidiary member's franking account is in surplus, the surplus is transferred to the head company's franking account[74] and if its franking account is in deficit, it will be liable for franking deficit tax.[75] Yet again, under the general rule, the subsidiary member's franking account is rendered inoperative during the period that it is a member of the group.[76]

[73] ITAA97, s 709-175(5) (item 1 in the table).
[74] ITAA97, s 709-60(2) (see 4.1).
[75] ITAA97, s 709-60(3) (see 4.2).
[76] ITAA97, s 709-65 (see 5).

Example 11

H Co is the head company of a consolidated group and is an exempting entity. J Co, which is also an exempting entity, joins the group on 1 August 2003. Assume that at the joining time, H Co has a $3m franking surplus in its franking account and a $5m exempting surplus in its exempting account and J Co has a $1m franking surplus in its franking account.

According to s 709-170(5), there is no change in the status of H Co on 1 August 2003 (ie it remains an exempting entity). H Co's franking account retains its $3m franking surplus. Likewise its exempting account retains its exempting surplus of $5m. J Co's $1m franking surplus is transferred to H Co's franking account in accordance with the following entries:

J Co's franking account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Franking surplus at joining time			$1m
1/8/03	Franking surplus transferred to H Co's franking account (s 709-60(2)(a))	$1m		Nil

H Co's franking account				
Date	**Details**	**Debit**	**Credit**	**Balance**
1/8/03	Franking surplus at joining time			$3m
1/8/03	Franking surplus received from J Co (s 709-60(2)(b))		$1m	$4m

8.2.7 Summary

In summary, it is possible to extrapolate certain fundamental principles that underpin the special rules discussed at 8.2.1 to 8.2.6. In particular, it is evident that the rules have been designed to preserve the single entity concept in that they ensure that the head company not only maintains a single franking account on behalf of the group, but also (where appropriate) a single exempting account on behalf of the group. Furthermore, the transfer of franking credits of subsidiary members that are exempting entities and exempting credits of subsidiary members that are former exempting entities to the relevant accounts of the head company ensures that any distributions ultimately franked with such credits will be subject to the operation of Div 208. In effect, this “pooling” mechanism preserves the underlying nature of the credits in the hands of the group and is obviously designed to protect the integrity of Div 208 as an anti-avoidance measure.

9. SPECIFIC ANTI-AVOIDANCE RULES TO PREVENT FRANKING CREDIT TRADING FOR CONSOLIDATED GROUPS

There is also a specific anti-avoidance rule, contained in ITAA36, s 177EB, which is designed to combat certain franking credit trading schemes that potentially might arise in the context of consolidation. In broad terms, the provision is targeted at schemes that, having regard to specified relevant circumstances, have been entered into by a person for the purpose of transferring credits from an entity to a head company as a consequence of the entity joining the group as a subsidiary member.[77] The anti-avoidance rule in s 177EB complements the anti-avoidance rule in ITAA36, s 177EA which is also targeted at franking credit schemes.[78]

[77] Ordinarily, such a transfer of credits would arise pursuant to s 709-60 (see 4.1).
[78] Neither provision is intended to limit the operation of the other: s 177EB(2).

The anti-avoidance rule in s 177EB only operates if all of the following criteria, specified in s 177EB(3), exist:

(a) there is a scheme for a disposition of membership interests in a joining entity;

(b) as a result of the disposition, the joining entity becomes a subsidiary member of a consolidated group;

(c) a credit arises in the franking account of the head company of the group because of the joining entity becoming a subsidiary member of the group;

(d) having regard to the "relevant circumstances" of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the credit to arise in the head company's franking account.

In general, the expressions used in s 177EB have the same meaning as the equivalent expressions in s I77EA.[79] However, there is a special definition of "relevant circumstances" in s 177EB(10).[80]

[79] ITAA36, s I77EB(1)(a). Expressions that are not defined in s 177EA, have the same meaning that they would otherwise have under the ITAA97.

[80] According to this provision, the relevant circumstances of a scheme include:

(a) the extent and duration of the risks of loss, and the opportunities for profit or gain, from holding membership interests in the joining entity that are respectively borne by or accrue to the parties to the scheme, and whether there has been any change in those risks and opportunities for the head company or any other party to the scheme (for example, a change resulting from the making of any contract, the granting of any option or the entering into of any arrangement with respect to any membership interests in the joining entity);

(b) whether the head company, or a person holding membership interests in the head company, would, in the year of income in which the joining entity became a subsidiary member of the group or any later year of income, derive a greater benefit from franking credits than other persons who held membership interests in the joining entity immediately before it became a subsidiary member of the group;

(c) the extent (if any) to which the joining entity was able to pay a franked dividend or distribution immediately before it became a subsidiary member of the group;

Note also that s 177EB is expressly deemed to apply to exempting credits in the same way that it applies to franking credits: s 177EB(11).

Where the criteria in s 177EB(3) have been satisfied, the Commissioner may make a written determination to deny franking credits being transferred from the joining entity to the head company: s 177EB(5). Such a determination has effect according to its terms: s 177EB(6).[81]

Obviously, the mere fact that membership interests in an entity have been acquired by a group and that franking credits are consequently transferred to the head company does not, by itself, trigger s 177EB. The provision can only operate, if it could objectively be concluded from the relevant circumstances that the scheme was entered into for a more than incidental purpose of enabling the credit to arise in the head company's franking account.

Furthermore, the requirement that there be a scheme for a "disposition of membership interests" means that it is unlikely that the provision could ordinarily apply in the "mere formation" context. In other words, it seems that it has no application where the transfer of franking credits arises simply as a consequence of the head company making an election to form a group with its existing subsidiary members since there would be no "disposition of membership interests" in this circumstance.

(d) whether any consideration paid or given by or on behalf of, or received by or on behalf of, the head company in connection with the scheme (for example, the amount of any interest on a loan) was calculated by reference to the franking credit benefits to be received by the head company;

(e) the period for which the head company held membership interests in the joining entity; and

(f) any of the matters referred to in s 177D(b)(i) to (viii).

[81] A taxpayer that is dissatisfied with a determination may object against it in accordance with Pt IVC of the *Taxation Administration Act 1953* (Cth).

10. FRANKING OPPORTUNITIES UNDER THE CONSOLIDATION RULES

Although the consolidation franking rules are largely mechanical provisions designed to reinforce the single entity concept and to preserve (in the hands of the head company) the benefit of any franking credits generated by subsidiary members prior to them joining a group, they can also provide a group with opportunities that would not otherwise be available if the group did not elect to consolidate.

In particular, the pooling of franking credits under the consolidation regime can overcome the "franking trap" that is occasionally faced by some companies. The franking trap arises in relation to companies that have losses but which also have surpluses in their franking accounts. The problem faced by these companies is that they are not able to distribute any franking credits to their shareholders as they cannot pay them dividends since they do not have the profits required to do this.[82]

Subject to the operation of any anti-avoidance rules, including the specific rule in s 177EB (see 7), so long as a head company of a group has profits, it would ordinarily be able to use any franking surpluses transferred to it by its subsidiary members to make franked distributions to its members. This is the case, even though the transferring entities may not have had any profits and would therefore not have been able to make any franked distributions themselves. Accordingly, the consolidation rules can enable franking credits that would otherwise be locked into a subsidiary member to be utilised by the group.

[82] The requirement that dividends are to be paid out of profits is contained in s 254T of the *Corporations Act 2001* (Cth). For a discussion of the concept of what constitutes a "profit", see: *Re Spanish Prospecting Co Ltd* [1911] 1 Ch 92; *FC of T v Slater Holdings Ltd* (1984) 156 CLR 447; and *QBE insurance Group Ltd v ASC* (1992) 10 ACLC 1,490.

Example 12

S Co is in a loss position, although it has a franking surplus of $1m in its franking account. As it does not have any profits to pay a dividend, it is unable to pass the benefit of any franking credits on to its shareholders.

If S Co becomes a member of a consolidated group, the $1m franking surplus in its franking account will be transferred to the head company of the group when it joins the group. Provided the head company of the group has profits, it ordinarily will be able to use this surplus to make franked distributions to its shareholders.

11. CONCLUSION

The consolidation regime certainly raises many issues that need to be carefully considered by a group of entities and their advisers. The way in which the consolidation regime interacts with the imputation system highlight that even the most fundamental concepts affecting a corporate group can become quite complicated and can require substantial modifications to be made to general principles. While, at first glance, the single entity rule appears to be quite a straightforward concept, the discussion in this article demonstrates that it requires to be supported by a swag of specific rules in relation to matters such as franking accounts and exempting accounts. Although these rules are principally technical in nature, they add a further dimension to the overall complexity of the regime.