# Treatment of assets relating to straddle contracts

This section explains how the tax cost setting rules apply when an entity contracts to sell or buy a CGT asset and the contract is not completed at the time the entity joins or leaves a consolidated group (i.e. a straddle contract). The tax consequences that arise on completion of the contract are also considered.

However, this section does not apply where:

- the entities entering into the contract are members of the same consolidated group at either the contract time or just after the contract is completed, or
- an asset is being acquired or disposed of through the use of a finance lease. In this context, 'finance lease' has the same meaning as that given in the Australian Accounting Standards AASB 117 Leases (AASB 117 is the Australian equivalent of the International Financial Reporting Standard (IAS 17) and applies from 1 January 2005).

## Sale cases

### Identifying the relevant asset

If an entity has contracted to sell a CGT asset that is the subject of a straddle contract, the asset is recognised as an asset of the entity at its joining or leaving time for the purposes of applying the tax cost setting rules in Divisions 705 and 711 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Generally, no other asset arising under the contractual arrangement would be recognised separately as an asset of the entity. However, some events and circumstances may lend value to an asset arising out of the contractual arrangement such that it could be recognised as a commercial or business asset of the joining or leaving entity. For example, this could occur where, in the absence of other factors to the contrary, the value of the CGT asset that is the subject of the contract is greater at the contract time than at the joining or leaving time. The economic value of the asset arising under the contractual arrangement is not to be confused with the gross value of any consideration receivable under the contract. → Taxation Determination TD 2008/31; 'Treatment of special classes of assets', C2-1-070

### Applying the tax cost setting rules

The CGT asset that is recognised as an asset of the joining entity is ordinarily a reset cost base for the purposes of allocating the group's allocable cost amount (ACA) for that entity.

In a leaving case, the terminating value of the CGT asset is used in calculating the tax cost of the group's membership interests in the leaving entity. While the rules for determining the terminating value vary according to the type of CGT asset, the terminating value generally equals the head company's cost base of the CGT asset at the entity's leaving time.

## Completion of the contract

When the contract is completed on the vendor transferring ownership of the CGT asset, there is a disposal for the purposes of CGT event A1.
→ section 104-10, ITAA 1997

The calculation of the capital gain or loss made on the asset's disposal will depend on whether the entity entered into the straddle contract to sell the asset:

- before it joined the group (entry-sell), or
- before it left the group (exit-sell).

**Entry-sell**

*Joining entity's tax consequences*

In an entry-sell case, the joining entity is taken to have disposed of the CGT asset at the contract time for CGT purposes. → Taxation Determination TD 2008/29

The capital gain or loss the joining entity makes on the disposal of the asset is calculated by using its cost base and reduced cost base for the CGT asset (rather than the group's tax cost for the asset set under Division 705 of the ITAA 1997).

Relevant costs and expenditure incurred by the entity after it joins the consolidated group are also added to the cost base and reduced cost base of the CGT asset in working out the joining entity's capital gain or loss. The sale proceeds received on settlement are relevant in determining the entity's capital proceeds from the CGT event for the purpose of working out its capital gain or loss. This is taken into account in working out the joining entity's net capital gain or loss for the income period in which the CGT event is taken to have happened – i.e. the income period before it joined the consolidated group
→ subsection 701-30(3) of the ITAA 1997.

*Head company's tax consequences*

As the joining entity is assessed on the disposal of the CGT asset, no CGT event happens to the group's head company when the asset ceases to be an asset of the group. The group's tax cost set for the asset at the joining time is subsequently ignored. The asset is effectively replaced by the consideration received on settlement of the contract.

Importantly, the CGT asset is not actually disposed of at the contract time – it is only once there has been a change of ownership of the CGT asset that the CGT provisions then take the time of the CGT event to be back at the contract time for tax purposes. There is, therefore, no need to recalculate the tax cost setting amounts for the assets held by the entity at its joining time, treating the consideration received under the contract as the relevant asset instead of the asset that was the subject of the contract.

If an asset arising under the contractual arrangement is also recognised as an asset of the joining entity, there are no CGT consequences for the head company when the contract is completed. The ending of that asset occurs within a continuum of events, from the time of the contract to the time of settlement, which comprises the disposal of the underlying CGT asset. Any cost allocated to the asset at the joining time is ignored with its value effectively replaced by the consideration received on settlement of the contract.

**Example 1 – Entry-sell**

*Facts*

On 22 June 2004, X Co enters into a contract to sell all of its shares in B Co (40%) to Y Co for $100,000.

On 10 July 2004, Head Co acquires all of the shares in X Co for $110,000, causing X Co to become a member of Head Co's consolidated group. The market value of shares in B Co is now $100,000. X Co's financial position is:

**Table 1: X Co's financial position at 10 July 2004 ($)***

| | | | |
|---|---|---|---|
| Cash | 10,000 | Contributed capital | 100,000 |
| Shares in B Co | 90,000 | | |

* Tax effect accounting is not considered for the purposes of this example

On 30 July 2004, the contract is settled and X Co ceases to be the owner of the shares in B Co.

*Calculation – setting the tax cost of X Co's assets*

Head Co must allocate the group's ACA for X Co to the assets of X Co when it becomes a subsidiary member.

Calculate ACA:

For the purposes of this example, assume X Co has no liabilities, undistributed profits or losses at the joining time. The ACA for X Co is calculated as:

| | |
|---|---|
| Step 1 amount (amount paid for X Co) | $110,000 |
| Total ACA | $110,000 |

Allocate ACA:

In relation to the contract, the relevant assets recognised for tax cost setting purposes are the shares in B Co. No asset that X Co may hold at its joining time arising under the contractual arrangement would be recognised separately by Head Co as an asset of X Co. The shares in B Co have been sold at market value which, as at X Co's joining time, has not changed since the time of entering into the contract.

| | |
|---|---|
| Cash | $10,000 |
| Shares in B Co | $100,000 |

After the settlement of the contract on 30 July 2004, Head Co's only asset is cash of $110,000. The ACA allocated to the shares in B Co is ignored.

*Calculation – capital gain or loss on disposal*

CGT event A1 happens to X Co on 22 June 2004 when it enters into the contract. The CGT event happens in a period before X Co joined H Co's consolidated group and so X Co must work out its capital gain or loss from the event and include this in its net capital gain or loss calculations for its non-membership period.

The capital proceeds from the disposal of B Co's shares are $100,000.

The cost bases of the shares in B Co are calculated in accordance with the ordinary CGT cost base rules in Divisions 110 and 112 of the ITAA 1997. The shares do not have a cost base equal to their tax cost set at X Co's joining time as this applies only for Head Co's core purposes.

Assuming the shares in B Co only have a first element cost base of $90,000, X Co makes a capital gain of $10,000 on their disposal.

**Exit-sell**

In an exit-sell case, the core consolidation rules operate to change the identity of the entity that is taken to have disposed of the asset. In this case, CGT event A1 is taken to have happened to the head company (not the subsidiary) of the consolidated group at the contract time → Taxation Determination TD 2008/29.

Incidental costs of disposal incurred by the subsidiary after it has ceased to be a member of the group are included in the cost base and reduced cost base of the underlying CGT asset for the purposes of working out if there is a capital gain or capital loss for the CGT event that happens to the head company.

As discussed above, there is no recalculation of the tax cost setting amounts at the entity's leaving time using the consideration receivable under the contract as the relevant asset (instead of the CGT asset that is the subject of the contract).

If an asset arising under the contractual arrangement is also recognised as an asset of the leaving entity, the asset's terminating value will generally be nil, subject to any incidental costs that could be included in its cost base. This is because the first element of the asset's cost base would include the market value of any property the leaving entity gave, or was required to give, in respect of acquiring the rights → paragraph 110-25(2)(b), ITAA 1997. Although the leaving entity may have given property to acquire the asset under the contract (being contractual rights created in the purchaser to have the CGT asset transferred), the market value of this right would generally be nil.

There are no CGT consequences on the ending of that asset when the contract is completed.

### Example 2 – Exit-sell

*Facts*

X Co is a subsidiary member of a consolidated group and the owner of land. Under the single entity rule, the land is an asset of the group's head company, Head Co.

On 16 June 2006, X Co enters into a contract to sell the land for $100,000. A deposit of $10,000 is paid by the purchaser (Y Co).

On 29 June 2006 it is evident that land values are falling sharply. The market value of the land is now $90,000.

On 30 June 2006, X Co leaves the consolidated group as a result of Head Co selling all of its shares in X Co to an individual for $150,000.

**Table 2: X Co's balance sheet at 30 June 2006 ($)***

| | | | |
|---|---|---|---|
| Cash | 60,000 | Contributed capital 100 shares | 100,000 |
| Land | 50,000 | Part-payment in advance on asset disposal^ | 10,000 |

* It is consistent with the accounting policies adopted by X Co that a beneficial contract is not recognised. For simplicity, the example also ignores tax effect accounting including any impact a tax funding agreement would have on X Co's financial position.

^ For the purposes of this example it is assumed that the accounting policy is to recognise revenue from the disposal of the land in full on contract completion.

The land contract is settled in August 2006. After leaving the group, X Co incurred legal expenses of $5,000 in defending the buyer's contention that the contract for the sale of land was not binding.

*Setting the tax costs of membership interests in X Co*

Head Co must identify the assets of X Co that Head Co holds at the leaving time (because X Co is taken to be a part of the head company under the single entity rule) in working out the ACA and the tax cost of the group's membership interests in X Co.

Calculate exit ACA for X Co:

Step 1: Add together the terminating values of the assets of X Co that Head Co holds at the leaving time.

X Co has three assets at the leaving time as shown in table 3.

**Table 3: X Co's assets at 30 June 2006**

| Asset | Terminating value ($) |
|---|---|
| Cash | 60,000 |
| Land | 50,000 |
| Asset arising under the sale contract | 0 |

The land is recognised as an asset of X Co that Head Co holds at the leaving time. → TD 2008/31

An asset arising under the contractual arrangement (separate from the land) is also recognised as an asset at the leaving time as it has become valuable to X Co. However, the asset would have a nil terminating value in accordance with Division 110 of the ITAA 1997.

Step 4: Subtract liabilities of X Co ($10,000).

Step 5: Exit ACA is $100,000.

*Calculation – capital gain or loss on sale of membership interests in X Co*

The tax cost of each share in X Co is $1,000.

Head Co's capital gain from the disposal of all of its membership interests in X Co totals $50,000. However, in working out its net capital gain or loss for the income year, Head Co disregards $45,000 of the capital gain made on the disposal of the group's membership interests in X Co that represents a duplication of the capital gain Head Co made on the disposal of the land (see below). In accordance with TD 2008/29, the Commissioner would not disturb such an approach.

*Calculation – capital gain or loss on disposal of land*

CGT event A1 happens to Head Co on the disposal of the land. The time of the event is 16 June 2006, when the contract is entered into.

In working out its capital gain or loss from the event, Head Co includes in the land's cost base the $5,000 legal expenses incurred by X Co after leaving the group. The capital proceeds from the CGT event are $100,000 and Head Co makes a capital gain of $45,000.

## Buy cases

### Identifying the relevant asset

In the case of a straddle contract to buy a CGT asset, the asset is not recognised as an asset of the purchasing entity at the time it joins or leaves a consolidated group.

The only asset that is capable of being recognised as an asset of the joining or leaving entity is one that arises out of the contractual arrangement. Whether such an asset can be recognised will depend on whether, consistent with TR 2004/13, it is something that would be recognised in commerce and business as having economic value to the entity at the joining or leaving time for which a purchaser of its membership interests would be willing to pay.

For example, this could occur where, in the absence of other factors to the contrary, a deposit was paid under the contract, or where the market value of the CGT asset being acquired is greater at the joining or leaving time than at the contract time. → Taxation Determination TD 2008/30; 'Treatment of special classes of assets', C2-1-070

### Applying the tax cost setting rules

In a joining case (entry-buy), any asset of the entity recognised in relation to the contractual arrangement would be a reset cost base asset for the purposes of allocating the group's ACA for the entity.

In a leaving case (exit-buy), the terminating value of an asset recognised in relation to the contractual arrangement would be used in calculating the tax cost of the group's membership interests in the leaving entity. Depending on the asset recognised, the terminating value could include, for example, any deposit or purchase price paid and any incidental costs incurred (before the leaving time) by the group to non-group entities to acquire the underlying CGT asset. The amounts forming part of the terminating value may have been paid or incurred by the leaving entity, or another member of the consolidated group. These transactions would be taken to be the head company's under the single entity rule.

### Completion of the contract

When the contract is completed on the vendor transferring ownership of the CGT asset, the CGT provisions would ordinarily apply to only give tax recognition to the acquisition of the CGT asset and not, for example, the ending of the rights under the contract. This is consistent with the 'look through' approach expressed in Taxation Ruling TR 95/35.

But in the case of uncompleted contracts straddling an entity's joining or leaving time, an asset arising from the contractual arrangements may, in accordance with TD 2008/30, be assigned a tax cost under the consolidation regime.

In the case of a contract to buy a CGT asset, there is a continuum of events, from the time of contract to the time of settlement, which comprises the acquisition of the CGT asset. Any asset of the purchaser that arises from the contractual arrangements is effectively transformed into the new asset. No CGT event happens in respect of the transformation.

In accordance with section 109-5 of the ITAA 1997, the CGT asset that is the subject of the contract would be taken to be acquired at the time of entering into the contract. Importantly, the CGT asset is not actually acquired on entering into the contract – it is only once there has been a change of ownership of the CGT asset that the CGT provisions take the asset's acquisition to be back at the contract time for tax purposes. There is, therefore, no need to recalculate the tax cost setting amounts at the entity's joining or leaving time using the CGT asset instead of the asset arising from the contract.

The cost base and reduced cost base of the CGT asset acquired under the contract would include the tax cost setting amount on joining or the terminating value of the asset recognised as arising under the contract on leaving (just before leaving), together with any additional amounts incurred in respect of the asset's acquisition.

**Example 3: Entry-buy**

*Facts*

On 16 June 2004, X Co enters into a contract to purchase shares (60%) in B Co for $80,000.

On 1 July 2004, all of the shares in X Co are purchased by Head Co, the head company of a consolidated group, for $120,000 and, as a result, X Co joins the group. No other members of Head Co's consolidated group hold shares in B Co.

At X Co's joining time, the shares in B Co are worth $100,000.

**Table 4: X Co's balance sheet at 1 July 2004 ($)***

| | | | |
|---|---|---|---|
| Cash | 90,000 | Contributed capital | 100,000 |
| Consumables | 10,000 | | |

* For the purposes of this example it is assumed that the accounting policies adopted by X Co do not require recognition of the beneficial contract.

After joining the group, X Co incurs legal fees of $5,000 (third party expenditure) to complete the purchase of shares in B Co. The contract settles on 16 August 2004 and X Co becomes the owner of the B Co shares.

*Calculation – setting the tax cost of X Co's assets*

Head Co determines the tax cost of each asset of X Co (the joining entity) based on a share of the ACA for X Co's shares.

Calculate ACA:

For the purposes of this example, assume X Co has no liabilities, undistributed profits or losses at the joining time. The ACA for X Co is calculated as:

Step 1: $120,000.

Total: $120,000.

Allocate ACA:

Head Co must allocate the group's ACA for X Co to the assets of X Co when it becomes a subsidiary member.

An asset of X Co arising out of the contractual arrangement to purchase the shares in B Co would be recognised for tax cost setting purposes because the value of the B Co shares increased between the time the contract was entered into and the time X Co became a member of the consolidated group (TR 2004/13).

**Table 5: Co's assets at 1 July 2004**

| | Market value of assets at joining time ($) | Tax cost setting amount for assets ($) |
|---|---|---|
| Contract to buy B Co shares | 20,000 | 20,000 |
| Consumables | 10,000 | 10,000 |
| Cash | 90,000 | 90,000 |

*Calculation – CGT consequences on completion of contract*

At the time of settlement of the contract, X Co completes its acquisition of the shares in B Co. The asset arising under the contract that was recognised at X Co's joining time is effectively transformed into the new CGT asset. No CGT event happens in respect of the transformation.

Head Co is taken to have acquired the B Co shares on 16 June 2004 (the date that X Co entered into the contract). The cost base of the shares includes the tax cost of the asset recognised as arising under the contract ($20,000) together with the $80,000 purchase price paid on settlement and the legal expenses (that is, $105,000).

**Table 6: X Co's assets on completion of contract**

| Asset | Terminating value ($) |
|---|---|
| Cash | 5,000 |
| Consumables | 10,000 |
| B Co shares | 105,000 |
| **Total** | 120,000 |

**Example 4: Exit-buy**

*Facts*

M Co is a subsidiary member of Head Co's consolidated group. On 12 May 2006, M Co enters into a contract to purchase land from Y Co, which is not a member of the group. A deposit of $20,000 is paid, with the balance of the purchase price of $50,000 to be paid on the settlement of the contract.

On 20 June 2006, Head Co sells all of the shares in M Co for $100,000. As a result, M Co leaves the group. There has been no change in the market value of the land.

Before leaving the group, M Co also incurs legal expenses of $10,000 in acquiring the asset.

The contract settles on 12 July 2006 and M Co becomes the owner of the land.

**Table 7: M Co's balance sheet at 20 June 2006 ($)**

| | | | |
|---|---|---|---|
| Cash | 70,000 | Contributed capital 100 shares | 100,000 |
| Non-current assets | 10,000 | | |
| Deposit land purchase* | 20,000 | | |

* For the purposes of this example it is assumed that the accounting policy is to recognise expenditure on the acquisition of the land on completion of contract.

*Setting the tax costs of membership interests in M Co*

At the leaving time, the tax cost of each membership interest in M Co (the leaving entity) is worked out by allocating the ACA at the leaving time.

Calculate exit ACA for M Co:

Step 1: Add together the terminating values of assets M Co takes with it.

Head Co must identify the assets of M Co that Head Co holds at the leaving time (because M Co is taken to be a part of the head company under the single entity rule) in working out the ACA. An asset of M Co arising out of the contractual arrangement for sale of land would be recognised as an asset that the head company holds at the leaving time, in this case as a result of the value created in the contract by paying a deposit.

M Co has three assets at the leaving time as shown in table 8.

**Table 8: M Co's assets at 30 June 2006**

| Asset | Terminating value ($) |
|---|---|
| Cash | 60,000 |
| Non-current asset | 10,000 |
| Asset arising under the sale contract | 30,000 |

The terminating value of the asset arising under the sale contract is made up of the $20,000 deposit plus legal expenses of $10,000. The step 1 ACA is therefore $100,000.

As it is assumed that there are no other steps in the ACA calculations, the total exit ACA for M Co is $100,000.

The tax cost of each share in M Co is $1,000, which is equal to the capital proceeds received on the disposal of each share. Head Co therefore makes a nil capital gain or loss on the disposal of the membership interests in M Co.

*Calculation – CGT consequences on completion of contract*

At the settlement of the contract, M Co completes its acquisition of the land. The asset M Co is recognised as holding under the contract is effectively transformed into the new CGT asset. No CGT event happens in respect of the transformation.

M Co is taken to have acquired the land on 12 May 2006 (the date that M Co entered into the contract). Its cost base includes the terminating value of the asset recognised as arising under the contract ($30,000) together with the remaining $50,000 purchase price paid on settlement (that is, $80,000).

## References

### Legislation

*Income Tax Assessment Act 1936*, section 70B

*Income Tax Assessment Act 1997:*

- section 104-10
- section 109-5
- subsection 701-30(3)
- Division 705
- Division 711

### Tax rulings

TR 95/35 – Income tax: capital gains: treatment of compensation receipts

TR 2004/13 – Income tax: the meaning of an asset for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*

TR 2005/10 – Income tax: consolidation: retained cost base assets consisting of Australian currency or a right to receive a specified amount of such currency

### Tax determinations

TD 2008/29 – Income tax: consolidation: capital gains: do the core consolidation rules in Division 701 of the *Income Tax Assessment Act 1997* modify the effect of the CGT contract rules if an entity contracts to buy or sell a CGT asset and the contract settles after the entity becomes, or ceases to be, a member of a consolidated group?

TD 2008/30 – Income tax: consolidation: capital gains: for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*, is the CGT asset that an entity has contracted to buy from another taxpayer an asset of the entity at a time it joins or leaves a consolidated group, if the contract is not completed at that time?

TD 2008/31 – Income tax: consolidation: capital gains: for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*, is the CGT asset that an entity has contracted to sell to another taxpayer an asset of the entity at a time it joins or leaves a consolidated group, if the contract is not completed at that time?

### Revision history

Section C2-1-080 first published 30 June 2009.

### Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).

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