

Worked example

Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules

Description This example shows how the pre-CGT status of the membership interests acquired by the group before 20 September 1985 is preserved by working out a pre-CGT proportion (measured by market value).

Commentary Changes to the mechanism for preserving the pre-CGT status of membership interests in a joining entity apply to an entity that joins a consolidated group on or after 10 February 2010 → *Tax Laws Amendment (2010 Measures No. 1) Act 2010*, Schedule 5, Part 3; Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.111 to 5.142.

However, the head company of a consolidated group can make a choice to apply the changes to an entity that joins a consolidated group before 10 February 2010. The choice:

- must be made on or before 30 June 2011, or within such further time as the Commissioner allows, and
- must be made in writing.

This option to apply the changes to entities that joined before 10 February 2010 will allow consolidated groups that are adversely affected by the operation of the pre-CGT factor rules to take advantage of the changes, given the compliance cost implications of applying the changes retrospectively. Where no such choice is made, the pre-CGT factor rules on leaving will continue to apply → 'Pre-CGT membership interests in a leaving entity (with pre-CGT factor attached to assets)', C2-5-710; 'Calculating the pre-CGT membership interests in a multiple exit case (with pre-CGT factor attached to assets)', C2-5-715.

Pre-CGT proportion of membership interests in a joining entity

Where an entity joins a consolidated group on or after 10 February 2010 (or where a head company makes a choice to apply the pre-CGT proportion changes to an entity that joins before 10 February 2010), the pre-CGT status of membership interests in the joining entity is preserved by working out a pre-CGT proportion (measured by market value) → section 705-125, *Income Tax Assessment Act 1997* (ITAA 1997).

The pre-CGT proportion is calculated as follows:

$$\frac{\sum \text{Market value of each pre-CGT membership interest held by head company} + \sum \text{Market value of each pre-CGT membership interest held by a subsidiary member}}{\sum \text{Market value of each membership interest in the joining entity}}$$

Stated simply, the pre-CGT proportion formula is:

$$\frac{\text{Market value of pre-CGT membership interests}}{\text{Market value of all membership interests}}$$

When an entity leaves a consolidated group, its pre-CGT proportion is used to work out the number of membership interests held by members of the old group that are treated as pre-CGT assets → subsection 711-65(4), ITAA 1997; 'Pre-CGT membership interests in a leaving entity – pre-CGT proportion rules', C2-5-715.

Integrity rules

Division 149 of the ITAA 1997 (previously Division 20, section 160ZZS of the *Income Tax Assessment Act 1936*) will apply under consolidation in that a greater than 50% continuity of underlying ownership must be maintained since 19 September 1985 to maintain the pre-CGT status of assets. The pre-CGT status is removed from the assets under existing law if this continuity of majority underlying ownership is not maintained. → Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.47

Where pre-CGT status is removed from assets under existing law, the cost bases of the affected assets are reset at their market values as at the time of the trigger event.

Where an entity in which pre-CGT membership interests are held joins a consolidated group on or after 10 February 2010 (or the head company makes a choice to apply the pre-CGT proportion changes to an entity that joins before 10 February 2010), a new integrity rule will apply to the entity when it leaves the consolidated group. The new integrity rule applies if any of the assets the leaving entity brought into the group stopped being pre-CGT assets under Division 149 (or would have stopped being pre-CGT assets under Division 149 if they were pre-CGT assets just before this time) while held by the head company of the group. → section 711-70, ITAA 1997

If the new integrity rule applies, the leaving entity's pre-CGT proportion is taken to be nil at the leaving time → subsection 711-70(2), ITAA 1997. In addition, an adjustment may be made to the old group's allocable cost amount (ACA) for the leaving entity → subsection 711-70(3), ITAA 1997; Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.119 to 5.129.

If the new integrity rule does not apply, consideration needs to be given to the possible application of CGT event K6, where the post-CGT assets of the leaving entity are equal to or greater than 75% of the net value of the entity.

Where a pre-CGT proportion has been worked out on entry for a leaving entity, two modifications are made to the operation of CGT event K6

→ subsections 711-75(2) and (3), ITAA 1997; Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.130 to 5.138.

Example 1

Facts This example shows how the pre-CGT status of the membership interests acquired by the group before 20 September 1985 is preserved by working out a pre-CGT proportion (measured by market value).

On 20 May 1985, HCo acquires 60 shares in ACo. HCo acquires the remaining 40 shares in ACo on 1 March 2010. On 1 July 2010, HCo forms a consolidated group with ACo as its subsidiary member. At that time, the net market value of ACo was \$800 (i.e. each share has a market value of \$8).

Calculation Pre-CGT proportion of membership interests in the joining entity (ACo)

At the joining time, the pre-CGT proportion of the membership interests in ACo is calculated using the formula:

$$\frac{\text{Market value of pre-CGT membership interests}}{\text{Market value of all membership interests}}$$

Step 1

At the joining time work out the market value of the pre-CGT membership interests in ACo, and the market value of all the membership interests in ACo.

The total number of shares in ACo is 100, of which 60 (i.e. 60%) were acquired pre-CGT. The market value of all the membership interests in ACo at the joining time (in this case at formation time) is \$800. Therefore, the market value of the pre-CGT membership interests in ACo at that time is \$480 (i.e. 60% of \$800).

Step 2

Work out the pre-CGT proportion:

$$\$480 / \$800 = 0.60$$

Therefore, the pre-CGT proportion of HCo's membership interests in ACo is 60%.

Example 2

Facts HCo acquired 30% of the equity in ACo in July 1985 for a consideration of \$300. ACo's financial position at this time is shown in table 1.

Table 1: ACo – financial position at 1 July 1985

Cash	\$1,000	Equity	\$1,000
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On 1 July 2002, HCo formed a consolidated group. On 30 June 2003, the remaining equity of ACo is acquired by HCo for \$1190 (70% of \$1,700 – see step 1 below) at which time ACo joined the group. ACo's financial position is shown in table 2.

Table 2: ACo – financial position at 30 June 2003

Cash	\$200	Equity	\$1,000
Land (MV \$2,000)	\$1,300	Liabilities	\$500
	\$1,500		\$1,500

Note: MV = market value

On 30 June 2010, HCo makes a choice in writing to apply the pre-CGT proportion changes to ACo when it joined the group on 30 June 2003. Therefore, the pre-CGT status of membership interests in ACo is preserved by working out a pre-CGT proportion (measured by market value).

Calculation Pre-CGT proportion of ACo

Step 1

At the joining time, work out the market value of the pre-CGT membership interests in ACo, and the market value of all the membership interests in ACo.

The market value of all the membership interests in ACo at the joining time is \$1,700 (Cash of \$200 plus market value of Land, \$2,000, less Liabilities of \$500). Therefore, the market value of the pre-CGT membership interests is \$510 (30% of \$1,700).

$$\text{i.e. } (\$200 + \$2,000 - \$500) \times 30\% = \$510$$

Step 2

Work out the pre-CGT proportion:

$$\$510 / \$1,700 = 0.30$$

Therefore, the pre-CGT proportion of HCo's membership interests in ACo is 30%.

References

Income Tax Assessment Act 1997, section 705-125; as inserted by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1, and amended by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 3

Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.108–113

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.111 to 5.142

Revision history

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