

Worked example

Pre-CGT membership interests in a leaving entity – pre-CGT proportion rules

Description This example shows how a proportion of the membership interests in an entity leaving a consolidated group are treated as pre-CGT assets by applying a pre-CGT proportion (measured by market value) to the number of membership interests in a leaving entity.

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 from 1 July 2002 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 pre-CGT membership interests in a multiple exit case (with pre-CGT factor attached to assets)', C2-5-715.

Where an entity joins a consolidated group on or after 10 February 2010 (or the head company makes a choice to apply the changes to an entity that joins before 10 February 2010), the pre-CGT status of membership interests is preserved by working out a pre-CGT proportion (measured by market value).

→ 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813

Pre-CGT membership interests in a leaving entity where pre-CGT proportion is worked out on entry

Subject to integrity rules (see below), when an entity leaves a consolidated group, the number of its membership interests that are treated as pre-CGT assets is worked out as follows:

$$\text{Number of membership interests in the leaving entity held by members of the old group} \times \text{Leaving entity's pre-CGT proportion}$$

→ subsection 711-65(4), *Income Tax Assessment Act 1997* (ITAA 1997)

The result gives the number of pre-CGT membership interests in the leaving entity (rounded down to the nearest whole number or zero if the number is less than 1). → subsection 711-65(3), ITAA 1997

Integrity rules

Division 149 of the ITAA 1997 (previously Division 20, section 160ZZS of the *Income Tax Assessment Act 1936*) applies 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 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 a leaving entity. The 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 60 out of HCo's 100 shares in ACo are pre-CGT membership interests. On consolidation the financial positions are shown in tables 1 and 2.

Table 1: HCo – financial position at 1 July 2010

Shares (100 in ACo)	\$100	Equity	\$100
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Table 2: ACo – financial position at 1 July 2010

Land (MV \$500)	\$50	Equity	\$100
Asset 2 (MV \$300)	\$50		
	\$100		\$100

Note: MV = market value

At the joining time the pre-CGT proportion of HCo's membership interests in ACo is 0.6. → 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813, Example 1

On 1 September 2010, HCo sells all its shares in ACo to a third party and ACo leaves the group.

Calculation Pre-CGT proportion of ACo's membership interests on leaving

a) Calculate the number of pre-CGT membership interests in the leaving entity by using the pre-CGT proportion worked out on entry – s. 711-65(4) and s. 705-125 of the ITAA 1997

$$100 \text{ shares} \times 0.6 = 60 \text{ shares}$$

b) Round down to nearest whole number of pre-CGT membership interests – s. 711-65(3) of the ITAA 1997 (*if applicable*)

In this example the result (60 shares) does not change.

Therefore, of the 100 shares in ACo disposed of, 60 are treated as pre-CGT membership interests. The remaining 40 shares will be subject to the CGT provisions.

Example 2

Facts HCo, the head company of a consolidated group, owns all 100 shares in ACo. The financial position of ACo at the joining time is shown in table 3.

Table 3: ACo – financial position at 30 June 2003

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

On 30 June 2010, HC makes a choice in writing to apply the pre-CGT proportion changes from 1 July 2002 so that the pre-CGT status of membership interests in ACo is preserved by working out a pre-CGT proportion (measured by market value) at the joining time.

At the joining time, the pre-CGT proportion of HCo's membership interests in ACo is 0.30. → 'Pre-CGT status of membership interests in a joining entity – pre-CGT proportion rules', C2-4-813, Example 2

On 31 December 2010, HCo disposes of 80 shares in ACo to a third party and ACo leaves the group.

Calculation Pre-CGT proportion of ACo's membership interests on leaving

a) Calculate the number of pre-CGT membership interests in the leaving entity by using the pre-CGT proportion worked out on entry – s. 711-65(4) and s. 705-125 of the ITAA 1997

$$100 \text{ shares} \times 0.30 = 30 \text{ shares}$$

b) Round down to nearest whole number of pre-CGT membership interests – s. 711-65(3) of the ITAA 1997 (*if applicable*)

In this example the result (30 shares) does not change.

Of the 80 shares in ACo that are disposed of, HCo chooses to sell 20 shares that are treated as pre-CGT membership interests.

The gain or loss on disposal of these 20 shares is treated as the sale of pre-CGT assets. The remaining 60 shares will be subject to the CGT provisions.

HCo continues to hold 20 shares in ACo:

- 10 shares are pre-CGT assets
- 10 shares are post-CGT assets.

Example 3

Facts HCo owns all the shares in CCo – which consist of 50 Class A shares and 50 Class B shares. The Class A shares are pre-CGT assets acquired by HCo before 20 September 1985.

On 1 July 2010, HCo forms a consolidated group and CCo is a subsidiary member of the group. The market value of CCo at the joining time is \$500. The market value of each Class A share is \$7, and the market value of each Class B share is \$3.

The pre-CGT proportion of the membership interests in CCo is:

$$\frac{\$350 \text{ (market value of pre-CGT membership interests)}}{\$500 \text{ (market value of all membership interests)}} \\ = 0.70 \text{ (70\%)}$$

On 1 September 2010, HCo sells 80 shares (40 Class A and 40 Class B) that it holds in CCo to a third party, and CCo leaves the group.

Calculation Pre-CGT proportion of CCo's membership interests on leaving

a) Calculate the number of pre-CGT membership interests in the leaving entity by using the pre-CGT proportion worked out on entry – s. 711-65(4), s. 705-125 and s. 711-65(6) of the ITAA 1997

The pre-CGT proportion is applied to each class of CCo's shares as if each class were all the shares held by HCo. → subsection 711-65(6), ITAA 1997

Class A shares: 50 shares x 0.70 = 35 shares

Class B shares: 50 shares x 0.70 = 35 shares

Therefore:

- 35 of the Class A shares are treated as pre-CGT membership interests
- 35 of the Class B shares are treated as pre-CGT membership interests.

b) Round down to nearest whole number of pre-CGT membership interests – s. 711-65(3) of the ITAA 1997 (*if applicable*)

In this example the result for each class of share does not change.

In relation to the 40 Class A shares sold – HCo treats 35 shares as pre-CGT membership interests. The remaining 5 shares will be subject to the CGT provisions.

In relation to the 40 Class B shares sold – HCo treats 35 shares as pre-CGT membership interests. The remaining 5 shares will be subject to the CGT provisions.

HCo continues to hold 10 Class A shares and 10 Class B shares in CCo, all post-CGT assets.

References

Income Tax Assessment Act 1997, section 711-65; 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 2002 (No. 1), paragraphs 5.147 – 153

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

Revision history

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