TD 2010/1EC - Compendium

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Ruling Compendium – TD 2010/1

This is a compendium of responses to the issues raised by external parties to draft TD 2009/D4 – Income tax: consolidation: capital gains: does paragraph 40-880(5)(f) of the *Income Tax Assessment Act 1997* prevent the deduction, under section 40-880 of that Act, of incidental costs described in subsection 110-35(2) of that Act that the head company of a consolidated group or MEC group incurs, in disposing of shares in a subsidiary member to a non-group entity, before the member leaves the group?

Summary of issues raised and responses

Issue No.	Issue raised	ATO Response/Action taken
	General comments The draft Determination focuses on outcomes in respect of incidental costs incurred before the leaving time in respect of the disposal of shares in a subsidiary member of a consolidated group or MEC group. We question the appropriateness of the ATO position taken in concluding that incidental costs incurred before the leaving time are disregarded in determining the cost base of shares due to the application of the tax cost setting rules just before the leaving time. Whilst we acknowledge that such an interpretation is (arguably) open, it does not provide the most appropriate tax recognition of expenditure that is clearly connected with a CGT event which is recognised for income tax purposes. The draft Determination evidences a lack of uniform consistent principles to the issue of expenditures relating to intra-group assets (incurred with non-members of the consolidated group) and whether they should be dealt with under the blackhole deduction provision rather than the CGT provisions – taking into account the operation of the single entity rule. The draft Determination must also discuss the capital gains tax and section 40-880 of the *Income Tax assessment Act 1997* (ITAA 1997)[1] outcomes if the incidental costs were incurred after the leaving time, as in practice incidental costs will generally arise both before and after the leaving time. (Presumably, such incidental costs would be included as part of the second element of the cost base of the	Please refer to the responses to the specific issues 1-6 set out below. These address all of the issues arising in the general comments.

[1] All legislative references are to the ITAA 1997 unless otherwise indicated.

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	shares as the tax cost setting rules would have no further application after the leaving time). Furthermore, ATO guidance must also be provided on the capital gains tax and section 40-880 outcomes where incidental costs are incurred in respect of a subsidiary member joining a consolidated group. That is, the ATO guidance should be holistic in its coverage of outcomes for joining and leaving cases, similar to that provided for CGT straddles. [*See issue 5 below.*] [*For specific comments, see issues 1 – 6 below.*]	
1.	**When incidental costs should be included in the cost base of shares in subsidiary members under the Single Entity Rule ('the SER argument')** 1. The draft Determination takes the same position as adopted in ATO ID 2008/96, which overturned ATO ID 2004/500 (with effect from 5 June 2008) in respect of the position taken on incidental costs incurred before the leaving time. 2. We question the appropriateness of the ATO position that incidental costs incurred before the leaving time are disregarded in determining the cost base of shares due to the application of the tax cost setting rules just before the leaving time. 3. In our opinion a more appropriate position under the SER is that the Head Entity has incurred expenses to sell some of its assets (that is those that are legally owned by the leaving entity while it is part of the consolidated group) and those expenses should be included in the tax cost of the relevant assets – which then feeds back into the cost base of the shares in the leaving entity. 4. In other words, as under the SER the tax consolidation provisions are based on the recognition of the underlying (non-intra-group) assets held by the members of a tax consolidated group, any expenses incurred to sell the (only) assets that are recognised under consolidation as being held by the Head Entity should form part of the tax cost of those assets – they are incurred to get the assets into the position/state where they can be sold.	In paragraphs 3-4, the commenting entities propose that the incidental costs of disposal of the shares are to be treated as costs of selling the assets the leaving entity takes with it, to be incorporated into the terminating values of those assets, and thus indirectly into the cost base or reduced cost base of the shares (and any other membership interests). However, there is no support for this proposition in the law or its stated objects, the extrinsic materials, or in the asset based model described in *Review of Business Taxation: A Platform for Consultation*. A further problem, were the proposition to be adopted, is that it would potentially give rise to a double benefit, as it would increase not only the tax costs of the membership interests in the hands of the head company, but also (via the exit history rule) the tax costs of the underlying assets in the hands of the leaving entity. This double benefit could be realised if there was a period beginning at the leaving time during which the leaving entity was not a member of a consolidated group. The entity would be able to take advantage of (for example) higher depreciation deductions or reduced capital gains on disposal of CGT assets.

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	5. This view is supported in the explanatory memorandum to Tax Laws Amendment (2006 Measures No. 1) Bill 2006,[2] the Bill that introduced the current section 40-880. It discusses the consolidation interaction with that section as follows: *2.87 In order to determine whether business capital expenditure incurred by a head company is deductible under section 40-880, the nature of the expenditure must be characterised in the hands of the head company, taking into account the effect of the single entity rule.* *2.88 The expenditure must be characterised at the time it is incurred by the head company. That is, a head company is not required to anticipate whether or not the expenditure is related to an asset that may become recognised for tax purposes at some time in the future. For example, expenditure incurred by a head company in relation to membership interests in a subsidiary member will be deductible under section 40-880 despite the fact that the expenditure is in relation to an asset that may at some point in the future become recognised for tax purposes (eg, immediately before the subsidiary member exits the consolidated group). [emphasis added]* 6. Accordingly, under the SER it is necessary to look at the assets held by the Head Entity at the time of 'incurrence'. This is made clear in the example provided in the EM where the expenditure is incurred by the Head Entity at a time that a company is not a member of the group : *Example 2.17 – A consolidated group incorporates a new subsidiary company, which becomes a subsidiary member of the consolidated group. The capital expenditure the head company incurs in doing so [i.e. to form/incorporate the new company] is deductible under paragraph 40-880(2)(a) as it does not relate to an [intra-group] asset that is held by the head company [at the time it is incurred].* 7. We submit that just because (for example) no balancing adjustment event will actually arise for the Head Entity regarding depreciable assets when the entity that legally owns those assets exits the group, should not prevent the expenses incurred by the Head Entity from forming part of the tax cost of those assets. The tax cost of the assets that is used to 'build up' the cost base of the shares in the leaving entity should reflect all of the expenses that the Head Entity has incurred regarding the	This would appear to be contrary to one of the objects of Part 3-90, and of the cost setting rules in particular, which is to prevent double taxation of gains and duplication of losses: see section 700-10, the note to subsection 711-5(2) and paragraph 705-10(3)(a). Further, paragraph 700-10(c) states a further object: 'to provide a systematic solution to the prevention of such double taxation and double tax benefits that will: (i) reduce the cost of complying with this Act; and (ii) improve business efficiency by removing complexities and promoting simplicity in the taxation of wholly-owned groups.' Adopting the proposition would appear to be inimical to both aims. In paragraph 5, paragraphs 2.87 and 2.88 of the EM are quoted in support of the proposition. It seems more likely that these paragraphs represent a view that business capital expenditure (such as the incidental costs) incurred before the leaving time in relation to membership interests in a subsidiary member while the single entity rule applies will be deductible under section 40-880 despite the fact that those membership interests will be recognised for income tax purposes just before the subsidiary member exits the consolidated group. Similarly, the reference made in paragraph 6 to Example 2.17 of the EM does not appear to assist in making a case for the proposition, because the point the example is making is that business capital expenditure incurred by the head company in relation to an asset that is not recognised under the single entity rule will fall for consideration under section 40-880. The same reasoning applied to the shares in the situation described in the Determination would reach a similar

[2] Subsequent references to 'the EM' are to this explanatory memorandum, unless otherwise specified.

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	(only) assets that exist up until the leaving time. 8. (As an aside, we note that focusing on the only assets that exist under the SER will allow a consistent approach to be taken to the tax cost of the underlying assets in both joining and leaving cases. That is, expenses incurred to acquire shares prior to an entity joining a group will go into the cost base of the shares (and hence be 'pushed down' into the tax cost of the underlying assets under the allocable cost amount process) while similar expenses incurred after the joining time will go straight into the tax cost of underlying assets – being the only assets that exist at that time under the SER).	conclusion in relation to the incidental costs. Regarding the argument in paragraph 7, there are no income tax consequences for the head company of ceasing to hold assets when the single entity rule ceases to apply to them – see section 701-25, particularly the note to subsection (3). Thus it is true that no balancing adjustment event arises for the head company when a depreciating asset leaves the group with the leaving entity, with the result that no expenditure may be included in the second element of the cost of the asset under paragraph 40-190(2)(b). Similarly (for example), there is no CGT event due to a CGT asset leaving the group with the leaving entity, so no amount may be included in the second element of the cost base or reduced cost base of the asset under subsection 110-25(3) and paragraph 110-35(1)(b). However, there is no legal basis for the assertion that the inability to utilise such provisions should not prevent the incidental costs incurred by the head company in relation to disposing of its shares in the leaving entity from forming part of the tax cost of the underlying assets of the leaving entity. The fundamental problem with the proposition is that what is being disposed of is (possibly only some of) the shares in the entity, not all of the underlying assets. The cost setting rules, in constructing a cost base for the shares, reflects this reality. Those rules, and those rules alone, determine the cost base and reduced cost base of the shares (and any other membership interests) just before the leaving time. In short, the ATO believes that the proposition set out in paragraphs 3 and 4 is not supported by the law, taking into account its objects and context. Therefore, there is no change in view between the draft and final Determinations in relation to this issue.

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2.	**An alternative way of achieving the same result as under the SER argument** 1. The ATO reasoning in the draft Determination is that the tax cost setting process determines the first element of the cost base of the shares at the leaving time (consistent with the approach taken in ATO ID 2004/238) plus it resets to nil all the other elements of the cost base at the leaving time. Incidental costs in the circumstances described in the draft Determination would not be taken into account in determining the exit allocable cost amount for the leaving subsidiary and would not otherwise be taken into account in determining the tax cost setting amount which is recognised for CGT purposes via section 701-55(5). 2. It should be noted that ATO ID 2004/238 focused on the impact of section 701-55(5) regarding the cost base of assets reset when subsidiaries join a consolidated group. The principles applied in ATO ID 2004/238 may be appropriate for non-intra-group assets but are not necessarily appropriate for intra-group assets – especially in a leaving case (for reasons discussed below). 3. In our view, the following principles would on balance provide a more appropriate tax recognition for costs associated with transactions in respect of intra-group assets: • Where the expenditure relates to an underlying intra-group transaction (acquisition of an asset or CGT event) that is NOT recognised for income tax purposes due to the application of the SER, then the expenditure should be taken into account under the blackhole provisions (for example legal fees arising from an intra-group transfer of shares in a subsidiary member) [Category 1 treatment]. • Where the expenditure relates to an underlying transaction that IS recognised for income tax purposes, then the expenditure should be taken into account under the relevant income tax provision that is relevant to the transaction (such as the CGT provisions) [Category 2 treatment]. The critical distinction is whether the underlying transaction in respect of the intra-group asset is recognised for income tax purposes. For example, incidental costs associated with the pre-joining	The reasoning in this Determination is on the basis that the effect of subsection 701-55(5) is that subsection 701-15(3) sets the cost base or reduced cost base of the shares just before the leaving time to an amount equal to the tax cost setting amount worked out for those shares under Division 711. The ATO does not agree with the technical basis set out in paragraph 4, for the following reasons: • In setting the first element of the cost base or reduced cost base of the shares to the tax cost setting amount, and allowing other elements to have non-zero values, the cost base or reduced cost base would exceed the tax cost setting amount, in contravention of subsection 701-55(5). The similar position taken in ATO ID 2004/500 (withdrawn) could not be sustained for this reason. • In proposing that 'in a leaving case, the tax cost setting amount of the intra-group asset should not override the other elements of the cost base of the asset that have arisen since the joining time', a presumption is made that those elements can arise. This may be unwarranted, given that the asset is disregarded because of the single entity rule. • In the case of the shares, no amount that might once have been included in an element of the cost base or reduced cost base of those shares influences the total cost base or reduced cost base that is established by the cost setting rules just before the leaving time. • There are good reasons why this ought to be the case. The cost base that is reconstructed just before the

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	time acquisition of shares in a subsidiary member (that is where the share acquisition occurs before the entity forms part of the consolidated group) or incidental costs associated with the divestment of shares in a subsidiary member (which is recognised for income tax purposes) should fall into Category 2. The timing of the expenditure should not impact the income tax treatment of the expenditure in this case. 4. In respect of the situation raised by the draft Determination, the technical basis for the application of Category 2 treatment could be as follows: • The tax cost setting amount of the shares at the leaving time is taken into account as the first element of the cost base of the shares (based on the principles applied in ATO ID 2004/238); • In a leaving case, the tax cost setting amount of the intra-group asset should not override the other elements of the cost base of the asset that have arisen since the joining time for the relevant subsidiary member (to the extent there are any – in most cases only the second element of the cost base will be applicable for intra-group assets). In this regard it would be necessary to depart from the approach taken in ATO ID 2004/238 in respect of the effect of the tax cost setting rules on the other elements of cost base in a leaving case (the leaving case treatment was not expressly addressed in the ATO ID but by implication it appears that the principle was to be applied consistently to both a joining and leaving case). • We submit that in a joining case, it may be appropriate for the tax cost setting amount to reset all the elements of the cost base of the asset, as the allocable cost amount process should reflect (through the value of shares in the subsidiary) the value of all incidental costs arising at the joining time for both intra-group assets and non-intra-group assets. However, in a leaving case the exit allocable cost calculation does not appropriately capture other elements of the cost base relating to intra-group assets (as these would not be reflected in the cost base of the entity's underlying assets).	leaving time may bear no resemblance whatsoever to the cost base just before the joining time, not least because the leaving entity may be taking out of the group quite a different set of assets and liabilities than those it brought in. There is no need for value shifting rules to take this into account precisely because the cost setting process on exit takes care of the problem. In summary the ATO believes that the argument advanced in paragraphs 1-4 is not supported by the law. What the plain words of the law and the extrinsic materials appear to indicate is that the exit cost setting provisions in Part 3-90 provide a complete code for the calculation of the cost base and reduced cost base of the membership interests of the leaving entity at a point in time just before the leaving time. Therefore, there is no change in view between the draft and final Determinations in relation to this issue.

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	5. Whilst the ATO's interpretation is arguably open, it does not appear to provide the most appropriate tax recognition of incidental costs relating to a transaction in respect of intra-group assets where that transaction is recognised for income tax purposes.	
3.	**Treatment of incidental costs incurred after the leaving time** 1. In the event that the ATO maintains the current approach in the draft Determination, the final determination must also discuss the capital gains tax and section 40-880 outcomes if the incidental costs were incurred after the leaving time, as in practice incidental costs will generally arise both before and after the leaving time. 2. Presumably, such incidental costs would be included as part of the second element of the cost base of the shares as the tax cost setting rules would have no further application after the leaving time. 3. Consequently, the tax treatment of incidental costs will differ depending on the timing of when they are incurred. This appears to be an anomalous outcome and reinforces the need for the ATO to review its proposed approach.	The ATO intends to address this case. See response to issue 5 below.
4.	**Which entity claims any section 40-880 deduction?** 1. In the event that the ATO maintains the current approach in the draft Determination, the final Determination should also clarify whether section 40-880 deductions are to be recognised solely by the Head Entity or whether section 40-880 deductions can be claimed by the leaving entity. 2. It is implicit in the draft Determination that these deductions are only available to the Head Entity as if the leaving entity is eligible for a section 40-880 deduction in respect of incidental costs relating to its shares the exit allocable cost calculation would be increased under Step 2 – by reference to the deductions that the leaving entity becomes entitled to under the exit history rule. 3. In this regard, we note that there is an argument that the leaving entity may be entitled to section 40-880 deductions applying the exit history rule in section 701-40, specifically, that the incidental costs incurred before the leaving time (at which time the shares in the subsidiary would be ignored) happened in relation to an asset or any business of the leaving entity. The leaving entity's	The interaction of the exit history rule and section 40-880 is not within the scope of the Determination. For background, see Example 2.17 of the EM.

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	deduction would not be impacted by reference to which member of the group had actually incurred the expenditure. 4. Based on Example 2.17 of the EM introducing the blackhole expenditure provision (referred to above) it would seem the intention is to retain the section 40-880 deduction with the entity that incurred the deduction: *Example 2.17 – A consolidated group incorporates a new subsidiary company, which becomes a subsidiary member of the consolidated group. The capital expenditure the head company incurs in doing so is deductible under paragraph 40-880(2)(a) as it does not relate to an asset that is held by the head company. Under the single entity rule, shares in a subsidiary member would be ignored for income tax purposes. <u>If the subsidiary member is later sold by the group, the subsidiary cannot deduct amounts for that expenditure. [emphasis added]</u>* 5. Per the original consolidation EM[3] however, Subdivision 40-I deductions for project pools under the ITAA 1997 may possibly go with the leaving entity. This is because there is a clear asset (the project) that can be attached to the exit and entry history rule of the leaving entity. While arguably the section 40-880 deduction can attach to the 'business' under the exit and entry / history rule, it would seem the EM to section 40-880 quoted above was clear that this was not the intention.	
5.	**Clarification of both joining and leaving case outcomes** 1. ATO guidance should clarify the capital gains tax and section 40-880 outcomes where incidental costs are incurred in respect of the acquisition of shares in an entity that becomes a subsidiary member of a consolidated group. That is, the ATO guidance should comprehensively deal with the treatment of incidental costs in respect of the acquisition of shares or disposal of shares in a subsidiary member. The ATO, to its credit, adopted such an approach when dealing with CGT events that straddled consolidation joining and leaving times in TD 2008/29, TD 2008/30 and TD 2008/31. The following scenarios should be addressed:	The ATO intends to address all of the cases identified in the table following paragraph 1.

[3] That is, the explanatory memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002: see particularly paragraphs 5.120 – 5.121 and 5.98 – 5.101.

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<tr><th colspan="2">Scenario</th><th>Outcome under ATO approach</th><th>Recommended approach</th></tr>
<tr><td>Joining case</td><td>Incidental costs in respect of acquisition of shares incurred before the joining time</td><td>2nd element of cost base</td><td>2nd element of cost base</td></tr>
<tr><td></td><td>Incidental costs in respect of acquisition of shares incurred after the joining time</td><td>Not taken into account in the 2nd element of cost base due to the SER.
Section 40-880 deduction to consolidated group</td><td>2nd element of cost base</td></tr>
<tr><td>Leaving case</td><td>Incidental costs in respect of disposal of shares incurred before the leaving time</td><td>Section 40-880 deduction to Head entity. Not taken into account in the 2nd element of cost base.</td><td>2nd element of cost base</td></tr>
<tr><td></td><td>Incidental costs in respect of disposal of shares incurred after the leaving time</td><td>2nd element of cost base</td><td>2nd element of cost base</td></tr>
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Issue No.	Issue raised	ATO Response/Action taken
6.	**Date of effect** 1. If the draft Determination is finalised in its current state then the final Determination should apply prospectively. 2. However, if the ATO confirms that the leaving entity is eligible for section 40-880 deductions in respect of the incidental costs, with the result that the exit allocable cost amount for the leaving entity is increased, then the final Determination could apply retrospectively from 1 July 2002 (as consolidated groups should not be disadvantaged). 3. If the recommended approach in this submission is adopted, then the final determination could also apply retrospectively from 1 July 2002 – however, relief would need to be provided to groups that followed ATO ID 2008/96 from 5 June 2008 to date.	The final Determination has the same date of effect as proposed in the draft. ATO ID 2004/500 does not apply from 5 June 2008, and ATO ID 2008/96, which overturned ATO ID 2004/500, adopted a similar view to that in the draft and final Determinations. This will provide full protection to taxpayers who incurred incidental costs as described in the Determination on or after 6 June 2008 and adopted a position in line with that in ATO ID 2008/96 or the draft Determination.