TD 2001/D11 - Income tax: capital gains: if expenditure incurred to increase an asset's value is reflected in that value at the time a CGT event happens to the asset, is this sufficient to satisfy the requirement in the fourth element of cost base and reduced cost base (subsections 110-25(5) and 110-55(2) of the Income Tax Assessment Act 1997 ('ITAA 1997')) that the expenditure be reflected in the 'state' or 'nature' of the asset at the time of the CGT event?

This document has been finalised by TD 2004/2.

Draft Taxation Determination

Income tax: capital gains: if expenditure incurred to increase an asset's value is reflected in that value at the time a CGT event happens to the asset, is this sufficient to satisfy the requirement in the fourth element of cost base and reduced cost base (subsections 110-25(5) and 110-55(2) of the *Income Tax Assessment Act 1997* ('ITAA 1997')) that the expenditure be reflected in the 'state' or 'nature' of the asset at the time of the CGT event?

Preamble

Draft Taxation Determinations (DTDs) present the preliminary, though considered, views of the Australian Taxation Office. DTDs should not be relied on; only final Taxation Determinations represent authoritative statements by the Australian Taxation Office.

1. No.

2. To the extent expenditure is reflected in the 'value' of an asset at a time a CGT event happens to it – and is not reflected in the 'state' or 'nature' of the asset at that time – the expenditure does not form part of the fourth element of the asset's cost base and reduced cost base. If expenditure is incurred to increase an asset's value and at the time of the CGT event is reflected not only in the value of the asset but also in its state or nature at that time it does form part of the fourth element of the asset's cost base and reduced cost base.

3. We take the same view in relation to the interpretation of paragraphs 160ZH(1)(c), 160ZH(2)(c), and 160ZH(3)(c) of the *Income Tax Assessment Act 1936* (ITAA 1936).

Explanation

4. For capital expenditure incurred to increase an asset's value to be included in the fourth element of the asset's cost base and reduced cost base, it must be reflected in the state or nature of the asset at the time of the CGT event (subsection 110-25(5) of the ITAA 1997). The same test applies in respect of the asset's reduced cost base (subsection 110-55(2) of the ITAA 1997).

5. The *Macquarie Dictionary* in its third edition says that the word 'state' refers to the 'condition' of a thing, 'as with respect to circumstances or attributes'. It can refer to a 'condition with respect to constitution, structure, form, phase or the like.' The word 'nature', in relation to a

thing, refers according to the *Macquarie Dictionary* to the 'particular combination of qualities belonging to a thing by birth or constitution; [its] native or inherent character'; or [its] 'character, kind or sort'. In the context of a CGT asset, its 'value' would normally refer to the asset's 'material or monetary worth'; or its 'worth … as measured by the amount of other things for which it can be exchanged, or as estimated in terms of a medium of exchange' in the sense that the word 'value' is used in the *Macquarie Dictionary*.

6. Expenditure incurred to increase an asset's value does not *by that fact alone* affect, or change, the asset's state or nature such that the expenditure can be said to be reflected in that state or nature. The asset may remain of the same state or nature, even though it is worth more. An asset's value – in the sense of its worth - is different from its condition (whether in relation to its circumstances, its attributes, or to its constitution, structure, form, phase or the like) and so is different from its 'state'. Equally, an asset's value is different from its qualities or its inherent character and so is different from its 'nature'.

7. The approach taken in this draft Determination is consistent with that taken by the Court of Session (UK) in *Aberdeen Construction Group Ltd v. Commissioners of Inland Revenue* (1978) 52 TC 281 (the *Aberdeen Construction* case) in relation to the interpretation of the similarly worded paragraph 4(1)(b) of Schedule 6 to the *Finance Act* 1965 (UK). [See also paragraph 32(1)(b) of the *Capital Gains Tax Act* 1979 (UK) and paragraph 38(1)(b) of the *Taxation of Chargeable Gains Act* 1992 (UK)].

8. Paragraph 4(1)(b) dealt with an element of deductible expenditure that was relevant to computing a gain or loss on the disposal of an asset and provided as follows:

> 'Subject to the following provisions of this Schedule, the sums allowable as a deduction from the consideration in computation under this Schedule of the gain accruing to a person on the disposal of an asset shall be restricted to…(b) the amount of any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal…'.

9. In the *Aberdeen Construction* case, a company ('Holding Co.') made unsecured loans to another company ('Subsidiary Co.') after having acquired all its issued share capital. The trading position of Subsidiary Co. later deteriorated, and Holding Co. agreed to sell its shares to a third company which agreed to buy them provided Holding Co. waived its loans, which it did.

10. Before the Court of Session, but not before the House of Lords where the case was resolved on another ground, it was argued on behalf of Holding Co. that the making of the loans and their later waiver constituted expenditure under paragraph 4(1)(b).

11. In the Court of Session, Lord Emslie stated (at 290):

> 'According to the Appellants the money laid out by way of loans was "expenditure" wholly and exclusively incurred "on" the share capital for the purpose of enhancing their value. The words "state or nature" must be applicable to incorporeal property and are wide enough to include every circumstance which can affect the value of such property. It follows that on the extinction of the loans this "expenditure" was reflected in the "state or nature" of the shares sold for they were then shares in a debt-free company and, having been worthless, acquired the value for which they were sold. Once again I am not persuaded that this argument ought to receive effect. It is permissible to suppose that the extinction of the debt owed by [Subsidiary Co.] enhanced the value of shares. To describe the making of the loans, or their waiver, as expenditure within the meaning of para 4(1)(b) of Sch 6 is

> however quite unacceptable… In any event, by no reasonable stretch of the imagination is it possible to classify the making of the loans or their waiver as expenditure wholly and exclusively incurred "on" the shares and I find it impossible to say that either were reflected in the state or nature of the shares which were sold. The waiver of the loans may well have enhanced their value but what para 4(1)(b) is looking for is, as result of relevant expenditure, an identifiable change for the better in the state or nature of the asset, and this must be a change distinct from the enhancement of value'. (Emphasis added.)

12. Lord Johnson (at 293) and Lord Avonside (at 294) expressed similar views.

13. There is a limited exception to the approach taken in this draft Determination expressly provided for in the share value shifting rules in Division 140 of the ITAA 1997. Section 140-65 of the ITAA 1997 provides that the fourth element of cost base and reduced cost base of each share that has increased in value includes an amount referable to a decrease in value of certain other shares. Subsection 140-65(1A) provides that the amount is included in the fourth element to the extent that it is reflected in the market value of the increased value share at the time of a later CGT event. That subsection goes on to provide that the amount is 'so included even if it is not reflected in the state or nature of the share at that time'. The fact that it was considered necessary to add these words in subsection 140-65(1A) reinforces the conclusion that an amount can be reflected in an asset's market value without being reflected in its state or nature.

Example

14. *Alpha Co. has an existing 100% shareholding in Beta Co. and contributes additional share capital to Beta Co. No additional shares are issued by Beta Co. to Alpha Co and the rights attaching to the existing shares are not varied. The state or nature of each share is unchanged by the contribution, although as a result each is worth more. The capital contribution cannot satisfy the requirement that the expenditure be reflected in the state or nature of each share when a CGT event later happens to it. The capital contribution cannot therefore be included in the fourth element of the share's cost base and reduced cost base.*

Note:

15. An issue of shares by Beta Co. to Alpha Co. equal in market value to the capital contribution may, where the relevant conditions in Divisions 110 and 112 are satisfied, ensure that the expenditure is included in the first element of cost bases and reduced cost bases of the newly issued shares.

Your comments

16. We invite you to comment on this Draft Taxation Determination. We are allowing 4 weeks for comments before we finalise the Determination. If you want your comments considered, please provide them to us within this period.

Comments by date:	**7 December 2001**
Contact officer:	**Glenn Davies**
E-mail address:	**glenn.davies@ato.gov.au**
Telephone:	**(07) 3213 5327**
Facsimile:	**(07) 3213 5971**
Address:	**PO Box 9990 Brisbane QLD 4001**

Commissioner of Taxation
7 November 2001

Previous draft:
Not previously issued in draft form

Subject references:
- asset
- capital gain
- CGT asset
- cost base
- expenditure
- fourth element
- nature
- reduced cost base
- reflected
- state
- value

Legislative references:
- ITAA 1936 160ZH(1)(c)
- ITAA 1936 160ZH(2)(c)
- ITAA 1936 160ZH(3)(c)
- ITAA 1997 110-25(5)
- ITAA 1997 110-55(2)
- ITAA 1997 Div 110
- ITAA 1997 Div 112
- ITAA 1997 Div 140
- ITAA 1997 140-65
- ITAA 1997 140-65(1A)
- Capital Gains Tax Act 1979 (UK) 32(1)(b)
- Finance Act 1965 (UK) 4(1)(b) of Schedule 6
- Taxation of Chargeable Gains Act 1992 (UK) 38(1)(b)

Case references:
- Aberdeen Construction Group Ltd v. Commissioner of Inland Revenue (1978) 52 TC 281

ATO references:
NO: T2001/017517
ISSN: 1038-8982