


TD 2005/D27 - 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 sell or buy a CGT asset and the contract settles after the entity becomes, or ceases to be, a member of a consolidated group?

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Draft Taxation Determination

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 sell or buy a CGT asset and the contract settles after the entity becomes, or ceases to be, a member of a consolidated group?

Preamble

*This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the **Taxation Administration Act 1953**. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

1. Yes, but only in the two cases set out in paragraph 3 of this Taxation Determination.
2. Once there has been a change of ownership of a CGT asset, CGT event A1 generally happens to the entity that owned the asset and entered into the contract to dispose of it: subsections 104-10(1) and (2) of the *Income Tax Assessment Act 1997* (ITAA 1997). That event happens at the time that entity entered into the contract: paragraph 104-10(3)(a) of the ITAA 1997. Similarly, the contract time is when the CGT asset is taken to have been disposed of by the entity which owned it, and when it is taken to be acquired by the entity which becomes its owner (see subsection 109-5(2) of the ITAA 1997). These are the 'CGT contract rules'.
3. There are two cases where the core consolidation rules in Division 701 of the ITAA 1997 (for example, the single entity, entry history and exit history rules) produce a different outcome. They are where:
 - a contract to sell a CGT asset is entered into by a subsidiary member of a consolidated group and the contract settles after the subsidiary has left the group – in that case, CGT event A1 happens to the head company (not the subsidiary) of the consolidated group at the contract time ('exit-sell case'); and

- a contract to buy a CGT asset is entered into by an entity before it becomes a subsidiary member of a consolidated group and the contract settles after that time – in that case, the head company of the consolidated group (not the subsidiary) is taken to have acquired the asset at the contract time ('entry-buy case').

4. If the head company of a consolidated group makes a capital gain on the disposal of a CGT asset in an exit-sell case, such a gain may be duplicated on the disposal of interests in the subsidiary. For example, it may be duplicated in a capital gain made by the head company (or a former subsidiary member of the group) on the disposal of membership interests, which are a direct or indirect membership interest, in the subsidiary member that entered into the contract to sell the asset. In such a case, we would not disturb a taxpayer's approach of calculating its net capital gain or net capital loss by disregarding a capital gain made on the disposal of the membership interests to the extent it represents a duplication of the gain made by the head company on the disposal of the asset.

5. To the extent that the approach in this Determination regarding the CGT contract rules discussed in paragraph 2 (about CGT event A1) is relevant for other CGT events with a contract rule (for example, CGT event D1 – subsection 104-35(2) of the ITAA 1997), the approach should be taken to apply with such modifications as necessary.

6. This Determination does not specify which assets to identify for tax cost setting purposes, nor does it specifically address other tax cost setting issues (see paragraph 55).

Application

7. This Determination does not apply if the CGT asset the subject of the contract is a CGT asset of the same consolidated group at both the contract time and the time just after settlement (see paragraphs 15 and 16).

Explanation

8. Under the ordinary operation of the CGT contract rules, a CGT asset is taken to be acquired or disposed of at the contract time by the entity that entered into the contract. However, when the contract settles after an entity that is a party to the contract becomes, or ceases to be, a subsidiary member of a consolidated group (referred to as a 'straddle contract'), the core rules in Division 701 of the ITAA 1997 must also be considered.

9. The core consolidation rules in Division 701 of the ITAA 1997 (for example, the single entity, entry history and exit history rules) do not operate in contract cases to change the usual CGT outcome in terms of whether there has been an acquisition or disposal of an asset and **the timing** of that acquisition or disposal. That is, for CGT purposes, there will be taken to be an acquisition or disposal at the contract time.

10. However, there are two cases where the core consolidation rules do change the identity of **the entity** that is taken to acquire or dispose of the asset. These are the cases set out in paragraph 3.

Exit-sell case

11. The first case is where a subsidiary member of a consolidated group enters into a contract to sell a CGT asset and the contract settles after the subsidiary has left the group. Normally (that is, outside consolidation) CGT event A1 would be taken to have happened to the subsidiary at the time it entered into the contract. However, as the subsidiary was a member of a consolidated group at that time, the event happens to the group's head company: refer to the single entity rule in section 701-1 of the ITAA 1997 (see Example 4). This will be the outcome even if the subsidiary is a member of another consolidated group at the settlement time (see Example 7).

12. If CGT event A1 were taken to have happened to the subsidiary at the contract date it would not be possible to tax the subsidiary on any resulting capital gain and the subsidiary may lose the benefit of any resulting capital loss. This is because a subsidiary's taxable income is worked out under section 701-30 of the ITAA 1997 by reference only to assessable income and deductions that arise in periods during which the entity is not a member of a consolidated group in an income year. The CGT event happens when it is a member.

13. As discussed in paragraph 4, where a head company makes a capital gain in an exit-sell case, that gain may be duplicated when membership interests in the contracting entity are disposed of. Gain duplication may occur if the terminating value of the asset is used for the purpose of working out the cost base of membership interests under the tax cost setting rules of Division 711 of the ITAA 1997. As a result, a further capital gain may be made by the head company or a former subsidiary member on the disposal of membership interests, that are direct or indirect membership interests, in the subsidiary member that entered into the contract. In such a case, we would not disturb a taxpayer's approach of calculating its net capital gain or net capital loss by disregarding a capital gain made on the disposal of the membership interests to the extent it represents a duplication of the gain made by the head company on the disposal of the asset (see Example 5).

Entry-buy case

14. The second case is where an entity enters into a contract to buy a CGT asset before it becomes a member of a consolidated group and the contract settles after the entity has become such a member of the group. Normally (that is, outside consolidation) the entity would be taken to have acquired the asset at the contract time. However, as a result of the entry history rule in section 701-5 of the ITAA 1997, the head company is taken to have acquired the asset at the contract time (see Example 1). This will be the outcome even if the entity was a member of another consolidated group at the contract time (see Example 6).

Application

15. As noted in paragraph 7, this Determination does not apply if the CGT asset the subject of the contract is a CGT asset of the same consolidated group at both the contract time and just after settlement. That is, it does not apply if, after the contract has settled, the asset is still in the same consolidated group it was in when the contract was entered into. For example, if a subsidiary member of a consolidated group contracts to sell a CGT asset to its head company (or any other member of the group), and the contract settles after the subsidiary has left the group. Or if an entity has contracted to buy a CGT asset from a member of a consolidated group and by the time the contract settles the entity has joined that group.

16. The asset has not left the consolidated group in these cases. It is therefore not appropriate that the outcomes in paragraph 3 apply. The outcome instead is akin to that which occurs generally in an intra-group transaction. That is, as a result of the single entity rule in section 701-1 of the ITAA 1997, the change in ownership of the CGT asset is not recognised for the group's income tax purposes, so that CGT event A1 does not happen and the CGT contract rules do not apply at all in such cases.

Examples

17. The following examples demonstrate the interaction between the CGT and consolidation rules in a number of straddle contract scenarios.

18. Examples 1 and 2 deal with contracts made by an entity before it joins a consolidated group that settle after joining where the entity was not a member of a consolidated group at the contract time (Entry cases).

19. Examples 3 to 5 deal with contracts made by an entity while it is a subsidiary member of a consolidated group that settle after the entity has left the group where the entity was not a member of any other consolidated group at the settlement time (Exit cases).

20. Examples 6 and 7 deal with contracts entered into by a member of a consolidated group where that entity is a member of another consolidated group at the settlement time (Group to group cases).

Example 1: Entry-buy

21. *On 16 June 2004, X Co entered into a contract to purchase land. On 1 July 2004, all of the shares in X Co were purchased by the head company of a consolidated group and, as a result, X Co joined the group.*

22. *On settlement of the land contract on 16 August 2004, when X Co was a subsidiary member of the group, X Co became the owner of the land.*

23. *The group's head company is taken to have acquired the asset on 16 June 2004 (that is, the date X Co entered into the contract).*

Example 2: Entry-sell

24. *On 22 June 2004, X Co entered into a contract to sell land for its market value of \$200,000. The land has a cost base of \$100,000.*

25. *On 10 July 2004, Head Co acquired all of the shares in X Co which caused X Co to become a member of Head Co's consolidated group.*

26. *On 30 July 2004, the land contract settled and X Co ceased to be the owner of the land.*

27. *CGT event A1 happens to X Co on 22 June 2004 when it entered into the contract.*

28. *X Co works out its capital gain or loss using its cost base and reduced cost base for the land (rather than any tax cost set under the tax cost setting rules).*

29. *Relevant costs and expenditure incurred by X Co after it joins the consolidated group are also added to the cost base and reduced cost base for the land in working out X Co's capital gain or loss. The sale proceeds received on settlement form part of X Co's capital proceeds for the purpose of working out its capital gain or loss.*

30. *X Co makes a capital gain of \$100,000. This is taken into account in working out X Co's net capital gain or loss for the income year in which the CGT event is taken to have happened. This will relate to X Co's income tax return for the period before it joined the consolidated group: subsection 701-30(3) of the ITAA 1997.*

Example 3: Exit-buy

31. *On 12 May 2003, M Co, a subsidiary member of a consolidated group, entered into a contract to purchase land for \$200,000. A deposit of \$40,000 was paid.*

32. *On 20 June 2003, the head company of the group sold all of the shares in M Co. As a result, M Co leaves the group.*

33. *On settlement of the land contract on 12 July 2003, M Co paid the balance of the purchase price (\$160,000) and became the owner of the land.*

34. *M Co is taken to have acquired the land on 12 May 2003 (that is, the date that M Co entered into the contract). The first element of the cost base and reduced cost base of the land is \$200,000.*

Example 4: Exit-sell

35. *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. The land has a cost base of \$100,000.*

36. *On 16 June 2004, X Co entered into a contract to sell the land for \$200,000.*

37. *X Co leaves the group on 30 June 2004 as a result of Head Co selling all of its shares in X Co to an individual.*

38. *The land contract settled in August 2004.*

39. *CGT event A1 happens to Head Co on 16 June 2004 (the contract time). 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 land for the purposes of working out if there is a capital gain or capital loss for the event.*

Example 5: Exit-sell: avoidance of double taxation

40. *S 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. The land has a cost base of \$2 million.*

41. *On 1 July 2005, S Co entered into a contract to sell the land for \$3.5 million and received a deposit of \$500,000.*

42. *All of the shares in S Co are sold to a non-resident on 21 August 2005 and, as a result, S Co leaves the group.*

43. *The land contract settles on 30 September 2005 and S Co receives the remainder of the purchase price being \$3 million. CGT event A1 happens to Head Co on 1 July 2005 and Head Co makes a capital gain of \$1.5 million which it must take into account in working out its net capital gain or net capital loss for the income year in which the CGT event is taken to have happened.*

44. *If it be assumed that the land is an asset of S Co that it takes with it when it leaves the group, and Head Co uses the cost base of the land as its terminating value for the purposes of working out the cost base of the membership interests in S Co, a capital gain of \$1.5 million may arise on the sale of the interests which duplicates the capital gain made by Head Co on the land. An approach by Head Co to disregard the \$1.5 million capital gain on the disposal of the relevant interests when calculating its net capital gain or net capital loss for the income year would not be disturbed.*

Example 6: Group to group-buy

45. *On 25 March 2005, M Co, a subsidiary member of a consolidated group (the 'target group'), entered into a contract to purchase land for \$200,000. M Co paid a deposit of \$40,000.*

46. *On 20 April 2005, all of the shares in the head company of the target group were acquired by Z Co, the head company of another consolidated group (the 'bidder group'). As a result, all of the members of the target group became members of the bidder group.*

47. *On settlement of the land contract on 12 May 2005, M Co paid the balance of the purchase price (\$160,000) and became the owner of the land.*

48. *Z Co, the head company of the bidder group, is taken to have acquired the land on 25 March 2005 (that is, the date that M Co entered into the contract).*

49. *The outcome would be the same if Z Co had instead acquired all the shares in M Co so that only M Co became a member of Z Co's bidder group.*

Example 7: Group to group-sell

50. *Assume the facts in Example 6, except that M Co (already the owner of the land) entered into a contract to sell the land.*

51. *CGT event A1 happens to the head company of the target group on 25 March 2005 (that is, the date M Co entered into the contract of sale).*

52. *The CGT event does not happen to Z Co, the head company of the bidder group, because M Co was not a subsidiary member of the bidder group at the contract time.*

Date of effect

53. *When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).*

Your comments

54. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date.

55. We are developing our views on the tax cost setting issues arising in the straddle contract scenarios. They include the relevant asset or assets (see Taxation Ruling TR 2004/13 about assets) and the application of the tax cost setting steps in Divisions 705 and 711 of the ITAA 1997. We are also considering the potential application of CGT events in Subdivision 104-L of the ITAA 1997. Therefore, any comments and submissions on these and other related issues are also welcome.

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Previous draft:

TD 2004/D71; TD 2004/D72; TD 2004/D73

Related Rulings/Determinations:

TR 92/20; TR 2004/13

Subject references:

- acquisition of CGT assets
- capital gains tax
- CGT assets
- CGT event A1-disposal of a CGT asset
- CGT events
- consolidation
- consolidation - tax liabilities
- head company
- joining entity
- leaving entity
- single entity rule

- time of CGT event

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 104-10(1)
- ITAA 1997 104-10(2)
- ITAA 1997 104-10(3)(a)
- ITAA 1997 104-35(2)
- ITAA 1997 Subdiv 104-L
- ITAA 1997 109-5(2)
- ITAA 1997 Div 701
- ITAA 1997 701-1
- ITAA 1997 701-5
- ITAA 1997 701-30
- ITAA 1997 701-30(3)
- ITAA 1997 Div 705
- ITAA 1997 Div 711

ATO references

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