TD 2010/1 - 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?

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Taxation Determination

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?

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Ruling

1. No. Paragraph 40-880(5)(f) of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] does not prevent the deduction, under section 40-880, of incidental costs described in subsection 110-35(2) 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 (that is, ceases to be a member of the group).

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

Application

2. This Determination does not apply to the extent (if any) that the incidental costs mentioned in paragraph 1 of this Determination are remuneration to a member of the group.

Example

3. *H Co is the head company of a consolidated group of which another company, Sub Co, is a subsidiary member. H Co's shareholding in Sub Co consists of 2,000 shares, all of the same class. H Co incurs a liability to pay legal and accounting fees of $10,000 to entities outside the group in negotiating the sale of all of its shares in Sub Co to a non-group entity. The fees are incidental costs that are described in subsection 110-35(2).*

4. *The shares are later sold for $700,000 ($350 per share), and Sub Co leaves the group. Just before the leaving time, Sub Co has assets consisting of cash ($100,000) and land with a cost base of $500,000. At that time, it has accounting liabilities totalling $160,000 to entities outside the group.*

5. *The cost base and reduced cost base of each of H Co's shares in Sub Co is $220.*[2] *H Co makes capital gains totalling $260,000*[3] *on the sale of the shares.*

6. *As the legal and accounting fees do not form part of the cost base or reduced cost base of the shares, they are not taken into account in working out the amount of the capital gain on the sale of these shares. Further, the legal and accounting fees incurred do not fit the description of any amount that forms part of the calculation of a capital gain or capital loss from any other CGT event. Therefore paragraph 40-880(5)(f) does not apply to prevent the deduction of any amount in relation to the fees that would otherwise be available under section 40-880.*

Date of effect

7. This Determination applies in cases where the incidental costs mentioned in paragraph 1 of this Determination are incurred on or after 6 June 2008. 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 75 to 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
24 February 2010

[2] That is, ($100,000 + $500,000 – $160,000) / 2,000. See sections 701-15 and 701-60, Division 711 and subsection 701-55(5).
[3] That is, 2,000 x ($350 – $220). See section 104-10.

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

Explanation

8. Paragraph 40-880(5)(f) prevents an amount of business capital expenditure from being deductible under section 40-880 to the extent the expenditure could be taken into account in working out the amount of a capital gain or capital loss from a CGT event.

9. In the context of this Determination, where CGT event A1[4] happens on the disposal of the shares in the subsidiary member, two factors – the head company's cost base (or reduced cost base) of the shares and the capital proceeds from their disposal – are taken into account in working out the amount of a capital gain or capital loss from that CGT event. The incidental costs incurred by the head company would be taken into account in working out the amount of a capital gain or capital loss from the CGT event if they formed part of the cost base (or reduced cost base) of the shares. However, the incidental costs would not reduce the capital proceeds.

10. The question of whether the incidental costs do form part of the cost base (or reduced cost base) of the shares is decided by examining how the cost base (or reduced cost base) is worked out under the consolidation tax cost setting rules when the subsidiary member leaves the group.

11. The object of the consolidation tax cost setting rules in Part 3-90 that apply when a subsidiary member leaves a consolidated group or MEC group, is to preserve the alignment between the head company's cost for its shares in entities and the entities' assets that is established by the tax cost setting process when entities join the group (that is, become members of the group).[5] Broadly the alignment is achieved by the cost of the shares reflecting the cost of the leaving subsidiary member's assets reduced by the amount of its liabilities.[6]

12. This has the result that the capital gain or capital loss on disposal of the shares in a subsidiary member reflects the gains or losses in respect of the underlying assets held by the member at the time it leaves the group. The legislation giving effect to this scheme is outlined in the following paragraphs.

13. Under subsection 701-1(1) (the 'single entity rule' or SER), an entity that is a subsidiary member of a consolidated group or MEC group for a period is taken to be part of the head company of the group for that period for the 'head company core purposes' and 'entity core purposes' set out respectively in subsections 701-1(2) and (3).

14. One effect of the SER is that the existence of shares held by group members in the subsidiary member is disregarded for the head company's core purposes[7] during the period it is a member of the consolidated group or MEC group. The tax costs of the shares held by group members in a subsidiary member are set under subsection 701-15(3) just before the member leaves the group.

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[4] Section 104-10.
[5] Subsection 711-5(2).
[6] Subsection 711-5(3).
[7] Paragraph 2.9 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002.

15. Subsection 701-15(3) sets the tax cost of each such share to its 'tax cost setting amount'. This amount, worked out under section 701-60 and Division 711[8], is arrived at (broadly) by reducing the sum of the costs[9] of the leaving subsidiary member's assets by the amount of the liabilities of the member and allocating the result amongst the shares (and any other membership interests).

16. Subsection 701-55(5) then applies so that if the capital gains tax provisions[10] are to apply to the shares, they operate as if the head company's cost base or reduced cost base of each share in the subsidiary member just before it leaves the group is its tax cost setting amount. The cost base or reduced cost base of the shares thus determined is used to work out the amount of any capital gain or capital loss to the head company on disposal of the shares.[11]

17. In this context, none of the actual elements of what, but for the SER, would have been the cost base or reduced cost base of the head company's shares in the leaving subsidiary member if they were recognised before the tax cost setting process, have a role to play in working out the amount of any capital gain or capital loss of the head company on disposal of the shares. The cost base and reduced cost base of the shares just before the subsidiary member leaves the group are determined strictly according to the provisions mentioned in paragraphs 15 and 16 of this Determination.

18. Therefore, the incidental costs mentioned in paragraph 1 of this Determination, which the head company incurred before the subsidiary member left the group, in disposing of the shares in the subsidiary member to a non-group entity, are not included in the head company's cost base or reduced cost base of the shares. Further, the incidental costs do not fit the description of any amount that forms part of the calculation of a capital gain or capital loss from any other CGT event.

19. As a result, paragraph 40-880(5)(f) does not prevent to any extent the deduction, under section 40-880, of incidental costs described in subsection 110-35(2) 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.

20. However, it does not follow that the incidental costs are deductible under section 40-880: that will depend on the facts of each case and whether the other requirements under that section are met.

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[8] Where the subsidiary member is an eligible tier-1 company of a MEC group, Subdivision 719-J modifies the way that the tax cost setting amounts of any shares held by members of the group are worked out under Division 711.

[9] More precisely, the head company's 'terminating values' for the assets as defined in section 711-30.

[10] That is, Parts 3-1 or 3-3.

[11] See *Handbury Holdings Pty Ltd v. Commissioner of Taxation* [2009] FCAFC 141 at paragraphs 17 and 45; 2009 ATC 20-136 at paragraphs 17 and 45.

References

Previous draft:

TD 2009/D4

Related Rulings/Determinations:

TR 2006/10

Subject references:

- blackhole expenditure
- capital expenditure
- capital gains tax
- CGT cost base
- consolidation
- cost setting rules
- leaving entity
- membership interest in an entity
- single entity rule
- tax cost setting rules

Legislative references:

- TAA 1953
- ITAA 1997
- ITAA 1997 40-880
- ITAA 1997 40-880(5)(f)
- ITAA 1997 Pt 3-1
- ITAA 1997 Pt 3-3
- ITAA 1997 104-10
- ITAA 1997 110-35(2)
- ITAA 1997 Pt 3-90
- ITAA 1997 701-1(1)
- ITAA 1997 701-1(2)
- ITAA 1997 701-1(3)
- ITAA 1997 701-15
- ITAA 1997 701-15(3)
- ITAA 1997 701-55(5)
- ITAA 1997 701-60
- ITAA 1997 Div 711
- ITAA 1997 711-5(2)
- ITAA 1997 711-5(3)
- ITAA 1997 711-30
- ITAA 1997 Subdiv 719-J

Case references:

- Handbury Holdings Pty Ltd v. Commissioner of Taxation [2009] FCAFC 141; 2009 ATC 20-136

Other references:

- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002

ATO references

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