TD 2011/9 - 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 acquiring shares in an entity that becomes a subsidiary member of the group, after the entity joins 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 acquiring shares in an entity that becomes a subsidiary member of the group, after the entity joins 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 that Act, of incidental costs described in subsection 110-35(2) of that Act that the head company of a consolidated group or multiple entry consolidated (MEC) group incurs, in acquiring shares in an entity that becomes a subsidiary member of the group from a non-group entity, after the member joins the group.

[1] Subsequent legislative references are to the ITAA 1997.

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. On 1 July 2010 Head Co, the head company of a consolidated group, acquired all 2,000 shares in Sub Co, an Australian resident company, for $700,000. All of the shares were of the same class. Sub Co immediately became a subsidiary member of the group.

4. On 1 August 2010, Head Co incurred a liability to pay legal and accounting fees of $10,000 to entities outside the group in relation to negotiating and drawing up a contract for the acquisition of all the shares in Sub Co. The fees are incidental costs that are described in subsection 110-35(2).

5. Head Co includes $350 in the cost base or reduced cost base of each share, which is taken into account in working out the step 1 amount of the allocable cost amount for Sub Co under section 705-65. The legal and accounting fees are not taken into account in working out the cost bases or reduced cost bases of the shares. Further, those fees do not otherwise fit the description of any amount that could be taken into account in working out a capital gain or capital loss from a CGT event. Therefore paragraph 40-880(5)(f) does not prevent any deduction for the fees that would otherwise be available under section 40-880.

Date of effect

6. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
4 May 2011

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

7. The answer to the question posed by this Determination requires consideration of the interaction of section 40-880, the cost base rules in Division 110, and the consolidation core rules in Division 701, particularly section 701-1 (the 'single entity rule', or SER) and the cost setting rules.

8. Section 40-880 allows certain business capital expenditure to be deducted in equal proportions over five income years,[2] subject to a number of limitations and exceptions. One of those exceptions is paragraph 40-880(5)(f), which provides that an entity cannot deduct anything under section 40-880 for an amount of expenditure it incurs to the extent that 'it could, apart from this section, be taken into account in working out the amount of a capital gain or capital loss from a CGT event'.

9. Incidental costs are defined in section 110-35. Those relevant to this Determination are described in subsection 110-35(2). Incidental costs are included in the second element of the cost base of the relevant CGT asset under subsection 110-25(3). They are similarly included in the second element of the reduced cost base of the CGT asset under subsection 110-55(2).

10. Where the cost base or reduced cost base of a CGT asset includes incidental costs, those costs could be taken into account in working out the amount of a capital gain or capital loss from a CGT event, because the cost base or reduced cost base is a factor in the calculation for many CGT events. Paragraph 40-880(5)(f) then prevents any deduction for those costs that would otherwise be available under section 40-880.[3]

11. In the circumstances considered in this Determination, the incidental costs are incurred by the head company of a consolidated group or MEC group to acquire shares in an entity that becomes a subsidiary member of the group. At the time the entity joins the group, the incidental costs have not yet been incurred, and so are not included in the cost bases or reduced cost bases of the shares at that time.

12. There is no requirement under the CGT provisions that incidental costs incurred to acquire a CGT asset be incurred before the acquisition in order to be included in the cost base or reduced cost base of the asset. However, because the head company incurs the incidental costs after the subsidiary member joins the group, the expenditure must be characterised in the hands of the head company at the time they are incurred taking into account the effect of the SER.[4]

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[2] See subsection 40-880(2).
[3] See paragraph 2.73 of the Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 1) Bill 2006.
[4] See paragraph 2.87 of the Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 1) Bill 2006.

13. Under the SER, an entity that is a subsidiary member of a consolidated group or MEC group for any period is taken to be part of the head company during that period for the purposes of working out the head company's liability to income tax or loss of any sort for income years in which any of the period occurs and subsequent income years.[5] A consequence of the SER is that when an entity becomes a subsidiary member of a consolidated group the membership interests in the entity held by the group are ignored for those purposes.[6] This means that while the SER applies, the incidental costs cannot be included in the cost base or reduced cost base of the shares.

14. For the purpose of characterising the incidental costs when they are incurred, the head company is not required to anticipate whether or not the expenditure is related to assets (such as the shares) that may be recognised for the purposes mentioned in paragraph 13 of this Determination at some time in the future.[7] Even when the head company does recognise the shares for those purposes just before the subsidiary member leaves the group, the method for reconstructing the cost base or reduced cost base of the shares does not take into account the incidental costs of acquiring the shares.[8]

15. Since there is no other way in which the incidental costs could be taken into account in working out a capital gain or capital loss from a CGT event, paragraph 40-880(5)(f) does not prevent an amount being deducted for the incidental costs under section 40-880. 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.

[5] See subsection 701-1(2).
[6] See paragraph 2.9 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) Bill 2002.
[7] See paragraph 2.88 of the Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 1) Bill 2006.
[8] The cost bases or reduced cost bases of the shares are set just before the leaving time under subsections 701-15(3) and 701-55(5) to amounts worked out under section 701-60 table item 2, and Division 711.

References

Previous draft:

TD 2010/D5

Related Rulings/Determinations:

TR 2006/10; TD 2010/1; TD 2011/8; TD 2011/10

Subject references:

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

Legislative references:

- ITAA 1997
- ITAA 1997 40-880
- ITAA 1997 40-880(2)
- ITAA 1997 40-880(5)(f)
- ITAA 1997 Div 110
- ITAA 1997 110-25(3)
- ITAA 1997 110-35
- ITAA 1997 110-35(2)
- ITAA 1997 110-55(2)
- ITAA 1997 Div 701
- ITAA 1997 701-1
- ITAA 1997 701-1(2)
- ITAA 1997 701-15(3)
- ITAA 1997 701-55(5)
- ITAA 1997 701-60
- ITAA 1997 705-65
- ITAA 1997 Div 711
- TAA 1953

Other references:

- Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 1) Bill 2006
- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002

ATO references

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