



TD 2004/2 - Income tax: capital gains: is reflection in the 'value' of an asset sufficient to constitute reflection in its 'state' or 'nature' for 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 and what are the implications of this issue for a shareholder that makes a non-scrip share capital contribution to a company?

 This cover sheet is provided for information only. It does not form part of *TD 2004/2 - Income tax: capital gains: is reflection in the 'value' of an asset sufficient to constitute reflection in its 'state' or 'nature' for 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 and what are the implications of this issue for a shareholder that makes a non-scrip share capital contribution to a company?*

 This document has changed over time. This is a consolidated version of the ruling which was published on 18 February 2004

Taxation Determination

Income tax: capital gains: is reflection in the ‘value’ of an asset sufficient to constitute reflection in its ‘state’ or ‘nature’ for 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* and what are the implications of this issue for a shareholder that makes a non-scrip share capital contribution to a company?

Preamble

*The number, subject heading, date of effect and paragraphs 1 to 27 of this Taxation Determination are a ‘public ruling’ for the purposes of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. The remainder of the Determination is administratively binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain how a Determination is legally or administratively binding.*

General principle

1. Reflection in the ‘value’ of an asset is not, of itself, sufficient to constitute reflection in its ‘state’ or ‘nature’ for the fourth element of cost base and reduced cost base in subsections 110-25(5) and 110-55(2) of the *Income Tax Assessment Act 1997* (ITAA 1997).

Non-scrip share capital contributions to a company

2. A non-scrip share capital contribution is not merely reflected in the value of a shareholder’s existing share in a company if it is directly associated with, or directly linked to, a change in the rights constituting that share (as it results in a change to their ‘nature’).

3. There is doubt whether a non-scrip share capital contribution that is not associated with a change in rights, is reflected in other than the value of an existing share, although it has been argued that it may be reflected in the ‘state’ of the share. While the matter is not free from doubt we accept, on balance, that certain non-scrip share capital contributions to a company may qualify for inclusion in the fourth element of the cost base and reduced cost base of an existing share in these cases.

4. To be included, the non-scrip share capital contribution must be made to enhance the value of the shareholder’s existing share. It must also be directly associated with, or directly linked to, an increase in the absolute amount of share capital that a shareholder is

entitled to in respect of the share and this entitlement must still be present at the time of the relevant CGT event. To the extent that the contribution has been distributed before a CGT event happens to the share, or can no longer be distributed because the company has suffered a loss of distributable funds, it will not qualify for inclusion in cost base or reduced cost base.

5. 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

6. For capital expenditure incurred to increase an asset's value to be included in the fourth element of the asset's cost base, it must be reflected in the state or nature of the asset at the time of a 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).

State or nature

7. 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 *Macquarie Dictionary* also says that the word 'nature', in relation to a thing, refers 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'.

Value

8. In the context of a CGT asset, '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*.

Value not part of state or nature

9. We consider that the value of an asset is different from the state or nature of an asset. Accordingly, expenditure in respect of an asset may enhance its value, yet leave its state or nature unaffected. For example, promotion expenditure that leads to an increase in demand for a fixed supply of items may increase the market value of those items without changing their state or nature.

10. The approach taken in this 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 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).

Non-scrip share capital contributions

11. A non-scrip share capital contribution happens if:

- a shareholder makes a contribution to a company (other than by way of loan)
- the amount of the contribution is directly, or indirectly, credited to the share capital account of the company,¹ and
- the contribution is not accompanied by an issue of scrip by the company to the shareholder.

12. A direct contribution to share capital without an issue of scrip may be made by a shareholder where the corporations law of the relevant jurisdiction allows it. An indirect contribution may also happen, for example, where the contribution constitutes part of the profit of the company and is capitalised.

13. Advice has been received from the Attorney General's Department of the Australian Government that it has probably not been possible, whether before or after the changes in the *Company Law Review Act 1998*, to make a direct contribution to the share capital of a company registered in Australia without an issue of scrip.² As the Tax Office cannot provide advice on questions of corporations law, taxpayers should consider seeking private legal advice in relation to this matter.

Non-scrip share capital contribution where share rights are changed

14. A non-scrip share capital contribution that is directly associated with, or directly linked to, a change in the rights constituting the shareholder's existing shares may be included in the fourth element of the cost base and reduced cost base of those shares (as it results in a change to their 'nature'). For example, there may be a change in the voting or dividend rights of the shares, or the holder may be given a special entitlement in respect of the amount of share capital contributed.

Non-scrip share capital contribution where share rights are not changed

15. The question has arisen whether a non-scrip share capital contribution that increases the absolute amount of a company's share capital without changing a shareholder's

¹ This Determination does not deal with contributions to, or accretions to, capital accounts other than the share capital account.

² If a contribution to share capital was made without an issue of scrip, the amount would be likely to constitute a component of the profit of the company for the relevant period. Such a profit might be capitalised and, since the corporations law reforms, this may occur without an issue of additional scrip. In circumstances such as this where a contribution 'indirectly' finds its way into the company's share capital account - and there is evidence that the contribution results in, is directly associated with, or is linked to the change to the rights constituting a particular share or an increase in the amount which a shareholder might be returned in respect of the share - we accept that the expenditure may satisfy the relevant nexus. It should be observed, however, that capitalising profit in this way may have the effect of tainting the company's share capital account for certain dividend and franking purposes (see, for example, section 6D and Division 7B of Part IIIA of the ITAA 1936).

proportional capital rights is reflected in a share's nature or state. It has been argued that, although the share rights (and therefore the nature of the share) is unchanged, such an amount may be reflected in the 'state' of the share, reflecting an additional amount that may be returned on it in the event of a share capital distribution. This is said to be more than just an increase in the value of the share.

16. Further, the non-inclusion of the amount in the cost base and reduced cost base of the share would result in 'black hole' expenditure. While the matter is not free from doubt we accept, on balance, that a contribution which is made to enhance the value of the contributor's share can be included in the fourth element of cost base and reduced cost base in certain circumstances. The contribution must be directly associated with, or directly linked to, an increase in the absolute amount of share capital that a shareholder is entitled to in respect of the share, and the entitlement must still be present when a CGT event happens to the share.

17. An entitlement will not still be present to the extent it has been distributed or has been dissipated, before a CGT event happens. We will accept any reasonable and consistent approach of determining whether an amount has been distributed or has been dissipated. For example, specific tracing or FIFO would be acceptable, and accounting entries will generally be accepted as demonstrating the source of a distribution.

18. We also accept that an amount which would otherwise qualify for inclusion in the cost base and reduced cost base of a share is still reflected in it when CGT event G1 in section 104-135 of the ITAA 1997 (about non-assessable payments) happens even if it is the return of that amount of share capital that triggers the CGT event. Thus, if a non-scrip capital contribution of \$100 by a shareholder is returned triggering CGT event G1, we will accept that the \$100 is still 'reflected' in the shareholder's existing shares at the time of the CGT event. Accordingly, if the existing shares had a total cost base of, say, \$2, the shareholder will not make a capital gain of \$98 as a result of the payment. Rather, the \$100 will be included in the fourth element of cost base of the existing shares, CGT event G1 will apply to the payment, and the total cost base (\$102) will be reduced to \$2 which reflects the economic reality of the contribution and return of \$100 of share capital.

19. It is noted, for the avoidance of doubt, that there will be a dilution of potential fourth element expenditure where a contributing shareholder does not hold all the shares in the company. Absent a change in share rights, the contributing shareholder will not be entitled to a return of the full amount contributed. Further, if a contributing shareholder does not have fixed rights in respect of share capital (for example, the directors have a discretion as to who might receive a distribution in the event of a decision to return share capital), then no amount can be included in respect of the contribution under the fourth element.

Example 1

20. *Alpha Co and Delta Co each has a 50% shareholding in Beta Co. Alpha Co contributes additional share capital directly to Beta Co as this is permitted by the corporations law in the jurisdiction in which Beta Co is registered. No additional shares are issued by Beta Co. The rights attaching to Alpha Co's existing shares are simultaneously varied to ensure that they are solely entitled, upon any return of share capital, to receive the additional contribution.*

21. *The nature of Alpha Co's shares is changed because the contribution is accompanied by a change in the shares' constituent rights. The capital contribution could satisfy the requirement that the expenditure be reflected in the state or nature of each share when a CGT event later happened to it. Provided the other conditions for the application of fourth element expenditure are met (that is, the expenditure is of a capital nature ... incurred to increase the value of the shares), the capital contribution can be included in the fourth element of the cost base and reduced cost base of the shares.*

22. *Note that if the rights attaching to Alpha Co's existing shares were not changed, the maximum amount the Commissioner would accept as eligible for inclusion in the fourth element would be 50% of the total contribution.*

Example 2

23. *Gamma Co has an existing 100% shareholding in Epsilon Co and contributes additional share capital to the company. No additional shares are issued. There is no change in the constituent rights attaching to Gamma Co's shares. They remain a 100% share of Epsilon Co's share capital. There is an increase in the balance of the share capital account to which, under the constituent document of Epsilon Co, the shareholders would have an entitlement upon a return of capital.*

24. *The Commissioner takes the view that as Gamma Co now has an increased entitlement to an amount of share capital the capital contribution can be included in the fourth element of the cost bases and reduced cost bases of its existing shares provided the other conditions for the application of fourth element expenditure are met.*

Example 3

25. *Assume that the facts are varied in Example 2, such that there are three shareholders and under the constituent document for Epsilon Co the shares do not carry fixed interests in share capital and the directors have an absolute discretion to determine whether particular shareholders receive a distribution on a return of capital, and in what amounts.*

26. *The conditions for inclusion of the amount in cost base under the fourth element are not satisfied. As the shares do not carry fixed rights in respect of share capital, Gamma Co does not obtain any entitlement to a greater amount of share capital as a result of the contribution. (The first limb requirement that the expenditure be incurred to increase the value of the shares may not, in any case, be satisfied).*

TD 2004/2

Date of effect

27. This Determination applies to years commencing both before and after its date of issue. However, it does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Commissioner of Taxation

18 February 2004

Previous draft:

TD 2001/D11

Related Ruling/Determinations

TR 92/1; TR 92/20; TR 97/16

Subject references:

- Asset
- Capital Gain
- CGT asset
- Cost base
- Expenditure
- Fourth element
- Nature
- Reduced cost base
- Reflected
- Share
- State
- Value

Legislative references:

- ITAA 1936 160ZH(1)(c)
- ITAA 1936 160ZH(2)(c)
- ITAA 1936 160ZH(3)(c)
- ITAA 1936 Pt IIIAA div 7B
- ITAA 1936 sec 6D
- ITAA 1997 104-135
- ITAA 1997 110-25(5)
- ITAA 1997 110-55(2)
- ITAA 1997 Div 110
- ITAA 1997 Div 112
- TAA 1953 Pt IVAAA
- Capital Gains Tax Act 1979 (UK) 32(1)(b)
- Company Law Review Act 1998
- 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: 2002/017517

