

***TD 2000/D17 - Income tax: capital gains: if you dispose of pre-CGT shares in a company and CGT event K6 in section 104-230 of the Income Tax Assessment Act 1997 happens, how do you calculate your capital gain?***

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## Draft Taxation Determination

### **Income tax: capital gains: if you dispose of pre-CGT shares in a company and CGT event K6 in section 104-230 of the *Income Tax Assessment Act 1997* happens, how do you calculate your capital gain?**

#### **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. Subsection 104-230(6) provides in these circumstances that you make a capital gain equal to that part of the capital proceeds from the shares which is reasonably attributable to the amount by which the market value of property referred to in subsection 104-230(2) is *more* than the sum of the cost bases of that property.
2. Your capital gain depends on whether the company ('your company') is in a single-tier company structure or in a multi-tiered company structure and is calculated by the reasonable attribution in subsection 104-230(6) as follows:

#### **Single-tier company structure**

$$\text{Capital gain} = \text{Capital proceeds from the pre-CGT shares} \times \frac{\text{CPE}}{\text{MVP}}$$

where:

'*Capital proceeds*' has the meaning of that term in Division 116 and includes money and the market value of any property received or receivable in respect of the happening of any of the CGT events specified in paragraph 104-230(1)(b) to the pre-CGT shares.

'*CPE*' means the post-CGT property excess, that is, the market value *less* the sum of the cost bases of property referred to in subsection 104-230(2): see draft Taxation Determination TD 2000/D16 . In a single tier company structure CPE is the market value less the sum of the cost bases of your company's post-CGT property.

'*MVP*' means the market value of all of your company's property and its assets (in either a legal or accounting sense). It covers your company's CGT assets, its off balance sheet assets and its identifiable assets in terms of the accounting standards: see subparagraph 43(c) of Taxation Ruling TR 1999/16.

#### **Multi-tier company structure**

3. For a multi-tier company structure, in calculating your capital gain you reasonably attribute the capital proceeds to the eligible post-CGT property owned by your company and to the eligible

post-CGT property owned by interposed companies and interposed trusts (at every level of the multi-tier structure). Your capital gain is calculated using the following formula:

$$\text{Capital gain} = \frac{\text{Capital proceeds from the pre-CGT shares}}{\text{MVP}} \times \frac{\text{CPE}}{\text{MVP}}$$

where:

'Capital proceeds' has the meaning of that term in Division 116 and includes money and the market value of any property received or receivable in respect of the happening of any of the CGT events specified in paragraph 104-230(1)(b) to the pre-CGT shares.

'CPE' means the post-CGT property excess, that is, the market value *less* the sum of the cost bases of property referred to in subsection 104-230(2): see draft Taxation Determination TD 2000/D16. In a multi-tier company structure CPE is the market value of eligible post-CGT property owned by your company and the market value of eligible post-CGT property owned by interposed companies and interposed trusts less the sum of the cost bases of that property. If your company owns a proportionate interest in an interposed company or trust, and thus your company owns a proportionate interest in post-CGT property of the interposed company or trust, that proportion of the market value of that property is taken into account in doing the reasonable attribution by adjusting the relevant part of CPE accordingly (see Example 2 below).

'MVP' means the market value of all of your company's property and its assets (in either a legal or accounting sense). It covers your company's CGT assets, its off balance sheet assets and its identifiable assets in terms of the accounting standards: see subparagraph 43(c) of Taxation Ruling TR 1999/16.

4. The following points may be made about the reasonable attribution in subsection 104-230(6) used in calculating your capital gain:

- (a) The object of the reasonable attribution is to bring to account as a capital gain that part of the disposal proceeds of shares in a company which is attributable to an increase in the value of the company's underlying property acquired on or after 20 September 1985: page 139 of the Explanatory Memorandum to the Income Tax Assessment Amendment (Capital Gains) Bill 1986. In subsection 104-230(6) the concept of 'an increase in the value of the company's underlying property acquired on or after 20 September 1985' is expressed as the excess of 'the market value of property referred to in subsection [104-230](2)' over 'the sum of the cost bases of that property'. This is referred to in this draft Taxation Determination as CPE.
- (b) The market value substitution rule in subsection 116-30 can apply to replace the capital proceeds from the CGT event (for instance CGT event A1) happening to the disposal of shares with the market value of the shares if the conditions for the operation of subsection 116-30 are satisfied: see Taxation Determination TD 93/239.
- (c) The reasonable attribution applies to the eligible post-CGT as a whole rather than to each item of post-CGT property separately. The reference to 'the sum of the cost bases of that property' in subsection 104-230(6) supports this approach.
- (d) In calculating the amount of any capital gain, the reasonable attribution takes into account *all* items of property whether the market value of each separate item of property is greater or less than the cost base of that item: see Example 1 below.
- (e) For the purposes of subsection 104-230(6), the 'market value' of the property is determined as at the time of CGT event K6 and is the price at which the property could be expected to be bought and sold as between a willing but not anxious seller and a willing but not anxious buyer: *Spencer v. The Commonwealth* (1907) 5 CLR 418 at 441; *Building and Civil Engineering Holidays Scheme Management Ltd v. Post Office* (1965) 1 All ER 163 at 169.
- (f) The reasonable attribution has no regard to the capital gains your company might have made on CGT assets comprised in its post-CGT property if relevant CGT events had happened to those CGT assets.

- (g) Views might differ on how much of the capital proceeds from the shares is reasonably attributable to the post-CGT property excess (that is, the excess of the market value of the eligible post-CGT property of your company and of all interposed companies and trusts over the sum of the cost bases of that property). If a dispute arises it is ultimately a matter for the courts to determine how much of the capital proceeds from the shares is reasonably attributable to the CPE.

5. When this draft Taxation Determination is finalised, Taxation Determination TD 92/149 will be withdrawn.

**Note 1:**

6. The formula above applies whether you dispose of all of the shares or a percentage of the total shares in your company.

**Note 2:**

7. In this draft Taxation Determination:

*'eligible post-CGT property'* means all post-CGT property of your company and of all interposed companies and interposed trusts in a multi-tier structure including:

- (a) post-CGT shares in an interposed company but disregarding the same proportion of these shares as the proportion which the market value of post-CGT property of the interposed company bears to the market value of all of its property; and
- (b) any post-CGT interest in an interposed trust but disregarding the same proportion of this interest as the proportion which the market value of post-CGT property of the interposed trust bears to the market value of all of its property.

*'interposed company'*, in relation to a company (company A), means another company (company B) in which company A owns shares – whether they are pre-CGT shares or post-CGT shares – if company B owns post-CGT property and extends to any company (say, company C) which is an interposed company of an interposed company (for example, company B) if the first mentioned interposed company (company C) owns post-CGT property;

*'interposed trust'*, in relation to a company, means a trust (trust A) in which the company owns an interest – whether it is a pre-CGT interest or a post-CGT interest – if the trust owns post-CGT property and extends to any trust (say, trust B) which is an interposed trust of an interposed trust (for example, trust A) if the first mentioned interposed trust (trust B) owns post-CGT property;

*'post-CGT asset'* means a CGT asset acquired on or after 20 September 1985;

*'post-CGT interest'* means an interest acquired on or after 20 September 1985;

*'post-CGT property'* means property (that is not trading stock) acquired on or after 20 September 1985;

*'post-CGT shares'* means shares acquired on or after 20 September 1985;

*'pre-CGT asset'* means a CGT asset acquired before 20 September 1985;

*'pre-CGT interest'* means an interest acquired before 20 September 1985;

*'pre-CGT shares'* means shares acquired before 20 September 1985; and

*'your company'* means a company in terms of paragraph 104-230(9)(a) in which you own pre-CGT shares.

**Note 3:**

8. The views expressed in this Determination in relation to shares in a company apply, adapted as necessary, to an interest in a trust to which section 104-230 applies.

**Example 1 - Items of property where the market value of each separate item of property is equal to, greater or less than, the cost base of that item**

9. At the time of disposal of all the pre-CGT shares by the shareholders for \$710,000, Coy X did not have any liabilities and held only the following post-CGT property:

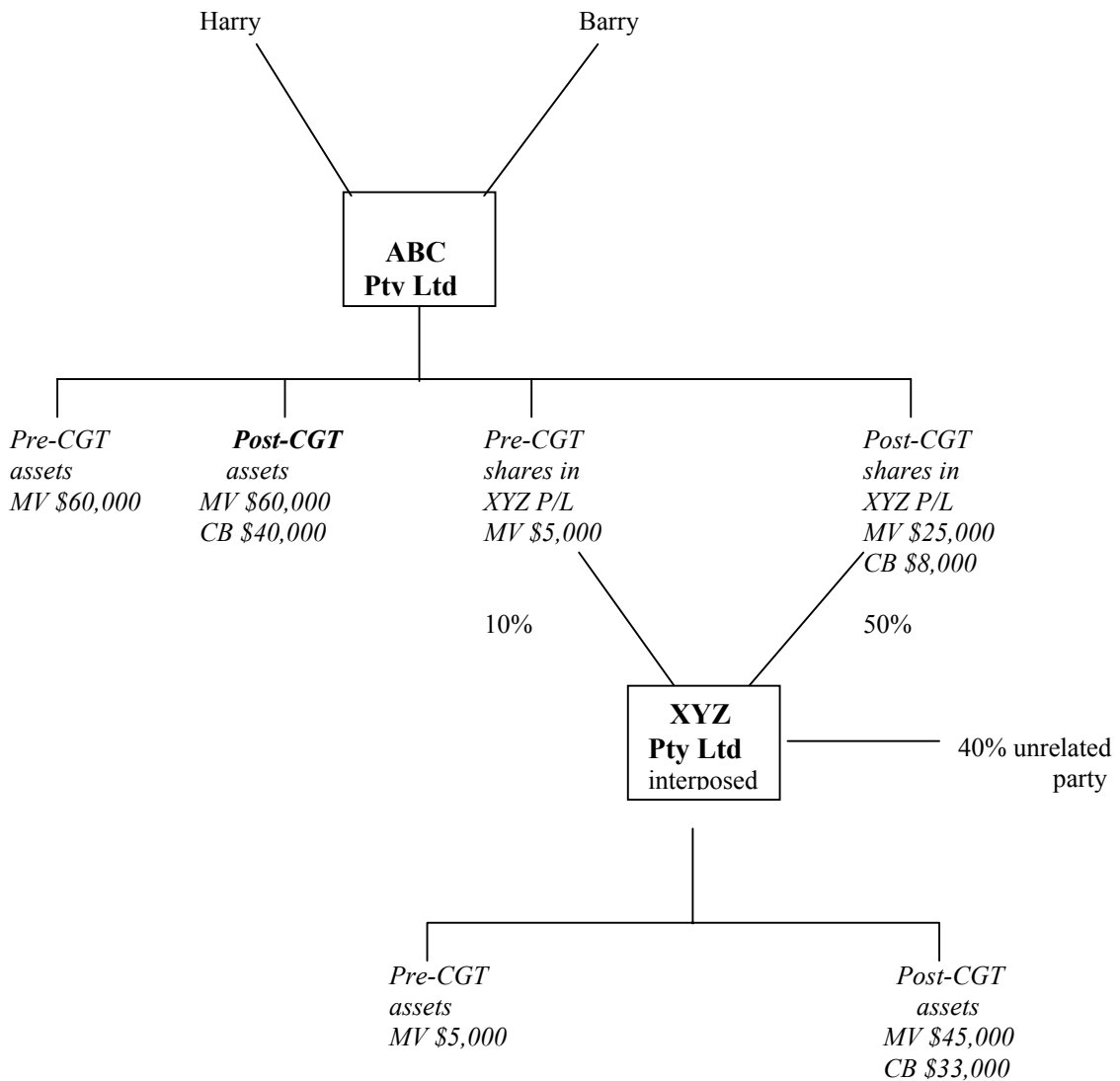
| <i>Property</i>    | <i>Market value</i> | <i>Cost base</i> |
|--------------------|---------------------|------------------|
|                    | \$                  | \$               |
| <i>Debtors</i>     | 10,000              | 10,000           |
| <i>Loans</i>       | 30,000              | 30,000           |
| <i>Land – QLD</i>  | 180,000             | 100,000          |
| <i>Land – NSW</i>  | 200,000             | 220,000          |
| <i>Land – VIC</i>  | 180,000             | 200,000          |
| <i>Land – WA</i>   | <u>110,000</u>      | <u>120,000</u>   |
| <i>Total value</i> | <u>\$710,000</u>    | <u>\$680,000</u> |

10. The capital gain calculated under subsection 104-230(6) by using the formula in this Taxation Determination is as follows:

$$\begin{aligned}
 \text{Capital gain} &= \text{Capital proceeds from the shares} \times \frac{\text{CPE}}{\text{MVP}} \\
 &= \frac{710,000}{X} \times \frac{(710,000 - 680,000)}{710,000} \\
 &= \$30,000
 \end{aligned}$$

**Example 2 - Capital gain in a multiple tiered structure where the interposed entity is not wholly owned.**

11. Harry and Barry acquired all of the shares of ABC Pty Ltd (a private company) before 20 September 1985 (pre-CGT). Harry sells his shares after 20 September 1985 (post-CGT) for \$75,000. The market value of the property of ABC Pty Ltd at the date of sale is \$150,000. At the time of the disposal of the shares, ABC Pty Ltd owns pre-CGT assets, post-CGT assets and 60% of the issued shares (10% pre-CGT and 50% post-CGT) in XYZ Pty Ltd, another private company. XYZ Pty Ltd owns pre-CGT assets and post-CGT assets each with a market value of \$25,000 (see the diagram below).



12. Harry calculates his capital gain by using the formula:

$$\text{Capital proceeds} \times \frac{\text{CPE}}{\text{MPV}}$$

13. However, before applying the formula, Harry must calculate the CPE. CPE in this multi-tier structure is the market value of ABC Pty Ltd's eligible post-CGT property and the market value of XYZ Pty Ltd's eligible post-CGT property. Because ABC Pty Ltd has only a proportionate interest in XYZ Pty Ltd's post-CGT property, part of the reasonable attribution in subsection 104-230(6) involves determining how much of the capital proceeds for Harry's shares is reasonably attributable to the market value of XYZ Pty Ltd's eligible post-CGT property. The remaining part of the reasonable attribution involves determining how much of the capital proceeds for Harry's shares is reasonably attributable to the eligible post-CGT property of ABC Pty Ltd.

CPE Calculation

|  | Market value | Cost base | CPE |
|--|--------------|-----------|-----|
| <b>ABC Pty Ltd's eligible post-CGT property:</b> |              |           |     |

|  |           |          |          |
|--|-----------|----------|----------|
| <ul style="list-style-type: none"> <li>• assets</li> <li>• shares in XYZ Pty Ltd<br/>(see Note 4)</li> </ul> | \$60,000  | \$40,000 |          |
|  | \$11,250  | \$3,600  |          |
| <b>XYZ Pty Ltd's eligible post-CGT property:</b>   |           |          |          |
| <ul style="list-style-type: none"> <li>▪ assets</li> </ul>   | \$45,000  | \$33,000 |          |
| <b>Totals</b>  | \$116,250 | \$76,600 | \$39,650 |

**Note 4:**

14. The market value of ABC Pty Ltd's shares in XYZ Pty Ltd (\$25,000) is reduced to \$11,250 and their cost base is reduced to \$3,600 to avoid double counting. These reductions are done by disregarding the same proportion of these shares as the proportion which the market value of XYZ Pty Ltd's eligible post-CGT property (\$45,000) bears to the market value of all of its property (\$50,000), namely, 45% - being 50% of 90%.

15. The capital gain Harry makes on the disposal of his pre-CGT shares in ABC Pty Ltd is:

$$\begin{aligned} & \text{Capital proceeds} \times \frac{\text{CPE}}{\text{MPV}} \\ &= \$75,000 \times \frac{\$39,650}{\$150,000} \\ &= \$19,825. \end{aligned}$$

**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.

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**Commissioner of Taxation**

23 August 2000

*Previous draft:*

Not previously issued in draft form.

*Related Rulings/Determinations:*

TD 2000/D13; TD 2000/D14; TD 2000/D15; TD 2000/D16; TD 2000/D18; TD 2000/D19;

*Subject references:*

- capital gain
- capital proceeds

- CGT assets
- CGT event A1
- CGT event K6
- cost base
- market value
- market value substitution rule
- property
- reasonably attributable

*Legislative references:*

- ITAA 1997 104-230
- ITAA 1997 104-230(1)(b)
- ITAA 1997 104-230(2)
- ITAA 1997 104-230(6)
- ITAA 1997 104-230(9)(a)
- ITAA 1997 Div 116
- ITAA 1997 116-30

*Case References*

- *Spencer v. The Commonwealth* (1907) 5 CLR 418;
- *Building and Civil Engineering Holidays Scheme Management Ltd v. Post Office* (1965) 1 All ER 163;

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