


***TD 2006/73 - Income tax: demergers: in reallocating the cost bases of ownership interests under a demerger, as required by subsection 125-80(2) of the Income Tax Assessment Act 1997, is there more than one method that produces a reasonable apportionment?***

 This cover sheet is provided for information only. It does not form part of *TD 2006/73 - Income tax: demergers: in reallocating the cost bases of ownership interests under a demerger, as required by subsection 125-80(2) of the Income Tax Assessment Act 1997, is there more than one method that produces a reasonable apportionment?*



---

## Taxation Determination

---

Income tax: demergers: in reallocating the cost bases of ownership interests under a demerger, as required by subsection 125-80(2) of the *Income Tax Assessment Act 1997*, is there more than one method that produces a reasonable apportionment?

**❶ This publication provides you with the following level of protection:**

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*. A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. If you rely on this ruling, we must apply the law to you in the way set out in the ruling (unless we are satisfied that the ruling is incorrect and disadvantages you, in which case we may apply the law in a way that is more favourable for you – provided we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

### Ruling

1. Yes.
2. Subsection 125-80(2) of the *Income Tax Assessment Act 1997* (ITAA 1997) requires only that the reallocation of cost base to new ownership interests and remaining original ownership interests (together referred to as 'post-demerger interests') produces a reasonable apportionment.
3. Depending on the facts and circumstances of each case, there may be more than one method of allocating the cost base over a taxpayer's post-demerger interests that results in a reasonable apportionment.
4. In all cases, the Commissioner considers that the apportionment will be reasonable if a taxpayer calculates the new cost base of each post-demerger interest in accordance with the market value of that interest relative to the total market value of all of their post-demerger interests. This method is referred to as the *relative market value method*.

**Example 1 – Relative Market Value method**

5. Nick owned post-CGT shares in Head Coy (that is shares acquired on or after 20 September 1985), a public company. Head Coy demerged all of its shares in its wholly-owned subsidiary Sub Coy under a demerger. Both Head Coy and Sub Coy had only one class of shares (ordinary shares) on issue.

6. Just before the demerger Nick owned the following post-CGT Head Coy shares:

- 200 with a cost base of \$4 each; and
- 200 with a cost base of \$6 each.

7. Nick received one Sub Coy share under the demerger for each Head Coy share that he owned (thus he received 400 Sub Coy shares as a result of owning 400 Head Coy shares). He chose rollover under subsection 125-55(1) of the ITAA 1997.

Just after the demerger, the market value of each Head Coy share was \$6 and each Sub Coy share was \$14.

**Note:** The head entity will usually assist their shareholders or unitholders by advising them of the percentages of the summed cost bases to allocate across all of the new ownership interests and all of the remaining original ownership interests.

8. In this example, Head Coy would advise shareholders that 30% of the summed cost base should be allocated across the remaining original ownership interests (in the Head Coy) and 70% across the new ownership interests (in Sub Coy).

9. Nick calculates the new cost base of his Head Coy and Sub Coy shares using the relative market value method, as follows:

- (i) Sum the cost bases (worked out just before the demerger):  
 $\$800$  (200 shares  $\times$  \$4) +  $\$1,200$  (200 shares  $\times$  \$6) =  **$\$2,000$**
- (ii) Allocate the summed cost bases by reference to the relative market value:

**For the Head Coy shares** apportion 30% of the summed cost base across his remaining Head Coy shares:

$$= \$2,000 \text{ cost base} \times 30\% = \$600$$

$$= \$600 \div 400 \text{ shares}$$

$$= \mathbf{\$1.50}$$
 as first element of the cost base of each Head Coy share

**For the Sub Coy shares** apportion 70% of the summed cost base across his remaining Head Coy shares:

$$= \$2,000 \times 70\% = \$1,400$$

$$= \$1,400 \div 400 \text{ shares}$$

$$= \mathbf{\$3.50}$$
 as first element of the cost base of each Sub Coy share

10. In a simple example such as this, the practical effect of this method is that each of the taxpayer's post-CGT remaining interests in the head entity will have the same cost base (just after the demerger). Similarly, each of the taxpayer's post-CGT new ownership interests in the demerged company (just after the demerger) will have the same cost base. For this reason, it is sometimes referred to as the averaging method.

11. Other methods, including those based on the approach referred to as the *parcel by parcel method*, can produce reasonable apportionments, but this may not always be the case. For example, the particular circumstances surrounding a demerger may be such that the apportionment delivered by a method other than relative market value is distorted. Such distortion would be unacceptable if it involved an exaggeration of cost base differentials between post demerger interests. A demerger undertaken by way of the cancellation of ownership interests can produce such unreasonable apportionments.

**Example 2 – parcel by parcel method**

12. Taking the example of Nick above, under the *parcel by parcel method*, he would allocate the sum of his cost bases in the following manner.

13. Remembering that just before the demerger Nick owned the following post-CGT Head Coy shares:

- 200 with a cost base of \$4 each; and
- 200 with a cost base of \$6 each.

14. Nick would calculate the new cost base of his Head Coy and Sub Coy shares using this information as follows:

- (i) sum the cost bases (worked out just before the demerger):  
 $\$800$  (200 shares  $\times$  \$4) + \$1,200 (200 shares  $\times$  \$6) = **\$2,000**
- (ii) Allocate the summed cost bases by reference to the relative market value and the original cost bases:

For the Head Coy shares apportion 30% of the summed cost base across his remaining Head Coy shares:

$$= \$2,000 \text{ cost base} \times 30\% = \$600$$

15. This amount is then allocated across each of the post-CGT Head Coy shares, taking into account the disparity in cost bases between the two original parcels:

Parcel 1

$$= \$600 \times (\$800 \div \$2,000) \div 200 \text{ shares}$$

$$= \mathbf{\$1.20}$$
 as first element of the cost base of each Head Coy share in parcel 1

Parcel 2

$$= \$600 \times (\$1,200 \div \$2,000) \div 200 \text{ shares}$$

$$= \mathbf{\$1.80}$$
 as first element of the cost base of each Head Coy share in parcel 2

**For the Sub Coy shares** apportion 70% of the summed cost base across his remaining Head Coy shares:

$$= \$2,000 \text{ cost base} \times 70\% = \$1,400$$

16. This amount is then allocated across each of the post-CGT Sub Coy shares, taking into account the disparity in cost bases between the two original parcels of Head Coy shares:

*Parcel 1*

$$= \$1,400 \times (\$800 \div \$2,000) \div 200 \text{ shares}$$

$$= \mathbf{\$2.80}$$
 as first element of the cost base of each Sub Coy share in parcel 1

*Parcel 2*

$$= \$1,400 \times (\$1,200 \div \$2,000) \div 200 \text{ shares}$$

$$= \mathbf{\$4.20}$$
 as first element of the cost base of each Sub Coy share in parcel 2

**Note:** it would also be acceptable for Nick to use the relative market value method for these Sub Coy shares. If he used that method, each of his 400 Sub Coy shares would have, as the first element of the cost base just after the demerger, **\$3.50** (that is  $\$1,400 \div 400$  shares).

#### **Date of effect**

17. This Determination applies to demergers happening on or after 1 July 2002. However, this Determination 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 issue of the Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

---

**Commissioner of Taxation**

22 November 2006

---

## Appendix 1 – Explanation

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

### Calculation of cost base after a demerger

18. Section 125-80 of the ITAA 1997 requires a taxpayer to re-calculate the cost base for each post-demerger interest a taxpayer owns. Subsection 125-80(2) requires that this first element must be a proportion of the sum of a taxpayer’s cost bases of their original interests held prior to the demerger.

19. Subsection 125-80(2) of the ITAA 1997 does not prescribe a particular method by which a taxpayer makes this calculation, but does require that the cost base for each post-demerger interest is a proportion of the sum that is reasonable having regard to the market values of a taxpayer’s post-demerger interests, or a reasonable approximation of those values.

### Relative market value method (averaging method)

20. The Commissioner considers that the requirements of subsection 125-80(2) of the ITAA 1997 will be satisfied in all cases where a taxpayer adopts the *relative market value method* to recalculate the cost base of their post demerger interests.

21. The *relative market value method* requires a taxpayer to:

- (i) sum the cost bases (worked out just before the demerger) of all their original ownership interests in the head entity; then
- (ii) apply a proportion of that summed cost base to each new ownership interest (in the demerged entity) and each remaining original ownership interest (in the head entity). The proportion applied to each ownership interest is equal to the market value of that ownership interest relative to the total market value of all of the taxpayer’s new ownership interests and remaining original ownership interests.

The market value of the new ownership interests and remaining original ownership interests may be either the actual market values just after the demerger, or an anticipated reasonable approximation of those market values.

22. This method is commonly used by taxpayers because it is generally simpler to apply than other methods (see Example 1 at paragraphs 5 to 10 of this Determination).

### Other methods

23. Depending on the particular circumstances of a demerger, other methods of recalculating the cost base may be used by a taxpayer, providing the result produced is reasonable for the purposes of subsection 125-80(2) of the ITAA 1997.

24. One method that is considered reasonable in most circumstances is commonly referred to as the *parcel by parcel method*.

25. Under such an approach, a taxpayer takes into account any differences in cost base (just before the demerger) between their parcels of original ownership interests. In allocating the summed cost base to their post-demerger interests, these differences are reflected in the cost base allocated to each interest, in addition to reflecting the relative market values of those interests (see Example 2 at paragraphs 12 to 16 of this Determination).

### **Circumstances where methods other than the relative market value method may produce unreasonable apportionments**

26. In some situations, a taxpayer will be required to use the *relative market value method* because the use of other methods can result in an unreasonable distortion of the cost bases for a taxpayer's post-demerger interests.

27. Where the demerger is undertaken by the cancellation of a proportion of the original ownership interests, the allocation of the cost bases of the cancelled ownership interests (or part thereof) to the head entity post-demerger interests can, for example, be done in a way that unduly distorts those cost bases if a method other than the *relative market value method* is used. In such circumstances, methods other than the *relative market value method* would not result in an apportionment that is reasonable.

28. The Commissioner is also of the view that an apportionment would not be reasonable where a mix of methods is used for either the head entity ownership interests or the demerged entity ownership interests. For example, it would not be reasonable for a taxpayer to apply the *relative market value method* to half of their head company parcels of shares and the *parcel by parcel method* to the other half. This can lead to an unreasonable distortion of the relevant cost bases.

29. Methods other than the two described above would be considered on a case by case basis to determine whether or not they result in a reasonable outcome in the context of subsection 125-80(2) of the ITAA 1997.

### **Other matters**

30. In this Determination we refer to the 'cost bases' of ownership interests just after the demerger. The rules in section 125-80 of the ITAA 1997 apply only to work out the 'first element of the cost base and reduced cost base' of ownership interests. Generally there are other elements which may be included to work out the cost base of ownership interests. However, immediately after a demerger the first element of the cost base and reduced cost base will be the same as the cost base. Therefore, for simplicity we refer only to cost base just after a demerger.

31. This Determination does not apply to new ownership interests received in the demerged company that correspond to pre-CGT ownership interests (that is ownership interests acquired before 20 September 1985) in the head entity where the taxpayer does not or cannot choose demerger rollover. In these circumstances the cost base adjustment rules in subsection 125-80(2) of the ITAA 1997 do not apply. Instead, the corresponding new ownership interests in the demerged entity are treated as post-CGT ownership interests, and the cost bases are worked out under the ordinary cost base rules in Divisions 110 and 112 of the ITAA 1997.

---

## References

---

*Previous draft:*

TD 2006/D19

*Subject references:*

- capital gains
- capital gains tax
- cost base
- demerger relief

*Legislative references:*

- ITAA 1997 Div 110
- ITAA 1997 Div 112
- ITAA 1997 125-55(1)
- ITAA 1997 125-80
- ITAA 1997 125-80(2)
- TAA 1953

---

*ATO references*

NO: 2005/10312

ISSN: 1038-8982

ATOlaw topic: Income Tax ~~ Capital Gains Tax ~~ demerger relief