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## DETERMINING THE COST BASE FOR DISPOSAL OF EQUITY

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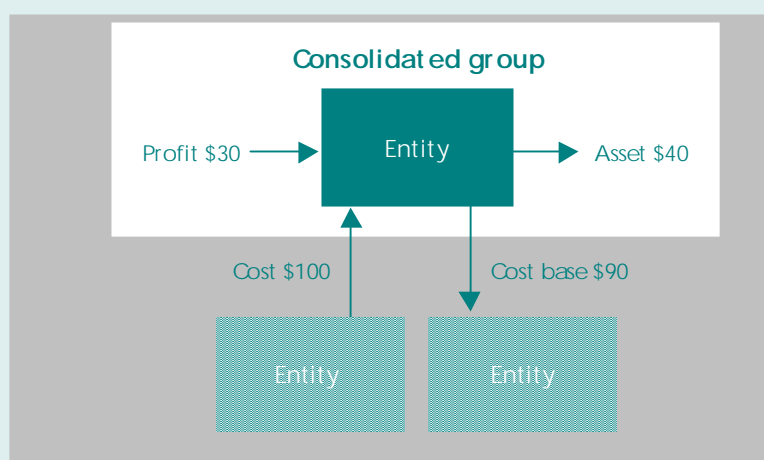
## Policy objective

### Meeting the need to reconstruct equity cost bases

27.1 Major objectives of consolidating the tax treatment of wholly owned groups are the reduction of current compliance costs and improving integrity by preventing double taxation of gains, duplication and cascading of losses and creation of losses. To achieve these objectives it is necessary to disregard all transactions between individual entities in a group that chooses to consolidate its tax affairs — and to disregard for tax purposes the identity of individual group entities and intra-group ownership interests in those entities.

27.2 Thus, during consolidation, the intra-group equity interests in individual group entities and the cost bases for capital gains tax purposes of those interests are ignored. This means it is necessary to reconstruct the cost bases of the equity (shares or units in unit trusts) in a group entity being sold by a consolidated group. The cost base is needed to determine any capital gains or losses on the sale of that equity.

#### Example 27.1: Requirements of the method of reconstructing equity cost bases



The figure shows an entity acquired by a consolidated group for \$100. Within the consolidated group, an asset with a market value of \$40 at the time the entity was acquired is transferred out of the entity, and profits of \$30 are reinvested in the entity. A satisfactory system of reconstructing the group's cost base for equity in this entity would subtract the 'at-entry' value (\$40) of the asset removed from the entity and add the reinvested profits (\$30) to the group's original cost (\$100). The reconstructed cost base for equity that nullifies the value shift (asset transfer) and avoids double taxation of profits is \$90. Any model proposed for the reconstruction of equity cost base should deliver this outcome. The capital gain or loss on the sale of the

entity is determined by deducting the \$90 cost base from the sale price.

27.3 The reconstruction of the cost bases needs to be done in a way that prevents the duplication of gains or losses previously realised by the group and reflected in the assets and liabilities in the entity being sold.

27.4 Example 27.1 illustrates requirements of the way in which the equity cost base for an entity sold by a consolidated group is reconstructed.

## Policy options

### Two models for reconstructing a cost base for equity

27.5 Two models for reconstructing equity cost bases have been developed:

- the *entity-based model* retains the identity of subsidiary entities within a consolidated group as a reference point for reconstructing equity cost bases; and
- the *asset-based model* abandons tax system recognition of subsidiary entities entirely and reconstructs equity cost base from asset cost bases alone.

27.6 Both models link the cost base for equity in an entity sold by a consolidated group to the price the group paid for the assets in that entity. They differ in the way they achieve this.

#### Option 1: The entity-based model

27.7 The entity-based model reconstructs an equity cost base by adding to an entity's equity cost base on entry into consolidation any net increase in the aggregate cost base of the assets of the entity during consolidation. If the aggregate cost base of the assets of the entity declines during consolidation, the reconstructed cost base for equity on exit will be correspondingly smaller than the cost base for the entity when it was brought into consolidation.

27.8 The basic intuition underlying the model is to continue to use the existing cost bases of assets and equity on entry into consolidation, and to use changes in the entity's asset cost bases to make adjustments to the cost base of equity on exit. During consolidation it is possible for there to be some duplication of pre-consolidation gains and losses (when assets held by the acquired entity on entry, with their original cost bases, are realised outside the

consolidated group). However, the options discussed in Chapter 28 would limit the duplication of pre-consolidation losses and any remaining double counting is reversed by the cost base adjustment to equity on exit.

### Key features

27.9 The key features of the entity-based model are:

- the cost base of equity (that is, shares in a company and units or other interests in a unit trust) on exit of an entity is the amount paid for the equity plus the change in the sum of the asset cost bases during consolidation;
- the information required by the group is the asset cost bases on entry and exit;
- the group can freely move assets within the group with no capital gains tax consequences; and
- there is no need for value shifting rules (except for 'at-consolidation' assets) and loss duplication rules within the group.

### How the model works

27.10 Under the entity-based model, the net revenue and capital gains or losses realised by an entity would be represented by the difference between the sum of the asset cost bases on exit from consolidation and the sum of the asset cost bases on entry into consolidation. To the extent that an entity's realised gains are not distributed, they would be reflected in the sum of the cost bases of assets held in the entity on exit. That is, gains realised by an entity during consolidation would be reflected in higher asset cost bases of replacement assets. Similarly, if the entity realises losses during consolidation, the asset cost bases of replacement assets would be lower. For example, if an asset were disposed of by the entity for a loss, the cost base of replacement asset(s) would be equal to the cost base of the original asset reduced by the amount of the loss realised on the asset.

27.11 Accordingly, the equity cost base of a group entity on exit from consolidation would be reconstructed as follows:

$$ECB_x = ECB_n + (ACB_x - ACB_n)$$

where:

$ECB_x$  is the equity cost base of a group entity on exit from consolidation;

$ECB_n$  is the equity cost base of a group entity on entry into consolidation;

$ACB_x$  is the sum of the asset cost bases on exit (that is, the cost to the entity of acquiring all of its assets, with cash treated as an asset and liabilities treated as negative assets — wasting assets are discussed later); and

$ACB_n$  is the sum of the asset cost bases on entry.

### Example 27.2: Reconstructing an equity cost base under Option 1

- There are two companies in a group — the holding company (H) and its subsidiary (S)
- H paid \$100 in subscribing for the shares in S on its creation (i.e. the equity cost base,  $ECB(1)$ , on entry is \$100).
- S acquires an asset, A(1), for \$100 (i.e. the asset cost base,  $ACB(1)$ , is \$100).
- H and S elect to consolidate immediately after formation of the group.
- The asset is sold by the group for \$160 with proceeds used to acquire another asset, A(2) (i.e. the asset cost base,  $ACB(2)$ , is \$160).
- H eventually sells the equity in S for \$200.
- The reconstructed ECB on exit would be:

$$\begin{aligned} ECB_x &= ECB_n + (ACB_x - ACB_n) \\ &= \$100 + (\$160 - \$100) \\ &= \$160. \end{aligned}$$

Accordingly, the capital gain on sale of the equity will be \$40; that is, the difference between the sale price (\$200) and the readjusted ECB (\$160). There is no duplication of the gain on disposal of asset A(1) — in contrast to the operation of the existing law, illustrated in Appendix A to Chapter 25.

The capital gain on sale of equity represents a realisation by the group of the unrealised gain (net of tax) in respect of A(2).

## Option 2: The asset-based model

27.12 The asset-based model dispenses entirely with tax recognition of group entities in consolidation. Upon the entry of an entity into consolidation, the group's cost base for its equity in the entity is transferred to the assets the entity brings with it, including goodwill on acquisition. The cost base for equity, when transferred to the individual assets, replaces existing asset cost

bases. Where a group sells equity, the group's cost base for that equity is reconstructed equal to the sum of the cost bases of the assets that go with it.

27.13 The intuition underlying this approach is that on entry into consolidation the equity cost base is transferred to the assets of the entity as a representation of the actual cost on consolidation of the assets to the overall group. On exit from the group the process is reversed and the cost base of the equity is derived from the assets of the entity at that time, as this is what is actually being taken out of consolidation.

### Key features

27.14 The key features of the asset-based model are:

- on entry into consolidation, the sum of the cost bases of the underlying assets of the entity is aligned with the amount paid for the equity in the entity — broadly, this is achieved by aligning the cost bases of identified assets with their market values and allocating any remaining difference to goodwill;
- the cost base of equity on exit of an entity is the sum of the cost bases of the underlying assets;
- the information required by the group is the market values of all assets on entry and the cost bases of assets on exit;
- the group can freely move assets within the group with no capital gains tax consequences; and
- there is no need for value shifting rules and loss duplication rules within the group.

### How the model works

27.15 The model can be represented symbolically as follows:

- upon consolidation

$$ECB_n \Rightarrow ACB_n$$

the equity cost base is transferred to the assets (and liabilities) acquired — potentially becoming the cost base for depreciation, as well as for capital gains tax, of depreciable assets — see under 'Other issues arising from the method of reconstructing equity cost base' below; and

- upon sale of equity

$$ACB_x \Rightarrow ECB_x$$

the cost bases of the assets being sold become the cost base for the equity.

27.16 If assets are sold directly by a consolidated group, as distinct from being sold in an entity, the cost bases of the assets would retain any adjustments made to those cost bases if the assets were brought into the consolidated group on the acquisition of an entity.

27.17 As in the discussion of the entity-based model, cash is viewed as an asset with a cost base equal to its face value and liabilities are treated as negative assets.

27.18 As with the entity-based model, net reinvested profits during consolidation add to the asset cost base of a group and, thereby, may add to the group's reconstructed cost base for disposals of equity.

### Example 27.3: Reconstructing an equity cost base under Option 2

The example used to illustrate the equity-based model (Example 27.2) can also illustrate the operation of the asset-based model:

- When H and S consolidate, H's cost base for its equity in S, that is, \$100, becomes its cost base for the asset A(1) — in this case this does not involve a change in the cost base of A(1).
- A(1) is sold for \$160 and the proceeds used to purchase another asset A(2).
- The group then sells equity in A(2) for 200. The reconstructed cost base for the sold equity is equal to the groups cost base for A(2), that is, \$160.

As with the entity-based model, the group makes a gain of \$60 on the sale of A(1) and a further gain of \$40 on the sale of equity in A(2).

### *Acquisition of entities more generally*

27.19 The price paid by a consolidated group to acquire an entity represents that group's costs of acquiring equity in the entity's respective assets. Any excess of the acquisition cost of the entity's equity over the market value of the entity's net assets plus the values of any franking credits and carry-forward losses may be viewed as the price paid for goodwill. Therefore, the group's cost base for its equity in the entity could be transferred to the acquired assets by:

- resetting the cost bases of the identified assets (and liabilities) equal to their respective market values at that time — ignoring the complicating effect of indexation, the market values would be the tax values at that time for wasting assets, appreciating assets and other assets and liabilities; and



- taking the balance of the cost of the equity as setting the capital gains tax cost base of the goodwill of the acquired entity.

27.20 Alignment of the asset cost bases, including for goodwill, with a group's cost base for equity requires market valuation of the assets referable to the time of acquiring the related equity interests. Because of this, special provisions (discussed below) are required where groups consolidate at a time other than immediately upon their formation, including at the commencement of the consolidation regime and also where a consolidated group acquires the equity of an entity incrementally.

#### Example 27.4: Alignment of cost bases on acquisition

Alignment of cost bases upon the acquisition of an entity by a consolidated group is illustrated in the following.

- A consolidated group, CG, acquires all of the equity in entity E for \$200. E is automatically subsumed in CG.
- At the time of acquisition E has two assets. Asset A(i) has a cost base of \$50 and a market value of \$40. Asset A(ii) has a cost base of \$100 and a market value of \$140.
- CG's cost base for its equity in E is transferred to the acquired assets. CG's cost bases for the assets will be:
  - A(i), \$40;
  - A(ii), \$140; and
  - Goodwill, \$20.
- Ignoring indexation, CG's tax value for A(i) and A(ii) would also be \$40 and \$140 respectively.

A more complex example, comparing the operation of the two models, is set out in Appendix A.

### Accounting treatment

For accounting purposes a group would initially recognise a wholly owned subsidiary by consolidating the subsidiary's assets and liabilities (including acquired goodwill) into line items in the group's financial statements. The assets and liabilities would be measured at their fair value at the date of acquisition. Any goodwill recognised in the group financial statements is amortised in subsequent periods and therefore reduces group profits.

The wholly owned subsidiary's financial statements would record transactions with other members of the group without regard to its status as a member of the group. If it were profitable, the subsidiary might develop its own reserves (including asset revaluation and retained profits). However, the group's financial statements would record transactions with other members of the group such that no profit would be recognised by the group. Nevertheless, the group's financial statements would reflect changes in the subsidiary's reserves.

If the wholly owned subsidiary were sold, the group's financial statements would include the proceeds of the sale held by the holding company. The group would therefore record a profit or loss equal to the difference between the revenue from the sale and the carrying amount of the assets and liabilities of the former subsidiary (including any unamortised goodwill).

The operation of the entity-based and asset-based tax models would have a broad degree of consistency with the accounting treatment at the group level. In particular, with both the tax and accounting approaches:

- intra-group transactions are disregarded; and
- gains and losses realised during consolidation are not duplicated upon the disposal of equity.

## *Key policy issues*

### How do the models deal with loss cascading, loss and gain duplication and value shifting?

27.21 Any model for consolidation needs to prevent loss and gain duplication, loss cascading and value shifting within consolidated groups.

## Loss cascading

27.22 Loss cascading (illustrated in Chapter 25, Example 25.1) can only arise when asset value is reflected in multiple layers of ownership. Both models prevent loss cascading during consolidation by ignoring intra-group equity interests in that period (re-recognition of equity only occurring on exit). Multiple layers of ownership are eliminated during consolidation.

## Loss and gain duplication

27.23 Duplication of gains and losses (illustrated in Chapter 28, Example 28.1) arises because of dual recognition of the same value. That is, gains or losses in the value of assets held by an entity are also reflected in the value of equity in that entity. Both models prevent duplication on the sale of equity of gains and losses *realised* within consolidated groups by:

- ignoring intra-group equity interests during consolidation — the elimination of multiple layers of ownership means that dual recognition of the same value is suspended during that period; and
- on the sale of equity, taking account of realised net reinvested gains or losses when reconstructing the cost base for that equity.

27.24 As with entities outside of consolidation, where a consolidated group sells an entity containing assets that have *unrealised* gains or losses — thus removing the entity from consolidation and reconstructing duplicate cost bases — gains or losses realised on the sale of equity can be duplicated by the entity that was sold subsequently selling those assets. These problems are addressed in Chapter 28.

27.25 Duplication of gains and losses first realised at the equity level on entry into consolidation (but unrealised at the asset level) can also arise on the direct sale of assets under the entity-based model. However, the options discussed in Chapter 28 would limit the duplication of pre-consolidation losses and any remaining double counting is reversed by the adjustment to cost base of equity on exit.

## Value shifting

27.26 Artificial capital losses can be created at the equity level by transferring assets between entities at under- or over-value (value shifting — illustrated in Chapter 29, Example 29.1). Both models prevent this loss creation in relation to assets acquired during consolidation by reconstructing the cost base for equity from the cost bases of the assets covered by that equity. In the case of the entity-based model, it is necessary to apply measures

to offset any value shifting on the transfer within the group of assets held by an entity at the time of consolidation. This is to prevent the realisation of losses (or reductions in gains) on the sale of the entity that are matched by (and attributable to) unrealised ‘at-consolidation’ gains on assets the entity brought into the group and which are retained within the group. Value shifting involving at-consolidation assets is illustrated in the example in Appendix A.

27.27 Table 27.1 compares the way in which the two models deal with loss cascading, loss and gain duplication and value shifting.

**Table 27.1: Treatment of loss cascading, loss and gain duplication and value shifting**

Issue	Entity-based model	Asset-based model
Loss cascading	Both models preclude loss cascading by withdrawing tax system recognition of equity interests within consolidation.	
Duplication of gains and losses — sale of equity	The adjustment of the equity cost base on disposal to reflect net gains or losses (revenue and capital) <i>realised</i> by the entity during consolidation prevents those gains or losses from being realised again.	Gains and losses <i>realised</i> during consolidation are reflected in the cost bases of assets held by a consolidated group. The reconstruction of the equity cost bases of exiting entities equal to the sum of the cost bases of assets held in the respective entities prevents gains and losses realised during consolidation from being duplicated when equity is sold.
	Gains or losses realised during consolidation are reflected in the cost base for equity on exit, but there is no adjustment for <i>unrealised</i> gains or losses. This allows gains and losses realised at the equity level to be duplicated by the subsequent direct sale of assets. These problems are addressed in Chapter 28.	
Duplication of gains and losses — sale of assets	Asset cost bases are not adjusted for unrealised gains and losses on acquisition of an entity by a consolidated group, except to the extent that losses may be adjusted by options raised in Chapter 28. This allows duplication of gains and losses realised at the equity level by subsequently selling assets directly. The equity cost base reconstruction formula offsets this duplication when the consolidated group subsequently sells the entity.	The cost bases of the assets of an acquired entity are set equal to a consolidated group’s cost of acquiring the equity of the entity. The effect of this is that asset cost bases are adjusted for unrealised gains and losses existing when the equity is acquired by the consolidated group. This prevents gains and losses realised at the equity level from being duplicated if the assets are subsequently sold directly.
Value shifting	Value shifting rules are not required to deal with the transfer within a group of assets acquired during consolidation but are required for assets held on entry into consolidation.	Alignment of equity and asset cost bases within consolidation removes the possibility of creating artificial capital losses (or artificially reducing capital gains) at the equity level by transferring assets at under- or over-value.

## What other issues arise from the method of reconstructing the equity cost base?

27.28 A range of other differences arise between the two models because of the difference in the ways they reconstruct cost bases for equity on exit from consolidation.

- The asset-based model's method for reconstructing equity requires *valuation* of the assets of an entity being brought into consolidation at the time of entry. This is not required under the entity-based model.
- Under the asset-based model, *goodwill* on acquisition is identified as a separate asset, valued and assigned its separate cost base when an entity is brought into consolidation. Under the entity-based model, goodwill on acquisition is not separately identified but is incorporated in the cost base for equity of an entity on its entry into consolidation.
- If indexation of capital gains tax cost bases were removed, *depreciable values* of assets and the capital gains tax cost bases of those assets could be permanently aligned (as a common 'tax value'). Then, the asset-based model, because it resets asset cost bases on the entry of an entity into consolidation, would also reset the depreciable values of those assets. (Just as the price received for equity should reflect capital gains or losses on the individual assets of the entity, it should also reflect any balancing adjustments on depreciable assets.) If indexation of capital gains tax cost bases is retained, the model would have to deal with non-aligned cost bases for capital gains tax and depreciation.

27.29 Both models, because they add net reinvested income to reconstructed equity cost bases, ensure that tax-preferred income is not taxed until it is distributed to shareholders outside of the consolidated group. Notably, where a consolidated entity sells equity in assets acquired from tax-preferred income, the tax-preferred income will be reflected in the reconstructed cost base for equity and will not be taxed as a capital gain on disposal of that equity. This is consistent with treatment of a consolidated group as a single entity but different from the current arrangements which 'claw back' *tax preferences* on disposal of equity, including disposals of equity in wholly owned entities.

27.30 Table 27.2 summarises and compares these differences between the two models.

**Table 27.2: Other issues arising from the method of reconstructing equity cost base**

Issue	Entity-based model	Asset-based model
Valuation of assets	Valuation of assets is not required on acquisition of an entity. However, to offset value shifting on the intra-group transfer of at-consolidation assets, valuation may subsequently be required for the transferred assets.	Valuation of the assets of an entity is required upon its acquisition by a consolidated group. The purpose of the valuation is to align the asset cost bases with the price the consolidated group paid for the equity.
Goodwill	Goodwill on the acquisition of an entity is not explicitly recognised but forms part of the difference between the equity cost base and the asset cost base of an entity on its entry into consolidation.	Goodwill on the acquisition of an entity is explicitly recognised as an asset of the consolidated group. A consolidated group's cost base for purchased goodwill will be the difference between the price paid for an entity and the sum of the market values of the net identified assets plus the value of any franking credits or carry-forward losses of that entity at the time of acquisition.
Depreciable assets	Values for depreciation are not affected by the entry of an entity into consolidation.	Values for depreciation are reset by the entry of an entity into consolidation.
Tax preferences	Tax preferences realised by a consolidated group (including on disposal of equity) are preserved within the group until the preferentially taxed or untaxed income is distributed to equity holders.	

## How do the models handle transition?

### The asset-based model

27.31 The asset-based model requires transitional provisions to provide wholly owned groups electing to consolidate upon the commencement of the consolidation regime with a means of aligning their asset and equity cost bases. Commonly, these groups would have subsidiaries that they acquired many years earlier. In order to align the cost bases of the assets of such a subsidiary with a group's cost base for its equity a record of the market values of the subsidiary's assets, including goodwill, would be required at the time the equity was acquired. In addition, that record would need to have been updated to retain the connection between the equity cost base and assets as assets were disposed of and new assets acquired through time. Groups will not have this information.

27.32 Two possible methods of bringing groups into consolidation in the absence of this information are:

- immediate cost base alignment on a reasonable basis; or

- use of the entity-based model.

### *Transition via immediate cost base alignment*

27.33 The required resetting of the asset cost bases could be achieved by allocating the whole of the cost base for equity across the individual assets immediately upon transition. Identification of groups' goodwill on acquisition of subsidiaries would be required for this. Groups will generally have an estimate of this in connection with companies acquired from April 1985 as, since then, the Australian Accounting Standards have required this goodwill to be shown in the consolidated accounts of the group.

27.34 Because the information for allocating the equity cost base accurately would not be available, a degree of arbitrariness would necessarily be involved. One approach might be to allocate the whole of a group's cost base for equity among the assets of the subsidiary entities, including goodwill on acquisition, in proportion to their respective market values — obtained at a time reasonably close to the time of consolidation.

27.35 Separate identification of a cost base for goodwill on acquisition, under this approach, is important. Without this, cost base properly applicable to goodwill would, inappropriately, be allocated to other assets.

### *Transition via the entity-based model*

27.36 The entity-based model, if not ultimately adopted as the model for consolidation, could, nevertheless, be used as a means of handling the transition of wholly owned groups into consolidation. It would require neither separate identification of goodwill on acquisition nor valuation of assets.

27.37 Entities forming consolidated groups at the time consolidation commences would be subject to the exit rule of the entity-based model. That is, the cost base for the equity of an entity on exit would be equal to the cost base for its equity on entry adjusted for any change in the aggregate cost base of its assets.

27.38 Entities and other assets acquired after consolidation would be subject to the asset-based approach. Over time, as entities forming consolidated groups at the commencement of the consolidation regime are sold or liquidated, the scope of the asset-based system would expand.

## **The entity-based model**

27.39 The entity-based model does not require transitional provisions because it does not reset cost bases at the time of consolidation.

The difference between the models in relation to transition is summarised in Table 27.3.

**Table 27.3: Transition**

Issue	Entity-based model	Asset-based model
Transitional groups	Special rules for groups transiting into consolidation are not required.	Transitional provisions will be required to align the cost bases of assets of subsidiaries of existing wholly owned groups with the groups' cost bases for equity, upon those groups entering into the consolidation.

## How do the models handle other significant issues?

27.40 Other significant issues that the models must deal with are the treatment of groups that defer consolidation, incremental acquisition of entities by consolidated groups and the treatment of assets and equity acquired before the commencement of the capital gains tax on 20 September 1985.

### Groups that defer consolidation

27.41 The entity-based model, because it does not reset cost bases upon consolidation, does not require specific provisions for groups that defer their election to consolidate. The asset-based model could apply its transitional provisions to groups existing at the commencement of consolidation but which defer their election to consolidate. For groups formed after the commencement of consolidation and for entities acquired by groups after the commencement of consolidation, the asset-based model would require cost base alignment upon consolidation.

### Incremental acquisitions of entities

27.42 Where a consolidated group acquires an entity incrementally, the asset-based model would require that the cost bases of the assets of the acquired entity, including goodwill on acquisition, be aligned with the group's cost base for equity upon completion of acquisition. The entity-based model does not require specific provisions to deal with this as it accepts both the asset cost bases and the cost base for equity as they are at the completion of the acquisition.



## Pre-capital gains tax status

27.43 Generally, both models preserve the pre-capital gains tax status of assets and equity subject to the existing rules for preservation of pre-capital gains tax status. However, where ‘at-consolidation assets’ are disposed of during consolidation, any pre-capital gains tax equity in respect of those assets would lose its pre-capital gains tax status. The equity would automatically acquire a cost base equal to the market value of the assets at the time of their disposal.

27.44 In addition, the entity-based model requires a limitation where a group disposes of its pre-capital gains tax equity interest in a group entity. The exempt capital gain or loss is limited to the net capital gain or loss that is attributable to the underlying pre-capital gains tax property held in the exiting entity and its wholly owned subsidiaries. (This rule would be equivalent to the existing rule that limits the tax-free disposition of post-capital gains tax assets by selling pre-capital gains tax equity.)

27.45 The asset-based model stores the pre-capital gains tax status of equity with the relevant assets by tagging individual assets with a capacity to reconstruct pre-capital gains tax equity equal to a specified proportion of their values. The asset-based model, therefore, does not allow post-capital gains tax assets to be placed under pre-capital gains tax equity and a rule to limit the exempt capital gain or loss when pre-capital gains tax equity is reconstructed and sold is not required. If the assets are sold directly, any capacity in those assets to reconstruct pre-capital gains tax equity would be lost to the group. Table 27.4 compares the way the two models deal with these issues.

**Table 27.4: Treatment of groups that defer consolidation, incremental acquisition and pre-capital gains tax status**

Issue	Entity-based model	Asset-based model
Groups that defer consolidation	The formula for reconstructing equity cost bases would be applied with effect from the time such groups adopt consolidated treatment.	The standard transitional provisions (above) could apply to groups that exist when the consolidation regime commences but defer consolidation. Where there is a deferral by groups that form after the consolidation regime has commenced, the rules for incremental acquisitions could apply. These rules could also apply to groups existing when the consolidation regime commences in relation to entities acquired after that time.
Incremental acquisitions of entities by consolidated groups	The formula for reconstructing the equity cost base could be applied without modification.	The cost bases of the assets of the acquired entity, including goodwill on acquisition, would be aligned with the group's cost base for equity upon full acquisition.
Assets and equity acquired prior to 20 September 1985	The pre-CGT status of assets brought into a consolidated group would be preserved subject to the existing rules regarding the pre-CGT status of assets.	
	Where a group disposes of its pre-CGT equity interest in a group entity, the exempt capital gain or loss would be limited to the net capital gain or loss that is attributable to the underlying pre-CGT property held in the exiting entity and its wholly owned subsidiaries.	The pre-CGT status of equity would be stored with the relevant assets and used to reconstruct equity with pre-CGT status when the consolidated group sells equity in those assets. If the assets are sold, any capacity in those assets to reconstruct pre-CGT equity would be lost to the group.

## *Comparison of the proposed models: a worked example*

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### Situation

A.1 Suppose the consolidated group (Congroup) acquires the entity Subco for \$450. Subco has three businesses — A, B and C. Subco has a cost base of \$80 for the net assets of each business and current market value of the identified assets of each business is \$150 with liabilities of each of \$50. The goodwill on acquisition of Subco is \$150, with equal proportions attributable to each business, that is, \$50 each.

A.2 Immediately after the acquisition:

- due to market re-assessment, the value of each business (that is, goodwill) increases by \$50;
- A is sold out of the group (together with the liability of \$50) for \$200;
- \$100 of the proceeds from the sale of A are applied to retiring the liabilities of \$50 each of B and C and the remaining \$100 is transferred out of Subco;
- B is transferred within the group without consideration; and
- Subco is sold, holding C only, for \$250.

### Treatment under the asset-based model

A.3 On acquisition the asset cost bases are aligned with Congroup's cost base for its equity. This involves resetting the cost bases of the identified assets less liabilities of each business equal to their respective market values, which is \$150 for assets and \$50 for liabilities for each business. It also

involves identifying the separable elements of goodwill and apportioning the \$150 cost base for acquired goodwill among them, which is \$50 for each business.

A.4 On the sale of A for \$200, Congroup makes a capital gain of \$50.

A.5 The application of \$100 of the proceeds from the sale of A to discharge debts has no tax consequences.

A.6 The transfer of \$100 of the proceeds from the sale of A within the group without consideration has no tax consequences.

A.7 The transfer of B within the group without consideration has no tax consequences.

A.8 On the sale of Subco, Congroup's cost base is reconstructed equal to the sum of the cost bases of its assets; that is, \$150 for the non-goodwill assets plus \$50 for goodwill. As the cost base of \$200 is less than the sale proceeds of \$250, Congroup makes a capital gain of \$50.

A.9 Thus, overall Congroup is actually or potentially taxable on a total of \$150, which equals the increase in the value of the underlying businesses acquired. The \$50 increase in the value of B has not yet been taxed as it has not been realised.

## Treatment under the entity-based model

A.10 On acquisition, Subgroup's assets retain their existing cost bases. Goodwill on acquisition is neither identified, valued nor assigned a CGT cost base. Congroup's cost of acquiring its equity in Subco is retained as information (called 'equity cost base on entry') for reconstructing a cost base if and when Subco is sold.

A.11 On the sale of A (with liabilities) for \$200, Congroup makes a capital gain of \$120 (\$200 - \$80, or \$250 - \$130 if liabilities are added back). Part of this gain (\$70) duplicates a gain made at the equity level on and/or prior to its acquisition by Congroup — \$20 unrealised gain at acquisition on net identifiable assets and \$50 unrealised gain at acquisition on goodwill. However, this duplication will be reversed on the sale of Subco. (In terms of the formula for reconstructing equity cost base,  $ECB_n$  is reduced by \$150 whilst  $ACB_x$  is reduced by only \$80.)

A.12 The use of \$100 of the proceeds from the sale of A to retire debts of businesses still operated within Subco has no tax consequences.

A.13 The transfer of the \$100 proceeds from the sale of A within the group without consideration has no immediate tax consequences — the cash

proceeds are not an at-consolidation asset. Also, it reduces both Subco's market value and its asset cost base by \$100.

A.14 The transfer of B within the group without consideration removes from Subco assets accounting for \$200 of Congroup's cost base for its equity in Subco — \$150 for the at-consolidation value of identified assets and \$50 for the at-consolidation value of goodwill. However, it only removes \$130 from the asset cost base available for reconstructing Congroup's cost base for equity. (The \$80 cost base for the net assets at acquisition was made up of \$130 for assets and -\$50 for liabilities. The liabilities were retired before B's transfer.) Therefore, a value shifting rule is required to remove the at-consolidation unrealised gain of \$70 (\$20 on identified assets and \$50 on goodwill) from the cost base that can be reconstructed for Congroup's equity in Subco. This negative adjustment would be made to the at-entry equity cost base for Subco.

A.15 After this adjustment, Congroup's reconstructed cost base for equity in Subco would be \$380 ( $\$450 - \$70$ ) for at-entry equity plus the increase in the cost base for Subco's assets during consolidation. At consolidation, the cost base for Subco's assets was \$240 (\$80 for each of the three businesses). At exit, the cost base for Subco's assets is \$130 (\$80 at entry plus \$50 as a result of removing negative cost base on the retirement of debt) — a reduction of \$110. Congroup's reconstructed cost base is, therefore, \$270 ( $\$380 - \$110$ ).

A.16 Congroup, therefore makes a capital loss of \$20 on the sale of Subco (cost base of \$270 less proceeds of \$250).

A.17 Congroup will thus have realised a net capital gain of \$100 from the disposal of businesses A and C (a gain of \$120 on the sale of A and a loss of \$20 on the sale of Subco containing C).

A.18 In addition, Congroup has an unrealised gain of \$50 on Business B. B has a market value \$250. Congroup's cost base for B is made up \$80 at acquisition, plus \$50 for the removal of negative cost base on the retirement of debt, plus \$70 increase in the equity cost base for the entity now holding B, following the application of the value shifting adjustment.

A.19 Thus, overall, Congroup is actually or potentially taxable on a total of \$150 (the correct amount) under the equity-based model, as it is under the asset-based model.

A.20 Table A.1 tracks the realisable capital gain/loss (–) on the sale of Subco immediately following any of the events involving it during consolidation.

Table A.1: Calculation of realisable gain from Subco

Immediately after	Market value of Subco \$	Reconstructible cost base for Subco $ECB_x = ECB_n + (ACB_x - ACB_n)$ \$	Realisable gain \$
Congroup buys Subco	450	$450 = 450 + (240 - 240)$	0
Market re-assessment	600	$450 = 450 + (240 - 240)$	150
Congroup sells A	600	$570 = 450 + (360 - 240)$	30
Transfer cash out of Subco	500	$470 = 450 + (260 - 240)$	30
Transfer B out of Subco	250	$270 = 380 + (130 - 240)$	-20

