
TOWARDS SINGLE RECOGNITION OF LOSSES AND GAINS

outside consolidation

<i>A case for reform</i>	593
Realised and unrealised loss duplication	593
Realised and unrealised gain duplication	596
 <i>A strategy for reform</i>	 597
To recognise an economic loss or gain only once	597
To integrate shareholder and entity interests?	597
 <i>Key policy issues</i>	 597
How could loss cascading be prevented?	597
How could duplication of realised losses be prevented?	598
How could duplication of unrealised losses be prevented?	599
How could duplication of realised and unrealised gains be prevented?	602
How could duplication of realised losses and gains in majority ownership cases be prevented?	603
 <i>Appendices</i>	
Appendix A: Additional discussion of some options	606

A case for reform

28.1 Duplication arises when a single economic loss or gain is recognised by the tax system more than once. This can occur because losses and gains on assets are reflected in the value of interests in the entities that own those assets. Under the present capital gains tax system, duplication of an economic loss or gain — capital or revenue, realised or unrealised — may arise upon disposal of interests in the entity that has produced the loss or gain.

Realised and unrealised loss duplication

28.2 With realised losses, the continuity of ownership test could prevent duplication by denying the loss to the company where there has been a substantial change in the company's majority underlying ownership. However, a company under new ownership may still claim the benefit of a carry-forward loss if it satisfies the same business test (referred to in Chapter 26).

28.3 The same business test was introduced prior to the introduction of the capital gains tax system at a time when a capital loss could not be claimed on disposal of equity interests in a 'loss company'. It served to allow losses to be utilised only once and only if the purchase of the loss company was not tax motivated. In a capital gains tax environment, the same business test effectively operates to allow the recoupment of losses by a company even though the losses have already been allowed to previous owners on the disposal of equity in the company.

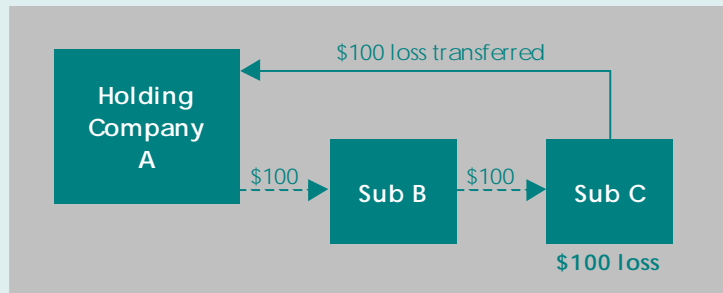
28.4 Where losses are unrealised at the time of a change in ownership (that is, assets are valued below cost), there are no restrictions upon the duplication of those losses through the subsequent realisation and recoupment of the losses by the entity under new ownership.

28.5 The duplicated realised and unrealised losses may be partly clawed back in the sale price or in later distribution of income that is sheltered by the loss. Nevertheless, the availability of the loss to the entity presents at least a deferral problem. The compensating transactions may not completely claw back the duplication or arise for a significant length of time.

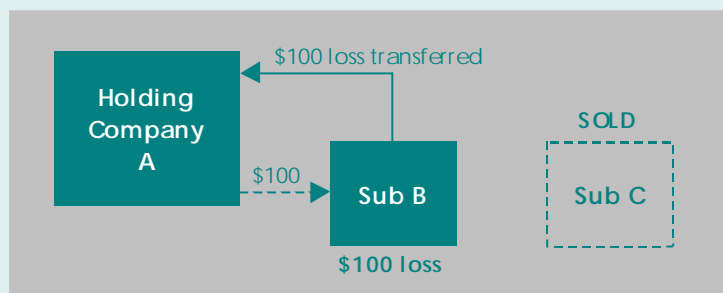
28.6 The following examples illustrate various forms of loss duplication.

Example 28.1: Loss duplication — loss cascading

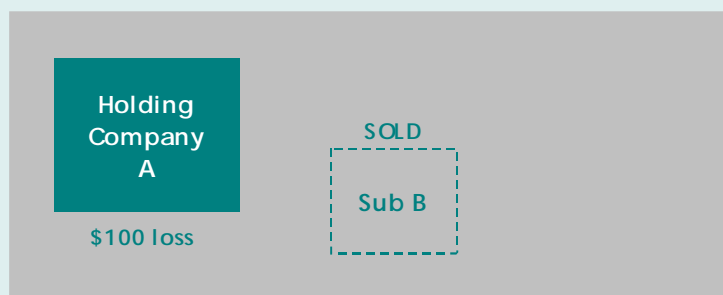
Suppose holding company A capitalises subsidiary B with \$100. Subsidiary B, in turn, capitalises subsidiary C with the same \$100. Subsidiary C acquires an asset for \$100, but the investment is poor and the value of the asset falls to nil. Subsidiary C disposes of the asset for its market value of nil, incurring a loss of \$100. The loss is then transferred under the grouping provisions to holding company A.



Subsidiary C has no market value, but subsidiary B's cost base for its equity in subsidiary C is still \$100. Accordingly, disposal of subsidiary C by subsidiary B will create a duplicate capital loss of \$100, which may also be transferred to holding company A.

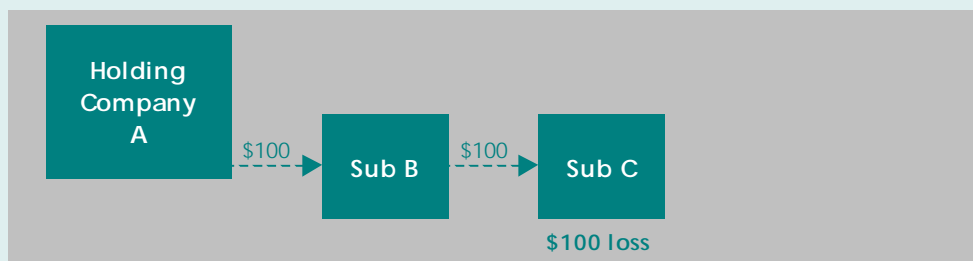


A further capital loss of \$100 could be created by holding company A through the disposal of subsidiary B. The original loss in subsidiary C would then be multiplied threefold to \$300 in holding company A. This form of loss duplication is called 'loss cascading'.

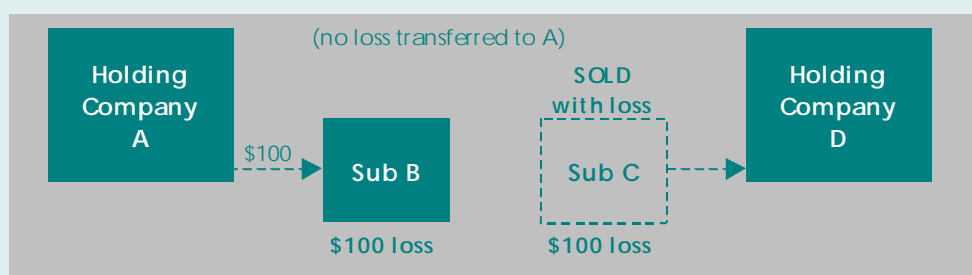


Example 28.2: Another form of loss duplication

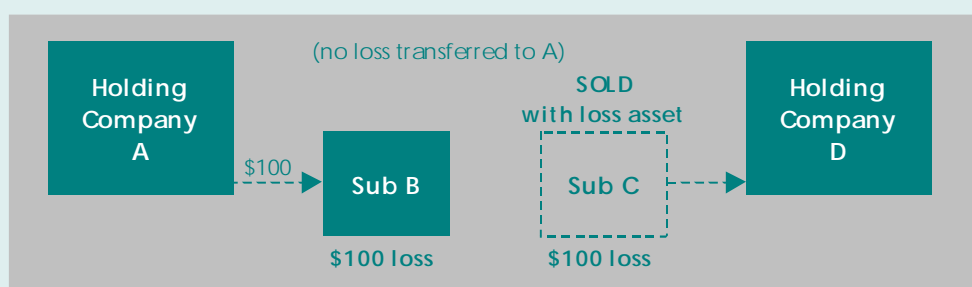
As in Example 28.1, subsidiary C disposes of its asset for its market value of nil and incurs a loss of \$100.



Instead of the loss of subsidiary C being transferred to holding company A, subsidiary B sells the shares in subsidiary C to holding company D. Subsidiary B would incur a loss of \$100 on the sale of the shares. Subsidiary C could offset its loss against income at some point in the future subject to satisfying the same business test. The loss allowed to subsidiary C is a duplicate of the loss allowed to subsidiary B.

**Example 28.3: Duplication of unrealised loss**

Instead of subsidiary C realising the loss asset by disposing of it (as in the above example), subsidiary B sells shares in subsidiary C while subsidiary C holds an asset with an unrealised loss of \$100. Subsidiary B would incur a loss of \$100 on the sale of shares. Subsidiary C could subsequently sell its asset and realise a duplicate loss of \$100.



Loss cascading

28.7 Example 28.1 illustrates the process of loss cascading, whereby losses are artificially duplicated through a chain of companies. Cascading is facilitated by the existence of loss transfer and asset rollover concessions applying to wholly owned company groups. The loss cascading issue is particularly severe because it effectively allows multiple losses to *the same wholly owned group*.

28.8 A series of legislative amendments has been introduced in recent years to limit the potential for loss cascading in certain circumstances. An important amendment is the proposed new provision in Part IVA of the 1936 Act which would bring capital loss generation schemes within the general anti-avoidance net. While the amendments deal with particular forms of loss cascading, they do not address what is a structural problem in a systemic way.

No change in majority ownership

28.9 Loss cascading may also occur where an entity with losses or 'loss assets' (assets valued below cost) is disposed of within a majority owned group. This method of loss duplication relies on taxpayers' ability to dispose of a legal ownership interest in an entity for a loss without having to dispose of their economic interest.

28.10 This can be demonstrated by modifying Example 28.2 to include a further company as the majority owner of both holding company A and holding company D. In these circumstances, multiple losses could be allowed to the same majority owned group. Company C would be allowed to carry-forward its realised loss as it would satisfy the continuity of ownership test. (Broadly, the continuity of ownership test, in its current form, would only be failed when there is a change in majority *beneficial* interest.) The same business test would be irrelevant.

Realised and unrealised gain duplication

28.11 Duplication of realised or unrealised gains may arise where a company retains taxed profits or owns 'gain assets' (assets valued above cost) and the owner subsequently disposes of the company to realise a gain. The amount of this gain will either reflect the retained profits that have already been subject to taxation or the gain assets which, when sold, will be subject to taxation. Double taxation may therefore arise (as illustrated in Appendix A, Chapter 25).

28.12 A distribution of profits after the change in ownership of the company may result in a decrease in the value of shares in the company, thereby giving rise to a loss or reduced gain on any subsequent disposal of the

company. This would offset the prior double taxation. However, the current law could, in some circumstances, deny a loss by reducing the cost base of the shares.

A strategy for reform

To recognise an economic loss or gain only once

28.13 A single economic loss or gain should only be recognised by the tax system once. The challenge is to determine workable arrangements to achieve this outcome. The objectives and policy design principles in *A Strong Foundation* help in assessing different options aimed at this result.

To integrate shareholder and entity interests?

28.14 An important criterion for evaluating the options should be the extent to which each option ensures that a net gain is assessed to the taxpayer deriving the economic gain. Similarly, a net loss should be allowable to the taxpayer bearing the economic loss. This would be consistent with the principle identified in *A Strong Foundation* of integrating shareholder and entity interests.

28.15 Also important is the need to balance the integrity benefits of each option against the associated costs, including compliance and administration costs.

Key policy issues

How could loss cascading be prevented?

Under the current proposals for consolidation

28.16 Under a system of taxing entity groups on a consolidated basis, loss cascading would not be an issue. Losses of consolidated groups would only be recognised once — at the asset level or at the equity level.

28.17 Under the principles for consolidation discussed in Chapter 26, the existing group concessions would be removed for corporate groups that do not elect to consolidate. In the absence of the loss transfer or asset rollover concessions outside consolidation, the scope for extraction of a carry-forward

loss or loss asset from an entity — a requirement for loss cascading — is greatly reduced.

28.18 If the consolidation proposals and the associated removal of the existing group concessions do not proceed, the issue of cascading will need to be revisited.

Extend existing rules to cover disposals of entities within the same majority-owned group

28.19 Current rules effectively prevent a capital loss from arising on the sale of a loss asset (including shares in a company) from one member of a *wholly owned* group of *companies* to another. Such rules should be extended to cover asset disposals within the same *majority*-owned group of entities. This should prevent loss cascading from disposals of entities within the same majority-owned group.

How could duplication of realised losses be prevented?

Amend the existing continuity of ownership test

28.20 Broadly, the existing continuity of ownership test is satisfied if the majority ownership of an entity in the year a loss was incurred is the same as in the year the loss is sought to be recouped. An amendment is required to remedy a defect in the test. The defect stems from the lack of any requirement to test for proportionate changes in shareholding among a continuing group. Table 28.1 shows that Bertha's holding in a company increased from 1 per cent to 99 per cent without the continuity of ownership test being failed. The prior realised losses may be almost completely duplicated in the corresponding selling down of Paul's interest from 99 per cent to 1 per cent.

28.21 This problem could be corrected by requiring that the owners, at the time a loss is recouped, each hold equity that they held when the loss was incurred and that the aggregate of such equity be more than 50 per cent of the equity of the entity on each occasion. Table 28.1 shows that the aggregate of equity held by both Paul and Bertha at the time the loss was both incurred and recouped was only 2 per cent. Table 28.2 illustrates circumstances where the reformulated test would be passed (with some loss duplication still possible).

Table 28.1: Illustration of how the test could be failed

Shareholder	Shares held when loss incurred as a percentage of total equity	Shares held when loss recouped as a percentage of total equity	Shares that satisfy the reformulated continuity of ownership test
Paul	99	1	1
Bertha	1	99	1
Total	100	100	2

The company fails the reformulated test because there is only a 2 per cent continuity of ownership. The test requires continuity of more than 50 per cent.

Table 28.2: Illustration of how the test could be satisfied

Shareholder	Shares held when loss incurred as a percentage of total equity	Shares held when loss recouped as a percentage of total equity	Shares that satisfy the reformulated continuity of ownership test
Perry	51	49	49
Brunehilde	49	51	49
Total	100	100	98

The company passes the reformulated test because there has been a 98 per cent (that is, more than 50 per cent) continuity in ownership.

Remove the same business test

28.22 The continuity of ownership test allows access to realised but unrecouped losses incurred by an entity during the tenure of an owner by allowing that owner a tax loss on the disposal of equity. To prevent duplication, the entity being sold should be denied the ability to carry-forward its tax losses if it fails the continuity of ownership test (discussed in Chapter 26). Thus, the same business test needs to be removed to prevent the duplication.

How could duplication of unrealised losses be prevented?

28.23 The existing continuity of ownership test that prevents transfers of ownership of company losses applies only to realised losses. The purpose of these rules can be circumvented by selling companies with unrealised losses, as there are no rules to prevent the losses being realised and utilised under the new ownership.

28.24 The option for preventing duplication of realised losses will be fully effective only if implemented in conjunction with one of the options for

dealing with unrealised losses. The two options discussed below for preventing duplication of unrealised losses could apply where:

- there has been a change in the majority underlying ownership of an entity; and
- an unrealised net loss exists in respect of the underlying assets of the entity.

28.25 Australia already has an equivalent rule in relation to bad debts. If applied to other unrealised losses on assets, it would require continuity of majority ownership from the time an asset was acquired until it was realised before a loss could be utilised. The following options are much less stringent than this test.

28.26 The options would apply also in the context of depreciable assets. Accordingly, a reference to an asset cost base should be taken to mean the reduced cost base, where relevant. A reduction in the cost base of a depreciable asset means a reduction in the asset's tax value for depreciation purposes.

28.27 Table 28.3 provides a summary of the identified advantages and disadvantages of each option.

Option 1: Adopt a Canadian-based approach

28.28 Measures dealing with the utilisation of unrealised capital losses currently exist in the Canadian taxation system. This option is based on the Canadian system.

28.29 Where the abovementioned criteria are satisfied, any unrealised capital losses attached to assets of the entity would be deemed to have been realised immediately before the change in ownership occurred.

28.30 Any unrealised capital loss that is deemed to be realised would be offset first against capital gains actually realised by the entity before the change in ownership. Any remaining deemed capital loss would then be allowed to be offset against the gains from the entity's assets treated, at the entity's option, as having been disposed of on change of ownership. Any deemed capital loss not able to be offset would be cancelled.

28.31 The option is consistent with the existing taxation rules dealing with current year capital and revenue losses when the majority underlying ownership of a company changes. Broadly, the current year loss rules prevent profits derived by a company in one part of a year of income (when it was owned by one set of shareholders) from being offset by losses incurred by the company during another part of the year (when it was owned by a different set of shareholders).

28.32 The option is also consistent with the proposed treatment of realised losses if the same business test were removed. The option denies the *whole* amount of a net loss to the entity where at least 50 per cent of the loss has been allowed on the sale of equity in the entity. The remaining portion of the loss would be available to the continuing equity owners when they sell the rest of the equity.

Option 2: Adopt a United Kingdom-based approach

28.33 Measures dealing with the utilisation of unrealised capital losses also currently exist in the United Kingdom taxation system. This option is broadly based on the United Kingdom system and is a variation of Option 1.

28.34 When an asset owned by the entity before the change in ownership ('pre-entry asset') is subsequently disposed of for a capital loss after a relevant change in ownership, the loss realised by the entity would be apportioned between, and allocated to, the pre- and post-ownership change period. This could be achieved by apportioning on a time or expenditure basis or a combination of both.

28.35 The pre-ownership portion of the loss would only be allowed to be offset against pre-ownership gains realised by the entity after the change of ownership. This would ensure that the pre-ownership portion of the loss cannot be duplicated by being used to offset gains accrued after the change in ownership.

28.36 Pre-ownership gains would be determined by applying similar apportionment rules as those applying for the unrealised losses. Any pre-ownership loss not able to be offset would be cancelled.

Table 28.3: Removing duplication of unrealised losses — comparison of the options

Option	Would tax loss arise in respect of taxpayer who incurred the loss?	Advantages	Disadvantages
Adopt rules based on Canadian model.	Yes. Losses are allowed to equity owners on sale of equity. Losses are denied to the entity where at least 50 per cent of the losses have been allowed at the equity level.		There would be some compliance and administration costs because market valuations would be required on change of majority underlying ownership.

Adopt rules based on the United Kingdom model.	Yes. Losses are allowed to equity owners on sale of equity. Losses are denied to the entity where at least 50 per cent of the losses have been allowed at the equity level.	Does not require market valuations on change of majority underlying ownership.	The calculation of pre-acquisition net losses would be arbitrary and potentially imprecise. The entity would need to 'tag' its pre-entry assets and keep records of unused losses available for future recoupment.
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How could duplication of realised and unrealised gains be prevented?

Extend the allowance of a capital loss to new equity owners

28.37 Double taxation of realised and unrealised gains are nullified by allowing a capital loss to the new equity owners (via a share buy-back or on selling the equity) resulting from the distribution of pre-acquisition realised and unrealised gains. Currently, individual portfolio interests already attract the loss — see Chapter 20. However, majority owners could, in certain circumstances, be prevented from realising a capital loss on disposal of equity because the equity cost base is reduced by any distribution of pre-acquisition profits. Under this option, in all cases, the equity cost base in an entity would not be reduced by distributions of pre-acquisition profits.

28.38 The option would be made possible by the full franking of previously unfranked inter-corporate distributions (or the removal of the section 46 rebate on those). For pre-acquisition unrealised gains, the allowance of the capital loss balances the application of tax on the distribution of untaxed profits. For pre-acquisition realised gains, the allowance of the capital loss removes the double taxation occurring first at the time of realisation and secondly at the time of the subsequent sale of equity.

28.39 This option is consistent with the options for a dividend-consistent treatment of share buy-backs and equivalent distributions discussed in Chapter 20. Table 28.4 provides a summary of the identified advantages and disadvantages of the option.

Table 28.4: Removing duplication of realised and unrealised gains by extending the allowance of capital loss to new equity owners — advantages and disadvantages

Would taxed gain in an entity be attributed to the taxpayer who realises the gain?	Would an entity's tax-preferred income be attributed to the taxpayer who realises the income?	Other advantages	Other disadvantages
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Would taxed gain in an entity be attributed to the taxpayer who realises the gain?	Would an entity's tax-preferred income be attributed to the taxpayer who realises the income?	Other advantages	Other disadvantages
Yes — but, if the entity (including franking credits) is not sold for full value, gains could be taxed at a marginal rate different from the original equity owner's marginal rate. The amount of tax effectively paid would depend on any difference in marginal tax rate between the original owner and subsequent owner(s) receiving taxed distributions. Also, tax on an economic gain could be borne, at least in part, by subsequent equity owners.	Yes. A capital loss would nullify any double tax borne by new equity owners when the tax-preferred income is distributed.	All taxpayers are treated the same regardless of the level of ownership interest held in an entity. Equity and neutrality is therefore achieved.	The compensating capital loss would be deferred.

How could duplication of realised losses and gains in majority ownership cases be prevented?

28.40 The models presented in Chapter 27 for determining the cost base for equity sold by a consolidated group can be adapted to deal with duplication of losses and gains in majority ownership situations. These models provide different ways for dealing with realised losses and gains. Accordingly, they would modify the proposals earlier in this chapter in relation to the continuity of ownership test for losses. The choice of option is independent of the option adopted for determining the cost base of equity sold by a consolidated group (discussed in Chapter 27).

28.41 Table 28.5 provides a summary of the identified advantages and disadvantages of the options.

Option 1: Adjust equity cost bases using the entity-based model

28.42 This option would increase a single (associate inclusive) majority owner's equity cost base by an amount of net gains realised by the entity during the period of majority ownership. The equity cost base would be increased by the owner's proportionate interest in the underlying realised gains (less amounts distributed to shareholders). This may be achieved under a model similar to the entity-based model for consolidation — discussed in Chapter 27. A more complete discussion of the option is contained in Appendix A.

Option 2: Adjust asset cost bases using the asset-based model

28.43 This option would align the entity's cost bases for its assets with the aggregate cost base for equity in the entity. This option is based on the asset-based model for consolidation discussed in Chapter 27. That model would, however, need to be adapted to the circumstances of majority ownership under this option. Neither the entity nor a single (associate inclusive) majority equity owner would know the aggregate cost base for equity in the entity — the cost bases of the equity of the minority owners would not be known.

28.44 Instead, when majority ownership is attained, the aggregate equity cost base would be calculated as if the majority owner had purchased the whole of the minority interests at the prevailing market price.

28.45 The approach would require the identification of goodwill of the entity equal to the difference between the market value of equity in the entity and the market value of the assets of the entity. Assignment of cost base to this goodwill asset would then form part of the alignment of cost bases. If this goodwill were ignored, the cost base attributable to goodwill would, inappropriately, be spread over the other assets.

28.46 A more complete discussion of the option is contained in Appendix A.

Table 28.5: Removing duplication of realised losses and gains using the consolidation models — advantages and disadvantages

Option	Would taxed gain or tax loss in an entity be attributed to the taxpayer who realises the gain or loss?	Would an entity's tax-preferred income be attributed to the taxpayer who realises the income?	Other advantages	Other disadvantages
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Option	Would taxed gain or tax loss in an entity be attributed to the taxpayer who realises the gain or loss?	Would an entity's tax-preferred income be attributed to the taxpayer who realises the income?	Other advantages	Other disadvantages
Adjust equity cost bases using either the entity-based or asset-based models in majority ownership cases.	Subsequent equity owners would bear the tax on pre-acquisition gains at their marginal rate. Realised but unutilised losses, however, would be allowed to the original owner at the owner's rate.	No. The original equity owner would not be taxed on tax-preferred income accrued during its ownership while new equity owners would effectively be taxed on distribution of previously accrued income. The issue does not arise when the models are applied to a consolidated group because group entities are to be treated as a single entity.	Applies symmetrically to remove duplication of realised gains and losses.	It requires a more liberal continuity test than the one currently applying. The modified test would cancel carry-forward losses only when an entity passes out of a particular majority ownership situation. Compliance cost could be high. Applies only to single majority owners.

Additional discussion of some options

<i>Adjust equity cost bases under the entity-based model</i>	605
<i>Adjust asset cost bases under the asset-based model</i>	608

Adjust equity cost bases under the entity-based model

A.1 In the entity-based model for consolidation, losses realised by an entity during consolidation would be reflected in lower asset cost bases of replacement assets. A departure from this treatment is required where the model is applied to entities under single majority ownership outside of consolidation as it would result in the equity cost base of a majority owner being reduced for a realised loss, even though the loss had not been utilised. The loss could then be utilised under a changed majority owner. This problem is overcome by treating the carry-forward losses of the entity as assets with a cost base equal to their face value.

A.2 In applying the entity-based model outside consolidation, a majority owner's equity cost base in an entity would be reconstructed as follows:

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

where:

ECB_x is the majority owner's cost base for the equity at the time of disposal;

ECB_n is the majority owner's cost base for:

- all of its equity immediately upon acquiring majority ownership; and
- parcels of the equity acquired whilst being the majority owner;

ACB_x is the sum of the asset cost bases on disposal of the equity;

ACB_n is the sum of the asset cost bases when the equity was acquired, or if the equity was acquired before the taxpayer became the majority owner, the sum of the asset cost bases when the taxpayer became the majority owner; and

α is the majority owner's equity interest being disposed of expressed as a percentage of the total equity in the entity.

A.3 Where a majority owner acquires additional equity after becoming the majority owner, the formula applies to each parcel of subsequently acquired equity separately.

A.4 The formula applies in determining the cost base for equity sold whilst a majority owner or on ceasing to be a majority owner. If some equity is retained on ceasing to be a majority owner, the cost base for that equity is fixed by applying the formula at that time, after which the formula ceases to have further application to that equity. A new application of the formula would occur if that owner re-established majority ownership.

A.5 Majority equity owners would be in a position to obtain the required information from the entity to work out the adjustment amounts.

A.6 Examples A.1 and A.2 illustrate the application of the model in various scenarios. Before-tax gains are used in the examples for illustrative purposes. Tax would not affect the validity of the examples.

Example A.1: Majority owner sells all equity

Assume the following facts occur in sequence.

- Company H pays \$60 in subscribing for 60 per cent of the total equity in company S on its creation (that is, the equity cost base on acquisition, ECB_n , is \$60).
- S carries on a business and realises a before-tax profit of \$180. Assuming no other assets apart from contributed capital and profits, S's market value increases to \$280 (that is, initial capital in S of \$100 plus \$180 profit).
- H sells all its equity in S for its market value of \$168 (60 per cent x \$280).

All of H's equity would be subject to reconstruction under the formula because it was acquired when H became majority owner of S and sold on H ceasing to be majority owner. Accordingly, H's reconstructed equity cost base would be:

$$\begin{aligned} ECB_x &= ECB_n + \alpha(ACB_x - ACB_n) \\ &= \$60 + 60\%(\$280 - \$100) \\ &= \$168 \end{aligned}$$

Since H's reconstructed equity cost base in S is equal to the market value of the equity, no capital gain or loss would arise on the disposal of equity by H.

Example A.2: Minority owner becomes majority owner and then sells some equity

Assume the following facts occur in sequence:

- Company H pays \$50 subscribing for 50 per cent of the total equity in company S on its creation (that is, the equity cost base on acquisition, ECB_n , is \$50).
- S carries on a business and realises a before-tax profit of \$180. Assuming no other assets apart from contributed capital and profits, S's market value increases to \$280 (that is, the initial capital in S of \$100 plus \$180 profit).
- H acquires a further 10 per cent of equity in S for its market value of \$28 (that is, 10% of \$280).
- S continues to trade and realises a profit of \$120. Assuming no other assets apart from contributed capital and retained profits, S's market value increases further to \$400 (that is, the market value of \$280 from contributed capital and previous profits plus profit of \$120).
- H acquires a further 10 per cent of equity in S for its market value of \$40 (that is, 10% of \$400).
- S continues to trade and realises a profit of \$100. Assuming no other assets apart from contributed capital and retained profits, S's market value increases further to \$500 (that is, the market value of \$400 from contributed capital and previous profits plus profit of \$100).
- H sells 40 per cent of the equity in the entity for its market value of \$200 (that is, 40% of \$500).

H's cost base for the equity does not become linked to the formula until H becomes a majority owner. This occurs when H increases its ownership of the equity from 50 per cent to 60 per cent.

As is the case under the existing law, H would be free to nominate the parcel of equity being sold. Assuming H chooses to sell 20 per cent from the parcel acquired initially and both of the 10 per cent parcels acquired subsequently, H's reconstructed equity cost base would be calculated as follows:

- in relation to the 20 per cent of equity, the ECB would not be adjusted by the formula from the time H became majority owner;

$$\begin{aligned} ECB_x &= ECB_n + \alpha(ACB_x - ACB_n) \\ &= \$20 + 20\%(\$500 - \$280) \\ &= \$64 \end{aligned}$$

continued

Example A.2: Minority owner becomes majority owner and then sells some equity (cont)

- in relation to the 10 per cent of equity acquired on H becoming majority owner;

$$\begin{aligned} ECB_x &= ECB_n + \alpha(ACB_x - ACB_n) \\ &= \$28 + 10\%(\$500 - \$280) \\ &= \$50 \end{aligned}$$

- in relation to the 10 per cent of equity acquired after becoming majority owner;

$$\begin{aligned} ECB_x &= ECB_n + \alpha(ACB_x - ACB_n) \\ &= \$40 + 10\%(\$500 - \$400) \\ &= \$50 \end{aligned}$$

The sum of the equity cost bases = \$64 + \$50 + \$50 = \$164.

The capital gain on sale of equity = \$200 - \$164 = \$36.

The capital gain represents 20 per cent of the realised gains that accrued in S between when H acquired its initial equity holding and when H became a majority owner (that is, \$180). The gain is duplicated because the equity was acquired before H became majority owner.

As H ceases to be a majority owner, the cost base for its remaining equity is reset at cessation by the formula. Because of H's selection when selling equity, the 30 per cent of equity in S retained by H is part of H's original stake in S. Applying the formula to this equity;

$$\begin{aligned} ECB_x &= ECB_n + \alpha(ACB_x - ACB_n) \\ &= \$20 + 30\%(\$500 - \$280) \\ &= \$86 \end{aligned}$$

This cost base includes a pro rata share of the net reinvested profits occurring while H was a majority shareholder.

Adjust asset cost bases under the asset-based model

A.7 If the asset-based model for consolidation were applied outside consolidation, losses realised (but unutilised) by an entity would be denied to single majority owners when they dispose of their equity. The loss could then be utilised by the entity under new majority ownership. This problem is overcome by treating the carry-forward losses of the entity as assets with cost bases equal to their respective amounts.

A.8 After alignment, as in consolidation, the majority owner's cost base for equity would be linked to the entity's cost base for its assets (including the amount of carried forward losses) — it would be a pro rata amount of the entity's cost base for assets. It is this feature that would prevent gains and losses realised by the entity from being duplicated when the owner sells equity.

A.9 It could be necessary to require that the asset cost bases be reset where the owner acquires substantial additional equity at a significantly different price.

A.10 If the owner acquired 100 per cent ownership and brought the entity into consolidation, the asset-based model already in place could be extended to the consolidation situation.

