

*Worked example*

## Transitional provision for foreign-held, Australian-resident subsidiaries to be members of a MEC group

**Description** The examples in this section show how a wholly-owned, Australian-resident subsidiary can be a member of a MEC group even when a foreign-resident entity is interposed between it and other members of the MEC group, provided the MEC group is formed during the transitional period for consolidation – that is, from 1 July 2002 to 30 June 2004.

This section also explains how the application of the cost setting rules for a foreign-held member differs according to whether membership interests in the member are held directly or indirectly by the foreign-resident entity.

**Commentary** A wholly-owned, Australian-resident subsidiary of one or more eligible tier-1 companies of a MEC group can be a member of that MEC group only if any entities interposed between it and the eligible tier-1 companies:

- are also members of the MEC group, or
- hold membership interests only as nominees for other members of the MEC group.

However, where a MEC group is formed during the transitional period a wholly-owned, Australian-resident subsidiary is allowed to become a member even when the interposed entity is a foreign resident, provided it satisfies further tests known as the ‘interposed foreign resident entity (IFRE) tests’.

For a company to be a subsidiary member of a MEC group under the IFRE tests, the group must form before 1 July 2004 and, at the formation time:

- the company must be an eligible resident company
- the company must be a wholly-owned, Australian-resident subsidiary of one or more eligible tier-1 companies of the group
- there must be at least one non-resident company or trust interposed between the test company and the eligible tier-1 companies, and
- any other entity interposed between the test company and the eligible tier-1 companies must be either:
  - a non-resident company or trust (or a partnership in which each partner is a non-resident company or trust), or
  - a member of the MEC group (or an entity holding membership interests as a nominee for one or more other members of the MEC group).

There are restrictions on trusts and partnerships being members of a MEC group under the IFRE tests. A resident trust or partnership (and their subsidiaries, if any) cannot be members of a MEC group where they

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immediately follow the IFRE – that is, where any membership interests in them are directly held by the IFRE. They can be members under the IFRE tests only if some or all membership interests in them are owned by companies that are already subsidiary members of a MEC group under the IFRE tests and any remaining interests are held by other members of the group.

→ For more information on eligibility see page 3.

#### Note

##### **'All in' principle applies**

Where an entity qualifies to be a subsidiary member of a MEC group under the IFRE tests, the 'all in' principle in consolidation requires that it must be a member of the group.

### **Cost setting implications for different types of foreign-held subsidiary**

The members of a MEC group under the IFRE tests are classified into two categories:

- If the member immediately follows an IFRE it is known as a 'transitional foreign-held subsidiary' (TFHS).
- If the member does not immediately follow an IFRE it is known as a 'transitional foreign-held indirect subsidiary' (TFHIS).

This is because the cost setting rules apply differently to each category.

→ For more information on the categories of foreign-held subsidiary and cost setting implications see page 6.

### **Transitional period**

Only MEC groups that form by 30 June 2004 can have members under the IFRE tests. This means a potential MEC group that has not formed a MEC group by 30 June 2004 does not include foreign-held subsidiaries.

After formation, an entity can be a TFHS of a MEC group only if it was a subsidiary member under the IFRE tests at the formation time. This prevents a company becoming a TFHS of an existing MEC group if the company was not at least partly foreign-held at the formation time.

→ For more information on eligibility at and after the formation time see page 3.

## Examples

### Basic eligibility

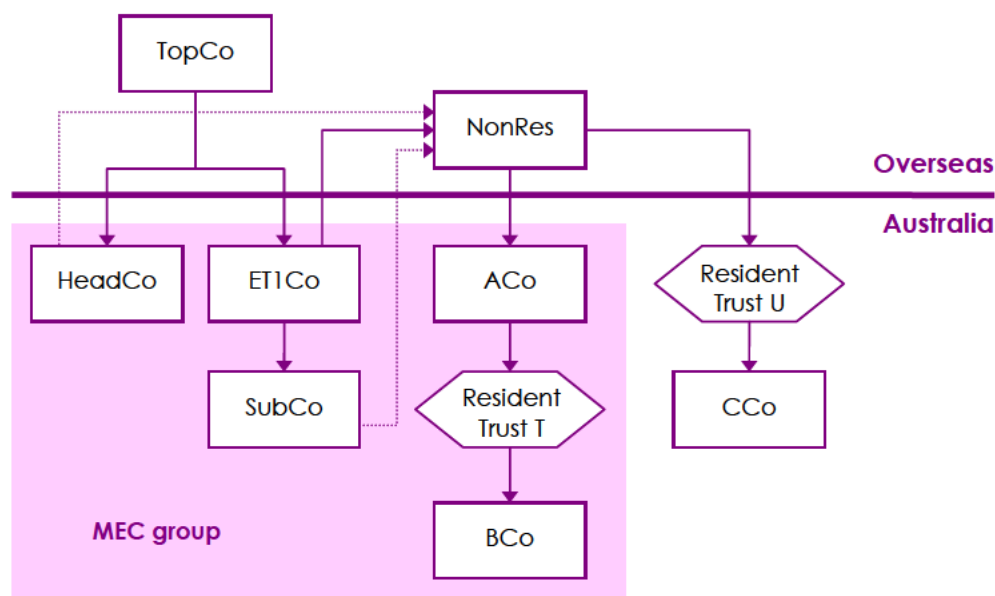
As shown in figure 1, the foreign-resident entity NonRes is interposed between an eligible tier-1 company, ET1Co, and some of its wholly-owned, Australian-resident subsidiaries: the companies ACo, BCo and CCo, and the trusts Resident Trust T and Resident Trust U.

Under the IFRE tests:

- ACo is a member of the MEC group.
- Resident Trust T and its subsidiary company BCo are members of the MEC group because Resident Trust T is a wholly-owned subsidiary of ACo, which is a member of the MEC group under the IFRE tests.
- Resident Trust U is not a member of the MEC group because a resident trust or partnership cannot be a member if it immediately follows the IFRE. CCo, which is a subsidiary of Resident Trust U, also cannot be a member.

The IFRE can be a wholly-owned subsidiary of one or more eligible tier-1 companies of the MEC group and/or other subsidiary members of the group. In this example, the eligibility of the foreign-held subsidiaries would be the same if NonRes were wholly owned by ET1Co, SubCo or HeadCo, or any combination of these.

**Figure 1: Membership of foreign-held subsidiaries**



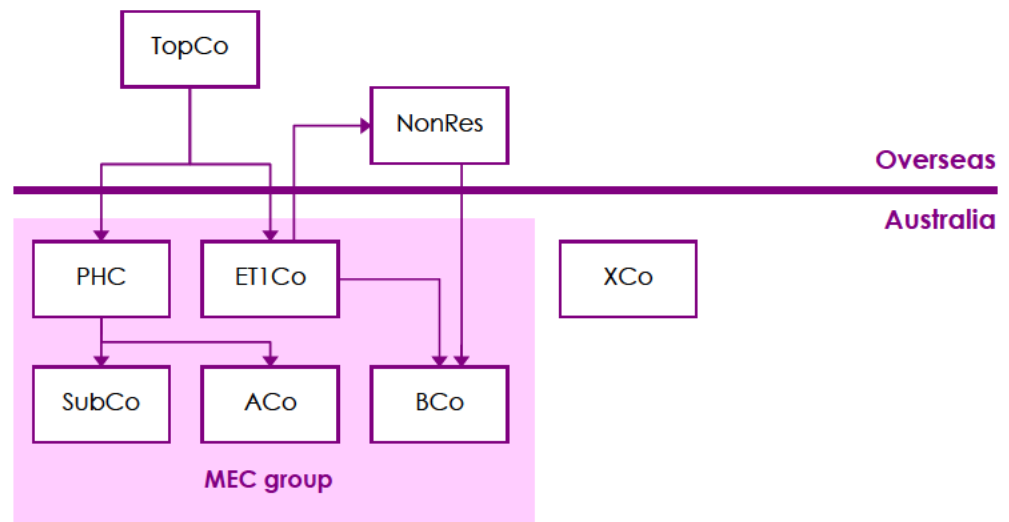
### Eligibility – time of formation and post-formation changes

After formation, a company can cease to be a transitional foreign-held subsidiary of a MEC group if its circumstances change but cannot *become* a transitional foreign-held subsidiary. An entity can be a transitional foreign-held subsidiary only if it was a subsidiary member under the IFRE tests at the formation time (which must have been before 1 July 2004).

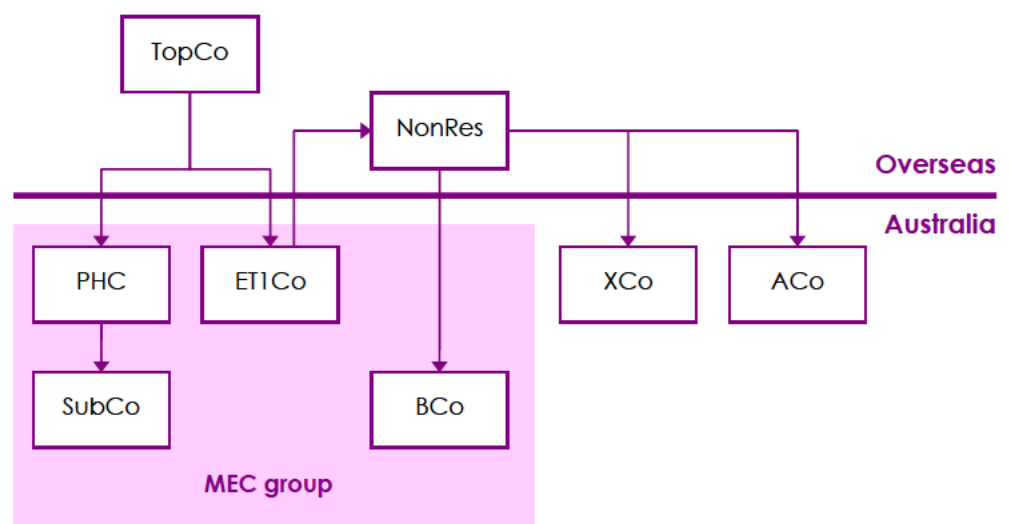
Figure 2 shows the TopCo group of entities at the time that its Australian-resident companies form a MEC group, which is before 1 July 2004. PHC and ET1Co are two eligible tier-1 companies of the MEC group; PHC is the provisional head company.

After formation, NonRes acquires all of the membership interests in ACo and XCo, and the remaining membership interests in BCo (figure 3).

**Figure 2: Group at formation time (before 1 July 2004)**



**Figure 3: Group after post-formation changes in membership interests**



At the time of formation XCo is an unrelated Australian resident company. NonRes acquires all the membership interests in XCo after consolidation. XCo cannot become a member of the MEC group.

NonRes acquires all the membership interests in ACo from PHC. ACo cannot continue to be a member because the IFRE (NonRes) did not have any membership interests in ACo at the time the MEC group was formed.

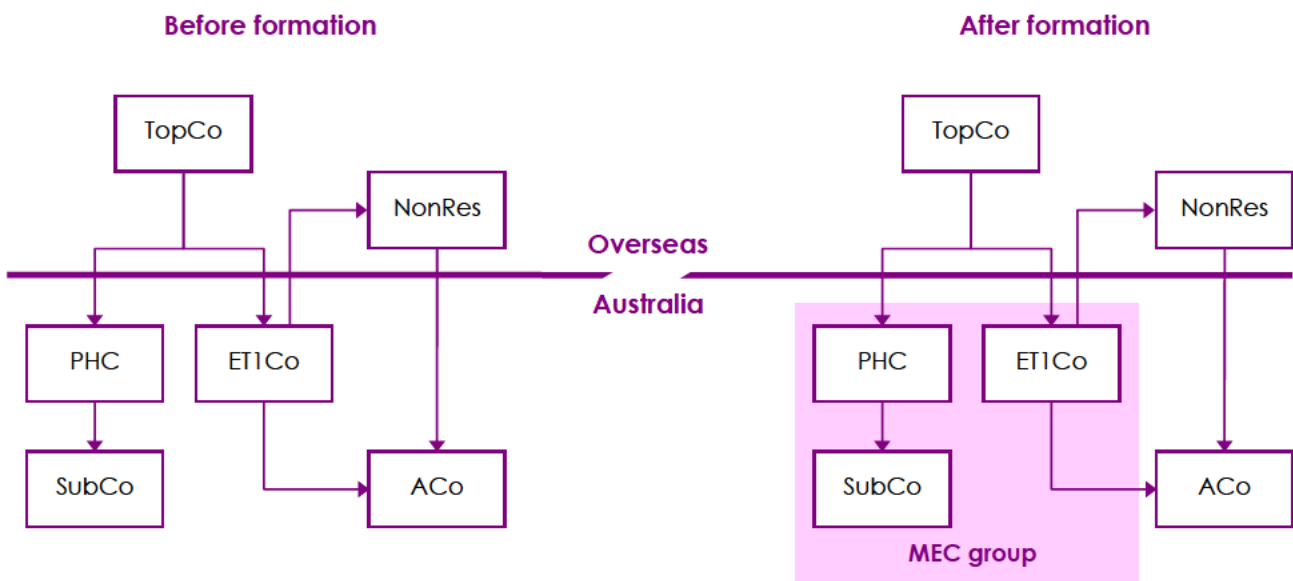
BCo is a transitional foreign-held subsidiary member of the MEC group at the formation time because some of its membership interests are held by NonRes, which is a wholly-owned, non-resident subsidiary of ET1Co. NonRes acquires ET1Co's membership interests in BCo, so that BCo becomes a wholly-owned subsidiary of NonRes. BCo continues to be in the MEC group as a foreign-held subsidiary member.

#### Formation after 1 July 2004

For an entity to be considered for membership of a MEC group under the IFRE tests, the group must form before 1 July 2004.

PHC, ET1Co, ACo, SubCo, TopCo and NonRes are members of a wholly-owned group. If the group consolidates after 1 July 2004, ACo cannot be a member of the resulting MEC group.

**Figure 4: Group formation after 1 July 2004**



## Cost setting implications

### Types of foreign-held subsidiary

The members of a MEC group under the IFRE tests are classified into two categories:

- transitional foreign-held subsidiary (TFHS), and
- transitional foreign-held indirect subsidiary (TFHIS).

This is because the cost setting rules apply differently to each category.

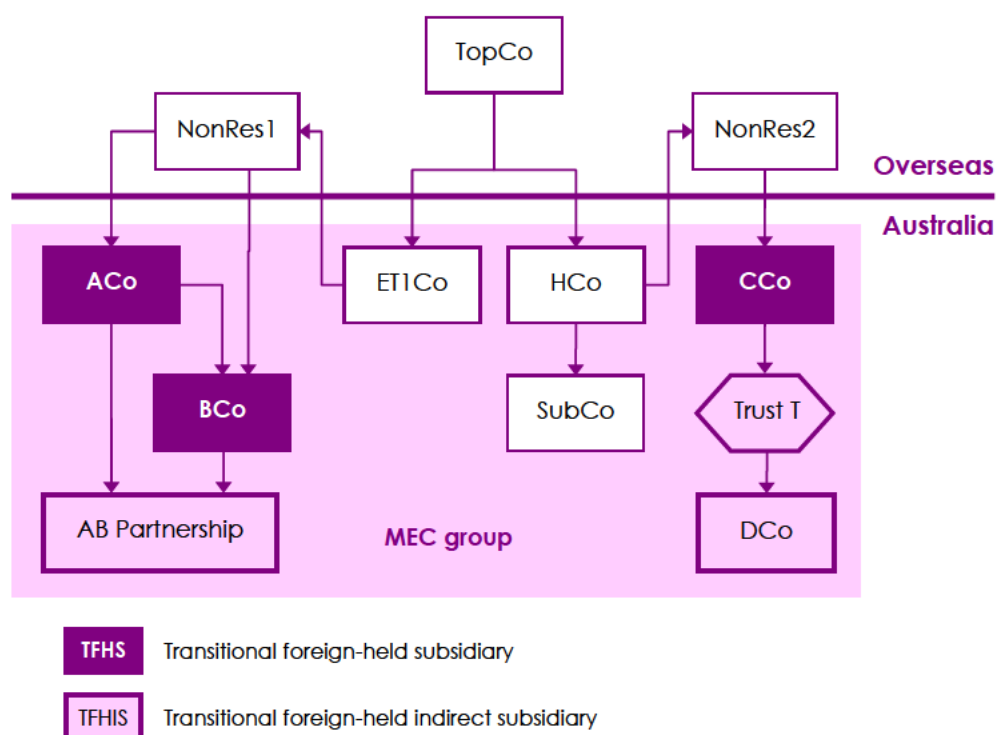
A TFHS is a member under the IFRE tests in which one or more membership interests are directly held by an IFRE. As shown in figure 5, ACo, BCo and CCo fall into this category.

A TFHIS is a member under the IFRE tests in which no membership interests are directly held by an IFRE – that is, the membership interests are held entirely by members of the MEC group. In figure 5, the AB partnership, Trust T and DCo fall into this category.

A member under the IFRE tests in which some membership interests are held directly by an IFRE and the remaining interests by a TFHS (such as BCo in figure 5) is itself a TFHS.

A MEC group can have a TFHIS only if it has a TFHS.

**Figure 5: TFHS and TFHIS members**



**Table 1: Cost setting rules for TFHS and TFHS members**

	Transitional foreign-held subsidiary (TFHS)	Transitional foreign-held indirect subsidiary (TFHIS)
<b>At formation time</b>	<p>The cost setting rules are modified for a TFHS.</p> <p>The modified rules treat a TFHS as if it were a part of the head company of the MEC group.</p> <p>The effect of this modification is that the tax costs of the assets of a TFHS are not reset – they retain their terminating values.</p>	<p>The formation time cost setting rules for subsidiary members of a consolidated group apply to a TFHIS without any modifications.</p> <p>The head company can choose to retain the terminating values of the assets of the TFHIS if it is also a transitional entity and the group is a transitional group.</p> <p>→ For more information see 'Treatment of transitional entity and TFHS'.</p>
<b>Trading stock</b>	<p>As the tax costs of the assets of a TFHS are not reset, it is not necessary to set a tax neutral amount for the trading stock of a TFHS.</p> <p>→ Section 701C-35, <i>Income Tax (Transitional Provisions) Act 1997</i></p>	<p>If the reset cost of trading stock of a TFHIS is more than its market value or terminating value, it is restricted to the greater of the two amounts.</p> <p>If the TFHIS is also a 'continuing majority owned entity', the trading stock is treated as a retained cost base asset and the value of the trading stock is worked out under Division 70 of the ITAA 1997.</p>
<b>At leaving time</b>	<p>When a TFHS leaves a MEC group, modified leaving time cost setting rules apply.</p> <p>Membership interests in the TFHS held by non-residents are treated as if the head company of the consolidated group holds them.</p> <p>→ Section 701C-40, <i>Income Tax (Transitional Provisions) Act 1997</i></p>	<p>Leaving time cost setting rules apply without any modification when a TFHIS leaves a MEC group.</p>

### Frankable distributions by a TFHS

**Any frankable distributions made by a TFHS to a foreign resident are treated as distributions made by the head company of the MEC group.**

→ Subsection 719-435(2), ITAA 1997

### Treatment of 'transitional entity' and TFHS

**A 'transitional entity' is an entity that becomes a member of a consolidated or MEC group during the transitional period and satisfies certain additional ownership requirements prior to becoming a member. A consolidated or MEC group that has a transitional entity is a 'transitional group'. The head company of a transitional group may choose that the assets of a transitional entity retain their existing tax costs at the joining time instead of being reset.**

→ 'Treatment of assets', C2-1

**The head company of a TFHS does not have this choice. The assets of a TFHS retain their tax costs at the joining time.**

However, if a TFHIS also qualifies as a transitional entity, the head company of the group may choose between resetting the costs of the assets and retaining their costs at the joining time.

## References

*Income Tax Assessment Act 1997*, sections 703-45 and 719-10

*Income Tax (Transitional Provisions) Act 1997*:

- Division 701A
- Subdivisions 701-A and 701C-B

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 4

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002:

- Chapter 4
- paragraphs 9.51 to 9.54

Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.77 to 1.88

Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 6) 2003, paragraphs 3.122 to 3.129

### Revision history

Section C10-2-120 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
27.10.03	Complete revision of section to include more information on: <ul style="list-style-type: none"><li>• eligibility under the IFRE tests</li><li>• the transitional period – restrictions on when a MEC group must form to have members under the IFRE tests, and restrictions on post-formation membership changes</li><li>• the cost setting implications for different types of members under the IFRE tests.</li></ul>	Provide more information about the operation of the measure generally.  Include rules set out in <i>Taxation Laws Amendment Act (No. 6) 2003</i> (No. 67 of 2003).