

Worked example

Pooling of external membership interests

Description This example shows how pooling rules and formulas are applied to reset the cost setting amounts of certain membership interests held in eligible tier-1 companies by entities that are not members of a multiple entry consolidated (MEC) group.

Note

This example does not consider the effect of the value shifting or loss integrity provisions in Divisions 715 and 727 and Subdivision 719-T of the *Income Tax Assessment Act 1997* (ITAA 1997). Adjustments required by those provisions are considered in:

- 'Effect of Subdivision 165-CC for MEC groups', C2-6-140
- 'Effect of Subdivision 165-CD for MEC groups', C2-6-150
- 'General value shifting regime (GVSR)', C2-6-170
- 'All assets in head company's loss denial pool become assets of leaving entity', C2-6-540.

Commentary A pooled interest is a membership interest in an eligible tier-1 company that is held by an entity outside the MEC group, provided it is not:

- an employee share scheme interest, or
- held by an entity only as a nominee for members of the MEC group.

'Pooling' describes the method used to reset the cost of pooled interests.

The cost of pooled interests is reset each time the events that trigger pooling (trigger events) happen to pooled membership interests. (For an explanation of events that trigger pooling see 'Events that trigger pooling in a MEC group', C10-2-410.) The time at which a trigger event occurs is referred to as the trigger time. The market value of the pooled interests (reset interests) as a whole must be more than nil just before the trigger time for the pooling rules to apply.

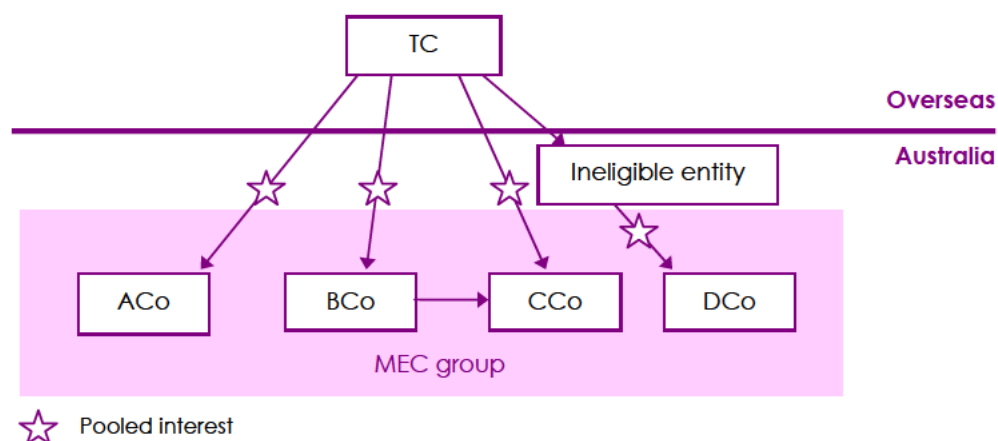
The formula used to reset each pooled interest will depend on whether the membership interest is held in a trigger company – the eligible tier-1 company that undergoes the trigger event – or in one of the other eligible tier-1 companies (non-trigger companies) in the MEC group when the trigger event occurs.

Examples of pooled interests

Examples of pooled interests are:

- where a non-resident member of a wholly-owned group holds membership interests in an eligible tier-1 company
- where the membership interests in an eligible tier-1 company are held by a resident interposed entity that is not a member of the MEC group (such as a pooled development fund), as in figure 1.

Figure 1: Membership interest in eligible tier-1 company held by a resident interposed entity



For more examples of pooled interests → page 10 in this worked example.

For an explanation of the method used to reset the tax cost of membership interests held in a leaving entity by members of the MEC group → 'An eligible tier-1 company leaving a MEC group', C10-2-430.

Pooling facilitates the tax-free transfer of assets within a MEC group by removing the need for value shifting adjustments at the eligible tier-1 company level.

How the pooling rules operate

Very broadly, the cost of membership interests (reset interests) held in eligible tier-1 companies by entities that are not members of the MEC group are pooled and an allocation made from the pool according to the market value of each reset interest. The reset amount is calculated in accordance with the formulas set out below.

An eligible tier-1 company that undergoes a trigger event is referred to as a trigger company. → 'Events that trigger pooling in a MEC group', C10-2-410

Where a company *is* a trigger company, the pool is allocated according to the trigger company's share of the market value of the MEC group.

Where the eligible tier-1 company *is not* a trigger company, the cost setting amount for each reset interest will, very broadly, equal the balance of the pool not allocated to reset interests in trigger companies divided by the number of reset interests in the remaining eligible tier-1 companies.

The tax cost of pooled interests is reset just before trigger time. A trigger event may happen to one or more eligible tier-1 companies at the same time and one or more trigger events may occur at the same time. For example, membership interests in one or more eligible tier-1 companies may be sold outside the wholly-owned group, which may cause all of those companies to leave the group.

Formula for calculating the tax cost of reset interests in trigger companies

$$\text{Cost setting amount} = \frac{\text{Market value of the reset interest}}{\text{Market value of the group}} \times \text{Pooled cost amount}$$

where:

- the **market value of the reset interest** is the market value (just before the trigger time) of all reset interests in that trigger company in the same class as the interest, divided by the number of reset interests in that company in that class
- the **market value of the group** is either:
 - the sum of the market value (just before the trigger time) of all reset interests in each of the trigger companies – this applies when every eligible tier-1 company that is a member of the MEC group just before the trigger time is a trigger company, or
 - the market value of the reset interests as a whole (including the market value of synergies arising from the combination of those interests) just before trigger time – this applies when only one or some of the eligible tier-1 companies are trigger companies. (The market value in this situation is not simply the sum of the market values of the eligible tier-1 companies. → paragraph 719-555(1)(c) of the *Income Tax Assessment Act 1997*; paragraph 3.65 Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002)

However, if the market value of the pooled interests as a whole (including the market value of synergies arising from the combination of those interests) just before the trigger time is nil, the existing cost base or reduced cost base of the pooled interests is retained

→ paragraph 719-555(1)(c) of the *Income Tax Assessment Act 1997*.

- the **pooled cost amount** is the sum of the cost bases (just before the trigger time) of all reset interests.

Formula for calculating the tax cost of reset interests in non-trigger companies

$$\frac{\text{Pooled cost amount} - \text{Amount allocated to trigger company interests}}{\text{Number of non-trigger company interests}}$$

Where:

- the **pooled cost amount** is the sum of the cost bases (just before the trigger time) of all reset interests
- the **amount allocated to trigger company interests** is the sum of all cost setting amounts worked out for the reset interests held in trigger companies under the trigger company formula, and
- the **number of non-trigger company interests** is the number of reset interests held in non-trigger companies.

Formula where the cost base is the reduced cost base

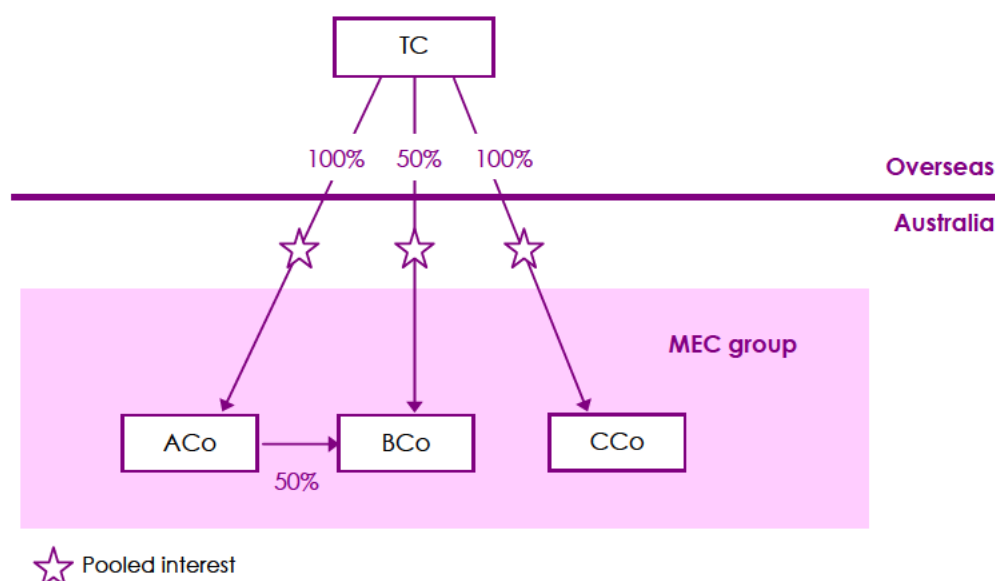
To work out the cost setting amount for a reset interest that has a reduced cost base, apply the formulas as if every reference to cost base were a reference to reduced cost base → subsection 719-570(3), ITAA 1997.

Example

Top Company (TC), a foreign resident company, has three wholly-owned Australian subsidiaries, companies ACo, BCo and CCo. One hundred membership interests in each of these three companies have been issued. TC owns only 50 of the membership interests in BCo, with ACo owning the other 50. ACo, BCo and CCo are all eligible tier-1 companies and comprise a MEC group.

The cost base of the 100 membership interests in each of ACo and CCo is \$100. The cost base of the 50 membership interests in BCo held by TC is \$50.

Figure 2: MEC group membership interests



Scenario 1 An eligible tier-1 leaves the MEC group

Assume that CCo issues membership interests outside the wholly-owned group. In these circumstances, a trigger event occurs to CCo. Even though there is no CGT event and no disposal of the membership interests, CCo leaves the MEC group. The tax cost of the membership interests in CCo must be reset using the pooling rules.

Note that:

- CCo is a trigger company
- CCo leaves the MEC group as it is no longer eligible to be a member of the MEC group
- CCo is owned 100% outside the MEC group. This means that when the company leaves the group, pooling is applied to determine the cost of each reset interest in each eligible tier-1 company in the group. The trigger company formula is applied.

To calculate TC's reset interest in CCo, assume that:

- the market value of CCo is \$290, and
- the market value of the reset interests as a whole is \$850.

The cost setting amount for each reset interest in CCo is worked out using the formula for trigger companies:

$$\frac{\text{Market value of the reset interest}}{\text{Market value of the group}} \times \text{Pooled cost amount}$$

Market value of each reset interest just before trigger time is:

$$\$290/100 = \$2.90$$

The pooled cost amount is:

$$(100 \times 2) + 50 = \$250 \text{ [or } 100 + 100 + 50 = \$250]$$

Therefore, the cost setting amount for each reset interest in CCo will be:

$$\frac{\$2.90}{\$850} \times \$250 = \$0.85 \text{ (rounded down) per reset interest}$$

This amount is the cost base that will be used if a CGT event happens to the membership interests in CCo. The cost setting amount for each reset interest in the remaining non-trigger eligible tier-1 companies of the MEC group will be worked out under the formula:

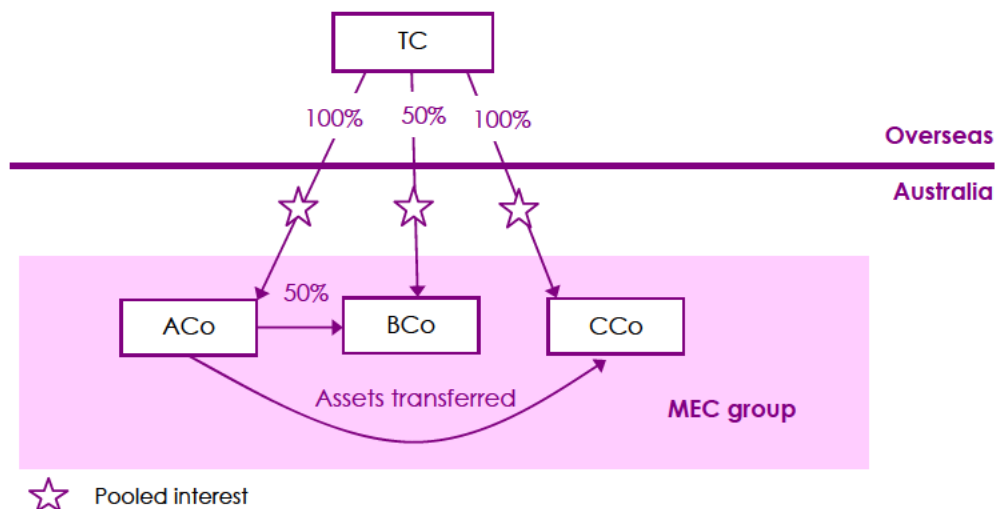
$$\frac{\text{Pooled cost amount} - \text{Amount allocated to trigger company interests}}{\text{Number of non-trigger company interests}}$$

$$\frac{\$250 - (\$0.85 \times 100 \text{ shares in CCo})}{150 \text{ shares in ACo and BCo}} = \$1.10 \text{ per reset interest}$$

The new cost base for the remaining interests TC holds in ACo and BCo is \$1.10 per reset interest, and is the cost to be used in subsequent pooling calculations for the pooled cost amount.

Scenario 2 A CGT event happens and the eligible tier-1 company leaves the MEC group following an asset transfer

Figure 3: CGT event – eligible tier-1 company leaves group following asset transfer



Assume that following formation of the MEC group assets were transferred from ACo to CCo. These transactions are ignored for income tax purposes under the single entity rule until the assets leave the group. However, the market value of the membership interests in each eligible tier-1 company may be affected.

Following the asset transfer, Top Company (TC) disposes of all its membership interests in CCo to a company that is not a member of the same wholly-owned group.

Note that:

- Pooling is triggered by the disposal of membership interests in CCo, which is a CGT event, and in this instance, CCo leaves the MEC group as it is no longer eligible to be a member.
- CCo is a trigger company.
- CCo is owned 100% outside the MEC group. This means that when CCo leaves the group, the cost of pooled interests is reset just before the trigger event.
- TC will be required to calculate any capital gain or loss.
- It is necessary to reset the cost of pooled interests in the remaining eligible tier-1 companies of the MEC group.
- The formula that applies will depend on whether the entity is a trigger company or not.

The cost base of the 100 membership interests in each of ACo and CCo is \$100. The cost base of the 50 membership interests in BCo held by TC is \$50.

Assume that market value of the assets transferred from ACo to CCo is \$17 for which no consideration was paid.

Assume the market value of CCo just before trigger time (that is, just before CCo is sold) is \$307 – i.e. \$290 (market value from Scenario 1) + \$17 – and the market value of the reset interests as a whole is \$850. The cost setting amount for each reset interest in CCo is calculated using the formula for trigger companies.

Step 1

Apply the trigger company formula:

$$\frac{\text{Market value of the reset interest}}{\text{Market value of the group}} \times \text{Pooled cost amount}$$

Market value of reset interests is:

$$\$307/100 = \$3.07$$

The pooled cost amount is:

$$(\$100 \times 2) + \$50 = \$250 \text{ [or } 100 + 100 + 50 = \$250]$$

Therefore, the cost setting amount for each reset interest in CCo is:

$$\frac{\$3.07}{\$850} \times \$250 = \$0.90 \text{ (rounded down) per reset interest}$$

Step 2

Calculate the capital gain or capital loss (in this instance the cost base as reset in step 1 is used).

Cost base (reset interest) of membership interests in CCo:

$$\$0.90 \times 100 \text{ membership interests} = \$90$$

Capital proceeds: \$307

Capital gain to TC:

$$\$307 - \$90 = \$217$$

Step 3

The cost setting amount for each reset interest that is held in the remaining eligible tier-1 companies of the MEC group will be worked out under the non-trigger company formula:

$$\frac{\text{Pooled cost amount} - \text{Amount allocated to trigger company interests}}{\text{Number of non-trigger company interests}}$$

Pooled cost amount:

$$(\$100 \times 2) + \$50 = \$250$$

Amount allocated to trigger company interests:

$$(\$0.90 \times 100 \text{ shares in CCo}) = \$90$$

Number of non-trigger company interests:

$$(250 - 100 = 150) \quad 150 \text{ shares in ACo and BCo}$$

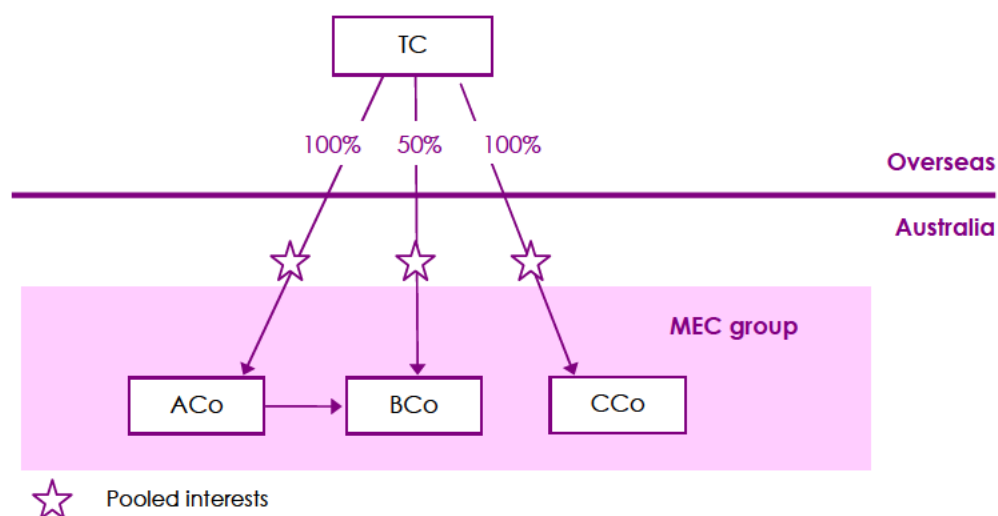
Therefore, the cost setting amount for each reset interest in ACo and BCo is \$1.07:

$$\frac{\$250 - 90}{150} = \$1.07 \text{ (rounded up) per reset interest}$$

These membership interests are still owned by TC and there is no CGT event. This amount (\$1.07) becomes the new cost base of reset interests still held by TC in ACo and BCo and is the cost to be used in subsequent pooling calculations for the pooled cost amount.

Scenario 3 A CGT event happens and the eligible tier-1 company does not leave the MEC group

Figure 4: CGT event – eligible tier-1 company does not leave group



The cost base of the 100 membership interests in each of ACo and CCo is \$100. The cost base of the 50 membership interests TC holds in BCo is \$50.

Assume TC disposes of its 50% interest in BCo to ACo, an entity that is a member of the wholly-owned group, for \$90. Assume the market value of the reset interests is ACo \$160, BCo \$90 and CCo \$100, but the market value of the reset interests as a whole at this time is \$400, which includes synergies arising from the combination of those interests.

Also assume that prior to the disposal of the membership interests no CGT assets were transferred between group members.

The disposal of the membership interests in BCo is a trigger event. In addition, BCo remains eligible to be a member of the MEC group.

To calculate TC's capital gain or capital loss:

Step 1

Apply the trigger company formula:

$$\frac{\text{Market value of the reset interest}}{\text{Market value of the group}} \times \text{Pooled cost amount}$$

Market value of reset interests is:

$$\$90/50 = \$1.80$$

The pooled cost amount is:

$$100 + 100 + 50 = \$250$$

Therefore the cost setting amount for each reset interest in BCo will be:

$$\frac{1.80}{400} \times \$250 = \$1.12 \text{ (rounded down) per reset interest}$$

Step 2

Calculate the capital gain or capital loss (in this instance the cost base as reset in step 1 is used):

Cost base (reset interest) of membership interests in BCo:

$$50 \times \$1.12 = \$56$$

Capital proceeds: \$90

Capital gain to TC:

$$\$90 - \$56 = \$34$$

Step 3

The cost setting amount for each reset interest that is held in the remaining eligible tier-1 company of the MEC group will be worked out under the formula:

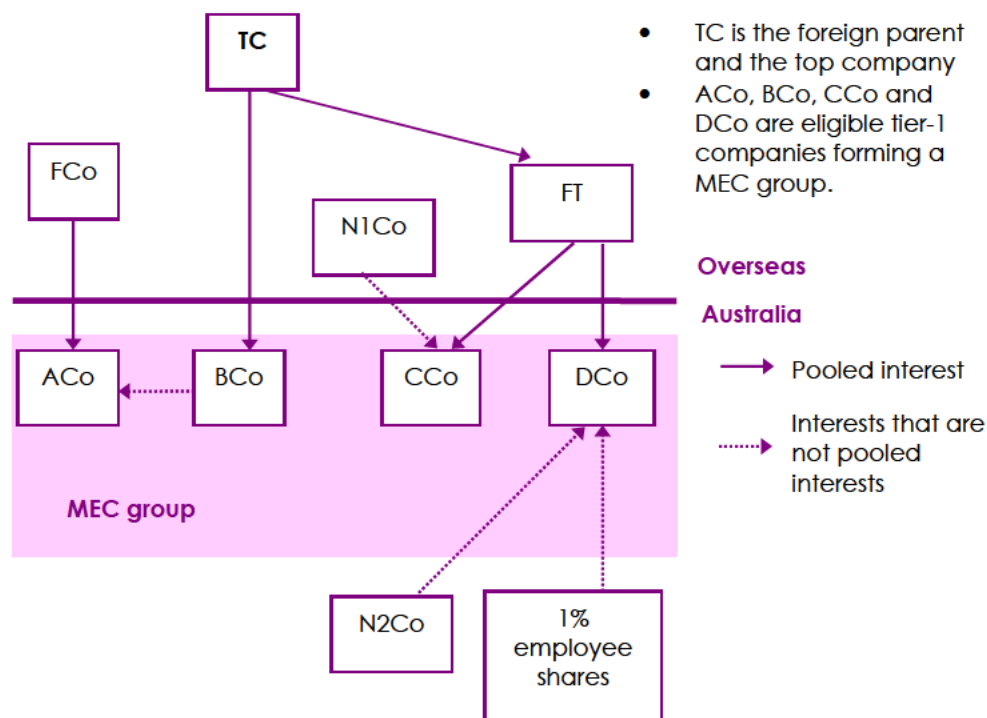
$$\frac{\text{Pooled cost amount} - \text{Amount allocated to trigger company interests}}{\text{Number of non-trigger company interests}}$$

$$\frac{\$250 - (\$1.12 \times 50)}{100+100} = \$0.97 \text{ (rounded up) per reset interest}$$

This amount (\$0.97) becomes the new cost base of reset interests still held by TC in ACo and CCo and is the cost to be used in subsequent pooling calculations for the pooled cost amount.

Pooled interests – examples

Figure 5: Examples of pooled interests in eligible tier-1 companies of a MEC group



| | | |
|---|----------------------------------|--|
| Pooled interests | TC's interests in ACo | FCo is a non-resident company holding membership interests in ACo as nominee for TC. |
| | TC's interests in BCo | |
| | FT's interests in CCo and DCo | FT is a non-resident trust interposed between TC and DCo and TC and CCo. |
| Interests that are not pooled interests | BCo's interests in ACo | A member of the MEC group holding membership interests in another member. |
| | BCo's interests in CCo | N1Co is a non-resident company holding some of the membership interests in CCo as nominee for BCo. |
| | CCo's interests in DCo | N2Co is a resident company holding the membership interests in DCo as nominee for CCo. |
| | The 1% employee interests in DCo | |

References

Income Tax Assessment Act 1997, Subdivision 719-K; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8

Income Tax Assessment Act 1997, Subdivision 719-T; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003)

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 3.50 to 3.71

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, paragraphs 11.94 to 11.145

Revision history

Section C10-2-420 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

| Date | Amendment | Reason |
|----------|-------------------------------|--------------------|
| 26.10.05 | Extensive changes throughout. | For clarification. |

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- <http://assistant.treasurer.gov.au> (Assistant Treasurer's press releases)
- www.treasury.gov.au (Treasury papers on refinements to the consolidation regime).