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. Adjustments required by those provisions are considered in:

- 'Effect of Subdivision 165-CC where an entity leaves a consolidated group', C2-5-120
- 'Effect of Subdivision 165-CD for consolidated groups', C2-6-130
- '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 membership interest in an eligible tier-1 company that is held by an entity outside the MEC group is a pooled interest, provided that 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 setting amount of pooled interests. The market value of the pooled interests as a whole must be more than nil for the pooling rules to apply.

An interest 'reset' is undertaken each time the events that trigger pooling ('trigger events') happen to pooled membership interests. (For an explanation of events that trigger pooling \rightarrow 'Events that trigger pooling in a MEC group', C10-2-410.)

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

Examples of pooled interests

Two examples of pooled interests are:

- where a member of the wholly-owned group that is a non-resident holds shares 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

Pooled interest

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

For an explanation of the method used to reset interests held in a leaving entity by members of the MEC group \rightarrow 'An eligible fier-1 company leaving a MEC group', C10-2-430.

Pooling facilitates the tax-free transfer of assets within a MEC group.

How the pooling rules operate Very broadly, the cost of membership interests (pooled 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. The reset amount is calculated in accordance with the formulas set out on the following pages.

A 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 cost setting amount for each reset interest will be that part of the pool that equals the market value of the reset interest as a proportion 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 time a trigger event occurs is referred to as the 'trigger time'. The pooled interests are 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, shares in one or more eligible tier-1 companies may be sold, which may cause all of those companies to leave the group.

Formula for reset interests in eligible tier-1 companies that are trigger companies

Cost setting amount	= -	Market value of the reset interest	х	Pooled cost
		Market value of the group		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:
 - the sum of the market value (just before the trigger time) of all reset interests in each of those 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
 - 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.

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 not more than nil, the existing cost base or reduced cost base of the pooled interests is retained \rightarrow 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 reset interests held in non-trigger companies

Pooled cost amount – Amount allocated to trigger company interests 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 under the trigger company formula, and
- the number of non-trigger company interests is the number of reset interests, other than those that are trigger company interests and excluded interests (employee and nominee shares).

Formula where the cost base is the reduced cost base

To work out the cost setting amount for reduced cost base assets for a reset interest, apply the formulas as if every reference in those subsections to cost base were a reference to reduced cost base \rightarrow subsection 719-565(2), ITAA 1997.

Note on The amount representing the market value of the group used in the formula is outlined in sections 719-560 and 719-570 of the ITAA 1997. The Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002 notes that the market value of the group where not all the eligible tier-1 companies are trigger companies is to be worked out taking into account the market value of the reset interests as a whole, including any synergies arising from the combination of those interests. The market value in this situation is not simply the sum of the market values of the eligible tier-1 companies.

Example Top Company (TC), a foreign resident company, has three wholly-owned Australian subsidiaries, companies ACo, BCo and CCo. One hundred shares in each of these three companies have been issued. TC owns only 50 of the shares 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 shares outside the wholly-owned group. In these circumstances, a triggering event occurs to CCo. Even though there is no CGT event and no disposal of the membership interests, CCo leaves the MEC group and the reset value of the pooled interests must be calculated to enable TC to calculate its cost base in CCo.

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 formula that applies will depend on whether the entity is a trigger company or not.

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:

<u>Market value of the reset interest</u> x Pooled cost amount Market value of the group

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

\$290/100 = \$2.90

The pooled cost amount is:

(100 x 2) + 50 = \$250 [or 100 + 100 + 50 = \$250]

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

 $\frac{\$2.90}{\$850} x \$250 = \$0.85 \text{ per pooled interest}$

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:

Pooled cost amount – Amount allocated to trigger company interests Number of non-trigger company interests

<u>\$250 - (\$0.85 x 100 shares in CCo)</u> = \$1.10 150 shares in ACo and BCo

The new cost base for the remaining interests TC holds in ACo and BCo is \$1.10 per pooled interest.

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



Figure 3: 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 until the assets leave the group. However, the market value of the membership interests may be affected.

On 1 July 2003, 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 of the MEC group.
- 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 the 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.

Assume the market value of CCo just before trigger time (that is, just before CCo is sold) is \$307 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:

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<u>Market value of the reset interest</u> x Pooled cost amount
Market value of the group
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Market value of reset interests is:

\$307/100 = \$3.07

The pooled cost amount is:

 $(\$100 \ x \ 2) + \$50 = \$250 \ [or \ 100 + 100 + 50 = \$250]$

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

<u>\$3.07</u> x \$250 = \$0.90 per share (rounded) \$850

Step 2

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

Cost base (reset interest) of membership interests:

\$0.90 x 100 shares = \$90

Capital proceeds: \$307

Capital gain:

\$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:

Pooled cost amount – Amount allocated to trigger company interests Number of non-trigger company interests

Pooled cost amount:

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

Amount allocated to trigger company interests:

(\$0.90 x 100 shares in CCo) = \$90

Number of non-trigger company interests:

(250 - 100 = 150) 150 shares in ACo and BCo

Therefore, the cost setting amount for each reset interest is \$1.07:

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

These shares are still owned and there is no CGT event. The new cost base of the shares still held in ACo and BCo is \$1.07 per share. This 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.

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

The disposal of the shares 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 and to ensure that ACo's cost base is the appropriate cost base, apply the trigger company formula:

<u>Market value of the reset interest</u> x Pooled cost amount Market value of the group

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:

 $\frac{1.80}{400}$ x \$250 = \$1.12 (rounded down)

The reset cost of 50 shares in B is:

 $50 \times 1.12 = 56$

Here the capital gain is: \$90 - \$56 = \$34

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:

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Pooled cost amount – Amount allocated to trigger company interests
Number of non-trigger company interests
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 $\frac{\$250 - (\$1.12 \times 50)}{100 + 100} = \0.97

The new cost base for the remaining interests TC has in ACo is \$0.97 cents (rounded up) per pooled interest.



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