

Worked example

An eligible tier-1 company leaving a MEC group

Description This example shows how to calculate the cost setting amount of membership interests in an eligible tier-1 company that leaves a multiple entry consolidated (MEC) group.

Note

This example does not consider the application of the loss integrity provisions in Division 715 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
- 'All assets in head company's loss denial pool become assets of leaving entity', C2-6-540.

(The cost setting rules for other subsidiaries are the same as for consolidated groups → 'Treatment of assets', C2-1.)

Commentary Entities that leave a MEC group will fall into the following broad categories:

- the eligible tier-1 company that is the head company of the MEC group
- companies that are eligible tier -1 companies whose membership interests are wholly held outside the MEC group
- companies that are eligible tier-1 companies in which some of the membership interests are held by members of the group
- wholly-owned subsidiaries of eligible tier-1 companies, and
- companies that are subsidiary members of the MEC group through the interposed foreign resident entity rules.

When one of the above entities leaves a MEC group, it is necessary to calculate, for capital gains tax (CGT) and revenue purposes, the leaving tax cost setting amount for each membership interest in the leaving entity. The method used to calculate the leaving cost setting amount depends firstly on whether the entity is a wholly-owned subsidiary of an eligible tier-1 company or an eligible tier-1 company within the MEC group and secondly, if the entity is an eligible tier-1 company, the extent to which membership interests are held outside the group (pooled interests) or by group members.

The provisions that apply to particular membership interests in the leaving entity are outlined in table 1.

Table 1: Provisions applying to membership interests in leaving entities

Leaving entity	Membership interests held by members of the MEC group	Pooled interests*
An eligible tier-1 company wholly owned outside the MEC group	Not applicable	Pooling rules (Subdivision 719-K)
An eligible tier-1 company partly owned outside the MEC group	Leaving entity rules in Divisions 701 and 711 as modified by Subdivision 719-J	Pooling rules (Subdivision 719-K)
A subsidiary member of the MEC group other than an eligible tier-1 company	Leaving entity rules in Divisions 701 and 711	Not applicable
A subsidiary member of the MEC group through the interposed foreign resident entity rules	Divisions 701 and 711 as modified by sections 701C-40 and 701C-50 of the Income Tax (Transitional Provisions) Act 1997	Not applicable

*Pooled interests are specific membership interests held in an eligible tier-1 company by entities other than members of the MEC group.

Pooled interests are membership interests that are not:

- employee share scheme interests
- any membership interests held by an entity only as a nominee for other members of the MEC group.

→ 'Events that trigger pooling in a MEC group', C10-2-410.

Note

The tax cost setting amount for the membership interests in each of the leaving subsidiary members (other than eligible tier-1 companies) is worked out on a 'bottom-up' basis. → section 711-55 of the Income Tax Assessment Act 1997 and paragraph 5.142 of the Explanatory Memorandum to New Business Tax System (Consolidation) Bill (no 1) 2002

Eligible tier-1 companies leaving a MEC group

A) An eligible tier-1 company that is wholly owned outside the MEC group

The pooling rules in Subdivision 719-K of the *Income Tax Assessment Act 1997* are used to determine the cost setting amount for pooled interests in eligible tier-1 companies that are wholly owned outside the MEC group. For the calculation and pooling rules → 'Pooling of external membership interests', C10-2-420.

(Note that the pooling rules in Subdivision 719-K are triggered by more than one event. An entity leaving the group is only one example.)

B) An eligible tier-1 company that is partly owned by members of the MEC group

The calculation of the cost setting amount for an eligible tier-1 company partly owned by members of a MEC group and partly owned outside the MEC group is determined by combining two separate provisions:

- the consolidation leaving entity provisions (Divisions 701 and 711, ITAA 1997 as modified by Subdivision 719-J), and
- the MEC pooling cases provisions (Subdivision 719-K).

The tax cost setting amount for the membership interests held by members of the MEC group is calculated in the same way as the cost setting amount for membership interests in a subsidiary leaving a consolidated group.

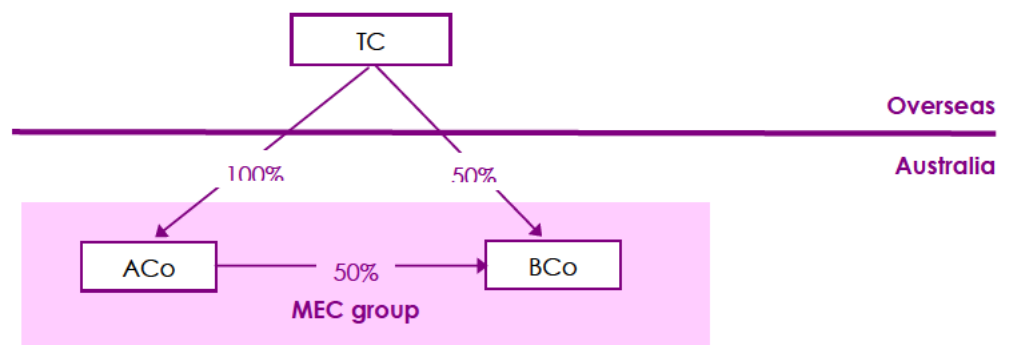
→ 'The cost setting process on exit', C2-2-210

Broadly, the tax cost setting amount is calculated with reference to Divisions 701 and 711 of the ITAA 1997. The calculation of the ACA for the leaving entity is not affected by the fact that some of the membership interests are pooled interests. Once calculated, the ACA is allocated to all membership interests, including both those held by members of the group, and all those held outside the group, in proportion to the market value of the interests. However, only the ACA allocated to the membership interests held by members of the group is relevant to calculating the tax cost setting amounts (cost bases) of those interests. The cost bases of the pooled interests are calculated using the pooling rules in Subdivision 719-K as modified by Subdivision 719-J, so the ACA calculated for those interests under Division 711 is ignored.

Example

The following is an example of an eligible tier-1 company that is partly owned outside the MEC group (BCo below).

Figure 1: Eligible tier-1 company partly owned by members of the MEC group



A foreign parent company, TC, owns 100% of the 100 membership interests in Australian resident ACo and 50% of the 100 membership interests in Australian resident BCo. The membership interests are held as CGT assets.

The remaining 50% of the membership interests in BCo are held by ACo (they are also CGT assets).

ACo and BCo are eligible tier-1 companies.

ACo's membership interests in BCo were acquired in two tranches. The first tranche of 20 membership interests was acquired on 1 July 2002 at \$10 each and the second tranche of 30 membership interests was acquired on 1 July 2003 at \$20 each.

There is only one class of membership interests in BCo.

Assume that the 50 membership interests acquired by the foreign parent company in BCo are acquired at the same time as ACo acquired its second tranche of membership interests in BCo ($50 \times \$20 = \$1,000$).

ACo and BCo choose to form a MEC group on 1 July 2004. The foreign parent will be the top company (TC).

On 1 July 2005, TC and ACo sell their membership interests in BCo to an unrelated party, causing BCo to leave the MEC group. A CGT event happens to the membership interests held by both TC and ACo and it will be necessary for both entities to calculate their capital gain or capital loss.

To calculate the capital gain or capital loss made by both TC and ACo, it is necessary to reset the cost bases (the tax cost setting amount) of the membership interests in BCo.

Calculating the tax cost setting amount for ACo's interests in BCo when BCo leaves the MEC group

The cost of the 50% membership interests owned by ACo in BCo is determined by working out the group's exit ACA for all the membership interests in BCo in accordance with Division 711 as modified by Subdivision 719-J. → 'The cost setting process on exit', C2-2-210

For example, if, at the leaving time, the sum of the terminating values of assets that BCo takes with it on exit is \$2,000 (assuming that steps 2 to 4 of section 711-20 for calculating the ACA do not apply), the exit ACA is \$2,000. This ACA amount is divided by the number of membership interests in the class in leaving company BCo. As the total number of membership interests in BCo is 100, the new cost base of each membership interest is \$20 ($\$2,000/100$).

Even though the exit ACA is calculated and allocated across the 100 membership interests in BCo, only the ACA for the membership interests held by members of the MEC group is relevant for the calculation of ACo's cost bases for the membership interests in BCo.

The capital gain ACo derives on the sale of the membership interests ACo held in BCo is the capital proceeds less the cost base of each membership interest in each class. In this instance, assume the capital proceeds for the 50 membership

interests is \$1,600 (market value). ACo's capital gain from the sales of 50 membership interests is:

$$\$1,600 - \$1,000 (50 \times \$20) = \$600$$

Calculating the cost setting amount for TC's interests in BCo using the pooling rules

For the purpose of this example assume:

- the market value of TC's pooled interests in BCo is \$1,600
- the cost base of TC's interest in ACo is \$1,000, and
- the market value of the group is \$5,000 just before the trigger time (that is, just before BCo is sold) → paragraph 719-501(1)(c).

Market value of the reset interests in BCo is:

$$\frac{\$1,600}{50} = \$32$$

The pooled cost amount is \$2,000 (the sum of the cost bases of all the reset interests: (ACo = \$1,000) + (BCo = \$1,000)).

Each pooled interest held in trigger company BCo is reset using the formula:

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

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

$$\frac{32}{5,000} \times 2,000 = \$12.80$$

The capital gain/loss from selling 50 membership interests by TC is calculated by:

$$\text{Capital proceeds} - \text{reset cost base} = \text{Capital gain}$$

(where the reset cost base = \$640 [\$12.80 x 50])

$$\$1,600 - \$640 = \$960$$

Therefore, TC makes a capital gain of \$960 on the sale of its membership interests in BCo.

Calculating the cost setting amount for the reset interests in the non-trigger company

Once BCo has left the MEC group, it is necessary to calculate the tax cost setting amount for the reset interests in the remaining eligible tier-1 company. This tax cost setting amount will be used in future pooling calculations.

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

where:

- the pooled cost amount = \$2,000
(The sum of the cost bases of all the reset interests
(ACo = \$1,000) + (BCo = \$1,000))
- the amount allocated to trigger company interests = \$640
(The amount of reset interests in the trigger company)

The number of non-trigger company interests is the number of pooled (reset) membership interests in the non-trigger company.

Therefore, the cost base of the non-trigger company reset interest is:

$$\frac{\$2,000 - \$640}{100} = \$13.60 \text{ per reset interest}$$

This amount is the cost base that is used in future pooling calculations.

References

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

Explanatory Memorandum to the New Business Tax system (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 3.40–49

Income Tax Assessment Act 1997, Division 701

Income Tax Assessment Act 1997, Division 711; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002)

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 5

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 the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11

Revision history

Section C10-2-430 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
26.10.05	Extensive revisions 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).