


TD 2005/D46 - Income tax: consolidation: losses: can item 4 in the table in subsection 707-320(2) of the Income Tax Assessment Act 1997 apply to reduce or maintain the available fractions of bundles of losses of the ongoing head company where an application event is covered by one of the exceptions in section 719-300 of the Income Tax Assessment Act 1997?

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Draft Taxation Determination

Income tax: consolidation: losses: can item 4 in the table in subsection 707-320(2) of the *Income Tax Assessment Act 1997* apply to reduce or maintain the available fractions of bundles of losses of the ongoing head company where an application event is covered by one of the exceptions in section 719-300 of the *Income Tax Assessment Act 1997*?

Preamble

*This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVA of the **Taxation Administration Act 1953**. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

1. Yes. Where an application event, as described in subsections 719-300(2) or 719-300(3) of the *Income Tax Assessment Act 1997* (ITAA 1997), is covered by one of the exceptions in subsections 719-300(4) or 719-300(5) of the ITAA 1997, item 4 in the table in subsection 707-320(2) of the ITAA 1997 (item 4) can apply to reduce or maintain the available fractions for bundles of losses of the ongoing head company. Such an application event can constitute an injection of capital as described in paragraph 707-325(4)(a) of the ITAA 1997.

Explanation

2. Where the application events described in subsections 719-300(2) and 719-300(3) involve a new eligible tier-1 company that had, immediately before becoming an eligible tier-1 company, been a member of the MEC (multiple entry consolidated) or consolidated group, those events will be events that are covered by subsection 707-325(4) of the ITAA 1997.

3. Item 4 requires the multiplication of the factor against the available fraction for a bundle of losses where there is an increase in the market value of the company to which the losses in the bundle were most recently transferred because of an event described in subsection 707-325(4) (but not an event that is covered by subsection 707-325(5) of the ITAA 1997).

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4. One of the events that is described in subsection 707-325(4) is an injection of capital into the entity. Taxation Ruling TR 2004/9 explains what is meant by the phrase ‘an injection of capital’.
5. The market value of an entity or group is assumed to reflect the capacity to generate income or gains in the future.¹ The available fraction for a bundle of losses ensures that the losses in that bundle can only be offset against that portion of the group’s future income that can be said to have been generated by those entities that made those losses.
6. An increase in the market value of an entity as a result of an event happening as described in subsection 707-325(4) will require the factor worked out for item 4 to be multiplied against each available fraction for a bundle of losses held by the ongoing head company.
7. Section 719-300 describes the two application events that will cause the calculation and adjustment rules in Subdivision 719-F of the ITAA 1997 or, if excepted, the general rules in Subdivision 707-C of the ITAA 1997 to apply. Subsection 719-300(2) states one application event to be that another company (the new tier-1 member) becomes both a member of the MEC group and an eligible tier-1 company of the top company for the group. Subsection 719-300(3) states that the other application event is that the MEC group comes into existence as a result of a special conversion event happening to the potential MEC group derived from the ongoing head company.
8. Subdivision 707-C will apply where an excepted application event in section 719-300 of the ITAA 1997 happens through the operation of section 719-2 of the ITAA 1997. Section 719-2 provides for Part 3-90 of the ITAA 1997 (other than Divisions 703 and 719 of the ITAA 1997) to have effect in relation to a MEC group in the same way in which it has affect in relation to a consolidated group, subject to the modifications set out in Division 719.
9. The inclusion of a new eligible tier-1 company is treated as being akin to a merger between the existing group and the new eligible tier-1 company.² In such cases, a group’s existing available fractions will be adjusted where the inclusion of the new eligible tier-1 company increases the group’s market value, which will reduce the proportion of the group’s income that the original loss entities can now be regarded as generating.³
10. The increase in market value (as a reflection of income generating capacity) occurs purely because of the new eligible tier-1 company’s relationship with the group’s top company.⁴ The change to an existing MEC group or conversion to a MEC group by way of inclusion of a new eligible tier-1 company occurs through notification of such to the Commissioner rather than through an acquisition by the head company of the group. The group has not given up anything of itself in either event.⁵

¹ Subsection 707-305(5) of the ITAA 1997.

² Paragraph 3.73 of the Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002.

³ Paragraph 3.75 of the Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002.

⁴ Paragraph 3.76 of the Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002.

⁵ Paragraph 3.76 of the Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002 begins:

The increase in value or income generating capacity occurs because the group has not paid cash or assets (or increased its liabilities) in order **to acquire** the additional eligible tier-1 company. [emphasis added]

11. Where the new eligible tier-1 company was, immediately before becoming an eligible tier-1 company, a member of the MEC or consolidated group, the calculation and adjustment rules contained in Subdivision 719-F will not apply. These specific exceptions, subsections 719-300(4) and 719-300(5) respectively, apply because the events are seen to be an internal reorganisation of the group's existing entities rather than an expansion that introduces an additional member or members to the group.⁶ For example, where the membership interests in a member company are transferred to the group's top company resulting in that member company becoming a new eligible tier-1 of the group because of the choice notification, it does not result in any 'new' entity joining the group. This scenario is known as a 'roll-up' case.

12. Nonetheless, where an event that is covered by one of the exceptions happens, the group's income generating capacity may be enhanced. For example, in a roll-up case the top company may have paid the group cash or assets in exchange for the membership interests in the member company. In such cases it can be said that capital has been injected into the group.⁷

13. An injection of capital will be taken to have occurred where all the characteristics of an injection of capital are displayed. The inter-related characteristics that need to be present are more fully described in paragraph 9 of Taxation Ruling TR 2004/9. Three of the characteristics required to be present are that the event results in an enhancement of the net assets of the entity, that the equity interests of the entity are affected, and the involvement of an external third party.

14. A reference to a company in subsection 707-320(2) is taken to be a reference to either a MEC group (because of section 719-2) or a consolidated group where that entity is subject to the operation of the single entity rule for an income year or a period in an income year.

15. Item 4 is intended to apply in this manner as described by paragraph 8.61 in the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002:

A **group's** available fractions are adjusted if the **group's** market value is increased as a result of capital injected into the **group** or a non-arm's length transaction involving the **group**. This increase in the **group's** income generating capacity reduces the proportion of income that loss entities within the **group** can be regarded as generating. Therefore, each available fraction is adjusted by multiplying it by the factor at item 4 in Table 8.1 (see also the discussion in paragraphs 8.92 to 8.102). [emphasis added]

Enhancement of net assets

16. In a roll-up case that involves an exchange of cash or assets for the membership interests in the member company that becomes a new eligible tier-1 company in the group, the net assets of the group will be enhanced as a result of that inflow.

⁶ Paragraph 3.84 of the Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002.

⁷ See paragraphs 3.77 and 3.85 of the Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002.

Equity interests are affected

17. The equity interests of the entity will be affected by the recognition of the equity interests in the new eligible tier-1 company as being a part of the collective equity interests of the head company of the group. This rationale for recognition is based on the view that all eligible tier-1 companies, representing the top level of a MEC group structure, are collectively equivalent to the head company of a consolidated group. This is the case even though, nominally, only one of those eligible tier-1 companies of a MEC group becomes the 'head company'.

Involvement of a third party

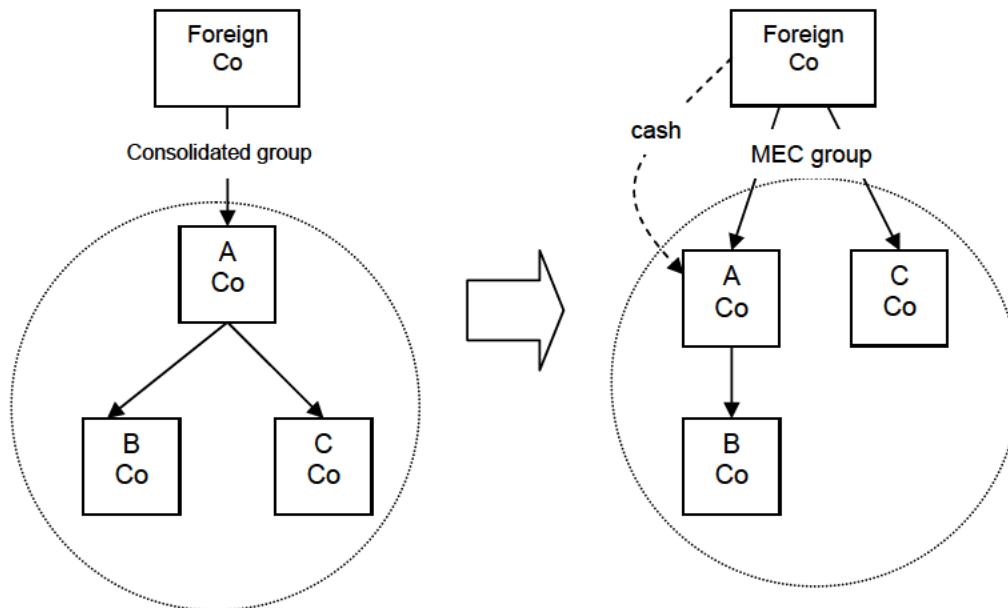
18. In order for a member company to become a new eligible tier-1 company of the group, it would be necessary for the membership interests in that member company to be transferred to either the top company of the group or an interposed entity between that top company and the group such that it met the conditions for being an eligible tier-1 company as contained in section 719-15 of the ITAA 1997.

Example

19. *A consolidated group consists of head company A Co and member companies B Co and C Co. A Co holds 100% of the membership interests in both B Co and C Co. A Co is wholly owned by Foreign Co, a non-resident company. Losses were transferred under Subdivision 707-A of the ITAA 1997 from both B Co and C Co to A Co when the consolidated group was formed and available fractions were worked out for each bundle of losses. B Co and C Co each had cash assets of \$100 represented by issued capital of \$100 whilst A Co had cash assets of \$100 and membership interests in subsidiaries of \$200 represented by \$300 issued capital.*

20. *Foreign Co acquired 100% of the membership interests in C Co from A Co for cash consideration two years after the formation of the consolidated group. A Co notified the Commissioner that a MEC group is to come into existence as a result of C Co becoming an eligible tier-1 company of the top company. The market value of the consolidated group just before the event was \$300 and the cash consideration received in respect of the disposal of membership interests in C Co to Foreign Co resulted in the market value of the group being increased by \$100.*

21. *The equity interests in the head company of the group were formerly represented as being those of A Co. As both A Co and C Co are now eligible tier-1 companies of Foreign Co, they collectively will form the head company of the MEC group that came into existence as a result of the event even though A Co will nominally be the 'head company'. Therefore, the equity interests of the MEC group will be represented by the collective equity interests of the group's eligible tier-1 companies. As such, the group's equity interests have been affected through the recognition of C Co's equity interests as a result of the event.*



22. *The available fractions in respect of the bundles of losses held by A Co will need to be adjusted by reference to the factor in item 4. The special conversion event, in this case, displays the necessary inter-related characteristics to determine that an injection of capital event has occurred.*

23. *The available fractions will be proportionally reduced by multiplying them by a factor of 0.75 (being $300/(300 + 100)$) using the formula in item 4.*

Date of effect

24. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Your comments

25. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date.

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Commissioner of Taxation

19 October 2005

Previous draft:

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Related Rulings/Determinations:

TR 92/20; TR 2004/9

Subject references:

- application event
- available fraction
- bundle of losses
- consolidation
- consolidated group
- eligible tier-1 company
- head company
- injection of capital
- losses
- market value
- MEC group
- membership interests
- new eligible tier-1 company
- ongoing head company
- special conversion event
- top company

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 Pt 3-90
- ITAA 1997 Div 703
- ITAA 1997 Subdiv 707-C
- ITAA 1997 707-305(5)
- ITAA 1997 707-320(2)
- ITAA 1997 707-325(4)
- ITAA 1997 707-325(4)(a)
- ITAA 1997 707-325(5)
- ITAA 1997 Div 719
- ITAA 1997 719-2
- ITAA 1997 719-15
- ITAA 1997 Subdiv 719-F
- ITAA 1997 719-300
- ITAA 1997 719-300(2)
- ITAA 1997 719-300(3)
- ITAA 1997 719-300(4)
- ITAA 1997 719-300(5)

Other references:

- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002
- Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002

ATO references

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