Worked example

Transitional provisions 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, 1 July 2002 to 30 June 2004.

This section also shows how the application of the cost setting rules for such a member depends on whether membership interests in the entity 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 generally 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 will be a member (where there are interposed foreign resident entities) if it satisfies 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 (the test 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 non-resident trust interposed between the test company and the eligible tier-1 companies
- any other entity interposed between the test company and the eligible tier-1 companies must be either:
  - a non-resident company or non-resident trust (or a partnership in which each partner is a non-resident company or non-resident 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), and
- the company must qualify to be a member of the MEC group if it were assumed that each of the interposed non-resident entities were a member.

There are restrictions on trusts and partnerships being members of a MEC group under the IFRE tests. A resident trust or resident partnership (and its subsidiaries, if any) cannot be a member of a MEC group where it immediately follows the interposed foreign resident – that is, where any membership interests are directly held by the interposed foreign resident. Trusts and partnerships can be members under the IFRE tests only if some or all membership interests in them are owned by entities that are already subsidiary members of the 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, subject to the operation of Division 701D of the *Income Tax (Transitional Provisions) Act 1997*. → 'Transitional foreign loss makers', C3-4-550

Classification of foreign-held subsidiaries

Members of a MEC group that qualify under the IFRE tests are classified into two categories:

- If any membership interests in the member are held directly by an interposed non-resident entity, the member is a 'transitional foreign-held subsidiary' (TFHS).
- If no membership interest is held directly by an interposed non-resident entity, that is all of the membership interests are held by other members of the group, the member is a 'transitional foreign-held *indirect* subsidiary' (TFHIS).

→ 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 4.

Examples

Basic eligibility

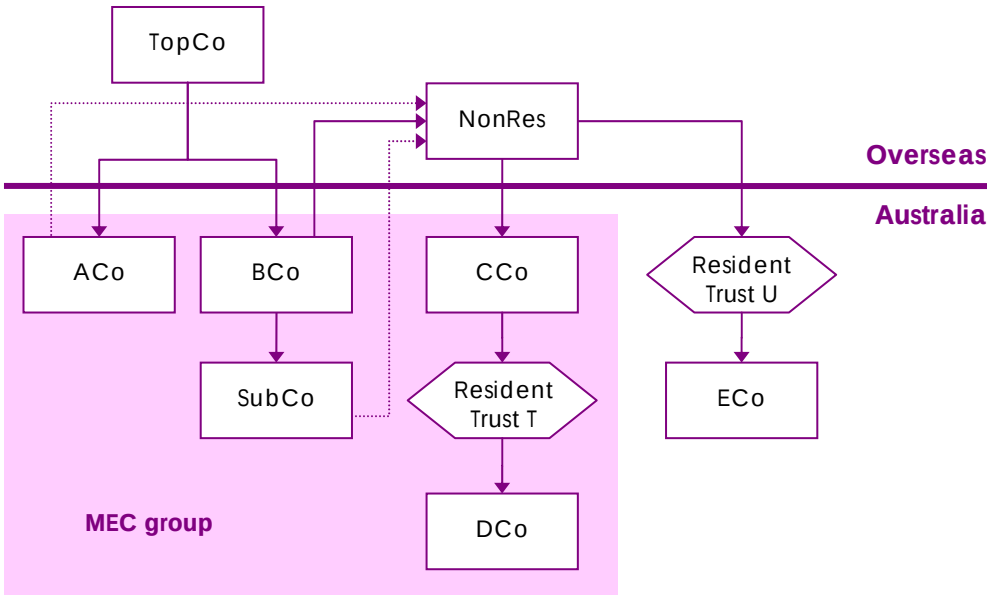
In figure 1, the foreign resident entity NonRes is interposed between an eligible tier-1 company (BCo) and some of its wholly-owned Australian resident subsidiaries: the companies CCo, DCo and ECo, and the trusts Resident Trust T and Resident Trust U.

Under the IFRE tests:

- CCo is a member of the MEC group.
- Resident Trust T and its subsidiary company DCo are members of the MEC group because Resident Trust T is a wholly-owned subsidiary of CCo, 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 an interposed foreign resident. ECo, which is a subsidiary of Resident Trust U, also cannot be a member.

The interposed foreign resident 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 BCo, SubCo or ACo, 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 TFHS of a MEC group if its circumstances change. It cannot, however, *become* a TFHS after formation unless it qualified as a TFHS under the IFRE tests at the time the MEC group was formed (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. ACo and BCo are two eligible tier-1 companies of the MEC group.

DCo is a TFHS of the MEC group at the formation time.

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

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

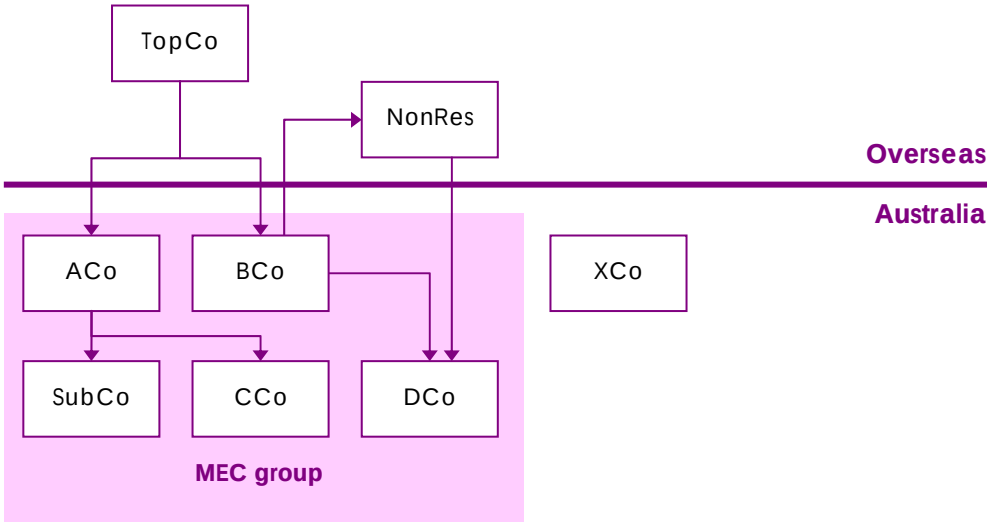
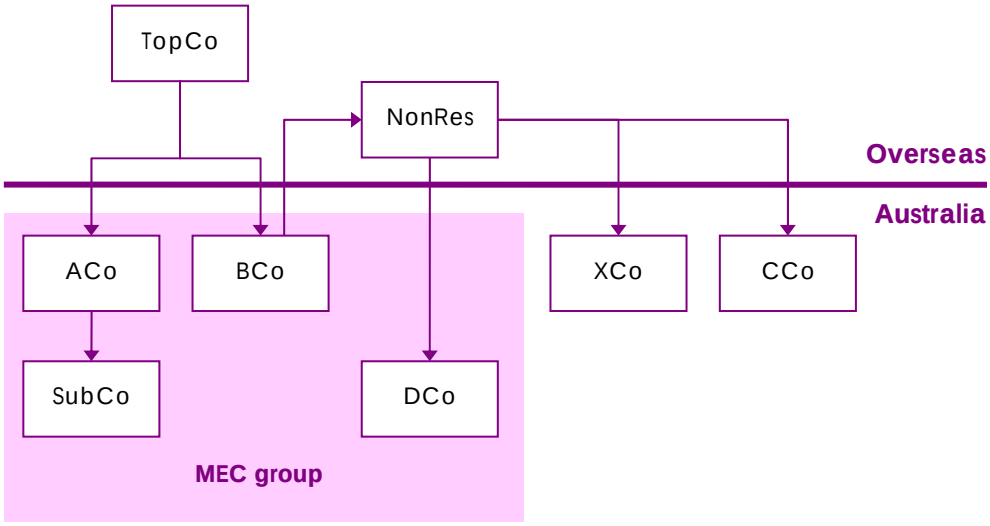


Figure 3: Group after post-formation changes in membership interests



Although XCo becomes a wholly-owned Australian resident subsidiary of TopCo it cannot become a member of the MEC group because at the time of formation it was not a TFHS of the MEC group.

CCo cannot continue to be a member of the MEC group when NonRes acquires all the membership interests in CCo from ACo because the interposed foreign resident (NonRes) did not have any membership interests in CCo at the time the MEC group was formed (CCo was not a TFHS at the time the MEC group was formed).

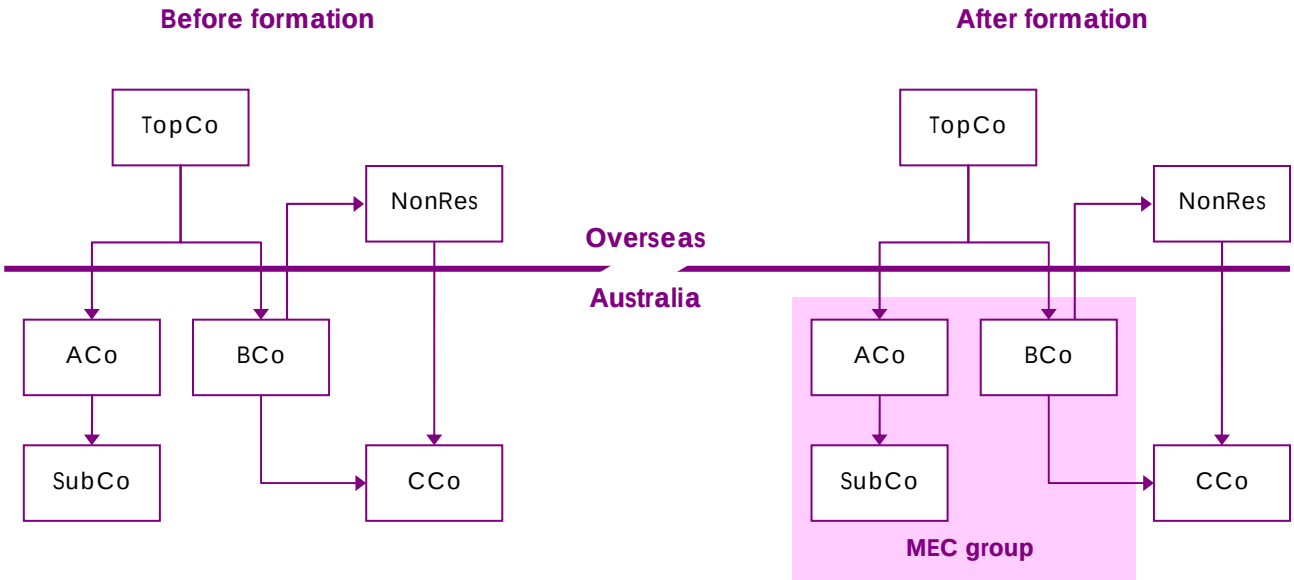
DCo will continue to be a TFHS of the MEC group when NonRes acquires the remaining membership interests in DCo from BCo because at the formation time some of its membership interests are held by NonRes (DCo was a TFHS at the time the MEC group formed).

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.

ACo, BCo, CCo, SubCo, TopCo and NonRes are members of a wholly-owned group. If the resident entities of the group consolidate after 1 July 2004, CCo cannot be a member of the resulting MEC group.

Figure 4: Group formation after 1 July 2004



Cost setting implications

Subsidiaries that qualify as members of a MEC group under the IFRE tests are classified as either a:

- transitional foreign-held subsidiary (TFHS), in which one or more membership interests are directly held by a foreign resident (in figure 5, ACo, BCo and CCo), or a
- transitional foreign-held *indirect* subsidiary (TFHIS), in which no membership interests are directly held by a foreign resident – that is, the membership interests are held entirely by members of the MEC group (in figure 5, the AB partnership, Trust T and DCo).

The cost setting rules apply differently to each category.

An eligible member in which some membership interests are held directly by a foreign resident and the remaining interests are held by a TFHS (such as BCo in figure 5) is itself a TFHS.

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

Figure 5: TFHS and TFHIS members

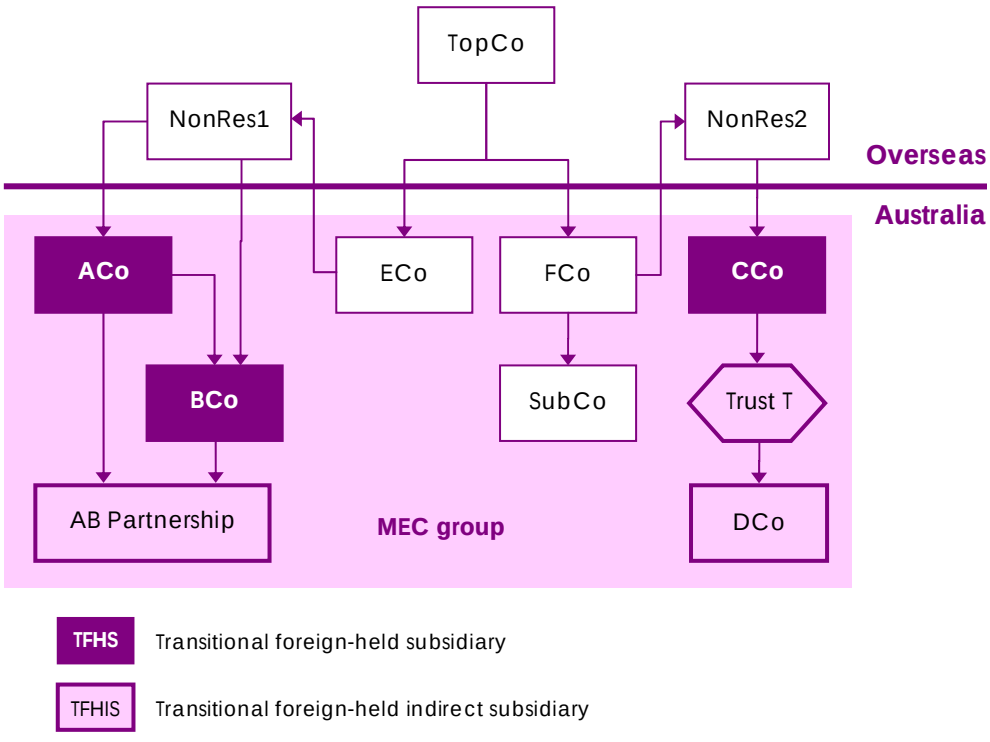


Table 1: Cost setting rules for TFHS and TFHIS members

	Transitional foreign-held subsidiary (TFHS)	Transitional foreign-held indirect subsidiary (TFHIS)
At formation time	A TFHS is treated as if it were a part of the head company of the MEC group. The effect of this modification is that the tax costs of the assets of a TFHS are not set – they retain their terminating values.	The formation cost setting rules for a TFHIS of a MEC group apply in a similar way as they apply to a subsidiary member of a consolidated group. The head company can choose to either retain the terminating values of the assets of the TFHIS or set new tax costs if it is a transitional entity of the transitional group. → For more information see 'Treatment of transitional entity and TFHIS'.
Trading stock	As the tax costs of the assets of a TFHS are not set, it is not necessary to set a tax neutral amount for the trading stock of a TFHS. → section 701C-35, *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997)	If the tax cost set for trading stock of a TFHIS would otherwise be more than its market value or terminating value, it is restricted to the greater of the two amounts. → section 705-40, *Income Tax Assessment Act 1997*(ITAA 1997) 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.
At leaving time	When a TFHS leaves a MEC group, modified leaving time cost setting rules apply. Membership interests in the TFHS held by non-residents are treated as if the head company of the group holds them. → sections 701C-40 and 701C-50, (IT(TP)A 1997)	Leaving time cost setting rules apply without any modification when a TFHIS leaves a MEC group.

Treatment of 'transitional entity' and TFHIS

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 values 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.

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

Cost setting on exit

When a TFHS leaves a MEC group, Division 711 of ITAA 1997, as modified by Subdivision 701C-C of IT(TP) Act 1997, applies to set the cost of membership interests in the TFHS held by a non-resident entity. Membership interests in the TFHS held by an interposed non-resident entity are treated as if the head company of the group held the interests.

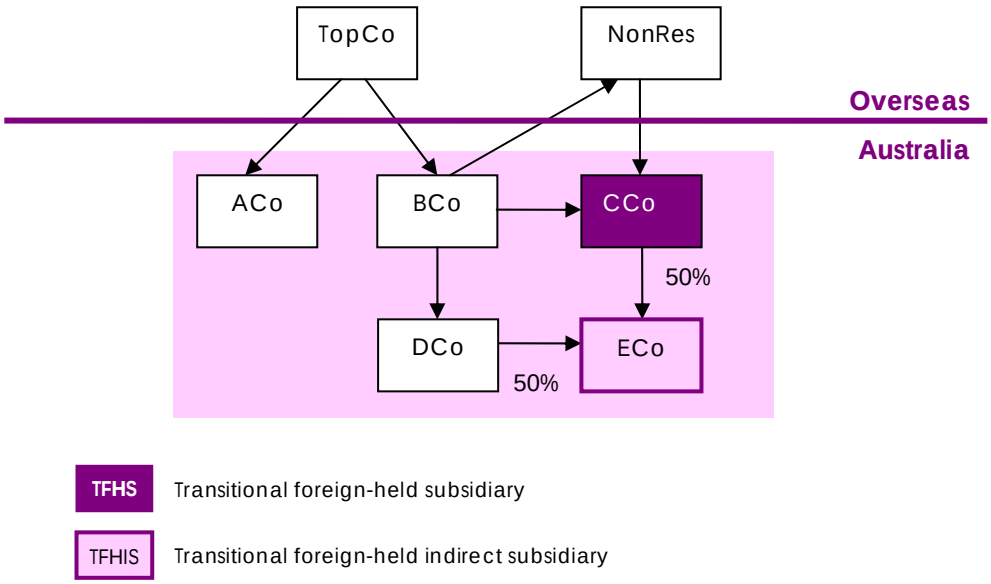
As membership interests in a TFHIS can only be held by members of the MEC group, Division 711 of ITAA 1997 applies to set the cost of membership interests in these entities when they leave a MEC group, in the same way it applies to any other subsidiary member leaving the group.

Example – cost setting

Facts

Figure 6 shows the TopCo group of entities at the time its Australian resident companies form a MEC group, which is before 1 July 2004. ACo and BCo are eligible tier-1 companies. CCo is a TFHS at the formation time because some of its membership interests are held by NonRes, a wholly-owned non-resident subsidiary of BCo. ECo is a TFHIS because 50% of its membership interests are owned by CCo, a TFHS, but none of its membership interests are directly owned by NonRes.

Figure 6: Group structure at formation time



The financial positions of CCo and ECo at the formation time are shown in tables 2 and 3.

Table 2: CCo – financial position at formation time ($)

Cash	100	Equity	410
Land (MV $200, CB $100)	100		
Motor vehicle (MV $10, AV $10)	10		
Membership interests in ECo MV $250, CB $200)	200		
	410		410

MV: market value. CB: market value. AV: adjustable value

Table 3: ECo – financial position at formation time ($)

Cash	200	Equity	400
Land (MV $200, CB $100)	100		
Equipment (MV $100, AV $100)	100		
	400		400

Assume the tax cost setting amount (TCSA) for the membership interests DCo holds in ECo as calculated under Division 705 of the ITAA 1997 is $150.

For more information about calculating the TCSAs for assets that a subsidiary brings into a consolidated group see 'The cost setting process on entry', C2-2-110.

Calculating the TCSAs for CCo's assets

CCo is a TFHS. It is treated as part of the head company for cost setting purposes and the tax costs of its assets will not be reset at the formation time. The group's tax costs for CCo's assets are:

Cash	$100
Land	$100
Motor vehicle	$10
Membership interests in ECo	$200

Calculating the TCSAs for ECo's assets

ECo is a TFHIS. The tax costs of the assets it brings to the group at formation are set under Division 705 of the ITAA 1997 (unless ECo meets the requirements to be a transitional entity of a transitional group in which case the head company may choose to retain existing tax values for Eco's assets).

Calculating the ACA

Step 1. Cost of membership interests

As the market value of CCo's membership interests in ECo ($250) is greater than the cost base ($200), the step 1 amount is the cost base → section 705-65, ITAA 1997. The step 1 amount for the membership interests DCo holds in ECo is the TCSA calculated for those interests ($150) → section 705-145, ITAA 1997.

The total step 1 amount is therefore $350.

Steps 2 to 7

There are no steps 2 to 7 amounts.

The ACA available to be allocated to ECo's assets is therefore $350.

Allocating the ACA

ECo's cash is a retained cost base asset with a tax cost setting amount equal to the amount of Australian currency concerned ($200) → section 705-25, ITAA 1997. The remainder of the ACA ($150) is then apportioned among ECo's remaining assets, other than excluded assets, in proportion to their market values, as shown in table 4 → section 705-35, ITAA 1997.

Table 4: Apportionment of ACA to ECo's reset cost base assets ($)

Asset	Terminating value (TV)	Market value (MV)	ACA apportioned	Assets held on revenue account – excess over greater of TV or MV	TCSA
Land	100	200	100		100
Equipment	100	100	50	0	50
Total		300	150	0	150

The TCSA of a depreciating asset cannot exceed the greater of the asset's market value and the joining entity's terminating value for the asset → section 705-40, ITAA 1997.

The terminating value for the Equipment, a depreciating asset, is equal to its adjustable value just before the joining time ($100) → section 705-40, ITAA 1997. As the TCSA of the equipment ($50) does not exceed the greater of the MV ($100) and the TV ($100), there is no adjustment to the TCSA.

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

References

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

Income Tax (Transitional Provisions) Act 1997:

- Division 701A
- Division 701D
- Subdivisions 701-A and 701C-B
- section 719-15

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

Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 7) 2003, Chapter 4

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: • eligibility under the IFRE tests • 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 • the cost setting implications for different types of members under the IFRE tests.	Provide more information about the operation of the measure generally. Include rules set out in *Taxation Laws Amendment Act (No. 6) 2003* (No. 67 of 2003).
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).