

Worked example

Cost setting rules for assets of a MEC group – at joining and formation times

- Description** This example explains how:
- broadly, the cost setting rules apply to multiple entry consolidated (MEC) groups in the same way as they do for the head company and subsidiary members of a consolidated group → 'Treatment of assets', C2-1, and
 - modifications and additions to those rules take into account the special characteristics of a MEC group.

Commentary

Overview The legislation for the cost setting rules is structured to cover the basic case of an entity joining a consolidated group, with modifications and some additional rules for the following situations:

- the formation of a consolidated group
- where a consolidated group joins an existing consolidated group, and
- where entities that are linked by membership interests join an existing consolidated group.

The rules are further modified as necessary to ensure they apply appropriately to MEC groups. → Subdivision 719-C, *Income Tax Assessment Act 1997* (ITAA 1997); section 719-2, ITAA 1997; section 719-2, *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997); Subdivision 719-C, IT(TP)A 1997

Determining asset tax costs at joining and formation time

For the formation of a MEC group, the cost setting rules are applied by considering:

1. the rules associated with the formation of a consolidated group – that is, the joining entity rules modified for the formation case
→ 'Treatment of assets', C2-1
2. any further modifications that apply to MEC groups.

The assets of the head company of a MEC group retain their existing tax values at the formation time – as with the assets of a head company of a consolidated group. → 'Determining asset values', B2-2

The cost setting rules are modified for the eligible tier-1 companies of a MEC group because those companies are treated for cost setting purposes as if they were part of the head company of a consolidated group. As a result, the assets of eligible tier-1 companies do not have their tax costs reset and they retain their existing tax values. → 'Cost setting rules' in 'Multiple entry consolidated (MEC) groups', C10-1; section 719-160, ITAA 1997

The same rule applies even where there are some membership interests held in an eligible tier-1 company by members of the MEC group. (Note, however, that two sets of rules apply when such an eligible tier-1 company leaves the group → 'An eligible tier-1 company leaving a MEC group', C10-2-430.)

Likewise, the assets of a transitional foreign-held subsidiary member of a MEC group do not have their tax costs reset because such a subsidiary is also treated as part of the head company (as in the case with a normal consolidated group).

→ 'Transitional provisions for foreign-held, Australian-resident subsidiaries to be members of a MEC group', C10-2-120; Subdivision 701C-C, subsection 719-161(2), IT(TP)A 1997; section 719-160, ITAA 1997

There is no modification to the cost setting rules for those subsidiary members (other than eligible tier-1 companies) that have *all* of their membership interests directly owned by the other members of the MEC group. At the forming or joining time, the tax cost of each asset of a subsidiary member includes a component for the liabilities of the subsidiary with adjustments for certain undistributed profits, losses and certain deductions to which the head company becomes entitled.

Transitional option

Where a MEC group is formed during the transitional period (1 July 2002 to 30 June 2004), the head company may choose to retain the existing tax values of a non-eligible tier-1 company subsidiary member's assets instead of setting new tax costs if the subsidiary member qualifies as a transitional entity. This option is available on a subsidiary by subsidiary basis on the group's formation.

→ 'Overview of cost setting process on formation and entry (including transitional rules)', C2-1-010

To qualify as a transitional entity in a MEC group, the subsidiary member can be a wholly-owned subsidiary of one or more eligible tier-1 companies.

A transitional entity for which the head company has chosen not to reset the cost of its assets is a chosen transitional entity.

The head company must make the choice by the later of 31 December 2005 and the day on which it lodges its income tax return for the income year in which the choice is made (or the last day on which it would be required to lodge if it was required to lodge). The head company is able to revoke this choice until 31 December 2005, providing that it obtains the agreement of each entity that left the group before the revocation time taking with it one or more assets that were previously those of the head company under the single entity rule. → Transitional rules: sections 701-1, 701-5 and 701-15, IT(TP)A 1997

Summary Table 1 summarises the asset cost setting rules for members of a MEC group.

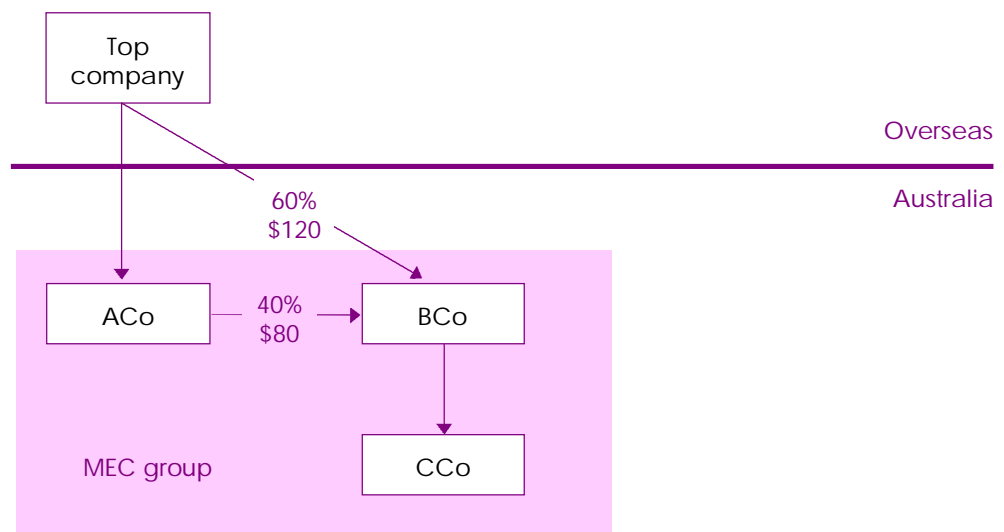
Table 1: Asset cost setting treatment for MEC group

| Type of entity | Asset treatment for cost setting purposes | Legislation |
|--|--|---|
| Head company – an eligible tier-1 company that has all its membership interests owned outside the MEC group and that has been jointly appointed by the other eligible tier-1 companies of the MEC group. | Existing tax values of assets are used – that is, assets are treated like the assets of a head company of a consolidated group. | Division 701 |
| Subsidiary members that are eligible tier-1 companies including any that have some of their membership interests held by MEC group members. | Eligible tier-1 companies are treated as part of the head company; assets retain their existing tax values rather than having their costs reset. | Division 701 Division 705 Subdivision 719-C |
| Subsidiary members in which all membership interests are directly owned by other members of the MEC group (i.e. subsidiary members other than a transitional foreign-held subsidiary – TFHS). | The cost setting rules are used to reset asset costs – that is, assets are treated like the assets of a subsidiary member of a consolidated group. | Division 705 Subdivision 719-C |
| Transitional foreign-held subsidiary (TFHS) members. | The TFHS is treated as if it were a part of the head company of the group; assets retain their existing tax values rather than having their costs reset. | Subdivision 701C-C IT(TP)A 1997 Division 701 |
| Transitional foreign-held indirect subsidiary members (TFHIS) | The cost setting rules are used to reset asset costs – that is, assets are treated like the assets of a subsidiary member of a consolidated group. | Subdivision 701C-C IT(TP)A 1997 Division 705B |

Example Formation case – where some of the membership interests in an eligible tier-1 company are held by members of the MEC group

Following an initial acquisition of 60% of the membership interests in BCo by the top company for \$120, ACo pays \$80 to acquire the remaining 40% of BCo. ACo, BCo and CCo then consolidate as a MEC group, as shown in figure 1. BCo has no liabilities and only one asset (being all the membership interests in CCo), which has an existing tax value of \$200.

Figure 1: Formation case



ACo's assets will not be reset because it is the head company of a MEC group and the existing tax values of the assets are used.

BCo's assets will not have their costs reset as BCo is an eligible tier-1 company and will be taken to be a part of ACo, the head company of the MEC group. BCo's only assets are all the membership interests in CCo, which have an existing tax value of \$200.

CCo is a subsidiary member of the MEC group but it is not an eligible tier-1 company. The cost of CCo's assets will be reset, unless the group qualifies under the transitional rules and the head company elects to use existing tax values for CCo's assets. If CCo's assets are reset, the allocable cost amount will include \$200 as the cost of membership interests in CCo together with its liabilities and other adjustments.

Pre-formation rollover after 16 May 2002 and transitional groups

If there has been a rollover of an asset under Subdivision 126-B or under item 4 of the table in subsection 40-340(1), and:

- the rollover was after 16 May 2002
- the group consolidates after the rollover but before 1 July 2004, and
- the tax values of the group's assets change because of the rollover,

then the rollover is disregarded for tax cost setting purposes on consolidation with certain exceptions. → sections 701-35 and 719-163, IT(TP)A 1997

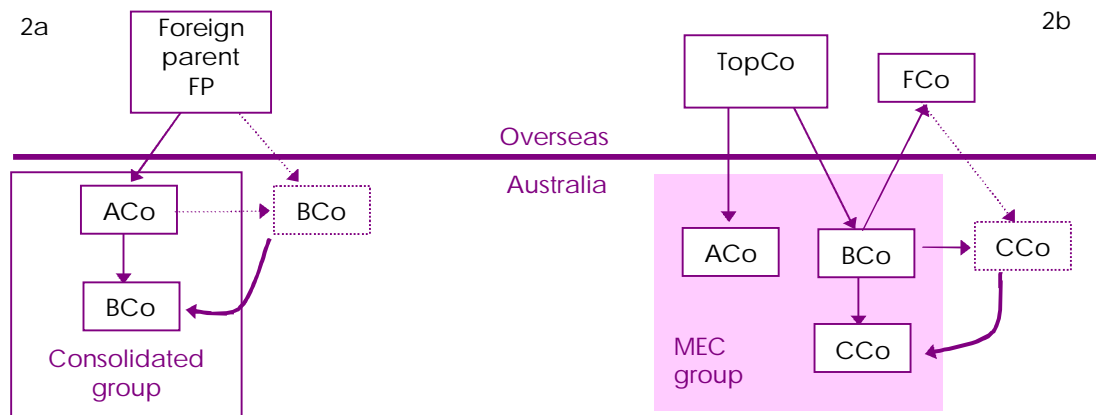
The rule is to prevent groups from using rollover relief to maximise their choices for the cost setting of their assets on consolidation.

Exception to pre-formation rollover after 16 May 2002 for foreign-owned groups

To enable a foreign-owned group that restructures to reset the cost of its assets on consolidation, an exception exists when the following conditions are satisfied:

- the rollover asset is a membership interest in an entity
- the membership interest is rolled over from a foreign-resident company to an Australian-resident company
- the entity whose membership interests were rolled over becomes a subsidiary member of a consolidated or MEC group at the time of formation
- the group is a transitional group, and
- the entity is not an eligible tier-1 company of a MEC group or an entity in which a foreign-resident company or a non-resident trust holds membership interests.

Figure 2: Rollover of membership interest in a company (Subdivision 126-B)



In figure 2a, the foreign parent rolls over its membership interests in BCo to ACo after 16 May 2002. After the roll-over and before 1 July 2004, ACo and BCo form a consolidated group. In this case, the rollover of the membership interests is not disregarded when the cost of the assets of the group is reset. ACo's cost base of the membership interests in BCo will be FP's cost base in BCo at the time of the roll-over plus ACo's cost base in BCo.

In figure 2b, FCo, a foreign subsidiary of BCo, rolls over its membership interests in CCo to BCo after 16 May 2002. After the roll-over and before 1 July 2004, ACo, BCo and CCo form a MEC group. CCo does not become an eligible tier-1 company of the MEC group. In this case, the rollover of the membership interests is not disregarded when the cost of the assets in CCo is reset. BCo's cost base for the membership interests in CCo will be FCo's cost base of the membership interests in CCo at the time of the roll-over plus BCo's cost base in CCo.

Exception where there is a demerger

There is also an exception if the rollover happens before a demerger and is in connection with the demerger, and:

- either the originating company or the recipient company ceases to be a member of the 'demerger group' (as defined in section 125-65 of the ITAA 1997) because of the demerger, and
- the recipient company and the originating company do not both join the same transitional group.

References

Income Tax Assessment Act 1997, Division 705; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

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

Income Tax Assessment Act 1997, Subdivision 719-C; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8 and *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedules 11 and 12

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

Income Tax (Transitional Provisions) Act 1997, sections 701-35 and 719-163; as amended by:

- *New Business Tax System (Consolidation, Value Shifting Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7
- *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 17
- *Tax Laws Amendment (2004 Measures No. 2) Act 2004* (No. 83 of 2004), Schedule 2
- *Tax Laws Amendment (2006 Measures No. 4) Act 2006* (No. 168 of 2006), Schedule 2

Income Tax (Transitional Provisions) Act 1997, section 701-5; as amended by *Tax Laws Amendment (2005 Measures No. 5) Act 2005* (162 of 2005), Schedule 3, Part 2

Explanatory Memorandum to New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, paragraphs 1.104 to 1.107

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, paragraphs 5.75 to 5.88

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 2) Bill 2004, paragraphs 2.107 to 2.117

Revision history

Section C10-2-210 first published 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

| Date | Amendment | Reason |
|----------|---|-------------------------|
| 26.10.05 | Changes to 'Commentary' explain how wholly-owned subsidiaries of one or more eligible tier-1 companies of a MEC group can qualify as transitional entities. | Legislative amendments. |
| 12.9.06 | Extension of time for head companies to make or revoke a choice to retain existing tax costs for assets or reset tax costs, p. 2. | Legislative amendment. |
| 6.5.11 | Reference to exception to section 701-35 of the IT(TP)Act 1997 applying where the rollover is because of a demerger, p. 6. | Legislative amendment. |