

## Worked example

## Continuity of a potential MEC group when the identity of the top company changes – assumptions about the test company failing the COT

**Description** This example describes a case in which the test company is deemed to have failed the continuity of ownership test (COT). In this example, the potential MEC group continues to exist despite a change in the top company arising from a change in ownership of the membership interests in the group's eligible tier-1 companies. → 'MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test', C10-2-325

**Commentary** In recognition of the special characteristics of MEC groups, Subdivision 719-F of the *Income Tax Assessment Act 1997* (ITAA 1997) modifies the rules about transferring and utilising losses within those groups.

The focal company (the company seeking to utilise the loss) is considered to have met the continuity of ownership conditions in section 165-12 of the ITAA 1997 if the test company would have met those conditions based on the assumptions in sections 719-270, 719-275 and 719-280.<sup>1</sup>

Under section 719-280, the test company is deemed to have failed the COT (section 165-12) in relation to a loss in certain circumstances. Broadly, those circumstances are when one of the following events happens to the focal company's MEC group, or potential MEC group, after the start of the focal company's ownership test period for the loss:<sup>2</sup>

- the potential MEC group ceases to exist
- the potential MEC group continues to exist but the identity of the top company changes as a result of the acquisition of membership interests in certain entities below the group's original top company (the relevant entities are the group's eligible tier-1 companies or any entities interposed between the eligible tier-1 companies and the original top company), or
- there ceases to be a provisional head company for the group.

<sup>1</sup> The assumptions contained in sections 719-270 and 719-275 relate to determining whether the test company has satisfied the COT. If the conditions in section 719-280 are satisfied, however, the test company is deemed to have failed the COT.

<sup>2</sup> Section 719-280 does not apply where the event occurs because the MEC group has converted to a consolidated group, where the conversion took place:

- on or after 27 October 2006, or
- before 27 October 2006 and a choice in writing is made within the prescribed time for Subdivision 719-BA to apply from 1 July 2002.

→ section 719-140, item 17, *Tax Laws Amendment (2010 Measures No. 1) Act 2010*; paragraphs 5.92, 5.105 and 5.106 of the Explanatory Memorandum to *Tax Laws Amendment (2010 Measures No. 1) Bill 2010*

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The test company will also fail the conditions in section 165-12 when those conditions are not met based on the assumptions in sections 719-270 and 719-275. When this actual COT failure occurs in addition to a deemed COT failure (under section 719-280), the COT failure time will be the earlier of the two. Under section 719-260, the focal company is considered to have failed to meet a condition in section 165-12 only at the first time that the test company would have failed to meet the condition.

## Example

### Facts

TopCo1 is a foreign-resident company that owns all the membership interests in the Australian-resident companies, ET1Co and HCo. ET1Co, in turn, owns all the membership interests in the Australian-resident company, SubCo.

A MEC group consisting of SubCo and the eligible tier-1 companies, ET1Co and HCo, forms on 1 July 2002, with HCo being nominated as the provisional head company.<sup>3</sup> On that date, Ben holds 55% of the membership interests in TopCo1 and the remaining membership interests are held by Bill. These membership interests in TopCo1 are held continuously from 1 July 2002 to 30 June 2004.

HCo is the provisional head company of the MEC group at the end of the income year ended 30 June 2003 and is therefore considered to be the head company of the MEC group for that income year (section 719-75). HCo makes a tax loss (in this case, a group loss) for the income year ended 30 June 2003.

On 1 August 2003, TopCo2 acquires all the membership interests in both ET1Co and HCo. On this date, Tom holds 70% of the membership interests in TopCo2 and Jerry holds the remaining 30%. These shareholdings in TopCo2 do not change during the income year ended 30 June 2004.

HCo seeks to utilise the group loss (made in the income year ended 30 June 2003) in the income year ended 30 June 2004.

### Calculation

HCo, the focal company, will be considered to have satisfied the continuity of ownership conditions in section 165-12 if the test company would have met those conditions based on the assumptions in sections 719-270, 719-275 and 719-280. In addition to establishing whether there has been a deemed COT failure under section 719-280 (step 5 below), it is also necessary to determine whether the COT has been satisfied in relation to the assumptions set out in sections 719-270 and 719-275 (steps 1 to 4 below).

#### *Step 1: Identify the test company*

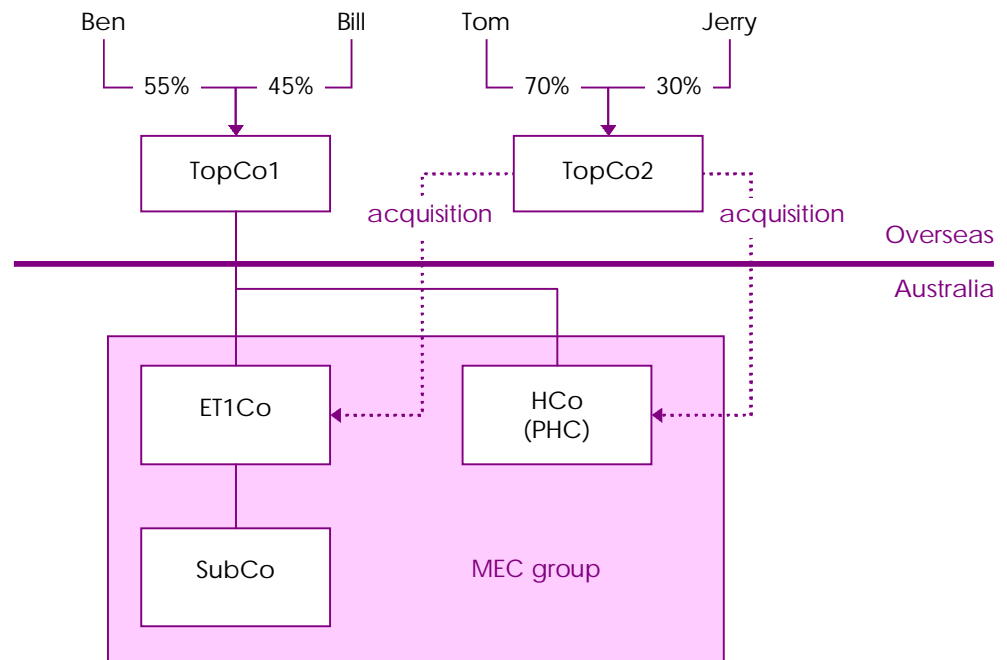
Applying section 719-265, the test company is TopCo1.

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<sup>3</sup> Under subsection 719-60(1), the appointment of a provisional head company must be included in the written choice to form a MEC group made under section 719-50.

Item 1 in the table in subsection 719-265(4) applies because the tax loss is a group loss and HCo, the focal company, was the head company of the MEC group at the beginning of the income year in which it made the loss (1 July 2002). TopCo1 is the test company because it was the top company at that time. HCo is the focal company because it is the company that is seeking to utilise the loss. → section 719-255

Figure 1: MEC group and changes in membership interests



*Step 2: Assume that the test company made the loss*

Applying section 719-270, TopCo1 is considered to have made the loss.

Subsection 719-270(1) applies as the test company, TopCo1, was the top company of the MEC group and the focal company, HCo, was the head company of the group.

*Step 3: Identify the start of the income year in which the test company is considered to have made the loss*

Applying section 719-270, the test company, TopCo1, is considered to have made the loss at the start of the income year ended 30 June 2003.

Item 1 in the table in subsection 719-270(1) applies, as the loss is a group loss. Under this item, the start of the test company's (TopCo1) loss year is the start of the income year in which the focal company (HCo) made the loss (in this case, 1 July 2002).

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*Step 4: Apply the COT to the test company, ignoring ownership and voting changes below the top company*

Applying section 719-275, the ownership structure between TopCo1 and TopCo2 is considered frozen after TopCo2 becomes the new top company of the MEC group (for the purposes of determining whether the continuity of ownership conditions in section 165-12 are met).<sup>4</sup> In this case, the freezing of the ownership structure does not affect whether TopCo1 satisfies the COT because TopCo2 does not hold any direct or indirect membership interests in TopCo1.

Taking into account the assumptions in sections 719-270 and 719-275, the test company, TopCo1, passes the COT. It satisfies the conditions in section 165-12 because 100% of TopCo1's ownership has remained unchanged from the start of the income year ended 30 June 2003 (the start of the loss year) to 30 June 2004 (the end of the loss claim year).

However, Top Co1 will fail to satisfy the conditions in section 165-12 if the deemed COT failure in section 719-280 applies.

*Step 5: Determine whether the deemed COT failure applies*

Section 719-280 applies to deem the test company, TopCo1, to have failed the continuity of ownership conditions in section 165-12 because a specified 'failing' event in subsection 719-280(3) occurred on 1 August 2003, which is after the start of the focal company, HCo's, ownership test period (1 July 2002). The specified 'failing' event in this instance occurs when TopCo2 acquires all of the membership interests in ET1Co and HCo. This event satisfies the conditions in subsection 719-280(3) because:

- there was a change in the membership interests in ET1Co and HCo (they were acquired by another entity, TopCo2)
- immediately before the time of the change, ET1Co and HCo were members of the MEC group and eligible tier-1 companies of TopCo1, the top company of the group, and
- the acquisition of the membership interests in ET1Co and HCo by TopCo2 does not cause the potential MEC group to cease to exist but it does change the identity of the top company of the potential MEC group from TopCo1 to TopCo2<sup>5</sup> (the potential MEC group does not cease to exist because the eligible tier-1 companies that were members of the group immediately before the change in the top company – ET1Co and HCo –

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<sup>4</sup> Section 719-275 applies because the identity of the top company changes from TopCo1 to TopCo2 (the event described in item 3 of the table in subsection 719-275(2)) between 1 July 2002 (the start of the income year in which the test company, TopCo1, is considered to have made the loss under section 719-270) and 30 June 2004 (the end of the loss claim year). Note that, in this example, subsection 719-275(3) treats the head company, HCo, as having made the loss for the purposes of establishing whether the item 3 event in subsection 719-275(3) has occurred.

<sup>5</sup> See item 1 in the table in subsection 719-20(1) for details on what constitutes a top company.

have not changed). → subsection 719-10(8); for details on what constitutes a potential MEC group, see section 719-10

*Step 6: Determine whether the focal company meets the conditions in section 165-12*

Under subsection 719-260(1), the focal company is considered to meet the continuity of ownership conditions in section 165-12 if the test company meets those conditions (based on the relevant assumptions).

In this case, therefore, the focal company, HCo, does not meet the conditions in section 165-12 because the test company, TopCo1, does not meet those conditions based on all the assumptions in sections 719-270, 719-275 and 719-280. In particular, TopCo1 fails to meet the conditions in section 719-280.

HCo is considered to fail the conditions in section 165-12 on 1 August 2003, at the time that TopCo1 is deemed to fail them based on the assumptions in section 719-280. → subsection 719-260(2)

## References

*Income Tax Assessment Act 1997*

- section 165-12
- Subdivision 719-A
- section 719-140; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapter 4

*Income Tax Assessment Act 1997*, Subdivision 719-F; as amended by *New Business Tax System (Consolidation and Other Measures) Act 2003* (No. 16 of 2003), Schedule 13

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 3

*Tax Laws Amendment (2010 Measures No.1) Act 2010*, item 17

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.92, 5.105 and 5.106

### Revision history

Section C10-2-390 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Addition of footnote p. 1 to reflect changes to the group conversion provisions.	Legislative amendment.