

Group conversions

A group conversion happens when:

- a consolidated group is created from a MEC group, or
- a MEC group is created from a consolidated group (a special conversion event).

New rules introduced in the *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010) enable a group conversion to happen with minimal tax consequences for ongoing members. The new rules are contained in Subdivision 719-BA of the *Income Tax Assessment Act 1997* (ITAA 1997).

The new rules apply to group conversions that happen on or after 27 October 2006. However, the head company of the MEC group or consolidated group can choose for the new rules to apply from 1 July 2002. The choice must be made in writing, on or before 30 June 2011 or within a further time allowed by the Commissioner. → *Taxation Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010) Item 17, Schedule 5

The time at which a consolidated group is created from a MEC group (→ section 703-55) or a MEC group is created from a consolidated group (→ section 719-40) is known as the conversion time. The group that existed before the conversion time is referred to as the old group and the group that exists after the conversion time is referred to as the new group.

Entities that were members of the old group just before the conversion time and that remain members of the new group at the conversion time are referred to as ongoing members.

→ 'Choice on formation, special conversion events and acquisition of new eligible tier-1 companies', C10-2-110; 'A MEC group becomes a consolidated group', C10-2-140

Key changes

When a group conversion happens, the old group ceases to exist and the new group comes into existence. Under the old rules covering group conversions, the ongoing members ceased to be members of the old group (i.e. they left the old group) and joined the new group, resulting in significant tax consequences and compliance costs. Under the new rules, ongoing members continue to leave the old group and join the new group but certain tax provisions that would normally apply when an entity leaves or joins a consolidated group or MEC group do not apply in relation to the ongoing members when a group conversion happens.

To minimise the tax consequences for the ongoing members, the new rules provide that:

- the head company of the new group retains the history of the old group
→ section 719-125 of the ITAA 1997

New group's
head
company
retains history
of old group's
head
company

- the tax cost setting rules that normally apply when an entity leaves or joins a consolidated group or MEC group do not apply in relation to ongoing members. → subsection 719-120(2), section 719-130, ITAA 1997

When a group conversion happens, the head company of the new group retains the history of the head company of the old group. This means that everything that happened in relation to the head company of the old group before the conversion time is taken to have happened to the head company of the new group. However, history in relation to assets, liabilities and businesses that ceased to be that of the head company of the old group (as a result of an entity leaving the old group) under the exit history rules is not inherited by the head company of the new group → section 719-125, ITAA 1997.

In most cases, the company that was the head company of the old group will be the head company of the new group. But, where a MEC group is created from a consolidated group and there is change in the provisional head company, after the conversion time, in the same income year as the conversion time, the new group will have a different head company. In either case, the head company of the new group retains the history of the head company of the old group. → subsection 719-125(1)

The history that is retained by the new group's head company includes everything that was taken to have happened immediately before the conversion time to the old group's head company because of:

- the single entity rule → subsection 701-1(1), ITAA 1997
- the entry history rule → section 701-5, ITAA 1997
- the effects of a choice by a consolidated group to continue as a consolidated group after an interposed company becomes the new head company → section 703-75, ITAA 1997
- the effects of a change in the head company of a MEC group → section 719-90, ITAA 1997, and
- any previous applications of Division 719 of the ITAA 1997.

For example, where a consolidated group is created from a MEC group, and there has been one or more changes to the head company of the MEC group before the conversion time, and history was transferred to each successive head company of the MEC group under section 719-90, the new group's head company inherits all the previous history of the MEC group and is treated as if it has always been the head company of the group.

Retaining the history of the old group's head company enables the tax liability or tax loss to be worked out

The retention of the history enables the new head company to fulfil its core purpose of working out its income tax liability or tax loss for the income year in which the conversion time happens and the subsequent income years.

→ subsection 701-1(2), paragraph 719-125(3)(a), ITAA 1997

Similarly, it enables a subsidiary member of the old group to work out its income tax liability or tax loss for any non-membership periods. → subsection 701-1(3), paragraph 719-125(3)(b), ITAA 1997

Further, it enables the head company or provisional head company of the new group to determine the franking account balance of the new group at or after the conversion time.

→ Subdivision 709-A, section 719-430, paragraph 719-125(3)(c), ITAA 1997; 'Franking accounts in consolidated groups', C5-2-110

Provisions that do not apply to ongoing members

Joining time provisions that do not apply to ongoing members

Certain joining time provisions that ordinarily apply when an entity joins a consolidated group or MEC group, other than the single entity rule (→ subsection 701-1(1)), do not apply to an ongoing member – in particular:

- CGT events L1, L2, L3, L4 and L8, which may apply when an entity joins a consolidated group or MEC group → Subdivision 104-L, ITAA 1997
- the modification to the operation of the same business test that ordinarily applies when an entity becomes a subsidiary member of a consolidated group or MEC group → section 165-212E, ITAA 1997
- the consolidation provisions in Part 3-90 that ordinarily apply when an entity joins a consolidated group or MEC group (other than the single entity rule and Subdivision 719-BA), and
- the transitional consolidation provisions in Part 3-90 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997) that ordinarily apply when an entity joins a consolidated group or MEC group.

→ subsections 719-130(1), (2) and (5), ITAA 1997

As a consequence of joining time provisions not applying:

- The tax cost setting rules in Division 705 do not apply in relation to the assets of an ongoing member when it joins the new group and, therefore, the tax costs of these assets are not reset.
- The loss transfer rules in Subdivision 707-A do not apply to an ongoing member when it becomes a member of the new group and, as a result, losses transferred from an ongoing member to the head company of the old group are taken to be transferred to the head company of the new group.

As these concessions apply only to ongoing members, they are not available for an entity that joins the new group at the conversion time. For example, where a MEC group is created from a consolidated group, the joining time provisions listed above will continue to apply in relation to those entities whose joining resulted in the MEC group being created.

Leaving time provisions that do not apply to ongoing members

Certain leaving time provisions that ordinarily apply when an entity leaves a consolidated group or MEC group do not apply to an ongoing member – in particular:

- Division 711, which ordinarily applies when an entity leaves a consolidated group or MEC group → Division 711, ITAA 1997
- CGT event L5, which applies because Division 711 applies
→ Subdivision 104-L, ITAA 1997
- the consolidation provisions in Part 3-90 that ordinarily apply when an entity leaves a consolidated group or MEC group (other than Subdivision 719-BA), and
- the transitional consolidation provisions in Part 3-90 of the IT(TP)A 1997 that ordinarily apply when an entity leaves a consolidated group or MEC group.

→ subsections 719-120(2) and 719-130(3) to (5), ITAA 1997

As a consequence of the leaving time provisions not applying, the tax cost setting rules in Division 711 do not apply in relation to an ongoing member of the old group and therefore the tax cost of its membership interests are not worked out.

As these concessions apply only to ongoing members, they are not available for an entity that leaves the old group at the conversion time. For example, a transitional foreign-held subsidiary in the old group will not be able to qualify as a member of the new group and therefore the leaving time cost setting rules will continue to apply.

Note

Where a MEC group is created from a consolidated group as a result of a subsidiary member of the consolidated group becoming an eligible tier-1 company of the top company at the conversion time (commonly referred to as a 'transfer-up'), Division 711 applies. → 'MEC group created from a consolidated group – special conversion event due to transfer-up (Division 711 and CGT event L5)', p. 7 of this section

‘MEC group ceases to exist’ provisions that do not apply

Where a consolidated group is created from a MEC group, the following provisions that would normally apply when the MEC group ceases to exist at the conversion time do not apply:

- section 719-280, which deems that the head company of the MEC group fails the continuity of ownership test in relation to unused losses because a MEC group ceases to exist¹
- section 719-465, which deems the head company of the MEC group to fail the continuity of ownership test in relation to bad debts because a MEC group ceases to exist
- sections 719-705 and 719-725, which deem a changeover time and an alteration time under the loss integrity rules for the head company of the group at the time a MEC group ceases to exist, and
- any other provision in Part 3-90, to the extent that the application of the provision is necessary for the application of sections 719-280, 719-465, 719-705 and 719-725. This would include, for example, other provisions in Subdivisions 719-F, 719-I and 719-T. → section 719-40, ITAA 1997

Provisions that continue to apply to ongoing members

Consolidated group created from a MEC group – pooling rules

When a consolidated group is created from a MEC group, the pooling rules in Subdivision 719-K, together with any other provisions to the extent they are necessary for the application of the pooling rules, continue to apply to an ongoing member. → section 719-135, ITAA 1997; ‘Pooling of external membership interests’, C10-2-420

Broadly, the pooling rules ensure that the cost base or reduced cost base of the membership interests in the head company of the consolidated group created from the MEC group, that were previously pooled interests in the head company of the MEC group, is set at the cost setting amount determined under Subdivision 719-K.

¹ As section 719-280 does not apply where a consolidated group was created from the MEC group and this conversion took place:

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

the provisions in Subdivision 719-F that modify the continuity of ownership test for MEC groups will not apply to the consolidated group after the conversion time. → section 719-140, item 17 of *Tax Laws Amendment (2010 Measures No. 1) Act 2010*; paragraphs 5.92, 5.105 and 5.106, Explanatory Memorandum to *Tax Laws Amendment (2010 Measures No. 1) Bill 2010*.

MEC group created from a consolidated group – special conversion event due to expansion

Available fractions

A MEC group is created from a consolidated group (that is itself a potential MEC group) due to an expansion when one or more companies that are not ongoing members become eligible tier-1 companies of a top company, and the top company already wholly owns, directly or indirectly, the head company of a consolidated group, and the head company makes a written choice that a MEC group is to form and informs the Commissioner of that choice in the approved form and within the prescribed time. → sections 719-40 and 719-78, ITAA 1997

Where a MEC group is created from a consolidated group because of an expansion, the provisions that apply to deem prior group losses to be transferred losses, and the provisions that apply to adjust or cap the available fractions for previously transferred loss bundles, and the prior group loss bundles, continue to apply at the conversion time. → sections 719-300 and 719-325, ITAA 1997

That is, for the purposes of section 719-300, the prior group loss of the old group will be taken to be transferred to the head company of the new group, and an available fraction calculated. → section 719-305, ITAA 1997

Similarly, the available fractions of the loss bundles in the old group will be adjusted when they become loss bundles in the new group. → section 719-310, ITAA 1997

Also, for the purposes of section 719-325, which deals with the choice to cancel losses in a bundle, the ongoing head company can choose to cancel all the losses in its bundle of prior group losses. It can also choose to cancel the losses in any previously transferred bundle of losses that is deemed to be transferred at the conversion time to the MEC group head company.

→ 'Adjusting available fraction - a new eligible tier-1 company joins a MEC group', C10-2-310

Loss integrity rules

Provisions that apply to set the reference time for the head company of the MEC group for the purposes of the loss integrity rules in Subdivisions 165-CC and 165-CD will continue to apply. → sections 719-700 and 719-720, ITAA 1997

→ 'Effect of Subdivision 165-CD for MEC groups', C2-6-150; 'Effect of Subdivision 165-CC for MEC groups', C2-6-140

MEC group created from a consolidated group – special conversion event due to transfer-up (Division 711 and CGT event L5)

Another way in which a MEC group is created from a consolidated group is when the head company of a consolidated group, which itself is a potential MEC group, transfers all the membership interests in a subsidiary member (the transferred-up entity) to the top company (a ‘transfer-up’), the transferred-up entity qualifies as an eligible tier-1 company of the top company and the head company makes a written choice that a MEC group forms and notifies the Commissioner, in the approved form and within the prescribed time, of that choice.

In a group conversion involving a transfer-up, even though the new eligible tier-1 company is an ongoing member, the tax cost setting rules in Division 711 apply to set the tax cost of the membership interests in that member.

The tax cost of the membership interests in the transferred-up entity just before the conversion time is worked out, under Division 711, to determine whether the head company has made a capital gain or loss on the transfer. As a result of Division 711 applying, CGT event L5 may also apply.

→ subsection 719-130(4), ITAA 1997

Where the transferred-up entity has membership interests in any lower tier subsidiary members, the tax cost setting rules in Division 711 apply to determine the tax cost of the transferred-up entity’s membership interests in the lower-tier subsidiary members (i.e. using the ‘bottom-up’ approach). It is necessary to determine the tax cost of the lower tier subsidiary members’ membership interests in order to work out the tax cost of the membership interests in the transferred-up entity. However, in applying Division 711 to the lower tier subsidiary members’ membership interests, CGT event L5 will not happen in relation to the lower tier subsidiary members.

→ subsection 719-130(1), ITAA 1997

Example

In figure 1, HCo is the head company of a foreign-owned consolidated group. The ultimate foreign parent, TCo, qualifies as a top company.

HCo also satisfies the requirements to be an eligible tier-1 company. SubCo 1 and SubCo 2 are subsidiary members of the consolidated group.

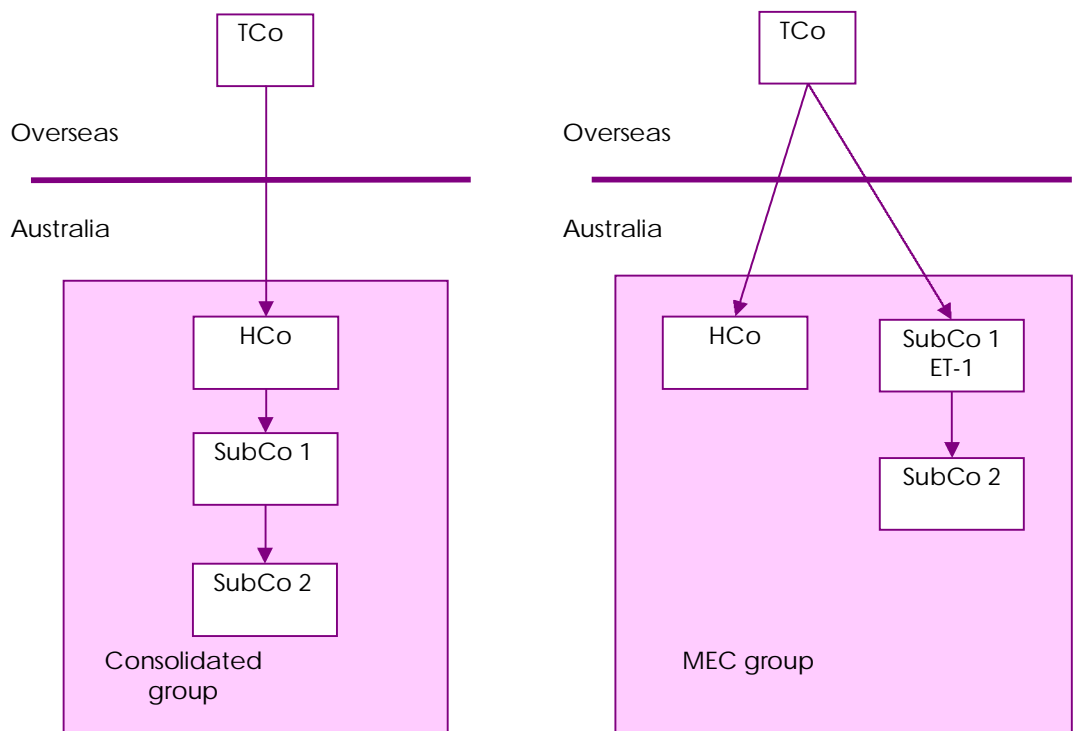
As part of a group restructure, HCo transfers all its membership interests in SubCo 1 to TCo.

SubCo 1 qualifies as an eligible tier-1 company of TCo, and HCo makes a written choice that a MEC group is to form with SubCo 1 as the new eligible tier-1 company and informs the Commissioner of that choice in the approved form and within the prescribed time.

Just before the conversion time, the tax cost of the membership interests in SubCo 2 is worked out under Division 711. However, CGT event L5 will not happen in relation to SubCo 2.

The tax cost of the membership interests in SubCo 2 is used in applying Division 711 to determine the tax cost of the membership interests in SubCo 1. This will determine whether HCo has made a capital gain or capital loss on the transfer. HCo may also make a capital gain under CGT event L5 in relation to the membership interests in SubCo 1.

Figure 1: Transfer-up



References

Income Tax Assessment Act 1997, Divisions 705 and 711, Subdivisions 104-L, 165-CC, 165-CD, 707-A, 719-F, 719-H, 719-I, 719-K and 719-T, sections 701-5, 703-55, 703-75, 719-40 and 719-90, and subsection 701-1(1).

Income Tax Assessment Act 1997, Subdivision 719-BA and Section 719-78; as inserted by *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (No. 56 of 2010), Schedule 5, Part 2

Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, paragraphs 5.65 - 5.10

Revision history

Section C10-1-210 first published 6 May 2011.