

Worked example

Freezing the ownership structure of a MEC group – when a loss-making company becomes head company of the group

Description This example shows how parts of the ownership structure of a MEC group are considered to be frozen in certain circumstances. It relates specifically to the situation where a loss-making company (that has not previously transferred the loss under Subdivision 707-A) becomes the first head company of a MEC group. This is combined with the situation where there is a continuity of ownership test (COT) transfer of a loss to the head company of a consolidated group from another company.

Both situations require assumptions to be made about the ownership structure.

→ '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.

When a loss-making company (that has not previously transferred the loss under Subdivision 707-A) becomes the head company of a MEC group, this event triggers freezing of the ownership structure between that company and the top company. This means it is assumed that there is no change in ownership of the loss-making company or of any entity interposed between it and the top company of the MEC group.

→ item 4 of the table in subsection 719-275(2)

For this freezing of the ownership structure to take place, it is necessary to apply subsection 719-275(3), which reinstates the head company of the MEC group as the loss-making company for the purposes of section 719-275. This is necessary, when the test company is not the head company, because section 719-270 assumes that the test company made the loss for an income year starting at a specified time.

Item 5 of the table in subsection 719-275(2) applies when there is a COT transfer of a loss to the head company of a consolidated group. This event also triggers freezing of the ownership structure, this time between the transferring company and the head company.

Example

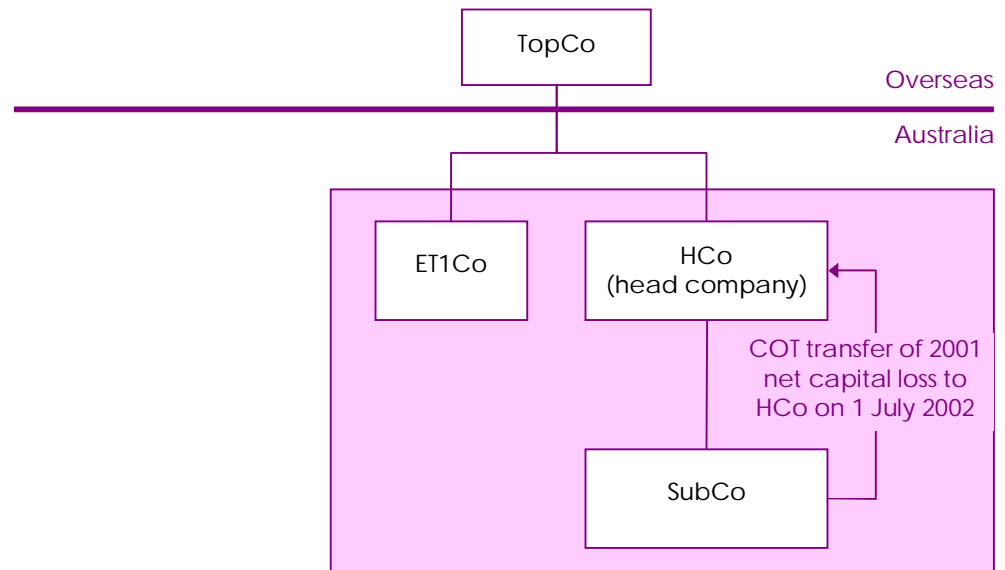
Facts

HCo is the head company of a consolidated group that forms on 1 July 2002. A net capital loss, incurred in the income year ended 30 June 2001 by SubCo, is transferred from SubCo to HCo at the time the group forms. The transfer from SubCo to HCo is a COT transfer as defined by subsection 707-210(1A).

HCo is a wholly-owned subsidiary of TopCo (a foreign-resident company). On 25 October 2002, TopCo acquires another wholly-owned subsidiary, ET1Co, an Australian-resident company. TopCo meets the conditions to be a top company, and both HCo and ET1Co are eligible tier-1 companies of TopCo.

On 25 October 2002, HCo makes a choice in writing to create at that time a MEC group from its consolidated group. HCo notifies the Commissioner in the approved form of its choice to create a MEC group from its consolidated group with ET1Co as another eligible tier-1 company. This is a special conversion event, as defined in section 719-40 → 'Choice on formation, special conversion events and acquisition of new eligible tier-1 companies', C10-2-110. **At the time of the special conversion event, HCo is taken to be appointed as the provisional head company of the MEC group. In the income year ending 30 June 2003, HCo, as the head company of the MEC group, seeks to utilise the loss transferred from SubCo.**

Figure 1: MEC group at 25 October 2002



Calculation

The test company is SubCo.¹ The start of its loss year is the start of the income year in which it made the loss (i.e. 1 July 2000) → item 1 in the table in subsection 719-270(4); 'Determining the start of a test company's loss year to assess the continuity of ownership of the focal company in a MEC group (COT transfer of a loss)', C10-2-350; 'Determining the start of a test company's loss year to assess continuity of ownership of the focal company in a MEC group (special conversion event)', C10-2-360.

The focal company, HCo, is seeking to utilise the loss in the income year ending 30 June 2003. HCo will satisfy the test in section 165-12 of the ITAA 1997 in the income year ending 30 June 2003 if SubCo satisfies the test for the period 1 July 2000–30 June 2003. This is the period in which certain events can trigger freezing of the ownership structure.

In this case, the focal company (HCo) is not the test company, but subsection 719-275(3) provides that, for the purposes of section 719-275, HCo is considered to have made the loss at the time the loss is transferred to it from SubCo under Subdivision 707-A (1 July 2002).

This means the event in item 4 of the table in subsection 719-275(2) – which refers to the company that has made the loss – applies. The item 4 event occurs at the time that HCo (the company considered to have made the loss) becomes the head company of the MEC group, i.e. when the MEC group was created from the consolidated group.

When HCo becomes head company of the MEC group on 25 October 2002, this triggers freezing of the ownership structure between it and TopCo.

Event 5 of the table in subsection 719-275(2) also applies to this scenario. The COT transfer of the loss from SubCo to HCo on 1 July 2002 (when SubCo joins HCo's consolidated group) also triggers freezing of the ownership structure, this time between SubCo and HCo.

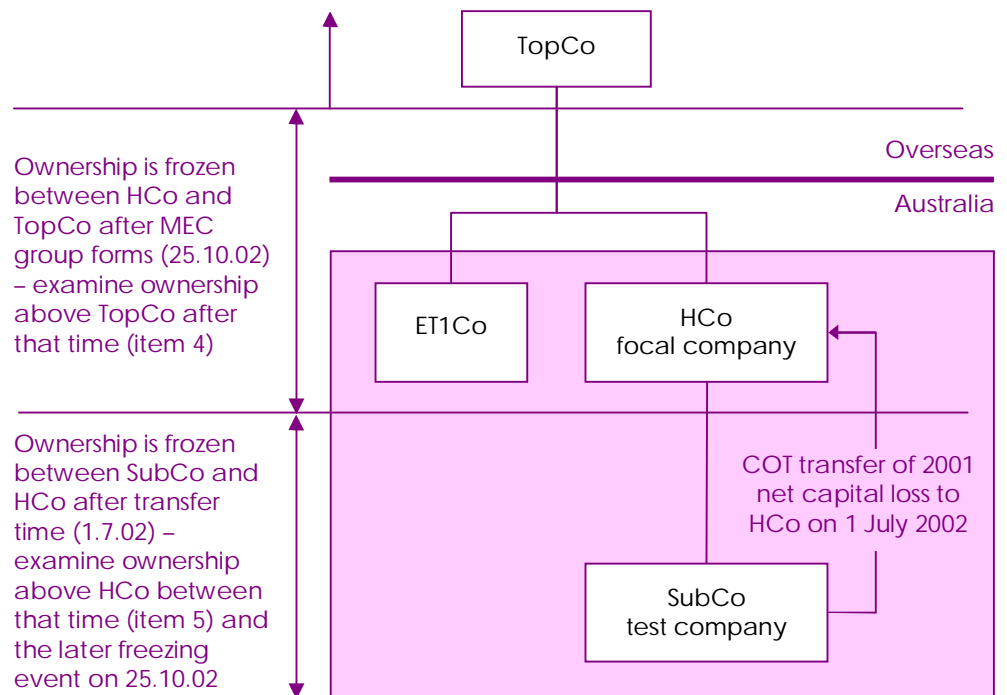
If HCo seeks to utilise the loss in the income year ended 30 June 2003, these two trigger events will freeze the ownership structure as shown in figure 2.

¹ The table in subsection 719-265(2) applies as the tax loss was made by the focal company (HCo) because of a COT transfer. Item 2 in the table applies as the focal company (HCo) and the transferor (SubCo) are different companies. In accordance with paragraph 719-265(1)(b), section 719-265 is re-applied assuming the focal company is the transferor, SubCo. In this re-application, the table in subsection 719-265(4) applies as the loss was not transferred under Subdivision 707-A from a company to the (deemed) focal company, SubCo. Item 3 in the table identifies the test company as the (deemed) focal company, SubCo. → 'Identifying the test company to determine continuity of ownership of the focal company in a MEC group (COT transfer of losses)', C10-2-330; 'Identifying the test company to determine continuity of ownership of the focal company in a MEC group (SBT satisfied)', C10-2-340

This means the ownership of SubCo (the test company) must be examined from 1 July 2000 to 30 June 2003 to determine whether HCo satisfies section 165-12, on the basis that:

- the ownership structure between SubCo and HCo is considered frozen from 1 July 2002, when the loss is transferred from SubCo to HCo as a COT transfer → item 5 of the table in subsection 719-275(2), and
- the ownership structure between HCo and TopCo is considered frozen after HCo becomes head company of the MEC group on 25 October 2002 → item 4 of the table in subsection 719-275(2).

Figure 2: Freezing of ownership structure



References

Income Tax Assessment Act 1997, sections 165-12 and 719-40

Income Tax Assessment Act 1997, Subdivision 719-F, subsection 707-210(1A); 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

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

Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010, Chapter 5, paragraphs 5.65 to 5.100

Revision history

Section C10-2-380 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
6.5.11	Revisions to reflect changes to group conversion provisions.	Legislative amendments.