

Worked example

Freezing the ownership of the test company – COT transfer of a loss to the head company of a MEC group

Description This example shows how the ownership structure of a MEC group is considered to be frozen after there is a continuity of ownership test (COT) transfer of a loss to the head company of the group. → ‘Multiple entry consolidated (MEC) groups’, C10-1; ‘MEC groups and losses – determining whether the focal company satisfies the continuity of ownership test’, C10-2-325 (high-level worked example)

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 (i.e. the company that is seeking to utilise the loss) is considered to meet the continuity of ownership conditions in section 165-12 of the ITAA 1997 if the test company, as determined by section 719-265, would meet those conditions based on the assumptions in sections 719-270, 719-275 and 719-280.

In order to apply the COT to the test company, it is necessary to assume that the test company made the loss, even if it actually did not (e.g. because the test company is also the top company).

The COT is applied to the test company for the period from the start of the test company’s loss year (as determined by section 719-270) until the end of the income year in which the focal company seeks to utilise the loss.

If any of the events defined in section 719-275 occur within this period, they trigger freezing of part of the ownership structure. This means it is assumed that there is no change in membership interests or voting power in entities in these frozen parts of the group structure. The COT transfer of a loss to the head company of a MEC group is one event that triggers freezing of the ownership structure between the transferor and the top company.

→ item 1 of the table in subsection 719-275(2)

Example

Facts

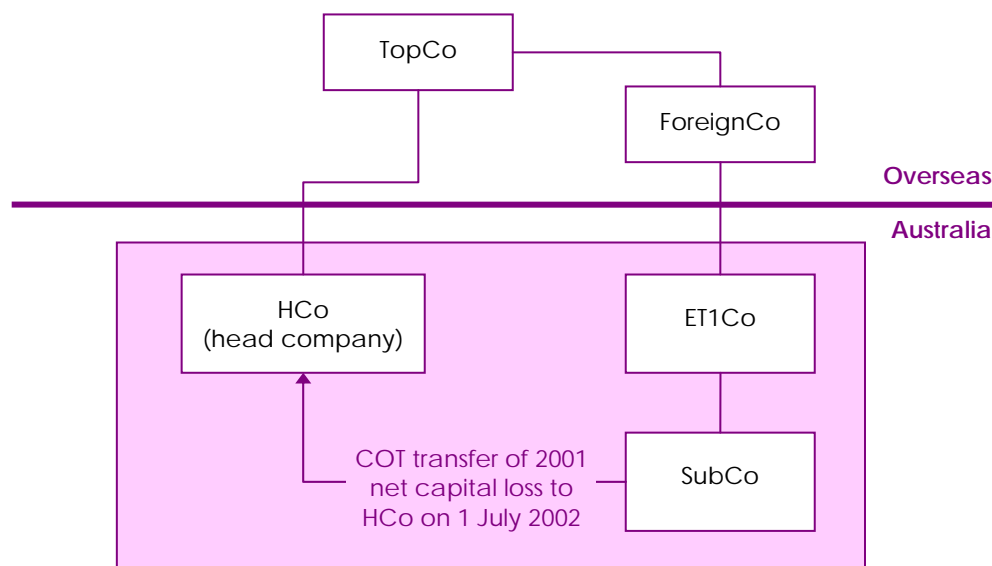
SubCo makes a net capital loss in the income year ended 30 June 2001. It is a wholly-owned subsidiary of ET1Co. ET1Co and HCo are both wholly-owned subsidiaries of the foreign-resident company, TopCo, and are TopCo’s first level of investment into Australia. TopCo meets the conditions to be a top company.

ET1Co and HCo are eligible tier-1 companies and they choose to form a MEC group on 1 July 2002. HCo is chosen to be the head company of the MEC group. The net capital loss incurred in the income year ended 30 June 2001 by SubCo is transferred from SubCo to HCo at the time the MEC group is

formed. The transfer is a COT transfer as defined by subsection 707-210(1A) of the ITAA 1997.

HCo seeks to utilise the loss in the income year ended 30 June 2004, as the MEC group has made a capital gain in that year.

Figure 1: MEC group at 1 July 2002



Calculation The test company is SubCo.¹ The start of SubCo's loss year is the start of the income year in which it made the loss (i.e. SubCo is considered to have made the loss in the income year starting 1 July 2000).

→ item 1 in the table, 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 (worked example)

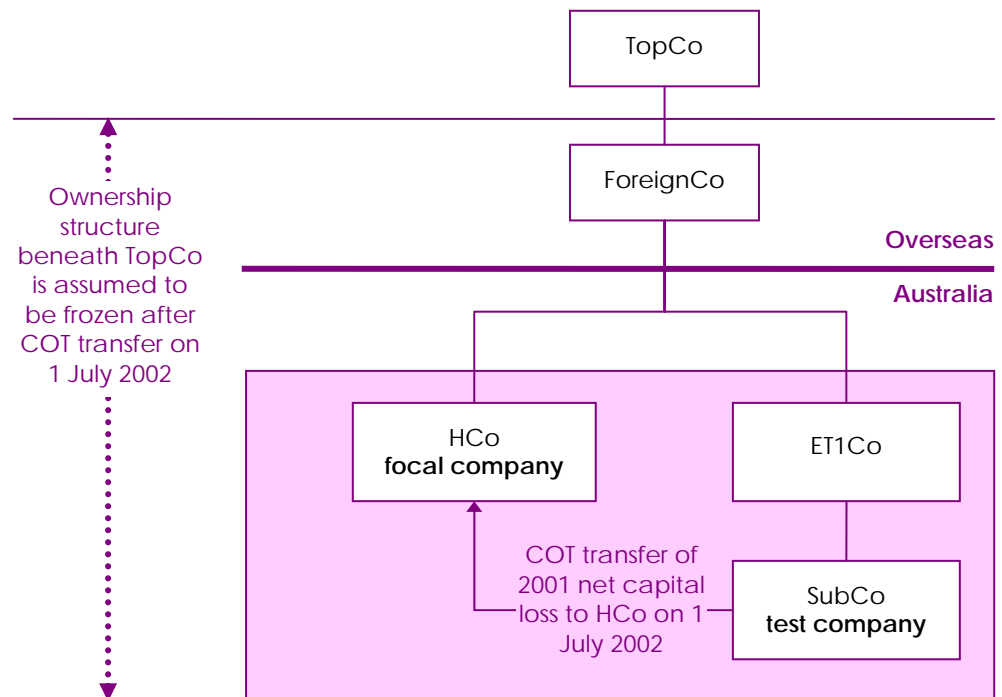
The focal company, HCo, seeks to utilise the loss in the income year ending 30 June 2004. HCo will satisfy the continuity of ownership test (COT) in section 165-12, for the income year ended 30 June 2004, if SubCo satisfies the test for the period 1 July 2000–30 June 2004.

During this period, certain events can trigger freezing of the group's ownership structure. The COT transfer of the loss from SubCo to HCo on 1 July 2002,

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 (worked example)

when the MEC group forms, is one such event → item 1 of the table in subsection 719-275(2). After this event, for the purpose of determining if SubCo satisfies the continuity of ownership provisions in section 165-12 in relation to the loss, it is assumed that the ownership of SubCo and all entities interposed between SubCo and TopCo remains unchanged. After this freezing of the membership interests in SubCo, and all entities interposed between SubCo and TopCo, the only relevant ownership changes are changes in the ownership of TopCo.

Figure 2: Freezing of ownership structure



References *Income Tax Assessment Act 1997*, section 165-12

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