

Worked example

An eligible tier-1 company leaving a MEC group

Description This example shows how to calculate the cost setting amount of membership interests in an eligible tier-1 company that leaves a multiple entry consolidated (MEC) group.

Note

This example does not consider the affect of the loss integrity provisions in Division 715 and Subdivision 719-T. Adjustments required by those provisions are considered in:

- 'Effect of Subdivision 165-CC where an entity leaves a consolidated group', C2-5-120
- 'Effect of Subdivision 165-CD for consolidated groups', C2-6-130
- 'All assets in head company's loss denial pool become assets of leaving entity', C2-6-540.

(The cost setting rules for other subsidiaries are the same as for consolidated groups → 'Treatment of assets', C2-1.)

Commentary Entities that leave a MEC group will fall into the following broad categories:

- the eligible tier-1 company that is the head company of the MEC group
- companies that are eligible tier -1 companies of the group
- subsidiary entities of eligible tier-1 companies, and
- companies that are subsidiary members of the MEC group through the interposed foreign resident entity rules.

When one of the above entities leaves a MEC group, it is necessary to calculate the cost setting amount of each membership interest in the leaving entity for capital gains tax (CGT) and revenue purposes. The method used to calculate the cost setting amount depends firstly on whether the entity is a subsidiary entity or an eligible tier-1 company within the MEC group and secondly, if the entity is an eligible tier-1 company, on the proportion of membership interests held outside the MEC group (pooled interests).

The provisions that apply to particular membership interests in the leaving entity are outlined in table 1.

Table 1: Provisions applying to membership interests in leaving entities

Leaving entity	Membership interests held by members of the MEC group	Pooled interests*
An eligible tier-1 company wholly owned outside the MEC group	Not applicable	Pooling rules [Subdivision 719-K]
An eligible tier-1 company partly owned outside the MEC group	Leaving entity rules in Divisions 701 and 711 and Subdivision 719-J	Pooling rules [Subdivision 719-K]
A subsidiary member of the MEC group other than an eligible tier-1 company	Leaving entity rules in Divisions 701 and 711	Not applicable
A subsidiary member of the MEC group through the interposed foreign resident entity rules	Rules are being considered	

* Pooled interests are specific membership interests held in an eligible tier-1 company by entities other than members of the MEC group → 'Events that trigger pooling in a MEC group', C10-2-410. Pooled interests are membership interests that are not:

- employee share scheme interests
- any membership interests held by an entity only as a nominee for other members of the MEC group.

Eligible tier-1 companies leaving a MEC group

A) An eligible tier-1 company that is wholly owned outside the MEC group

The pooling rules in Subdivision 719-K of the *Income Tax Assessment Act 1997* are used to determine the cost setting amount for pooled interests in eligible tier-1 companies that are wholly owned outside the MEC group. For the calculation and pooling rules → 'Pooling of external membership interests', C10-2-420.

(Note that the pooling rules in Subdivision 719-K are triggered by a variety of things. An entity leaving the group is only one example.)

B) An eligible tier-1 company that is partly owned outside the MEC group

The calculation of the cost setting amount for an eligible tier-1 company partly owned by members of a MEC group and partly owned outside the MEC group is determined by combining two separate provisions:

- the consolidation leaving entity provisions (Divisions 701 and 711, ITAA 1997), and
- the MEC pooling cases provisions (Subdivision 719-K).

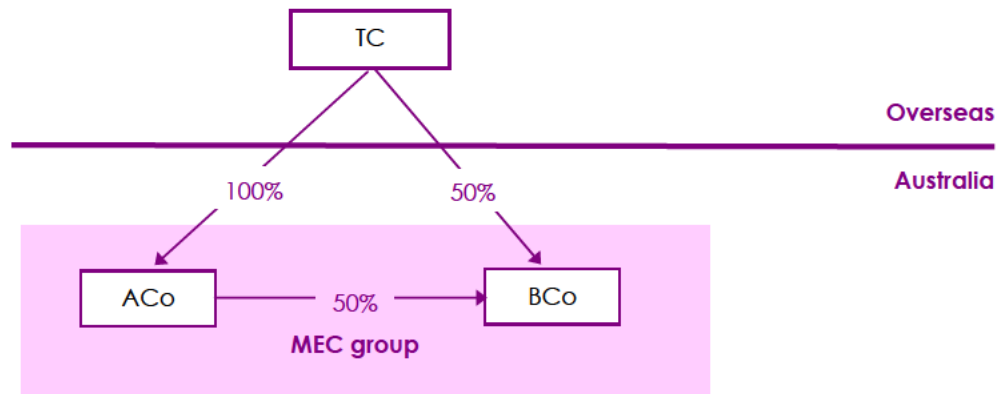
The cost setting amount for membership interests where the interests are held by members of the MEC group is calculated in the same way as the cost setting amount for membership interests in a subsidiary leaving a consolidated group → 'The cost setting process on exit', C2-2-210. Broadly, they are calculated with reference to Divisions 701 and 711 of the ITAA 1997. In this instance, the allocable cost amount (ACA) is calculated for all membership interests held in the eligible tier-1 company. However, following allocation of the ACA only those membership interests that are held by members of the MEC group are

used. The pooled interests – that is, those interests held by an entity outside the group – are subject to the pooling rules in Subdivision 719-K, so the ACA calculated for these interests under Division 711 is ignored.

Example

The following is an example of an eligible tier-1 company that is partly owned outside the MEC group (BCo below).

Figure 1: Eligible tier-1 company partly owned outside MEC group



A foreign parent company owns all 100 membership interests in resident ACo and 50 of the 100 membership interests in resident BCo. The membership interests are held as CGT assets. The remaining 50 shares in BCo are held by Australian-resident company ACo (they are also CGT assets).

ACo and BCo are eligible tier-1 companies.

ACo's membership interests in BCo were acquired in two tranches. The first tranche of 20 membership interests was acquired on 1 July 2002 at \$10 each and the second tranche of 30 membership interests was acquired on 1 July 2003 at \$20 each.

There is only one class of membership interests in BCo.

Assume that the 50 membership interests acquired by the foreign parent company in BCo are acquired at the same time as ACo acquired its second tranche of membership interests in BCo ($50 \times \$20 = \$1,000$).

ACo and BCo choose to form a MEC group on 1 July 2004. The foreign parent will be the top company (TC).

On 1 July 2005, TC and ACo sell their membership interests in BCo to an unrelated party, causing BCo to leave the MEC group. A CGT event happens to the membership interests held by both TC and ACo and it will be necessary for both entities to calculate the capital gain or capital loss. (In other instances the gain or loss may be on revenue account.)

To calculate the capital gain or capital loss made by both TC and ACo, it is necessary to reset the cost bases (the cost setting amount) of the membership interests in BCo.

Calculate the cost setting amount of ACo's interests in BCo when BCo leaves the MEC group

The cost of the 50% membership interests owned by ACo in BCo is determined by working out the group's exit ACA for all the membership interests in BCo in accordance with Division 711 as modified by Subdivision 719-J. → 'The cost setting process on exit', C2-2-210

For example, if, at the leaving time, the sum of the terminating values of assets that BCo takes with it on exit is \$2,000 (assume that step 2 to 4 of section 711-20 of calculating the ACA do not apply), the exit ACA is \$2,000. This ACA amount is divided by the number of membership interests in the class in leaving company BCo. As the total number of membership interests in BCo is 100, the new cost base of each membership interest is \$20 (\$2,000/100).

Even though the exit ACA is calculated and allocated across the 100 membership interests in BCo, it is only the ACA for the membership interests held by members of the MEC group that is relevant for the calculation of ACo's cost bases in BCo.

The capital gain ACo derives on the sale of the membership interests ACo held in BCo is the capital proceeds less the cost base of each membership interest in each class. In this instance, assume the capital proceeds for the 50 membership interests is \$1,600 (market value). ACo's capital gain from the sales of 50 membership interests is:

$$\$1,600 - \$1,000 (50 \times \$20) = \$600$$

Calculate the cost setting amount for TC's interests in BCo using the pooling rules

For the purpose of this example assume:

- the market value of TC's pooled interests in BCo is \$1,600
- the cost base of TC's interest in ACo is \$1,000, and
- the market value of the group is \$5,000 just before the trigger time (that is, just before BCo is sold) → paragraph 719-501(1)(c).

Market value of the reset interests in BCo is:

$$\frac{\$1,600}{50} = \$32$$

The pooled cost amount is \$2,000 (the sum of the cost bases of all the reset interests: (ACo = \$1,000) + (BCo = \$1,000)).

Each pooled interest held in trigger company BCo is reset using the formula:

$$\frac{\text{Market value of the reset interest}}{\text{Market value of the group}} \times \text{Pooled cost amount}$$

Therefore, the cost setting amount for each reset interest in BCo will be:

$$\frac{32}{5,000} \times 2,000 = \$12.80$$

The capital gain/loss from selling 50 membership interests by TC is calculated by:

$$\text{Capital proceeds} - \text{reset cost base} = \text{Capital gain}$$

(where the reset cost base = \$640 [$\12.80×50])

$$\$1,600 - \$640 = \$960$$

Calculate the reset interests for the non-trigger company

$$\frac{\text{Pooled cost amount} - \text{Amount allocated to trigger company interests}}{\text{Number of non-trigger company interests}}$$

Where:

- the pooled cost amount = \$2,000
(The sum of the cost bases of all the reset interests
(ACo = \$1,000) + (BCo = \$1,000))
- the amount allocated to trigger company interests = \$640
(The amount of reset interests in the trigger company)

The number of non-trigger company interests is the number of pooled (reset) membership interests in the non-trigger company.

Therefore, the cost base of the non-trigger company reset interest is:

$$\frac{\$2,000 - \$640}{100} = \$13.60 \text{ per reset interest}$$

This amount is the cost base that is used in future pooling calculations.

References

Income Tax Assessment Act 1997, Subdivisions 719-J and 719-K; as amended by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002), Schedule 8

Explanatory Memorandum to the New Business Tax system (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 3.40–49

Income Tax Assessment Act 1997, Division 711; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002)

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

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

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002, Chapter 11