Determining the reduction amount – subsection 707-325(3)

The available fraction is the core component of the rules for the utilisation of transferred losses by consolidated groups. It establishes the limit for the utilisation of transferred losses in a bundle for an income year. The rationale is that the rate of loss usage should be restricted to approximate the rate that would have been available to the entity from which the loss was transferred had it remained a single entity outside the consolidated group.

To maintain the integrity of the available fraction methodology, an integrity rule prevents the modified market value of an entity being inflated by certain events. Inflation of modified market value has the effect of increasing the available fraction and thereby potentially increasing the utilisation rate of losses in that bundle. The integrity rule is contained in subsections 707-325(2) to (5) of the *Income Tax Assessment Act 1997*.

If the integrity rule applies, a 'reduction amount' must be determined and the modified market value of the entity reduced by this amount.

Note

Worked examples

The *Consolidation reference manual* provides worked examples of how the reduction amount may be calculated in different situations:

- 'Determining the reduction amount – multiple events – determining the initial increase in market value', C3-6-110
- 'Determining the reduction amount – diminution in value up to the joining time', C3-6-120
- 'Determining the reduction amount – injection of capital that does not result in increased modified market value', C3-6-130
- 'Determining the reduction amount – compounding of value up to the joining time', C3-6-140
- 'Determining the reduction amount – injection of capital subsequently injected into a subsidiary', C3-6-150
- 'Determining the reduction amount – multiple events – market value reduced under some events', C3-6-160.

The worked examples show the procedure for applying the integrity rule. They are not intended to provide guidance on what constitutes an event or how valuations should be undertaken.

When is a reduction required?

The modified market value of an entity is reduced if:

- one or more of the events described in subsection 707-325(4) occurred in the four years[1] before the joining time, and
- the modified market value worked out under subsection 707-325(1) exceeds what it would have been had none of those events occurred (the 'excess').

The events described in subsection 707-325(4) are, broadly:

- an injection of capital[2] into the entity or an associate of the entity, and
- a non-arm's length transaction involving the entity or an associate of the entity.

Certain injections of capital, as described in subsection 707-325(5), are disregarded. Broadly, they are injections into a listed public company made through a dividend reinvestment scheme and injections under a qualifying employee share scheme.

The reduction amount

Once it is established that one or more events have resulted in an excess, the modified market value of the entity must be reduced by the amount worked out under subsection 707-325(3).

The amount of the reduction is the lesser of:

- the excess in the entity's modified market value at the joining time, and
- the total increase in the entity's market value resulting from summing each increase in market value that occurred immediately after each event because of the event (the 'initial increase').

This ensures no reduction is required if the event has not actually resulted in an inflated modified market value at the joining time. → 'Determining the reduction amount – injection of capital that does not result in increased modified market value', C3-6-130

Limiting the reduction amount to the initial increase in market value also ensures that the compounding effects of the events are not incorporated. For example, if additional profits (as reflected in the modified market value) are generated as a result of applying the initial increase, the reduction amount is only the amount of the initial increase. → 'Determining the reduction amount – compounding of value up to the joining time', C3-6-140

[1] Events that take place before 9 December 2000 are disregarded → section 707-329, *Income Tax (Transitional Provisions) Act 1997*.

[2] Taxation Ruling TR 2004/9 provides the Tax Office view on the meaning of the expression 'injection of capital'.

Excess in entity's modified market value at the joining time

The excess in modified market value of an entity is the difference between the entity's modified market value at the joining time and what would have been its modified market value had the event(s) not occurred.

Two valuations are required to determine the excess. The first establishes the modified market value of the entity at the joining time, based on the assumptions in subsection 707-325(1)[3]. The second valuation establishes the 'hypothetical modified market value' of the entity – that is, what the modified market value would have been in the absence of the event(s). → 'Determining the reduction amount – diminution in value up to the joining time', C3-6-120

Initial increase in market value

A method of establishing the initial increase in market value is to obtain, in respect of an event, two valuations. The first would be undertaken as at the time just after the event occurs, to establish the market value of the entity immediately after the event – the 'initial market value' of the entity. The second valuation would be undertaken as at that time on the assumption the event did not occur. This valuation establishes what the market value of the entity would have been had the event not occurred – the 'hypothetical initial market value' of the entity. The difference between the actual and hypothetical market values establishes the initial increase in the entity's market value.

Using this approach, actual and hypothetical market valuations need to be undertaken for each event. Where there are multiple events, the total increase in market value is the sum of the initial increase in market value from all events.

→ 'Determining the reduction amount – multiple events – determining the initial increase in market value', C3-6-110

→ 'Determining the reduction amount – multiple events – market value reduced under some events', C3-6-160

Valuation assumptions and methodology

In verifying compliance with the integrity rule the Tax Office would expect a taxpayer to be able to clearly demonstrate how the valuation has been calculated, given the particular facts of each case. Assumptions made in arriving at a valuation should be documented to support the calculations made. Evidence to support valuations undertaken for the purposes of determining the reduction amount may include:

- valuation reports
- board minutes
- prospectus details, and
- records of discussions held with third parties, such as financiers, advisers and project partners.

The Tax Office has published guidelines on undertaking the valuations required by consolidation law. → 'Market valuation guidelines', C4-1

[3] The modified market value of an entity is, broadly, its market value, assuming it has no losses or franking credits and assuming it has no membership interest in any other group member.

Calculating the reduced modified market value

There are six steps to determine the modified market value of an entity in a situation where the integrity rule applies:

1. Determine the modified market value under subsection 707-325(1).
2. Determine the ‘hypothetical modified market value’ required by paragraph 707-325(2)(b). Hypothetical modified market value is calculated, under the assumptions in subsection 707-325(1), as though the prescribed event (or events) did not take place.
3. Reduce the step 1 amount by the step 2 amount. This is the paragraph 707-325(3)(a) amount.
4. Calculate the initial increase in market value that occurred after each event because of the event. The sum of these amounts is the paragraph 707-325(3)(b) amount.
5. The lesser of step 3 and step 4 is the ‘reduction amount’.
6. Reduce the step 1 amount by the reduction amount.

Reduction amount short cut option

There may be substantial costs in obtaining the valuations required to accurately calculate the reduction amount. In recognition of these costs, the Commissioner of Taxation has provided a reduction amount short cut option that removes the need to obtain additional valuations in certain circumstances. The short cut option is provided under the Commissioner’s general administrative powers[4].

The short cut option is only available where the event or events are cash injections. In this situation, the Tax Office will accept the actual dollar amount of the cash injected into the entity as the reduction amount and there is no need to follow the six step process to determine the reduced modified market value.

The short cut option is not available where an event is a non-cash transaction or a transaction that did not take place at arm’s length. In these situations there is still a requirement to obtain the necessary valuations.

[4] Section 8 of the *Income Tax Assessment Act 1936*.

Example

Applying the reduction amount short cut option

The head company of a consolidated group transfers losses to itself when the group forms on 1 January 2005. The losses are contained in 'bundle HCo'.

During the four years prior to group formation the head company issued additional shares on the share market. The share subscription raised $3 million of additional share capital.

At formation time, the modified market value of the head company is determined to be $50 million. The adjusted market value of the consolidated group is $90 million.

Applying the reduction amount short cut option, the available fraction for bundle HCo is determined as follows:

$$\frac{\$50m - \$3m}{\$90m} = 0.522$$

Revision history

Section C3-6 first published 18 May 2005.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).