Worked example

Determining the reduction amount – injection of capital that does not result in increased modified market value

Description

This example shows how to determine whether a reduction to modified market value is required under subsection 707-325(2) of the *Income Tax Assessment Act 1997* (ITAA 1997). In this example, capital introduced as a result of a share issue is directly invested in a new exploration project. The success or otherwise of the project (as reflected in the modified market value of the joining entity) as at the joining time must be considered when establishing the reduction amount.

Note

More information:

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6

Commentary

An integrity rule prevents the modified market value of an entity being inflated by certain events occurring prior to consolidation. → subsections 707-325(2) to (5), *Income Tax Assessment Act 1997*

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 – these events are, broadly:
  - an injection of capital 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, 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 amount of the reduction is the lesser of:

- the difference between the entity's modified market value at the joining time and what would have been its modified market value if the events had not occurred (the 'excess'), 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').

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

Determining the excess in modified market value requires two valuations. The first establishes the modified market value of the entity at the joining time, based on the assumptions in subsection 707-325(1)[2]. 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).

Six step process to calculate 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.

If there is no excess at step 3 the integrity rule does not apply as the requirement in subsection 707-325(2)(b) is not satisfied, and consequently there is no need to obtain the valuations at step 4.

In such situations there is no reduction to the modified market value of the entity.

Note

Valuation assumptions and methodology

This worked example highlights the steps to be undertaken when applying the integrity rule. Taxpayers should be able, when required, to provide evidence of the assumptions made and methodologies used in arriving at a particular value.

→ 'Determining the reduction amount – subsection 707-325(3)', C3-6
→ 'Market valuation guidelines', C4-1

[2] 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.

Example

Facts

The Listed Group, a consolidatable group consisting of HeadCo and SubCo, consolidates on 1 July 2003.

A tax loss is transferred from HeadCo to itself at the joining time. HeadCo establishes its modified market value as at the joining time for the purposes of determining an available fraction for its bundle containing the transferred tax loss.

In April 2001 HeadCo advertised a renounceable rights issue to raise funds. Existing shareholders were offered one right to acquire shares in the Listed Group for every four shares owned, at a discount of 20c on the prevailing Australian Stock Exchange (ASX) share price.

A prospectus was sent to all shareholders detailing how the funds raised by the rights issue were to be invested. It stated in part:

> The funds are to be used for the development of additional oil fields in the Bluewater Basin. The exploration drilling program will commence in a largely unexplored but apparently viable reservoir.

The rights issue was fully subscribed and had a positive impact on the market value of the Listed Group. The share issue is an injection of capital event for the purposes of the integrity rule.

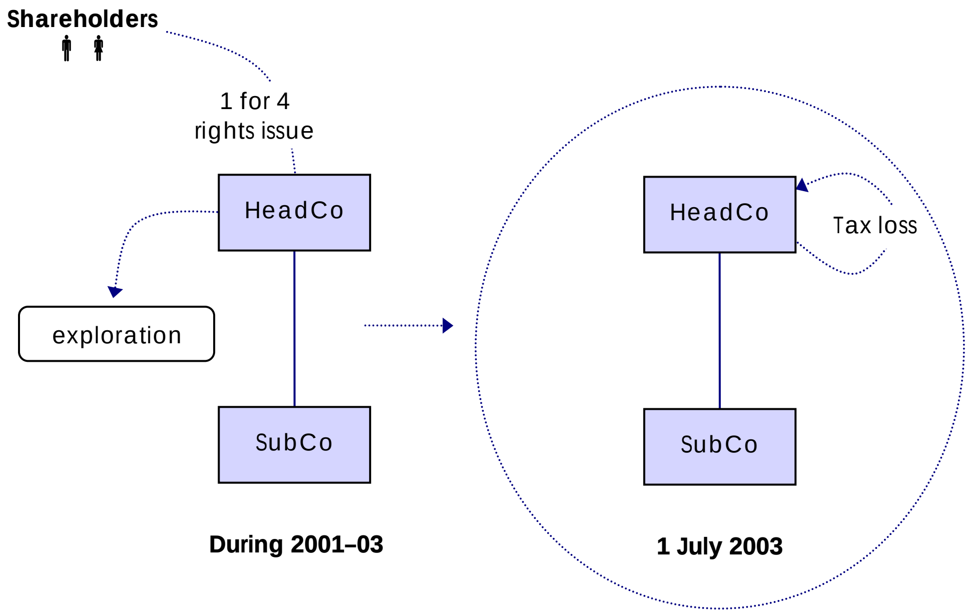
The project proceeded. However, in June 2003 the Listed Group issued a statement that:

- exploration activity for the Bluewater Basin project had been abandoned because of a lack of reserves, and
- all monies raised from the share issue and invested in the project were lost, as well as additional operating cash flows that were expended for that purpose.

The integrity rule may require a reduction to the modified market value of HeadCo.

These facts are represented in figure 1.

Figure 1: Pre-consolidation injection of capital and subsequent consolidation



Calculation

Valuations undertaken to determine the reduction amount are shown in table 1.

Table 1: Valuation data – HeadCo

Valuation	$ ('000)
Modified market value of HeadCo at the joining time	3,000
Hypothetical* modified market value of HeadCo at the joining time	3,600

* As though the event (or events) had not occurred.

The hypothetical modified market value of HeadCo is worked out on the assumption the losses incurred from the drilling activity would not have occurred in the absence of the rights issue.

Applying the six step reduction method to HeadCo

Table 2: Establishing the reduction amount – HeadCo

Step	Explanation	$ ('000)
1	Modified market value	3,000
2	Hypothetical modified market value	3,600
3	Step 1 reduced by step 2	nil*
4	Initial increase in market value	
5	Reduction amount (lesser of step 3 and step 4)	
6	Reduced modified market value	

* The step 3 amount cannot be reduced below nil.

As there was no excess at step 3 the modified market value of HeadCo is not reduced. The modified market value of HeadCo at 1 July 2003 that is used for the purpose of determining the available fraction for the HeadCo bundle is $3,000,000.

References

Income Tax Assessment Act 1997, section 707-325

Revision history

Section C3-6-130 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).