Worked example

Adjusting available fraction – post-consolidation injection of capital into subsidiary member

Description

This example shows the application of adjusting event 4 to an injection of capital into a subsidiary member of a consolidated group. The injection is made by an entity external to the group in exchange for additional membership interests in the subsidiary, resulting in that member entity leaving the group. Item 4 in the table in subsection 707-320(2) of the ITAA 1997 may operate to reduce available fractions for loss bundles held by the consolidated group if the leaving entity remains an associate of the head company. The adjustment required, if any, will depend on the impact of the injection of capital on the market value of the group.

Note

For more information:

- 'Adjusting the available fraction – post-consolidation events that increase market value of group', C3-4-340 (explanation)
- 'Adjusting available fraction – post-consolidation injection of capital where head company issues shares in scrip for scrip merger', C3-4-342 (worked example)
- 'Market valuation guidelines', C4-1

Commentary

The available fraction for a bundle of losses is reduced if the market value of the company[1] to which the losses were most recently transferred is increased as a result of either of these events:

- an injection of capital[2] into the group or an associate of the group, or
- a non-arm's length transaction that involves the group or an associate of the group.→ subsection 707-325(4), ITAA 1997

When applying item 4 in the table in subsection 707-320(2) (adjusting event 4) to an existing consolidated group, each available fraction is reduced just after the event by multiplying it by the following factor:

$$\frac{\text{Market value of the company just before the event}}{\text{Market value of the company just before the event} + \text{Amount of the increase}}$$

[1] This will generally be the head company of a consolidated group or MEC group. In a situation where the consolidated group or MEC group has ceased to exist, this will be the former head company of that group.

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

The reference to an increase in the market value of the company will mean an increase in the market value of the entire consolidated group where the company still meets the definition of a head company in section 703-15. This is as a result of the operation of the single entity rule.[3] As this worked example focuses on adjusting event 4 applying to a head company, the term 'market value of the group' is used hereafter for ease of understanding.

Four-step process to calculate reduced available fractions

There are four steps to determine the reduced available fraction for each bundle of losses in a situation where adjusting event 4 applies:

1. Determine the market value of the consolidated group just before the event.
2. Determine the increase in the market value of the consolidated group attributable to the injection of capital or non-arm's length transaction.
3. Divide the step 1 amount by the sum of the step 1 and step 2 amounts.
4. Multiply the available fraction for the bundle of losses by the step 3 factor. Repeat for each bundle of losses.

Injection into subsidiary

Timing of the event

A reduction to the available fractions of existing loss bundles may be necessary where a subsidiary member of a consolidated group issues additional shares in itself in return for cash consideration from an entity that is not a member of the consolidated group.[4] Such a transaction will result in the member entity leaving the consolidated group.[5] If the leaving entity remains an associate[6] of the head company for the purposes of paragraph 707-325(4)(a), an event for the purposes of adjusting event 4 is taken to have occurred in relation to the group.

The leaving entity will remain a subsidiary member of the group until the injector becomes entitled to be registered as owner of the shares.[7] The event does not occur until the transaction displays all of the characteristics of an injection of capital.[8] For the purposes of this example, it is assumed that the leaving entity leaves the group at the time the event takes place. Therefore the injection of capital is not considered to have been made into the group.

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[3] For a MEC group, ATO Interpretative Decision 2004/961 states that a reference to the 'market value of the company' in item 4 in the table in subsection 707-320(2) is a reference to the market value of the entire MEC group.

[4] Note that consideration may be in the form of property rather than cash (paragraph 11 of TR 2004/9).

[5] As the entity will no longer be a wholly-owned subsidiary of the head company of the group.
→ section 703-15, ITAA 1997

[6] 'Associate' is defined in section 318, ITAA 1936.

[7] Similar to the rule in section 703-33 of the ITAA 1997, which determines when beneficial ownership changes where shares in a company are sold.

[8] Paragraph 12, TR 2004/9.

Impact on market value

A reduction to available fractions is required if there is an increase in the market value of the consolidated group as a result of the event. The market value of the group will increase if the value of its holding in the leaving entity increases.

A method of establishing the amount of the increase in respect of an event is to obtain two valuations. The first would be undertaken as at the time just after the event occurs. The second valuation would be undertaken as at that time on the assumption the event did not occur. This second valuation establishes what the market value would have been had the event not occurred. The difference between these two valuations establishes the amount of the increase.

In arriving at an assessment of the impact of the event on the market value, the Tax Office expects taxpayers to clearly demonstrate, where required, how the valuation has been calculated. Assumptions made in arriving at a valuation should be documented and supportable.

Example

Facts

The HCo Group, a consolidatable group consisting of HeadCo and its wholly-owned subsidiaries ACo and BCo, consolidates on 1 July 2003.

A loss is transferred from BCo to HeadCo at the joining time. The available fraction calculated for the bundle containing the loss (bundle BCo) is 0.800.

On 1 December 2003, XCo, an entity not associated with HeadCo, acquires a 20% membership interest in ACo by subscribing for new shares in the capital of ACo.

ACo remains an associate of HeadCo.

The issue of shares by ACo is considered an event under paragraph 707-325(4)(a) for the purposes of adjusting event 4 in relation to HeadCo.

To illustrate the effect of this share issue on the available fraction for bundle BCo, it is assumed that this injection of capital has a positive impact on the value of ACo. This may, for example, be a result of XCo being in a position to better exploit the assets held by ACo than the HCo Group.

Accordingly, through its holding in ACo, HeadCo's market value also increases. As such, the available fraction for bundle BCo must be reduced under adjusting event 4.

These facts are represented in figures 1 and 2 below.

Figure 1: HCo Group consolidates

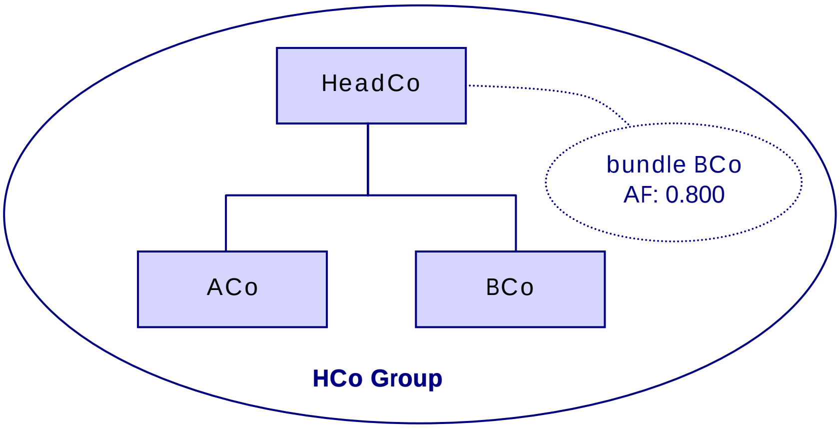
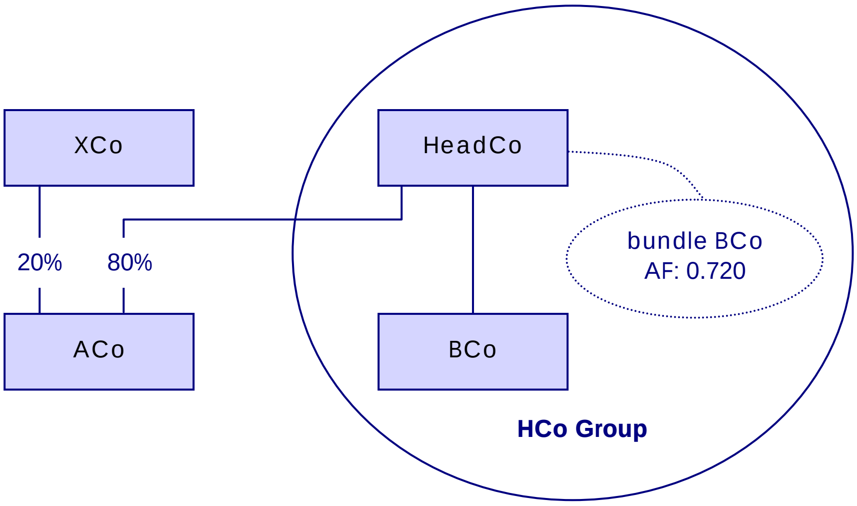


Figure 2: ACo leaves the HCo Group (1 December 2003)



Calculation

Market values ascertained for the purpose of calculating the adjustment required under item 4 are shown in table 1.

Table 1: Three separate market values of HCo Group

Valuation	$
Market value of HCo Group just before the injection of capital	360
Market value of HCo Group just after the injection of capital	400
Hypothetical market value of HCo Group just after the injection of capital, as if the event did not occur	360

In this case, the first and third market values are the same because the valuer considered that the only factor impacting on the HCo Group's market value around the time of the event was the issuing of the new shares in ACo to XCo.

Applying the four-step method to reduce the available fraction

Table 2: Establishing the reduced available fraction for bundle BCo

Step	Explanation	Amount
1	Market value before event	$360
2	Amount of the increase	$40
3	Factor	$360 / ($360 + $40) = 0.9
4	Adjust available fraction	0.800 × 0.9 = 0.720

The available fraction for bundle BCo is adjusted on 1 December 2003 to 0.720.

As the adjustment has taken place part-way through the 2004 income year, utilisation of the loss in bundle BCo must be apportioned. → section 707-335, ITAA 1997

Apportionment recognises that an available fraction has only applied for a part of the income year. → 'Apportioning the use of transferred losses', C3-4-610

References

Income Tax Assessment Act 1997:

- sections 701-1, 703-15, 703-33
- item 4 in the table in subsection 707-320(2)
- subsection 707-325(4), paragraph 707-325(4)(a)
- section 707-335

Income Tax Assessment Act 1936:

- section 318

Taxation Ruling TR 2004/9

Revision history

Section C3-4-341 first published 6 April 2006.

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).