Worked example

Modified market value is nil where company has negative net assets

Description

When a loss is transferred from an entity (the 'real loss-maker') to the head company of a consolidated group for the first time, an available fraction may need to be calculated for the bundle containing the loss. To calculate an available fraction, the modified market value of the entity that transferred the loss must be determined as at the joining time. Where the value donor concession applies, the modified market value of each value donor must also be determined[1].

This example shows how the available fraction for the real loss-maker is determined where:

- the value donor concession applies, and
- one of the real loss-makers/value donors in the group has a net deficiency of assets (i.e. the value of liabilities exceeds the value of assets).

Commentary

The available fraction is a representation of the market value of the loss entity as a proportion of the market value of the consolidated group (including the loss entity). The market values are determined as at the joining time.

The calculation of the available fraction is as follows:

$$\frac{\text{Modified market value of the loss entity}}{\text{Adjusted market value of the consolidated group}}$$

The modified market value of an entity is its market value based on assumptions contained in subsection 707-325(1) of the *Income Tax Assessment Act 1997* (ITAA 1997). → 'Modified market value of a single joining entity' C3-4-110

The adjusted market value of the consolidated group is its market value ignoring any losses it has and assuming that its franking account balance is nil.

Generally, an increase in the value of the loss entity is excluded from the entity's modified market value if the increase results from either of these events:

- an injection of capital into the loss entity, its associate or, if the loss entity is a trust, an associate of the trustee → 'Calculating an available fraction – losses transferred for the first time where there has been a pre-joining injection of capital', C3-4-120, or
- a non-arm's length transaction that involved the loss entity, its associate or, if the loss entity is a trust, an associate of the trustee.

[1] Unless the market valuation transitional option applies. → 'Treatment of losses', C3-1

The market value of any operating or trading entity should not, on the face of it, be less than nil. For an operating entity to have less than nil or negative market value implies that it has no prospects whatsoever, either at present, or in the future; the only plausible outcome is that it would cease to conduct business.

For any entity that is a limited liability company, where liabilities exceed the value of assets, the exposure of the holder of the membership interests (shares) is limited to the paid-up share capital. Another 'willing but not anxious' purchaser may be prepared to accept the transfer of shares in a limited liability company without making payment (consideration) in the expectation that the company may become valuable sometime in the future.

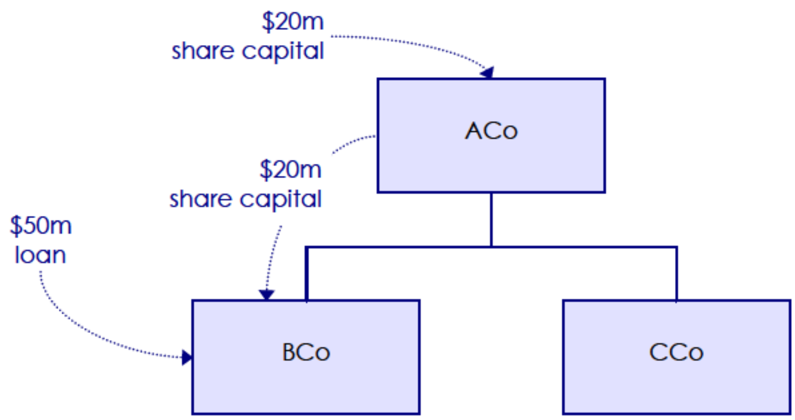
Where these situations are apparent at any point in time, the market value of the membership interest in the entity can be taken to be nil and does not result in a negative market value being assigned to that membership interest.

Example

Facts

ACo, BCo and CCo have constituted a wholly-owned group for a number of years (figure 1). On 21 March 2001, ACo raises an additional $20 million in capital through an external share placement. It uses these funds to subscribe for 20 million new shares in BCo at $1.00 per share. At the same time, BCo borrows $50 million from outside the group. The additional funds are intended for intragroup financing and investment in suitable projects by BCo.

Figure 1: Original group structure and fund flows in March 2001



On 1 July 2003 HCo acquires all the shares in ACo and, as the head company, elects for the group to consolidate on that date.

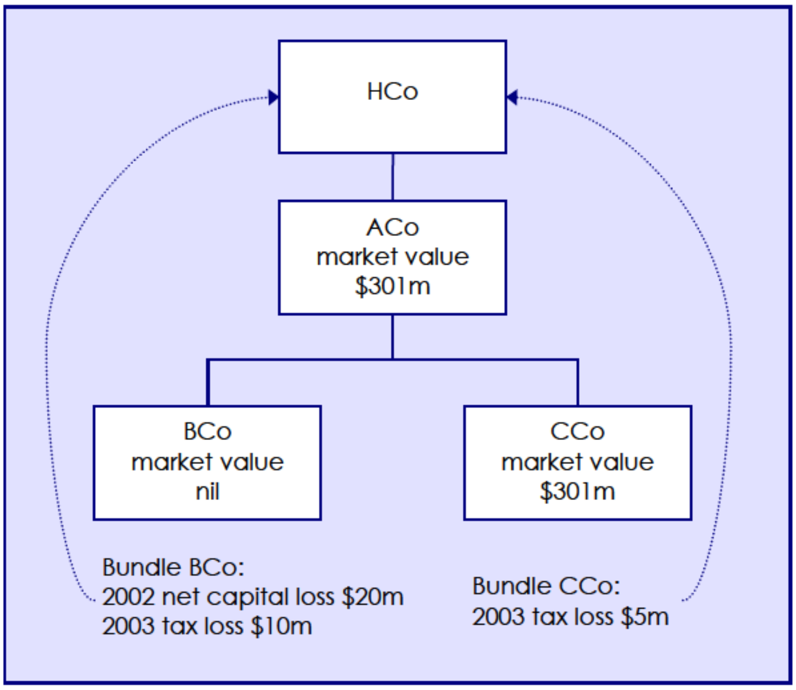
Upon consolidation, BCo's and CCo's losses are transferred to HCo under Subdivision 707-A of the ITAA 1997 (figure 2). (The transfers take place as a result of the same business test having been met → 'Transfer testing with modified same business test – where ownership or control failure in trial year but after loss year', C3-3-240.)

At the joining time the entities have the following market values:

- **CCo: $301 million.** $1 million of CCo's market value is attributable to the 2003 tax loss of $5 million. CCo does not have any franking credits.
- **BCo: nil.** As a result of some poor investment decisions in the preceding two years, BCo has a net deficiency of assets of $40 million at the joining time. However, its market value is nil (as explained in 'Commentary' above).
- **ACo: $301 million.** ACo's only assets consist of its shareholdings in BCo and CCo.

The adjusted market value of the consolidated group – that is, its market value ignoring any losses and assuming a nil franking account balance – is $1,000 million[2].

Figure 2: Consolidated group on 1 July 2003



ACo, BCo and CCo satisfy all the requirements in relation to the value donor concession in Subdivision 707-C of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP) Act 1997). Consequently, HCo elects for any modified market value from ACo and BCo to be donated for the purposes of working out the available fraction for CCo's bundle of losses. It also elects to treat the losses transferred from BCo as if they were included in the bundle of losses transferred from CCo for the purpose of determining their rate of utilisation.

[2] HCo owns other assets in addition to the shares in ACo.

Calculation

Modified market values

It is necessary to determine the modified market value of each loss-maker and value donor in the group as at the joining time:

- CCo's market value is $301 million, $1 million of which is attributable to the 2003 tax loss. One of the assumptions used in determining the modified market value of an entity is that it has no losses. Therefore, CCo's modified market value is $300 million → 'Modified market value of a joining entity', C3-4-110.
- BCo's market value is nil, despite having a net deficiency of assets of $40 million (as explained in 'Facts' above). BCo's modified market value is also nil. It should be noted that BCo has had capital injected into it after 8 December 2000 and within four years preceding the time it joined the consolidated group. Therefore, the 'anti-inflation' rule may apply

  → 'Calculating an available fraction – losses transferred where there has been a pre-joining injection of capital', C3-4-120. However, as BCo's modified market value would be nil ignoring the capital injection, the anti-inflation rule does not apply here (i.e. the capital injection has not resulted in an increase in BCo's modified market value). Therefore, BCo's modified market value remains at nil.
- ACo's market value is $301 million. All of ACo's market value is attributable to its interest in CCo, another corporate member of the consolidated group. Another assumption used in determining the modified market value of an entity is that its market value does not include an amount attributable to a membership interest in another member of the group that is a corporate tax entity. Therefore, ACo's modified market value is nil → 'Modified market value of a joining entity', C3-4-110.

Again, it should be noted that while ACo has also had capital injected into it in circumstances that could trigger the anti-inflation rule, this rule would not apply, for the same reasons as in BCo's case (i.e. the capital injection has not resulted in an increase in ACo's modified market value).

Value donor concession and available fraction

HCo cannot be a value donor to CCo because CCo would not have been able to transfer its loss to HCo under the group loss transfer rules in Division 170 of the ITAA 1997 → 'Adding to modified market value to reflect loss transferability', C3-4-210.

Both value donors, BCo and ACo, have modified market values of nil. They are able to donate only a nil amount of modified market value to CCo. Therefore, CCo is not able to increase its modified market value for the purpose of calculating its available fraction. However, because all of the relevant conditions in Subdivision 707-C of the IT(TP) Act 1997 are satisfied, HCo is able to treat the losses transferred from BCo as if they are included in the bundle of losses transferred from CCo for the purpose of determining their rate of utilisation → 'Including value donor's losses in real loss-maker's bundle', C3-4-220.

This bundle will have an available fraction of:

$$\frac{300\text{m} + 0 + 0}{1{,}000\text{m}} = 0.300$$

References

Income Tax Assessment Act 1997:

- Division 170
- Subdivisions 707-A, 707-C

Income Tax (Transitional Provisions) Act 1997, Subdivision 707-C

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Chapters 8 and 9

Revision history

Section C3-4-250 first published 3 December 2003.