Worked example

Determining the reduction amount – multiple events – determining the initial increase in market value

Description

This example shows that where there are two separate injections of capital[1], the total increase in an entity's market value is the sum of the initial increase in market value from each injection.

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[2] 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').

Limiting the reduction amount to the initial increase in market value ensures that the compounding effects of the event are not incorporated. For example,

[1] An injection of capital into the entity or an associate of the entity is an event described in paragraph 707-325(4)(a) of the *Income Tax Assessment Act 1997*. Taxation Ruling TR 2004/9 provides the Tax Office view on the meaning of the expression.

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

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

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 – market value reduced under some events', C3-6-160

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

Example

Facts

The Battletown Group, a consolidatable group consisting of HeadCo and SubCo, consolidates on 1 July 2006.

A tax loss incurred by SubCo is transferred to HeadCo at the joining time. An available fraction must be calculated to establish the rate at which the tax loss can be utilised by the Battletown Group.

During 2002, the board of directors of the Battletown Group decided to complete a placement of fully paid ordinary shares in the capital of the head company to Australian and foreign institutional investors. The capital raised was injected into SubCo, which used the funds to acquire assets for a new project. This was documented in the explanatory memorandum to the notice of general meeting:

> …the funds raised from the placement will be used to acquire mining assets for subsequent use in a new mining project.

On 1 December 2002 (the acceptance date of the share placement), HeadCo communicated acceptance of the offer to successful shareholders and injected the funds into SubCo. Both the capital raising by HeadCo and the subsequent injection of funds into SubCo are considered to be events for the purpose of the integrity rule.

The injected funds increased the working capital balance of SubCo. SubCo then acquired the new mining assets.

HeadCo decided to complete a second placement of fully paid ordinary shares in the capital of the company during 2004. The capital raised was intended to finance the continued operation of the mining project.

On 1 December 2004 (the acceptance date of share placement), HeadCo communicated acceptance of this offer to successful shareholders and injected the funds into SubCo. Both the capital raising by HeadCo and the subsequent injection of funds into SubCo are considered to be events for the purpose of the integrity rule.

Calculation

Valuations undertaken to determine the total increase in market value immediately after each event are shown in tables 1 and 2.

Table 1: Valuation data – HeadCo

Valuation	($ '000)	
1st share issue		
Initial market value of HeadCo immediately after acceptance	28,000	
Hypothetical* initial market value of HeadCo	20,000	
Initial increase in market value		8,000
2nd share issue		
Initial market value of HeadCo immediately after acceptance	38,000	
Hypothetical* initial market value of HeadCo	28,000	
Initial increase in market value		10,000
Total initial increase in market value		**18,000**

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

The sum of the increases in HeadCo's market value immediately after the events is $18,000,000. However, the integrity rule does not apply to HeadCo because the capital raised was immediately injected into SubCo. → 'Determining the reduction amount – injection of capital subsequently injected into a subsidiary', C3-6-150

Table 2: Valuation data – SubCo

Valuation		($ '000)
1st share issue		
Initial market value of SubCo immediately after receiving injected funds	18,000	
Hypothetical* initial market value of SubCo	10,000	
Initial increase in market value		8,000
2nd share issue		
Initial market value of SubCo immediately after receiving injected funds	28,000	
Hypothetical* initial market value of SubCo	18,000	
Initial increase in market value		10,000
Total initial increase in market value		**18,000**

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

Conclusion

The sum of the increases in SubCo's market value immediately after the events is $18,000,000.

A reduction in the modified market value of SubCo may be required under subsection 707-325(2) of the ITAA 1997.

SubCo satisfies the criteria to be able to adopt the short cut option for establishing the reduction amount. SubCo is able to use the total amount injected in the period up to the joining time as the reduction amount.

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

References

Income Tax Assessment Act 1997, section 707-325.

Revision history

Section C3-6-110 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).