Worked example

Determining the reduction amount – diminution in value up to the joining time

Description

This example shows how to determine a reduction to modified market value under subsection 707-325(2) of the *Income Tax Assessment Act 1997* (ITAA 1997). In this example, the initial increase in market value associated with a non-arm's length transaction diminishes in the period from the time of the event taking place to the joining time. In establishing the reduction amount, the diminution of value up to the joining time must be taken into consideration.

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').

This ensures no reduction is required if the event has not actually resulted in an increased 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

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

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.

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 Cable Group, a consolidatable group consisting of HeadCo and SubCo, consolidates on 1 July 2005.

Carry-forward tax losses are transferred from SubCo at the joining time.

A restructure of the group occurred in 2002, resulting in SubCo being responsible for manufacturing and HeadCo taking on the group's retail function.

The restructure involved the transfer of plant and equipment used in the manufacturing of cables at its written down value. It was documented in board minutes:

> Due to a restructure of the Cable Group, all plant and equipment will be transferred to SubCo from HeadCo in an effort to centralise the manufacturing function of the group.

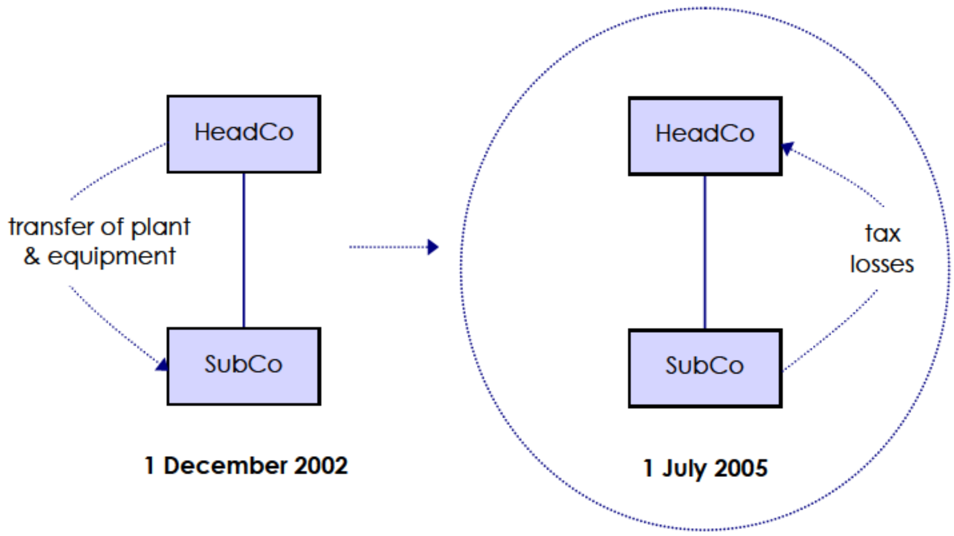
On 1 December 2002, HeadCo transferred the plant and equipment to SubCo for their book value of nil. Based on the output produced by the plant and equipment, the transfer had a positive impact on the market value of SubCo.

By 1 July 2005, production has reduced by half due to obsolescence. The positive impact on value attributable to the plant and equipment has diminished.

A reduction to the modified market value of SubCo may be required.

These facts are represented in figure 1.

Figure 1: Pre-consolidation non-arm's length transaction and subsequent consolidation



Calculation

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

Table 1: Valuation data – SubCo

Valuation	**($ '000)**
Modified market value of SubCo at the joining time	1,250
Hypothetical* modified market value of SubCo at the joining time	1,000
Excess in modified market value	**250**
Initial market value of SubCo immediately after the transfer	1,500
Hypothetical* initial market value of SubCo	1,000
Initial increase in market value	**500**

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

Applying the six step reduction method to SubCo

Table 2: Establishing the reduction amount – SubCo

Step	Explanation	$ ('000)
1	Modified market value	1,250
2	Hypothetical modified market value	1,000
3	Step 1 reduced by step 2	250
4	Initial increase in market value*	500
5	Reduction amount (lesser of step 3 and step 4)	250
6	Reduced modified market value	1,000

*[initial market value] – [hypothetical initial market value].

The modified market value of SubCo at 1 July 2005 that is to be used to determine the available fraction for the SubCo bundle is $1,000,000.

References

Income Tax Assessment Act 1997, section 707-325

Revision history

Section C3-6-120 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).