

Worked example

Determining the reduction amount – compounding of 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 a situation where additional profits are generated as a result of investing the funds received through an injection of capital.

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 years¹ 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, 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.

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 Medical Group, a consolidatable group consisting of HeadCo and SubCo, consolidates on 1 July 2003. The Medical Group is owned by five individual shareholders, who each hold an equal proportion of the share capital in HeadCo.

Carry-forward net capital losses are transferred from SubCo at the joining time. HeadCo is chosen to be a value donor² to SubCo for the purposes of determining an available fraction for the bundle containing the transferred net capital losses.

In March 2001, shareholders of the Medical Group subscribed for additional shares in HeadCo. It was documented in the board minutes that the share capital obtained from the existing shareholders would be used to fund further research into a discovery.

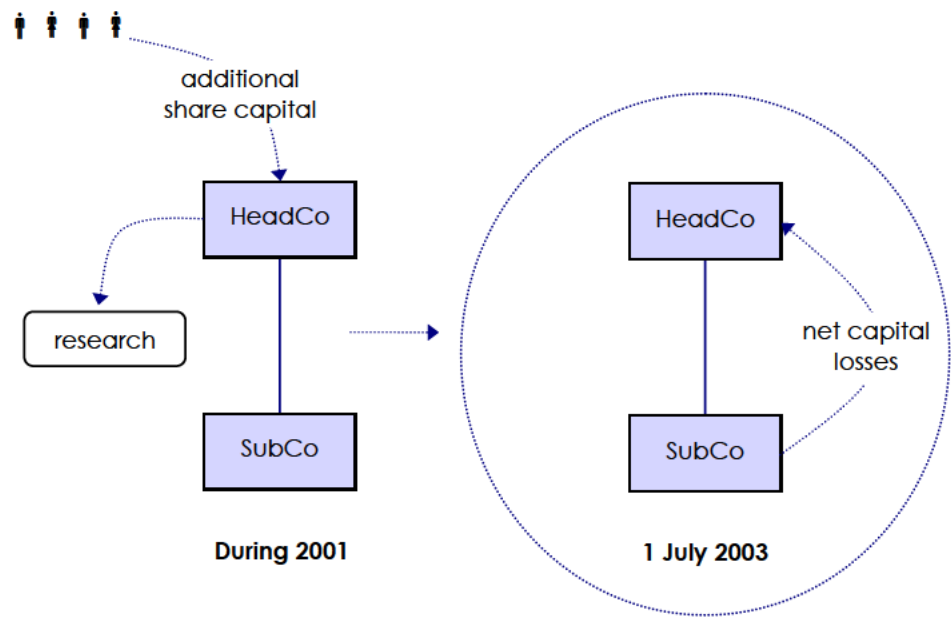
² The value donor concession is contained in Subdivision 707-C, *Income Tax (Transitional Provisions) Act 1997* → 'Adding to modified market value to reflect loss transferability' C3-4-210.

The research began and led to a medical breakthrough, which was commercially marketed and made a significant contribution to profits in the 2003 financial year.

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

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	6,000
Hypothetical* modified market value of HeadCo at the joining time	4,000
Excess in modified market value	2,000
Initial market value of HeadCo immediately after the injection of capital	5,200
Hypothetical* initial market value of HeadCo	5,000
Initial increase in market value	200

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

The data indicate that the use of the share capital considerably increased the value of HeadCo – its modified market value is much greater than it would have been had the share capital not been received. The hypothetical modified

market value for HeadCo is determined on the basis that the profits and value generated from the discovery would not have occurred in the absence of the injection of capital.

Applying the six step reduction method to HeadCo

Table 2: Establishing the reduction amount – HeadCo

Step	Explanation	\$ ('000)
1	Modified market value	6,000
2	Hypothetical modified market value	4,000
3	Step 1 reduced by step 2	2,000
4	Initial increase in market value*	200
5	Reduction amount (lesser of step 3 and step 4)	200
6	Reduced modified market value	5,800

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

The reduction amount is limited to the initial increase in market value that was attributable to the injection of capital (\$200,000). The modified market value of HeadCo at 1 July 2003, that is to be donated to SubCo for the purpose of determining the available fraction for the SubCo bundle, is \$5,800,000.

References *Income Tax Assessment Act 1997*, section 707-325

Revision history

Section C3-6-140 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).