Worked example

Determining the reduction amount – injection of capital subsequently injected into a subsidiary

Description

As shown in this example, there is only one reduction to modified market value under subsection 707-325(2) of the *Income Tax Assessment Act 1997* (ITAA 1997) where an injection of capital flows immediately to another entity within a wholly-owned group.

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').

Flow-through of injection of capital

It is a common commercial practice to raise funds by way of a share issue at the head or 'holding' company level of a corporate group. The funds raised are then injected in full into a wholly-owned subsidiary (either directly or through interposed entities), where they are invested in a business activity. In this scenario, assuming modified market values need to be determined for both

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

entities, an event occurs when the holding company accepts the offer and when the wholly-owned subsidiary receives the injected capital.

However, the holding company is merely acting as a conduit to transfer the funds. Provided the funds pass immediately and in full to the wholly-owned subsidiary, there is no reduction to the holding company's modified market value. A reduction amount is calculated only for the wholly-owned subsidiary that ultimately receives the funds.

This is because the modified market value of the head company disregards all membership interests in other group members[2]. In the absence of any other events, the head company's modified market value equals what it would have been in the absence of the injection (its 'hypothetical modified market value'). There is, therefore, no excess as described in paragraph 707-325(2)(b).

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

[2] Paragraph 707-325(1)(c), ITAA 1997.

Example

Facts

The Economic Group, a consolidatable group consisting of HeadCo and SubCo, consolidates on 1 January 2004. A net capital loss is transferred to HeadCo from SubCo at the joining time.

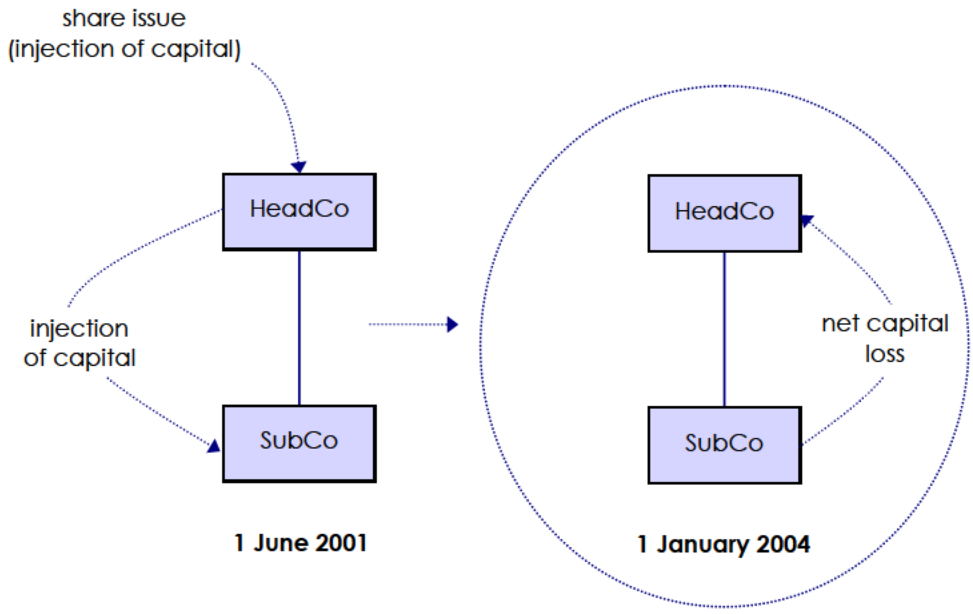
HeadCo is chosen to be a value donor[3] to SubCo for the purposes of determining an available fraction for the bundle containing the transferred net capital loss.

On 1 June 2001 HeadCo announced acceptance of an ordinary share issue, the purpose of which was to raise capital to fund the business activities of SubCo. On the same day the funds were received they were injected into SubCo, by way of HeadCo subscribing for additional shares in SubCo. The cash injection increased the working capital balance of SubCo.

Both the capital raising by HeadCo and the cash injection into SubCo are considered to be events for the purpose of the integrity rule. However, a reduction to modified market value may be required only for SubCo, even though there has also been an event in respect of HeadCo.

These facts are represented in figure 1.

Figure 1: Pre-consolidation injections of capital and subsequent consolidation



[3] 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

Calculation

Valuations undertaken to determine the reduction amount are shown in tables 1 and 2.

Table 1: Valuation data – HeadCo

Valuation	$ ('000)
Modified market value of HeadCo at the joining time	200
Hypothetical* modified market value of HeadCo at the joining time	200

* As though the event had not occurred.

The value attributable to the membership interests HeadCo holds in SubCo (that would include the value attributable to the injected funds) is disregarded in determining the modified market value for HeadCo. The hypothetical modified market value for HeadCo equates to its modified market value as the capital generated by the share issue was subsequently injected in full into SubCo.

Table 2: Valuation data – SubCo

Valuation	$ ('000)
Modified market value of SubCo at the joining time	500
Hypothetical* modified market value of SubCo at the joining time	400
Excess in modified market value	**100**
Initial market value of SubCo immediately after the cash injection	500
Hypothetical* initial market value of SubCo	400
Initial increase in market value	**100**

* As though the event had not occurred.

Applying the six step reduction method to both HeadCo and SubCo

Table 3: Establishing the reduction amount – HeadCo

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

As there is no excess at step 3 the modified market value of HeadCo is not reduced. 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 $200,000.

Table 4: Establishing the reduction amount – SubCo

Step	Explanation	$ ('000)
1	Modified market value	500
2	Hypothetical modified market value	400
3	Step 1 reduced by step 2	100
4	Initial increase in market value*	100
5	Reduction amount (lesser of step 3 and step 4)	100
6	Reduced modified market value	400

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

The modified market value of SubCo at 1 July 2003, that is to be used to determine the available fraction for the SubCo bundle, is $400,000.

References

Income Tax Assessment Act 1997, section 707-325

Revision history

Section C3-6-150 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).