TR 2004/9 - Income tax: consolidation: what is meant by 'injection of capital' in section 707-325 of the Income Tax Assessment Act 1997?

Taxation Ruling

Income tax: consolidation: what is meant by 'injection of capital' in section 707-325 of the *Income Tax Assessment Act 1997*?

Preamble

*The number, subject heading, **What this Ruling is about**, **Date of effect**, and **Ruling** parts of this document are a 'public ruling' for the purposes of **Part IVAAA of the Taxation Administration Act 1953** and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling is about ascertaining the meaning of the expression 'injection of capital' as it is used in Subdivision 707-C of Part 3-90 of the *Income Tax Assessment Act 1997* (ITAA 1997). That Subdivision, headed 'Amount of transferred losses that can be utilised', provides the legislative framework for the utilisation of losses that have been transferred to the head company of a consolidated group under Subdivision 707-A. The expression 'injection of capital' appears in the event described by paragraph 707-325(4)(a) of the ITAA 1997 (the ***capital injection test***).

2. In order to utilise a transferred loss, an available fraction is required to be worked out in respect of the bundle of losses to which it belongs. The expression 'injection of capital' is relevant to both the initial calculation of an available fraction and its subsequent maintenance.

Date of effect

3. This Ruling applies to years of income commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Ruling

Effect of an 'injection of capital' on utilisation of transferred losses

4. The expression 'injection of capital' is used in paragraph 707-325(4)(a) of the ITAA 1997. It is used in the context of the rules that apply to consolidated groups for working out the rate at which losses transferred under Subdivision 707-A to a head company can be utilised. This rate is called the 'available fraction' in respect of a bundle of losses.[1]

5. The available fraction is worked out having regard to the market value of the entity that made the loss as at the time it became a member of the consolidated group.[2] This is subject to a number of statutory modifications. An injection of capital into the entity (or an associate of the entity) within 4 years[3] before joining the consolidated group is one of two types of events that can result in a reduction to the modified market value of an entity. The other event is described in paragraph 707-325(4)(b) of the ITAA 1997 (the ***non-arm's length test***). Such a reduction has the effect of reducing the available fraction for a bundle of losses.

6. The available fraction is only reduced if the market value of the entity exceeds what it would have been had the event not occurred (the ***integrity rule***).[4]

7. An injection of capital into the company to which the losses were most recently transferred after a joining time can also result in a reduction of the available fraction for a bundle of losses (the ***adjusting event***).[5]

Meaning of 'injection of capital' – principles

8. The expression 'injection of capital' is not defined for the purposes of paragraph 707-325(4)(a) of the ITAA 1997. Accordingly, it has its ordinary meaning consistent with the purpose of the provisions.

9. We consider that, for the purposes of paragraph 707-325(4)(a) of the ITAA 1997, the expression covers transactions and acts with the following inter-related characteristics:

- *Wealth introduced from outside* – The transaction or event has introduced wealth into the entity from a source outside of the entity and not from transactions or acts from the entity's own resources.

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[1] ITAA 1997 subsection 707-320(1).
[2] ITAA 1997 sections 707-320 and 707-325.
[3] But not before 9 December 2000, *Income Tax Assessment (Transitional Provisions) Act 1997* (IT(TP)A 1997) section 707-329.
[4] ITAA 1997 subsection 707-325(2).
[5] ITAA 1997 subsection 707-320(2) table item 4.

- *Enhanced net assets* – The transaction or act produces an enhanced net asset position for the entity. A change in assets that relates to a corresponding change in liabilities does not enhance the net asset position of the entity and is not an injection of capital.
- *Equity interests affected* – The transaction or act affects the equity interests in the entity. A change in equity that relates to a corresponding change in assets and liabilities is an injection of capital if it also satisfies the other elements of an injection of capital. If the transaction or act only affects the assets and liabilities of the entity and does not affect equity it is not an injection of capital.
- *Not related to earnings and profit* – The transaction or act affects that part of the equity interests that are capital and not profit. Injections of capital are contributions to the entity and are not earnings made by the entity from its activities and operations. A contribution is an injection of capital if it also satisfies the other elements of an injection of capital. A transaction or act that contributes to, or is part of the entity's profit is not an injection of capital.
- *External party required* – The transaction or act involves the entity into which the capital is injected and an entity that injects the capital. An enhancement in the net asset position of the entity from the entity's own activities and resources is not an injection of capital.
- *Of a capital nature* – The transaction or act is on capital account or is capital in nature. It must affect the capital structure of the entity. A transaction on profit account is not an injection of capital. That is, a transaction in the ordinary course of business, for example, the ordinary sale of trading stock, is on profit account; it is not on capital account and is not an injection of capital. However, a particular transaction that would ordinarily be on profit account may be on capital account, having regard to factors including the identity of the parties, the purpose of the transaction, or the effect it has on the rights and obligations of the equity holders in the entity.

Purpose of transaction

10. The purpose of the transaction or act is not a factor that determines the application of the integrity rule or adjusting event. In particular, whether the transaction has the purpose (either objective or subjective) of increasing the market value of the entity or the available fraction is not determinative.

Physical inflow or reduced outflow

11. An injection of capital can arise where there is a physical inflow of money or property or a reduction of liabilities. It can also arise where the assets of the entity are increased in value by ways other than an actual inflow of money or property. It is the overall effect of the transaction or act on the net assets of the entity that is to be considered.

Timing of the injection of capital

12. An injection of capital does not arise until the transaction or act displays all of the characteristics of an injection of capital. This will depend on the nature and individual circumstances of the transaction or act. For example, a transaction that is otherwise an injection of capital will only be treated as such when the net assets of the entity are increased.

Classification of specific types of transactions

Issue of shares for consideration

13. The most common form of an injection of capital is by way of the issue of shares for consideration. Consideration is not limited to money.

Issue and contribution of other types of equity

14. The issue of any security or interest in the entity, or contribution to the entity, that involves a credit to the equity interests in the entity, or equity accounts of the entity, is considered to be an injection of capital.

Partly paid shares or equity interests

15. The issue of partly paid shares is an injection of capital to the extent that the shares are paid. The extent to which the shares are unpaid is not an injection of capital at the time of issue. However, an injection of capital will arise when the shares are later paid or there is a legally enforceable obligation to immediately pay. Separate calls in respect of the same share issue will be taken to be separate injections of capital made at the time the call is paid. This is because the net asset position of the company is enhanced only to the extent that the shares are paid.

Warrants, calls and instalment receipts

16. Whether any particular arrangement of these kinds is an injection of capital depends on whether the net asset position of the entity is enhanced and the arrangement involves equity interests in the entity, or a credit to an equity account. Calls and instalment receipts that have these features will be injections of capital when the call or instalment is paid or there is a legally enforceable obligation to immediately pay.

Initial capitalisations

17. An initial share issue is not considered to be an injection of capital for the purposes of paragraph 707-325(4)(a) of the ITAA 1997. This is because an initial share issue is not considered to be an 'injection of capital into the entity'. An initial share issue is part of the process of the *formation* of the entity.

18. For the purposes of this ruling, an initial share issue is an equity raising made at or around the time of the formation of the company or before the company commenced any operating or trading activity and its only activity to date (if any) related directly to the raising of initial finance. Deferred payments, including but not limited to calls, instalments and overdue payments made for an initial share issue are an injection of capital into the company at the time the deferred payment is made.

19. An initial share issue will be treated as an injection of capital if it forms part of a wider arrangement in respect of which, as a whole, it would be reasonable to form the view that the arrangement is an injection of capital. Arrangements that have been structured in a contrived manner to appear to be initial share issues will also not be treated as initial share issues for the purposes of this ruling. Each case will be considered according to its own facts.

Compulsory capitalisations – regulatory and prudential requirements

20. An issue of shares or other types of equity made to meet an obligation imposed by regulatory or prudential requirement is an injection of capital. Such transactions are usually for the express purpose of enhancing the net asset position of the entity to a required minimum standard and the transaction results in a credit to an equity account.

Conversion of one type of equity into another

21. A transaction enabling the conversion of one type of equity into another that does not effect a change in either the assets or liabilities of the entity is not an injection of capital for the purposes of paragraph 707-325(4)(a) of the ITAA 1997. Also, none of the other characteristics of an injection of capital would be present. For

example, the redemption of a redeemable preference share issue by an ordinary share issue will not be an injection of capital where the ordinary shares are issued directly to the holders of the redeemable preference shares. Similarly, where the redemption is effected out of a fresh issue of ordinary shares to third parties, then the fresh issue of shares will not be an injection of capital to the extent of the redemption.

Capitalisation of profits

22. The capitalisation of profits is not considered to be an injection of capital for the purpose of paragraph 707-325(4)(a) of the ITAA 1997. A bonus share issue funded from retained earnings affects only the equity accounts of the entity in that there is a shift from its profit account to its capital account. Such a transaction does not satisfy the other characteristics of an injection of capital. There is no change in either the assets or the liabilities of the entity. However, whilst recognising that a bonus share issue is not ordinarily an injection of capital, it may nonetheless amount to an injection depending on all the facts and circumstances of the case (that is, if the other characteristics of an injection of capital are present because of the particular features or circumstances of the transaction) and may therefore be subject to the integrity rule.

Debt/equity swap

23. A conversion or swap from debt, or any other form of liability financing, held in an entity, into equity in that entity is an injection of capital for the purposes of paragraph 707-325(4)(a) of the ITAA 1997. This is because the entity has been provided with funding that enhances its net asset position through a transaction that involves equity interests in the entity, or a credit to an equity account. The swap has the effect of satisfying or releasing the entity from further obligation to repay the debt in return for the entity issuing equity interests.

Loans and debts

24. A *commercial* and *arm's length* loan or other debt is not an injection of capital. It is not a transaction that affects the equity interests in the entity nor is there an increase in the net assets of the entity as a result of that loan or debt. The increase in assets from the amount that is borrowed is matched by a corresponding increase in the liabilities for the amount owed to the creditor or lender.

25. A loan or other debt that is not on commercial terms or otherwise arm's length may amount to an injection of capital and may also fall for consideration in respect of the non-arm's length test. This test does not require a change to an entity's equity account.

Debt forgiveness

26. A debt forgiveness would not normally be considered to be an injection of capital for the purposes of paragraph 707-325(4)(a) of the ITAA 1997. Forgiving a debt does not ordinarily involve a transaction or act that affects equity interests in the capital of the entity, or the capital accounts of the company. However, if a particular forgiveness arrangement involves a credit to an equity account of the entity, then the arrangement would be an injection of capital. For example, a forgiveness may be consideration for the issue of shares in the entity.

Other aspects of the capital injection test

Effect on market value

27. If a transaction or act is an injection of capital, the market value of the entity is only reduced under 707-325(2) of the ITAA 1997 if the injection had the effect of increasing the market value of the entity and that increase was still reflected in its market value at the time it becomes a member of a consolidated group.

28. A transaction that is an injection of capital into an associate which does not involve an increase in the market value of the entity will not result in a reduction to the modified market value in respect of the entity.

Relationship with non-arm's length test

29. The capital injection test and non-arm's length transaction test operate independently. For example, a transaction or act involving some, but not all, of the essential elements of an injection of capital may still result in an adjustment to the available fraction because it is a non-arm's length transaction.

30. Where a transaction or act satisfies the conditions for both tests, it will not result in more than one application of the integrity rule or adjusting event.

Pre-loss capitalisations

31. An injection of capital can arise either before or after the entity made the relevant loss. The test is not limited to post-loss capitalisations.

Insolvent entities

32. An injection of capital into an insolvent entity can be an injection of capital for the purposes of paragraph 707-325(4)(a) of the ITAA 1997.

Injections of capital into associates of the entity

33. A transaction or event that involves an associate of the entity can give rise to an injection of capital for the purposes of paragraph 707-325(4)(a) of the ITAA 1997. Accordingly, any transaction or act of a kind that would be an injection of capital if it were made to the entity can be an injection of capital if it is made to an associate of that entity.

Explanation

Expression not defined

34. In working out the available fraction or in the course of its subsequent maintenance, the expression 'injection of capital' may become relevant in ascertaining whether a transaction is an 'event' for the purposes of subsection 707-325(2) of the ITAA 1997. The expression appears in paragraph 707-325(4)(a) of the ITAA 1997:

> (4) These are the events:
>
> (a) an injection of capital into the entity or an entity that was an *associate of the entity (or of the trustee of the entity, if the entity is a trust) at the time of the injection.

35. As the expression is not defined in the Act it is necessary to consider its ordinary meaning. As it is possible that the ordinary meaning will vary according to the context in which it is used, it is necessary to consider the legislative framework in which the expression appears.

Legislative framework

36. Subdivision 707-C of the ITAA 1997 sets out the framework for the utilisation of losses transferred to a head company of a consolidated group under Subdivision 707-A. The rules contained therein are designed to ensure that the use of transferred losses by the consolidated group is restricted, to approximate the same rate they would have been used by the joining entity had it remained outside the group.[6]

37. The rate of loss utilisation is determined by reference to that amount of the group's income that is considered to have been generated by the joining entity. This represents the maximum amount of the losses transferred to the head company by that entity that can be used in that income year. The term 'available fraction' is the proxy used for determining that amount.

[6] Refer principle in ITAA 1997 subsection 707-305(3).

38. The available fraction for a bundle of losses is the proportion the joining entity's modified market value bears to the adjusted market value of the whole group when the losses in the bundle are first transferred to a head company.[7] As the calculation of the available fraction is the integral component for the utilisation of transferred losses, special rules are necessary to ensure that its integrity is established and maintained.

39. The basic rule for working out the modified market value of an entity is set out in subsection 707-325(1) of the ITAA 1997. The amount worked out under that subsection is subject to the rule (the *integrity rule*) to prevent inflation of the modified market value in subsection 707-325(2) because of one or more events described in subsection 707-325(4).[8]

40. The subsequent maintenance of the available fraction is governed by subsection 707-320(2) of the ITAA 1997 and the table therein identifies the relevant adjusting events. Adjusting event Item 4 in the table requires the available fraction to be adjusted each time the market value of the company[9] is increased as a result of an event described in subsection 707-325(4).[10] This adjustment operates on a progressive basis as the available fraction being adjusted should already reflect prior events and effects (if any) thereof.

Effect of integrity rule and adjusting event to maintain proportion of group's income or gains generated by loss entity

41. An examination of the purpose behind the inclusion of both the integrity rule and adjusting event Item 4 (the rules), and their effect when applied, provides the context in which the meaning of the expression is to be understood. Both of the rules are referenced to the two events described in subsection 707-325(4) of the ITAA 1997.

42. Where an event under subsection 707-325(4) of the ITAA 1997 has occurred within the prescribed 4 year period before the joining time,[11] the amount worked out under subsection 707-325(1) may be reduced by reference to the value attaching to that event. Where the integrity rule has applied, the modified market value under subsection 707-325(2) is used for the purpose of working out the initial available fraction under subsection 707-320(1).

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[7] The formula in ITAA 1997 subsection 707-320(1) reflects the proxy given in ITAA 1997 subsection 707-305(5).

[8] The integrity rule is also known as the 'anti-inflation rule' and in the Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002 (the December EM) as the 'capital injection rules'.

[9] The relevant 'company' will be that to which the losses in the bundle were most recently transferred.

[10] But not in respect of an event covered by ITAA 1997 subsection 707-325(5).

[11] ITAA 1997 paragraph 707-325(2)(a), but not before 9 December 2000 IT(TP)A 1997 section 707-329.

43. Paragraph 8.91 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 (the May EM) states that the rules:

> … prevent a loss entity from inflating its market value before it joins a consolidated group in order to obtain a higher available fraction.

It operates with the overall object to establish, at a particular point in time (the joining time), that fraction of the joined group's market value said to be attributable to the joining entity.[12]

44. Where the event occurs after a joining time, the available fractions of the company are to be adjusted by reference to the increase in the market value of the company caused by the event. Each available fraction of the company is adjusted by multiplying it by the factor provided at Item 4 in the table in subsection 707-320(2) of the ITAA 1997.

45. The rationale for adjusting an existing available fraction is that the additional value associated with the event is seen to increase the group's income generating capacity. This would have the effect of reducing that proportion of income that a loss entity within the group could be regarded as generating.[13] Accordingly, the available fraction is adjusted to reflect that reduced contribution to the group's income producing capacity.

46. The integrity rule is about establishing the initial proportional representation of the income generating capacity of the group in respect of each loss entity in the group. The adjusting event requires the available fraction to be adjusted each time additional value is introduced into the group so as to reduce that proportion. This combination is designed to ensure that the use of transferred losses is not accelerated or increased but, rather, is maintained or reduced.

When do the rules operate?

47. It should be noted that not all transactions that increase the market value of the loss entity or group will trigger these rules. The fact that they will only operate when an event described in subsection 707-325(4) of the ITAA 1997 occurs is a clear indication that transactions may exist that increase market value that fall outside the ambit of both rules.

48. It would also be erroneous to conclude that because a transaction is an event within subsection 707-325(4) of the ITAA 1997, subsection 707-325(2) will always effect a reduction. Subsection 707-325(2) only considers the effect of the event on the market value of the entity and, if it has increased, then a reduction will be effected. In addition, where the event occurs outside the four-year period then subsection 707-325(2) will not effect a reduction even though the event may have increased the entity's market value.

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[12] See ITAA 1997 section 707-305 and, in particular, paragraph 707-305(4)(b) and subsection 707-305(5).
[13] See May EM at paragraph 8.61.

49. The rules are not expressed as all encompassing nor are they subject to a purpose based test. That is, they are not limited to events entered into for an express purpose of inflating the market value of the loss entity or group to increase an available fraction. Whilst transactions with that purpose might be subject to these rules it is the nature and effect of the transaction that is determinative.

50. The main object of the available fraction methodology is to prevent the modified market value of an entity from being inflated by any transaction that is an event as described in subsection 707-325(4) of the ITAA 1997.

51. The provisions concentrate on describing which transactions are relevant and then dealing with the effect of the event so entered into. The integrity rule could be summarised as two questions:

- is the transaction an event under subsection 707-325(4) of the ITAA 1997; and
- has the event increased the market value of the entity?

52. Subsection 707-325(4) of the ITAA 1997 merely describes the two events that will trigger the integrity rule.

53. Similarly, all that is required to trigger the operation of the adjusting event rule is for the transaction to fall within either of the events described in subsection 707-325(4) of the ITAA 1997. If the event increases the market value of the company then the available fraction must be adjusted by the factor provided for in the table in subsection 707-320(2).

Exceptions

54. Subsection 707-325(5) of the ITAA 1997 specifically disregards, for the purposes of paragraph 707-325(2)(a), injections of capital in two particular situations.

55. The first is where the injection of capital is into a listed public company through a dividend reinvestment scheme, provided that the entity to which the shares are issued held a share in the listed public company before the capital injection.

56. The second is where the injection is made in association with an acquisition of shares under an employee share scheme if the scheme is one described in the rules dealing with membership of a consolidated group.

57. Whilst both exceptions concern the issuance of shares by a company, it cannot be taken to mean that this is necessarily the intended extent of the expression ‘injection of capital’. They are merely two exceptions from the application of subsection 707-325(2) of the ITAA 1997.

58. It is noteworthy that they are the only exceptions other than those injections of capital that are disregarded because they occurred outside the prescribed period. If the dividend reinvestment scheme or employee scheme does not meet the criteria to be excepted then these injections of capital will be events that will not be disregarded from the application of subsection 707-325(2) of the ITAA 1997.

Injection not necessarily a physical inflow

59. In the first exception, the share issue does not involve a *physical* inflow of monies into the company. The shares are issued in lieu of a physical outflow of monies associated with the payment of a dividend. It can therefore be deduced that the word 'injection' is not necessarily limited or restricted to transactions requiring a physical influx of money or property.

Establishing the ordinary meaning

Interchange of 'injection of capital' with 'capital injection'

60. In ordinary parlance the expression 'injection of capital' may be substituted by the expression 'capital injection'. A key example of this interchange is to be seen in the latter's use in the Exposure Draft, New Business Tax System (Consolidation) Bill 2000 (the ED). The heading to proposed subsection 168-925(2) in the ED, '*Modified market value reduced by capital injections*', is followed by proposed paragraph 168-925(2)(b) referring to 'one or more injections of capital'.

61. In paragraphs 3.181 to 3.193 of the Explanatory Material accompanying the ED, the expressions 'injections of capital', 'capital injected', 'capital injections' and 'injecting capital' are used to express the same concept. At paragraph 3.190 headed '***What is a capital injection?***' it states '[t]he expression *capital injection* is not defined'.[14] This interchange is repeated in the May EM at paragraph 8.100:

> The pre- and post-consolidation **capital injection** events … [emphasis added]

62. In light of this usage it is reasonable to assume that the meaning intended to be attached to one expression does not differ markedly to the other in the context of these rules.

[14] It is noted though that the ED use of these expressions was in the context of them applying to some transactions that would now fall within the description of the event under paragraph 707-325(4)(b) of the ITAA 1997.

Dictionaries

63. In ascertaining the ordinary meaning of an expression or term, recourse can be had to the use of dictionaries.[15] The use of a standard dictionary is not mandatory for finding the meaning of a term[16] nor is there any one dictionary that is to be taken as authoritative.

64. Whilst a definition of 'injection of capital' is not to be found in *Butterworths Business and Law Dictionary*[17] it does however define the expression 'capital injection' as being:

> [t]he acquisition and utilisation of additional funds by an organisation. Such funds may be raised through an issue of shares and bonds or through an allocation by a parent or associated company.

65. This definition is a useful starting point in ascertaining what the ordinary meaning of 'injection of capital' will be in the context of the rules. There is the suggestion of an act that results in additional funds being acquired for use by the entity. That act may involve the issue of equity interests or debt raisings, or, it could be by some other means such as an allocation by a parent or associate. It is not an exhaustive definition and it likely contemplates transactions that are entered into that produce the same or a similar effect.

66. Care should always be exercised when considering a compound expression, such as 'injection of capital', not to look to the meanings of each word and from that construct a meaning for the expression which may, in fact, have already acquired a special meaning. Notwithstanding this, in the absence of finding a special meaning, it is open to examine how capital is 'injected' into an entity and what actually is meant by the word 'capital' in the expression so used in the law. Reference to their respective dictionary meanings may lead to a better understanding of what the definition of 'capital injection' entails to confirm whether it is of relevance or whether 'injection of capital' requires a different meaning.

What is meant by 'injection'?

67. In respect of the term 'injection', both the *Oxford*[18] and *The Macquarie*[19] dictionary meanings refer to that which is 'injected'. In the case of the former, 'inject' can mean to 'place (a quality, money, etc.) into something' whilst the latter provides 'to introduce (something new or different) into a thing'.

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[15] *Haigh v. Charles W Ireland Ltd* [1974] 1 WLR 43 at 55 per Lord Diplock.
[16] Gifford, DJ and KH, 1994, *How to Understand an Act of Parliament*, 8th edn, The Law Book Company Ltd, Sydney, at p89.
[17] Ipp, D.A. Weerasooria, W.S. (Wickrema, S.) Sydney: Butterworths. 1997.
[18] The Oxford Dictionary for the Business World, Oxford University Press, 1993
[19] The Macquarie Dictionary, edited by A. Delbridge et al, 3rd ed (revised), North Ryde NSW: Macquarie Library, 2001.

68. These dictionary meanings infer that something, albeit tangible or intangible, monetary or property, is placed or introduced into a thing. This would indicate that an external act is required to effect that placement or introduction of something into the entity. It may be initiated by the entity but the outcome is that something has been introduced into it to give it further substance.

69. The use of the word 'into' both in the definitions of 'inject' above and in paragraph 707-325(4)(a) of the ITAA 1997 signals that something is being placed or introduced into an entity that is already in existence. In other words, the injection is, in effect, additional to whatever was there preceding the transaction or act. In the absence of an entity then there would not be anything to inject into. It is notable that in both of the exceptions in subsection 707-325(5), the entity is a company already in existence.

70. We have concluded therefore that the term 'injection' contemplates the adding of 'capital' to an entity. This is consistent with the 'capital injection' definition above which refers to the acquisition and utilisation of **additional** funds.

What is meant by 'capital'?

71. The High Court has indicated that the term 'capital' cannot be precisely defined[20] and, given the breadth of meaning attributable to it in the dictionaries, care needs to be exercised in determining its scope. For example, the *Macquarie* defines 'capital', among other things, as being:

- the wealth, whether in money or property, owned or employed in business by an individual, firm etc;
- an accumulated stock of such wealth;
- any form of wealth employed or capable of being employed in the production of more wealth;
- (in trust law) the original fund of money or property, as distinct from the income or profits produced thereby;
- (in company law) the funds a company proposes to raise through the issue of shares; and
- the ownership interest in a business.

72. The *Oxford* includes 'capital' as being:

- the total assets of a person less liabilities;
- that amount of the proprietor's interests in the assets of an organisation, less its liabilities;
- the money contributed by the proprietors to an organization to enable it to function;

[20] *Incorporated Interests Pty Ltd v. Federal Commissioner of Taxation* (1943) 67 CLR 508 at 515 and 520.

- the share capital as provided by way of shares and the loan capital as provided by way of loans; and
- in the case of the proprietors of a company, as not only consisting of the share and loan capital, but also includes retained profit, which accrues to the holders of the ordinary shares.

73. These meanings suggest that capital is not limited to just the 'funds' of an entity and is referable to other assets. They also confirm that 'capital' can be funded (or sourced) by way of both share (equity) issues and loans. Depending on the perspective taken, capital can be seen as either all the assets of an entity or, alternatively, all the interests (debt and equity) in that entity represented by those assets.

74. It is also notable that capital can also be described, *inter alia*, as the total or net amount of equity *contributed* to a company or as the total or net assets of the business. It can be equated with the wealth of an entity or the net worth of proprietorship. Whilst share issues and loan capital are a source for the influx of wealth they are not necessarily the only source for increasing wealth: the accumulation of profits through the profitable employment of the entity's assets is a case in point.

Distinction between the profit and capital accounts of an entity

75. The idea of 'capital injection' is narrower than these dictionary definitions of capital. The use of the word 'injection' precludes those trading activities giving rise to profits, which ordinarily would form part of capital, as being an event for paragraph 707-325(4)(a) of the ITAA 1997. The word 'inject' conjures the image of an external act providing an additional source of wealth rather than the entity's profitable use of its own resources.

76. To conform the term 'capital' to the 'capital injection' definition, a distinction is required to be made between those transactions or acts that provide additional funds to be employed by the entity which affect its capital accounts from those that affect its profit accounts. A transaction or act that results in a change to the capital accounts of the entity that relates to a corresponding enhancement of its assets will be a capital injection. Those parts of transactions or acts that contribute to or are taken into account in working out the entity's profit are not capital injections.

Compound meaning to be given to 'injection of capital'

77. As a composite expression, 'injection of capital' takes the narrow meaning of capital to consider only those transactions or acts that contribute additional wealth to the structure or capital base of the entity. Such an approach excludes those transactions that generate wealth from the profitable use of the entity's own resources.

78. It emphasises the respective meanings to be given to both the words 'injection' and 'capital' but without changing the overall meaning given to the latter expression. That is, the use of the word 'injection' conveys a conscious need for an external act to add or introduce to the entity further capital or wealth. The conjunction 'injection of' with 'capital' clearly stresses that it is only capital, whether sourced from equity or debt, to be introduced into the entity.

Explanatory Material – The May EM

Wealth or capital of the entity is all its assets

79. Paragraph 8.97 of the May EM confirms that the expression is not defined and is to take its ordinary meaning. It then states:

> Capital is generally understood as the wealth of an entity, whether in money or property.

80. From the perspective of the entity, the term 'wealth' would include funds sourced through debt or loan capital and is referable also to the accumulation or retention of profits and gains. For example, an infusion of funds from a commercial loan would see an increase in the assets held by an entity (wealth) but it would not lead to a corresponding increase in that entity's net wealth or net assets. In this instance the equity accounts of the entity are unaffected and the corresponding increase in assets is matched by an increase in the entity's liabilities.

81. Similarly, where the entity profitably uses its resources to generate profits, those profits will lead to an increase in its assets (wealth) matched by a corresponding increase in the entity's profit accounts. These profits, if undistributed, can in turn be used in the furtherance of the entity's activities to generate further wealth and add to the entity's store of capital.

Wealth or capital to exclude profits

82. However, paragraph 8.97 of the May EM confirms the emphasis to be put on the word 'injection' in the context of these rules. By requiring an external act, it precludes increases in wealth attributable to the profitable use of assets:

> The use of the word injection conveys that the capital or wealth has been introduced from outside the entity (or group) in the sense that it has not been obtained from the entity's (or group's) own resources.

83. Commercial and arm's length transactions or acts by the entity using the resources at its disposal (wealth) which affect the entity's profit accounts are not considered to be injections of capital. This understanding of the context is reflected by the comment made in paragraph 3.191 of the Explanatory Material to the ED which says 'if

an entity accumulates profits for its business, there is no capital injection'.[21]

84. The conclusion to be drawn from the May EM is that whilst the term wealth is equated with the wider meaning of capital to include all of the assets of the entity, a key focus of the expression is on the *injection of* capital *into* the entity. That is, only those transactions that affect the capital accounts of the entity.

Focus of capital injection test is on the enhancement of an entity's net asset position and changes to its equity accounts

85. Whilst the extrinsic material is consistent with the compound meaning that the expression injection of capital will focus attention on those transactions or acts that result directly in the capital structure of the entity being enhanced, the expression must still be viewed in the context of how the capital injection test applies in relation to the integrity rule in section 707-325 of the ITAA 1997 and adjusting event Item 4 in subsection 707-320(2). Both seek to affect a change where the event has caused an increase in market value.

86. An increase in market value is not of itself an indicator of whether a transaction or act will be an injection of capital. At best, it may be indicative that there has been an event as described under either test in subsection 707-325(4) of the ITAA 1997.

87. Where the net asset position of an entity remains unchanged following an injection of capital, there is less likelihood of an increase in the entity's market value. A change in assets that relates to a corresponding change in liabilities does not enhance the net asset position of an entity. The focus of the capital injection test is on those transactions and acts that enhance the net asset position and correspondingly affect the equity accounts of the entity.

88. Injections of capital that affect only the liability or debt accounts of an entity will not be subjected to the capital injection test. For example, a commercial loan is an injection of debt capital that increases the wealth (total assets) of the entity. As noted, it does not enhance the net asset position of that entity as the increase in assets is offset by a corresponding increase in liabilities.

89. Contrast this with the example illustrating the desired context in which the expression is to apply. Paragraph 8.97 of the May EM concludes with what it considers to be the simplest example of an injection of capital: 'the payment of cash to an entity as consideration for membership interests in the entity'. This example highlights key facets of the transaction: its net asset position is enhanced by the additional funds (cash) received from an external source that augments both the wealth of the entity and its market value.

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[21] This paragraph was considering the expression 'capital injection' in the context of proposed subsection 168-922(2), the precursor to section 707-325 of the ITAA 1997.

Alternative views

Share issues for cash consideration only

90. There has been a view that the injection of capital test is to be read very narrowly and that is to be limited to share issues for cash consideration only. This view is based primarily on the 'simplest' example, as expressed in the paragraph 8.97 in the May EM, and that the reference to 'capital' is to be taken as meaning share capital.

91. The fact that the example is labelled as being the 'simplest' is an indication that more 'complex' examples exist and are contemplated.

92. Restricting its application to transactions that involve a physical inflow of cash is contrary to the intent expressed in the May EM that 'capital', as a form of wealth, can be represented either in 'money or property'. For example, membership interests could be issued to secure membership interests in other entities or property and assets including businesses. The exception in paragraph 707-325(5)(a) in respect of dividend reinvestment schemes is a case in point.

93. Similarly, such a restrictive application would limit the event only to companies, when there is a clear indication that it is to apply to other types of entities that become members of a consolidated group. The reference to 'if the entity is a trust' in paragraph 707-325(4)(a) of the ITAA 1997 signals that intention.

94. The focus of the expression 'injection of capital' is on its potential effect on the net wealth of the entity and not on the form of the assets that might represent it. Share issues for cash consideration may represent a significant proportion of the type of transaction falling within the ambit of this expression but will not be the only type.

Examples

95. The examples that follow consider whether the transaction described will be an injection of capital for the purposes of paragraph 707-325(4)(a) of the ITAA 1997. Each example assumes that the member entity of the consolidated group is required to determine the modified market value at the initial transfer time.

Example 1: share subscription for initial capital

96. Head Co Pty Ltd (Head Co) lodged an application with the Australian Securities and Investments Commission (ASIC) to register a new company to be named X Pty Ltd (X Co). Incorporation of X Co occurred on 1 December 2001 being the date of registration stated on the registration certificate from ASIC. The application set out that the initial capitalisation was $100,000.

97. On 15 December 2001, X Co received $100,000 in initial paid-up capital as consideration for the issue of 100,000 ordinary shares to Head Co at $1.00 per share. Head Co formed a consolidated group on 1 July 2003 with X as a subsidiary member. X transferred a loss made in the 2003 income year to Head Co.

98. The $100,000 initial capitalisation of X is not an event for the purposes of the capital injection test. The money received by the entity, as consideration for issuing the initial equity interests in it will not constitute an injection of capital as it goes to the formation of the entity.

99. Note: The contribution would not be treated as an initial capitalisation if, for example, the payment is not made within a reasonable period of time, is delayed without cause relating to the formation process, or it forms part of a wider transaction that is not limited to the formation process, or is contrived to appear as an initial capitalisation. The following examples will not be treated as an initial capitalisation:

- deferred payment of an initial capitalisation, or that part of the payment that is deferred, for example, an extended settlement period for making payment for an initial share issue (allowing a reasonable time for, say, commercial and legal clearances);
- an initial capitalisation that is lent back to the contributors or which otherwise leaves the company in a transaction that is not entered into solely for the purposes of conducting the company's business; or
- an initial capitalisation that is spent on acquiring an asset that is not intended to be used and enjoyed by the company, for example where the proceeds of the capitalisation are used to acquire an asset from a related party, is held in the company, and later re-sold to the related company.

Example 2: initial fundraising

100. NewCo Pty Ltd (New Co) is acquired 'off the shelf' by OldCo Ltd (Old Co) as a vehicle to commence a new business venture. New Co was a shelf company and had never traded. Old Co purchased its issued shares for $10 from a company broker. The new venture involved an initial public offer (IPO) of $2 million. Old Co contributed $100,000 to meet IPO costs including the preparation of a prospectus and engaging a share broker to market and underwrite the offer. Under the IPO, New Co receives $2 million and immediately allots fully-paid shares.

101. The acquisition (and previous registration) of the company for $10, the $100,000 contribution to meet initial financing costs and the $2 million IPO are not treated as injections of capital as they are considered to be part of the initial capitalisation of New Co.

Example 3: 'compulsory' injections of capital

102. A Government regulator sets a prudential standard as to the minimum capital requirement (MCR) expected to be maintained by those companies engaged in the general insurance industry. In response to a perceived increase in risk, the regulator increases the MCR for this industry. General Co, the head company of a consolidatable group, operates in this insurance market. As a consequence, General Co is forced to seek additional capital sourced from Foreign Co, its non-resident parent company to meet the new standard. Foreign Co injects cash into General Co in exchange for additional shares. The transaction takes place within the prescribed period.

103. This 'compulsory' injection of funds by Foreign Co into General Co, made for the purpose of complying with the Government regulator's prudential requirements, is an injection of capital. The net asset position of General Co has increased as a result of receiving additional funds in return for issuing additional equity interests. Injections that take place as a result of complying with a prudential standard are not distinguished from other forms of capital raisings.

Example 4: debt/equity swap

104. Head Company Ltd (Head Co), the head company of a consolidatable group, borrowed funds from Foreign Co, a related non-resident company. Under a subsequent arrangement, Head Co issues additional shares to Foreign Co, in exchange for the discharge of the outstanding debt. The arrangement takes place within the prescribed period.

105. Head Co forms a consolidated group and seeks to utilise a capital loss it had made in an earlier income year. In the process of working out Head Co's modified market value, it is necessary to consider whether the transaction described satisfies the capital injection test.

106. The arrangement (commonly referred to as a debt/equity swap) is an injection of capital. The distinguishing features of a debt/equity swap are such that the creditor (Foreign Co) releases the debtor (Head Co) from the obligation to repay a debt in exchange for the debtor issuing equity (usually shares) to the creditor.

107. Under the arrangement, Foreign Co has 'acquired' additional equity interests in Head Co, in return for releasing Head Co from its debt. Despite the fact that there is no physical flow of funds, the net asset position of Head Co has increased by virtue of it no longer having an obligation to repay the loaned funds. As such, the debt/equity swap is considered an injection of capital.

Example 5: commercial loan at arm's length

108. On 15 August 2001, Joining Co Pty Ltd borrowed funds on commercial terms from Bank Co Pty Ltd. Bank Co Pty Ltd charged a commercial rate of interest for the funds. All parties dealt with each other at arm's length.

109. Joining Co Pty Ltd becomes a member of the consolidated group formed by Head Co Pty Ltd on 1 July 2002 (joining time). At the joining time, Joining Co Pty Ltd is required to determine its modified market value and it is necessary to consider whether this transaction involving a commercial loan, satisfies the capital injection test.

110. The loan does not constitute an injection of capital for the purpose of the application of the integrity rule. On receipt of the loan funds, there is no enhancement of the net assets of Joining Co Pty Ltd. This is because the parties were dealing with each other at arm's length and the funds were provided at a commercial rate of interest. The increase in assets of Joining Co Pty Ltd, as a result of the receipt of the loan funds, is matched by a corresponding liability to Bank Co Pty Ltd.

Example 6: share splits

111. Head Company Ltd (Head Co) is a public company that first listed on the Australian Stock exchange on 20 August 1998. The group was listed following a successful public float whereby 100 million ordinary shares were issued at $1.00 per share. Subsequently, the group traded profitability and this was reflected in a substantial increase in the value of these ordinary shares in the market, despite Head Co making a net capital loss in the 2000 income year.

112. On 30 September 2001 a motion was passed at the Annual General Meeting of the group that the issued shares would be split 2:1. The company directors stated that this would enable the share price to be more affordable and attractive to potential shareholders. On 31 October 2001, all shareholders had their shareholding doubled and the share registry notified all the shareholders of their new entitlements. The group consolidated on 1 July 2003 with Head Co being the head company of the consolidated group.

113. In working out Head Co's modified market value, it was necessary to consider whether the transaction involving the share split satisfies the capital injection test.

114. As the share split did not introduce additional funds or otherwise result in an enhancement of the net asset position of the entity, this transaction is not an injection of capital. This is despite the fact that there had been an issue of 100 million additional ordinary shares to existing shareholders.

Definitions

115. The following definitions are used for the purpose of this Ruling.

116. *Capital injection test* – the test of whether a transaction or act is an event as described by paragraph 707-325(4)(a) of the ITAA 1997 for the purpose of the integrity rule in subsection 707-325(2) and the adjusting event in Item 4 of the table in subsection 707-320(2).

117. *Non-arm's length test* – the test of whether a transaction or act is an event as described by paragraph 707-325(4)(b) of the ITAA 1997 for the purpose of the integrity rule in subsection 707-325(2) and the adjusting event in Item 4 of the table in subsection 707-320(2).

Detailed contents list

118. Below is a detailed contents list for this Taxation Ruling:

Commissioner of Taxation
8 September 2004

Previous draft:
TR 2004/D10

Related Rulings/Determinations:
TR 92/1; TR 92/20; TR 97/16

Subject references:
- adjusting event
- available fraction
- bundle of losses
- consolidated group
- consolidation
- head company
- injection of capital
- losses
- market value
- modified market value
- transferred losses

Legislative references:
- TAA 1953 Pt IVAAA
- ITAA 1997 Pt 3-90
- ITAA 1997 Subdiv 707-A
- ITAA 1997 Subdiv 707-C
- ITAA 1997 707-305
- ITAA 1997 707-305(3)
- ITAA 1997 707-305(4)(b)
- ITAA 1997 707-305(5)
- ITAA 1997 707-320
- ITAA 1997 707-320(1)
- ITAA 1997 707-320(2)
- ITAA 1997 707-320(2) item 4
- ITAA 1997 707-325
- ITAA 1997 707-325(1)
- ITAA 1997 707-325(2)
- ITAA 1997 707-325(2)(a)
- ITAA 1997 707-325(4)
- ITAA 1997 707-325(4)(a)
- ITAA 1997 707-325(4)(b)
- ITAA 1997 707-325(5)
- ITAA 1997 707-325(5)(a)
- IT(TP)A 1997 707-329

Case references:
- Haigh v. Charles W Ireland Ltd [1974] 1 WLR 43
- Incorporated Interests Pty Ltd v. Federal Commissioner of Taxation (1943) 67 CLR 508;

Other references:
- Butterworths Business and Law Dictionary, 1997, Butterworths, Sydney
- Explanatory Material to the Exposure Draft, New Business Tax System (Consolidation) Bill 2000
- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002
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