

Worked example

Determining the reduction amount – multiple events – market value reduced under some events

Description As shown in this example, all events, including those that reduce the market value of an entity, are assumed not to have taken place in determining hypothetical modified market value.

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').

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

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

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.

Reduction in market value after event

In determining the step 4 amount, only events that increase the initial market value of the entity are taken into account. This step does not provide for offsetting of increases and reductions in market value from different events.

However, all events described in subsection 707-325(4) must be disregarded in determining the hypothetical modified market value at step 2. Events that have a negative impact on market value, as well as events that have a positive impact on market value, are assumed not to have taken place.

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

A consolidatable group consisting of HeadCo and SubCo consolidates on 1 July 2003. A tax loss is transferred to HeadCo 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 tax loss.

During June 2003, the following events took place:

- HeadCo obtained additional capital from a new share subscription.
- HeadCo sold an asset to an associated company overseas at below market value. The sale had an immediate negative impact on the market value of HeadCo.

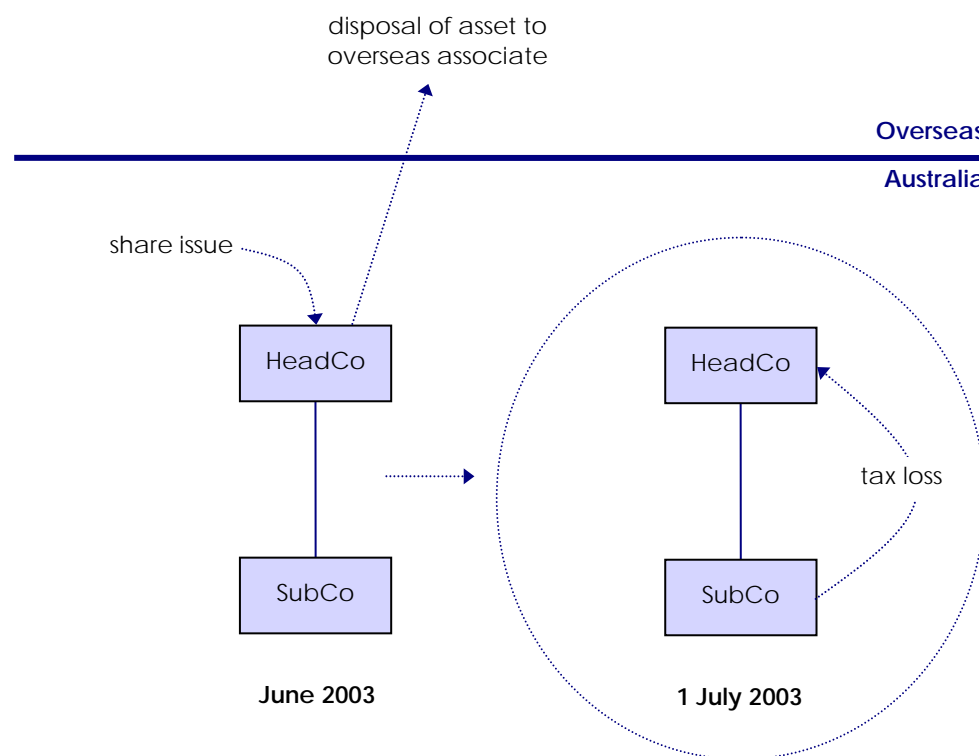
² The value donor concession is contained in Subdivision 707-C, *Income Tax (Transitional Provisions) Act 1997*. → 'Adding to modified market value to reflect loss transferability', C3-4-210

Both the capital raising and the disposal of the asset are considered to be events for the purpose of the integrity rule. The first event is an injection of capital and the second is a transaction that did not take place at arm's length.

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

These facts are represented in figure 1.

Figure 1: Pre-consolidation events 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	700
Hypothetical modified market value* of HeadCo at the joining time	400
Excess in modified market value	300
Initial market value of HeadCo immediately after capital raising	1,500
Hypothetical initial market value** of HeadCo immediately after capital raising	1,000
Initial increase in market value	500

* As though the capital raising and disposal of asset had not occurred.

** As though the capital raising had not occurred.

Applying the six step reduction method to HeadCo

Table 2: Establishing the reduction amount – HeadCo

Step	Explanation	\$ ('000)
1	Modified market value at joining time	700
2	Hypothetical modified market value	400
3	Step 1 reduced by step 2	300
4	Total initial increase in market value	500*
5	Reduction amount (lesser of step 3 and step 4)	300
6	Reduced modified market value	400

* There is no reduction in the initial increase in respect of the disposal of the asset.

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 400,000.

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

Revision history

Section C3-6-160 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).