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Australian Taxation Office

Guide to the general value shifting regime

A comprehensive explanation of the application of the general value shifting regime, including worked examples and references to relevant legislation

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ABOUT THIS GUIDE

The *Guide to the general value shifting regime* provides a comprehensive explanation of the features of the general value shifting regime (GVSR), including the exclusions and safe harbours. There are worked examples that show the rules in operation, and links to relevant legislation.

The guide is detailed and deals with a complex area of tax. If you would prefer a general explanation of the regime refer to *General value shifting regime: in brief* – a four-page introductory document written for non-specialists.

Using the guide

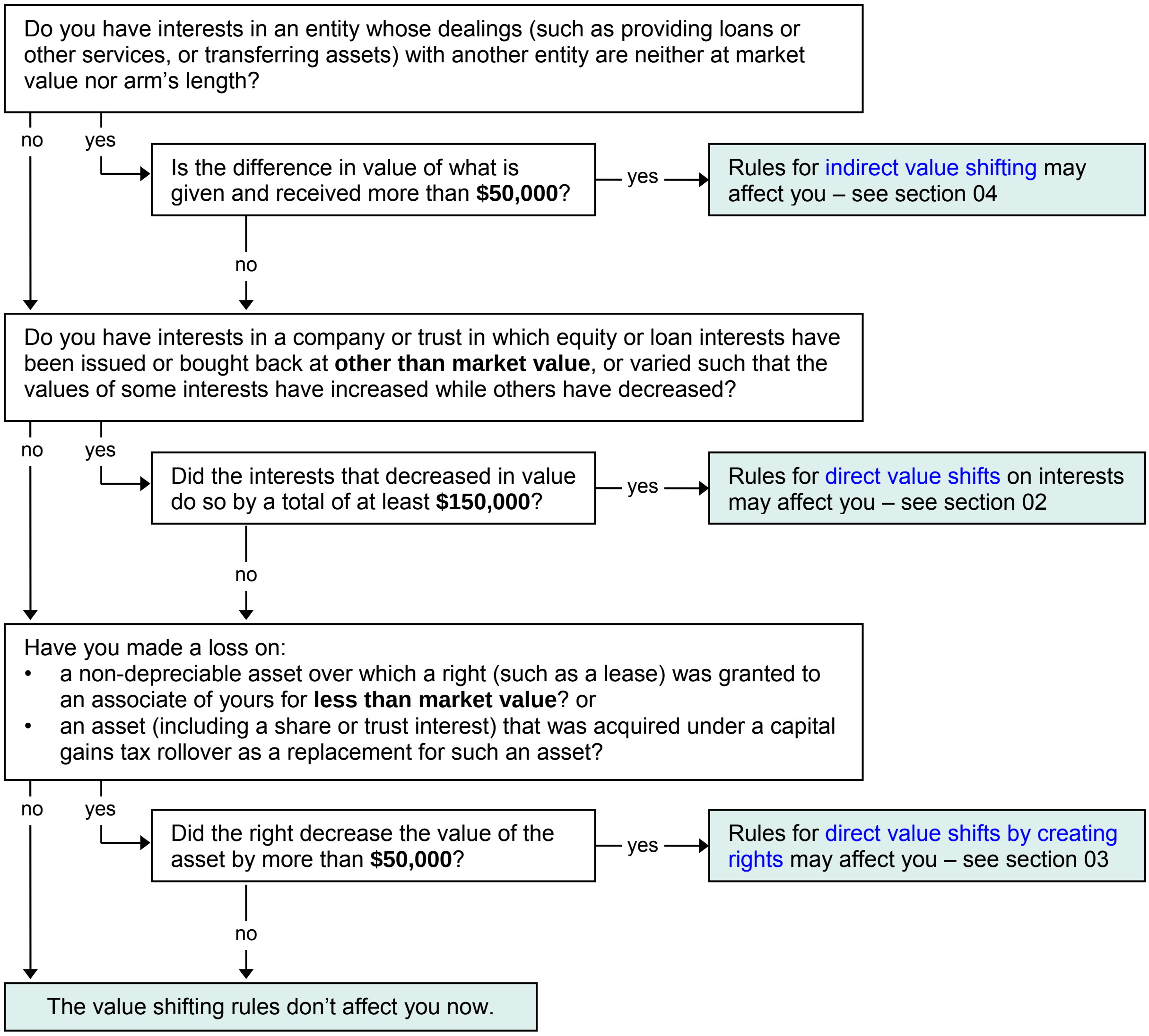
Flowcharts make it easier to find out which aspects of the GVSR might affect you and work through the issues. The flowcharts also provide links to relevant information contained in this guide. The main flowchart is on the next page.

To obtain a general understanding of the regime before delving into specific issues refer to the overview of the general value shifting regime section of this guide.

A glossary of terms is provided to explain some of the terms used in this guide. These terms are *italicised* where they appear in the guide (if viewing the guide electronically you can click on the italicised terms to go to the definition).

ARE YOU AFFECTED BY THE GENERAL VALUE SHIFTING REGIME?

You can use this flowchart to work out whether you are affected by the GVSR and navigate to relevant information contained in this guide. The flowchart links to additional flowcharts for each component of the GVSR.



OVERVIEW OF THE GENERAL VALUE SHIFTING REGIME 01

This section of the guide includes:

- introductory information about the key features of the general value shifting regime (GVSR), and
- an overview of the components of the regime, how it applies to consolidated groups, and the control threshold tests.

1.1 INTRODUCTION

What is the general value shifting regime?
The GVSR replaced the current value shifting rules contained in Divisions 138, 139 and 140 of the *Income Tax Assessment Act 1997* (ITAA 1997), generally with effect from 1 July 2002.

The regime addresses arrangements that shift value out of assets, distorting the relationship between their market values and their values for tax purposes. Without a value shifting regime, these arrangements could encourage the creation of artificial losses and the deferring of gains.

The previous value shifting rules:

- did not apply comprehensively – for instance, they applied to shares in a company but not to interests in a trust
- did not contain adequate small value exclusions or safe harbours to ease compliance, and
- resulted in unintended consequences in some instances.

The *Review of business taxation* (1999) recommended the introduction of the regime to address these deficiencies and to improve the overall integrity of the tax system. The regime achieves these objectives by ensuring broadly consistent treatment for comparable value shifts across different types of entities and dealings.

When did the regime start?
The regime applies from 1 July 2002 to entities including those with substituted accounting periods. The previous value shifting rules contained in Divisions 138, 139 and 140 of the ITAA 1997 do not apply to any schemes entered into on or after that date.

The regime may also apply where a scheme is entered into on or after 27 June 2002 and the value shift happens after 30 June 2002.

Are there any exclusions from the operation of the rules?
Small value exclusions ensure the regime is targeted at substantial value shifts. As a result many businesses will not be affected by the regime, and those that are will have smaller compliance costs than if all value shifts had to be identified. The small value exclusions are:

- entity interest direct value shifting rules – total value shifts under a scheme are less than $150,000
- created rights direct value shifting rules – the market value of the right granted exceeds the proceeds for the grant by $50,000 or less, and
- indirect value shifting rules – total value shifted is equal to or less than $50,000.

There are several exclusions and safe harbours in the indirect value shifting rules. For example, an entity that is eligible to be a *simplified tax system taxpayer* or an entity that satisfies the *maximum net asset value test* will not be required to make any adjustments under the indirect value shifting rules.

There are safe harbours to ensure the rules do not affect assets transferred at cost (in most cases) and most value shifts relating to services are excluded unless they are significant in size.

A *realisation time method* of making adjustments is also available under the indirect value shifting rules, and value shifts of less than $500,000 that happen more than four years before realisation of certain interests can be disregarded.

When does the general value shifting regime not apply?
You can make sure the regime doesn't apply by ensuring:

- *equity and loan interests* in entities are issued at market value
- rights over any *underlying asset* are granted for full market value consideration, and
- entities provide economic benefits to each other at market value or otherwise deal at arm's length.

1.2 COMPONENTS OF THE GENERAL VALUE SHIFTING REGIME

The GVSR has three components:

- direct value shifting rules for entity interests
- direct value shifting rules for created rights, and
- indirect value shifting rules.

The direct value shifting rules apply to assets that are directly affected by a value shift. Broadly, a direct value shift happens where something is done that results in the market value of an asset decreasing, usually with a resulting increase in the market value of another asset. Some examples of direct value shifts are where share rights are varied for one class of shares but not another, or where an owner of an asset grants a right of use to another entity for no payment.

Such value shifts distort the relationship between the asset's market value and the asset's value for tax purposes. The direct value shifting rules seek to address this distortion.

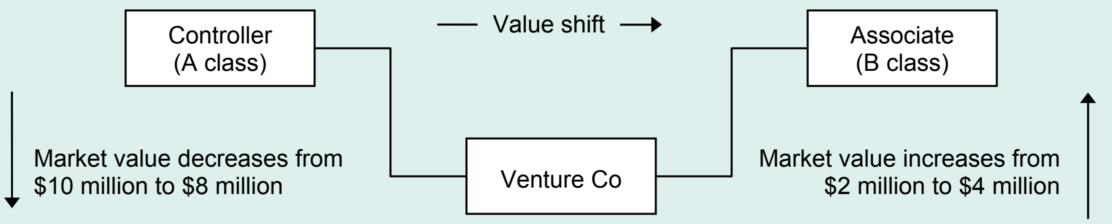
The indirect value shifting rules apply to interests in entities that have value shifted to or from them, resulting in an indirect effect on the value of the interests.

1.2.1 Entity interest direct value shifting rules

Broadly, the entity interest direct value shifting rules apply where a *scheme* effectively results in a value shift between equity or loan interests in a company or trust that is *controlled (for value shifting purposes)* by another entity. Such value shifts include the issue of interests in a company or trust at a discount to market value (shifting value out of existing interests) or the variation of rights attaching to a class of existing interests in a company or trust (for example, shifting value out of that class and increasing the value of another class). Interests issued for more than market value do not trigger the rules (but existing capital gains tax (CGT) rules may limit the first element of cost base and reduced cost base of the interests to market value).

The entity interest direct value shifting rules generally nullify the effect of a value shift by adjusting the tax values of certain equity and loan interests in the company or trust. These are interests that are owned by the controller, their *associates*, associates of associates, and, for *closely held entities*, by *active participants* in the scheme. However, in some instances the rules may treat the value shift as if it were a partial realisation of the interests from which the value was shifted, possibly resulting in an assessable gain. It cannot result in a loss. The tax values of interests are adjusted to reflect this treatment.

Example 1-1: Entity interest direct value shift



A controller holds all 10 A class shares on issue in Venture Co; these shares have a market value of $1 million each. The controller's associate holds all 10 B class shares in the same company; these shares have a market value of $200,000 each.

Controller and Associate agree to vary the rights attaching to both classes of share, which results in the market value of the A class shares decreasing by $200,000 each, and the market value of the B class shares increasing by $200,000 each.

There has been a value shift of $2 million – from Controller's shares to Associate's shares – to which the entity interest direct value shifting rules may apply.

Controller may make an assessable gain depending on the tax value of the A class shares and, in any case, tax value adjustments for the A class and B class shares may be required.

MORE INFORMATION

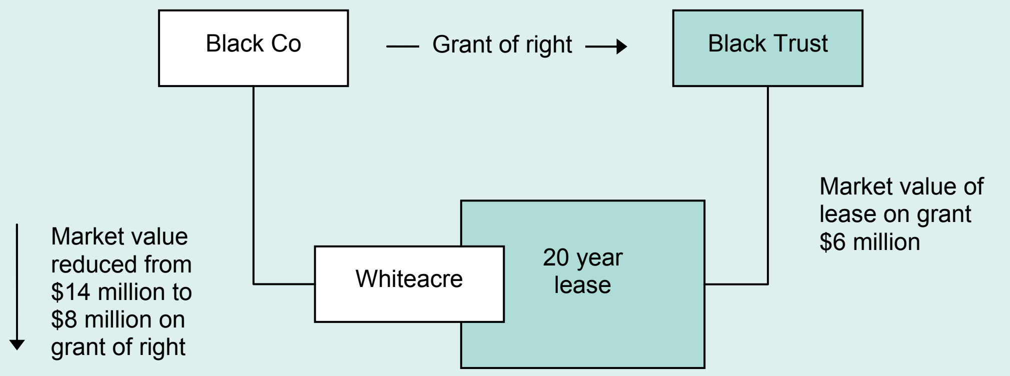
The entity interest direct value shifting rules are explained in detail in section 02.

1.2.2 Created rights direct value shifting rules

Broadly, the created rights direct value shifting rules can apply where a right is created out of, or over, an asset for less than market value in favour of an associate and the *underlying asset* is later *realised at a loss* while the right still exists. The creation of the right distorts the relationship between the market value of the underlying asset and the value of that asset for tax purposes.

The created rights direct value shifting rules address the effect of the value shift by reducing the amount of any loss on realisation of the underlying asset. The rules do not apply to *depreciating assets*, *conservation covenants* or testamentary estates.

Example 1-2: Created rights direct value shift



Black Co owns Whiteacre, a property with a cost base of $10 million and a market value of $14 million. Black Co grants to Black Trust (an associate) a 20-year lease for $100 premium and no rental. The market value of the lease when granted is $6 million.

The grant of the lease reduces the market value of Whiteacre by $6 million (to $8 million). Immediately after the grant of the lease, Black Co sells Whiteacre for $8 million.

The created rights direct value shifting rules may apply to this arrangement to prevent a $2 million capital loss on disposal of Whiteacre.

MORE INFORMATION

The created rights direct value shifting rules are explained in detail in section 03.

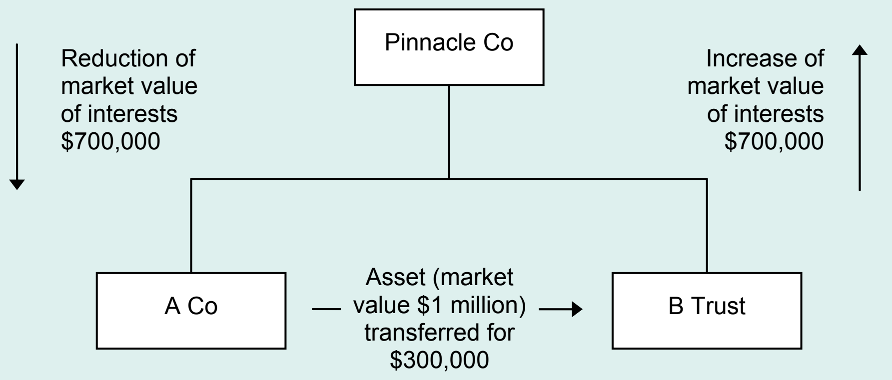
1.2.3 Indirect value shifting rules

Generally, an indirect value shift happens when entities that are not dealing at arm's length engage in a non market value transaction. The value shifting effect is referred to as 'indirect' because it affects the values of interests held in those entities. Such value shifts distort the relationship between the market value of the interests and their values for tax purposes. The indirect value shifting rules seek to address this distortion.

The rules can affect equity and loan interests in the *losing or gaining entity for an indirect value shift* where those entities are commonly controlled or commonly owned. A losing entity is a company or trust that loses value because of the shift. A gaining entity gains value. The rules nullify the effect of the value shift either by:

- making adjustments to the value of the interests for tax purposes just before the time of the value shift, or
- making adjustments to losses or gains arising when those interests are realised.

Example 1-3: Indirect value shift



Pinnacle Co controls (for value shifting purposes) A Co and B Trust.

A Co transfers an asset with a market value of $1 million to B Trust in exchange for a single cash payment of $300,000 in a non arm's length dealing.

The indirect value shifting rules may apply either to:

- adjust the values for tax purposes of Pinnacle Co's interests in A Co and B Trust because of this arrangement, or
- reduce any loss Pinnacle Co may make on subsequently realising interests in A Co, or reduce any gain it may make on realising interests in B Trust.

Note: The indirect value shifting rules do not impact on the underlying transaction that causes the value shift: the transfer of the asset from A Co to B Trust. The tax treatment of that transaction is determined under the general CGT rules and income rules.

MORE INFORMATION

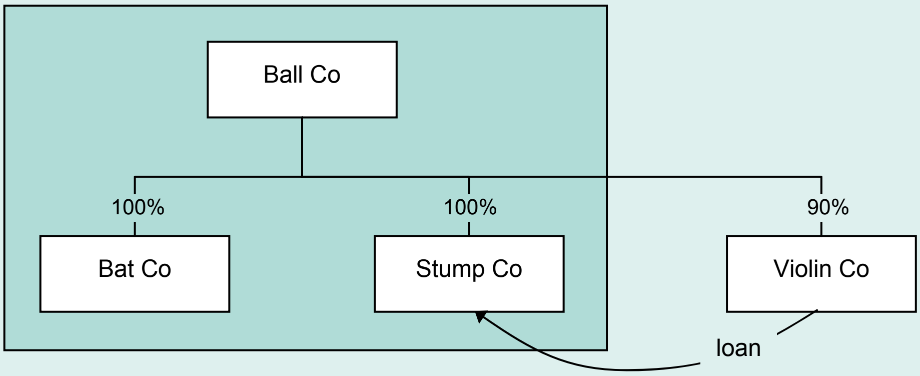
The indirect value shifting rules are explained in detail in section 04.

1.3 HOW DOES THE REGIME APPLY TO MEMBERS OF A CONSOLIDATED GROUP?

The *single entity rule* means that the regime has no impact for *equity and loan interests* of one group member in another within consolidated and *multiple entry consolidated (MEC) groups* during consolidation. Under the single entity rule, subsidiary members of a consolidated group or MEC group are treated, for certain purposes, as parts of a head company rather than as separate entities for income tax purposes.

Value shifts between group members are addressed by the leaving tax cost reconstruction rules for such interests. Interests held by non-group members in a consolidated or MEC group, and interests held by consolidated or MEC group members in non-group members, are potentially subject to the regime (or the new *loss reduction method*).

Example 1-4: Consolidation and value shifting



Ball Co is the head company of a consolidated group including subsidiary members Bat Co and Stump Co. Ball Co also has an interest (90%) in Violin Co (non-group member).

The GVSR has no application to the transfer of an asset from Stump Co to Bat Co at less than market value. The tax cost of Ball Co's shares in Stump Co or Bat Co are reconstructed on the basis of the assets in the company when it leaves the group under the consolidation rules.

Special rules (called the loss reduction method) may also apply to prevent a loss made on a loan by Violin Co to Stump Co unless the loss could be shown to be attributable to something other than losses or indirect value shifts involving the group.

However, the normal rules may apply where an asset is transferred from Violin Co to a consolidated group member for less than market value. Ball Co's shares in Violin Co (not being a group member) are not subject to consolidation reconstruction rules but could be affected by the indirect value shifting rules.

MORE INFORMATION

The interaction of the GVSR with consolidation is explained in detail in section 05.

1.4 CONTROL THRESHOLD TESTS

Control threshold tests are an important feature of the regime as they ensure the rules are properly targeted at entities (affected owners) that can shape the transactions that create the value shift, or that are related to such entities. Where a value shift affects an asset or interest held by an entity that is not within this framework, any increase or decrease in its value is treated as a windfall for which there are no consequences under the regime.

Control tests are relevant for the entity interest direct value shifting rules and the indirect value shifting rules. Control tests are not relevant to the created rights direct value shifting rules.

MORE INFORMATION

The control threshold tests are explained in detail in section 06.

ENTITY INTEREST DIRECT VALUE SHIFTING RULES 02

This part of the guide includes:

- a brief introduction to the measure, including commencement dates
- a flowchart you can use to work through the issues and navigate to relevant information
- a detailed explanation of the entity interest direct value shifting rules
- a worked example that demonstrates the application of the rules in practice, and
- a comparison of the operation of the old and new laws.

2.1 INTRODUCTION

What is the measure?

The entity interest direct value shifting rules address the inappropriate tax outcomes that arise where material value is shifted between interests (whether equity or loan) held in a company or trust. Value may be shifted between interests in an entity by, for instance, varying the rights attaching to interests in the entity or issuing new interests at a discount to market value. Without these rules, arrangements of this kind could allow the creation of artificial losses and the deferral of gains.

Previously the share value shifting rules (contained in Division 140 of the ITAA 1997) addressed these inappropriate outcomes in a limited range of cases. A comparison of the new and old laws is contained below (section 2.8).

When does the measure start?

The entity interest direct value shifting rules apply to direct value shifts that happen under *schemes* entered into on or after 1 July 2002.

The rules also apply to direct value shifts that happen under schemes entered into on or after 27 June 2002 and before 1 July 2002, provided that the increases and decreases in market value for the interests affected by the scheme all happen on or after 1 July 2002.

> Section 727-1 of the *Income Tax (Transitional Provisions) Act 1997*

What entities are affected under the measure?

The rules affect the following entities owning interests in a company or trust:

- the controller of the company or trust
- an *associate* of the controller
- in some cases involving interests that increase in value or are issued at a discount, an associate of an associate of the controller, and
- where the company or trust is closely held, an *active participant* in the scheme.

These entities are called *affected owners*.

What is the impact of the measure?

The rules impact on entities with interests in companies or trusts in different ways. A direct value shift under a scheme between equity or loan interests in a company or trust gives rise to the following consequences for affected owners:

- entities with equity or loan interests that decrease in value will be required to decrease the tax values of their interests and, in some cases, may make gains that are included in assessable income in the year in which the value shift happens, and

- entities with equity or loan interests that increase in value, or that are issued at a discount, in relation to the same scheme will be required to increase the tax values of their interests.

Where the equity or loan interests that decrease in value are pre-CGT interests that are held as capital assets, their owners will not be required to include any gains that are made under the rules in assessable income. Decreases will still be required to the tax values of the interests.

The rules will apply to equity or loan interests in companies or trusts irrespective of their character for tax purposes. This means the rules will not be confined in their application to those interests held as capital assets but will also extend to those held as trading stock or otherwise held as revenue assets.

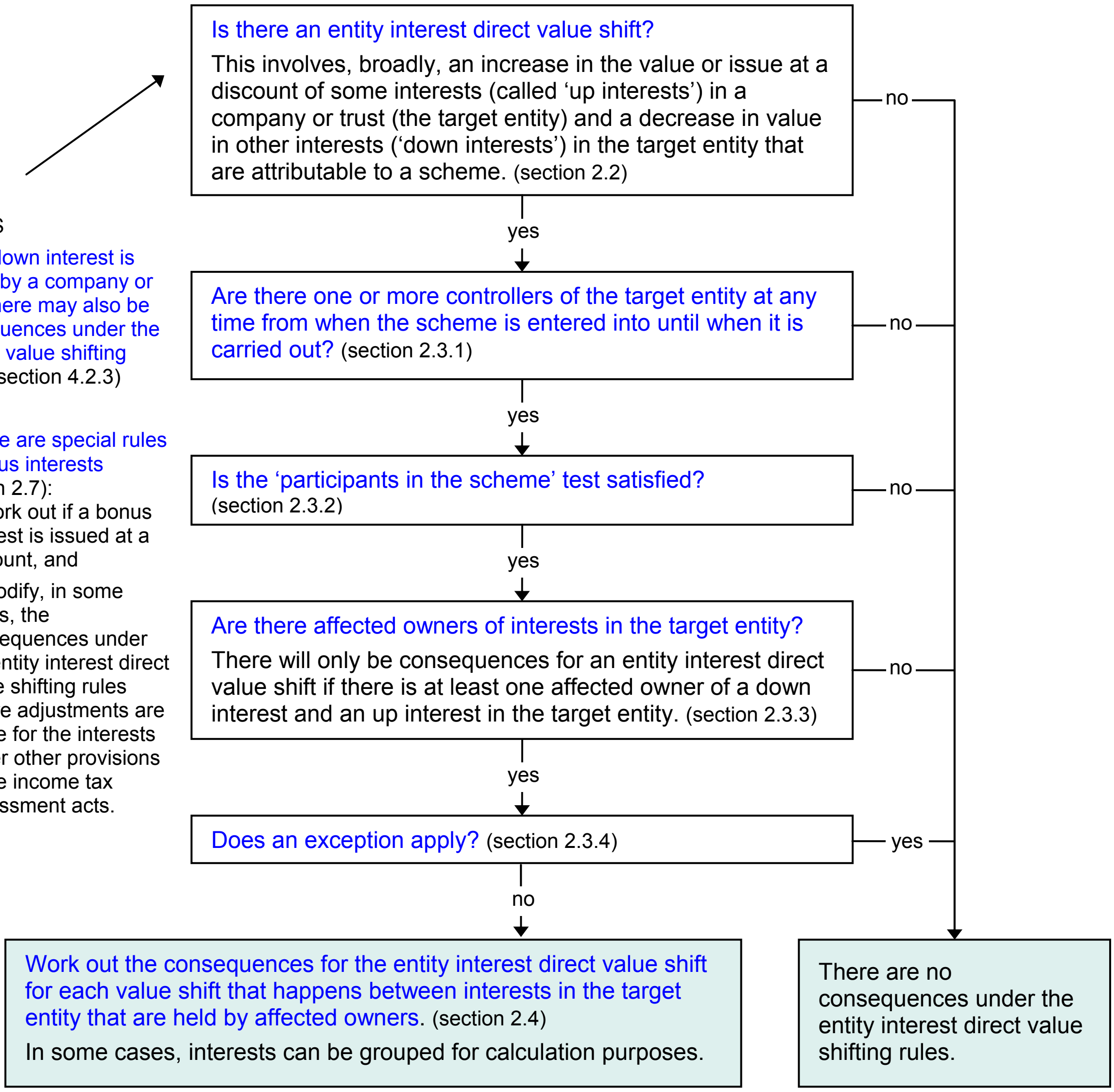
Where can I find the rules?
The entity interest direct value shifting rules can be found in Division 725 of the ITAA 1997.

Figure 2-1: Flowchart – entity interest direct value shifts

NOTES

1. If a down interest is owned by a company or trust, there may also be consequences under the indirect value shifting rules. (section 4.2.3)

2. There are special rules for bonus interests (section 2.7):
- to work out if a bonus interest is issued at a discount, and
- to modify, in some cases, the consequences under the entity interest direct value shifting rules where adjustments are made for the interests under other provisions of the income tax assessment acts.



2.2 IS THERE AN ENTITY INTEREST DIRECT VALUE SHIFT?

The first step in working out the impact of the rules is determining whether there is an entity interest direct value shift. This involves working out:

- whether there is an impact on the market value of interests in a company or trust (the target entity) – a decrease in the market value of interests in a target entity, and increase in market values, or issue at a discount, of other interests in that entity, and
- if so, whether those things happen under a scheme.

Section 725-145

2.2.1 Is there an impact on the market value of interests in the target entity so that there are down interests and up interests?

There cannot be an entity interest direct value shift unless:

- there is a decrease in the market value of one or more *equity or loan interests* in a *target entity* (called *down interests*), and
- there is an increase in the market value of one or more equity or loan interests, or the issue at a discount of one or more equity or loan interests in the same target entity (called *up interests*).

When is an interest issued at a discount?
An interest is issued at a discount where the market value of the interest when issued exceeds the amount of the payment that the issuing entity receives.

Section 725-150

Example 2-1: Issue at a discount

A share in a company is issued for $3. Its market value when issued is $7. The share is an up interest, as it is issued at a discount of $4.

There are special rules for working out if a *bonus interest* covered by another provision of the tax law – eg section 6BA of the *Income Tax Assessment Act 1936* (ITAA 1936) – is issued at a discount. See 'Interaction between the entity interest direct value shifting rules and the bonus interest rules' (section 2.7).

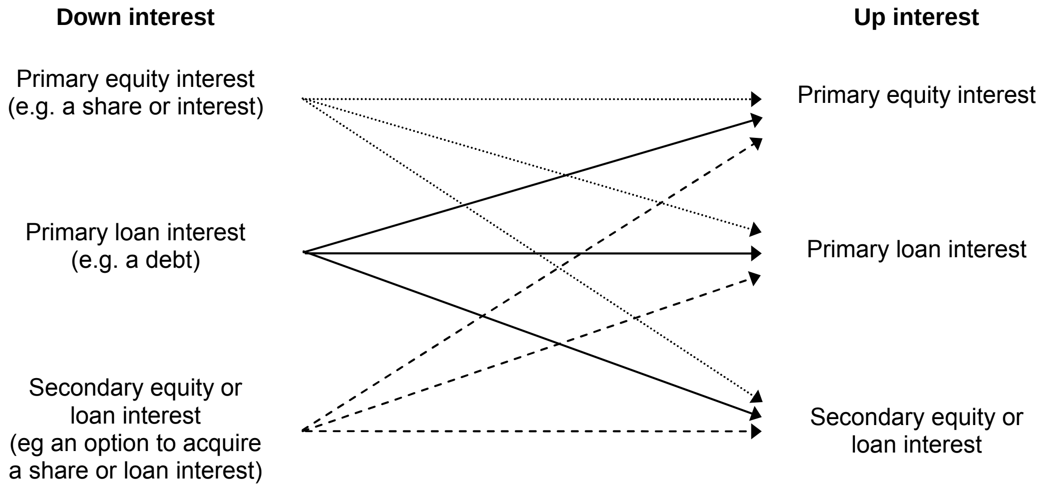
What equity or loan interests must decrease and increase in value or be issued at a discount?
The range of equity or loan interests in a target entity that can have consequences under the entity interest direct value shifting rules are:

- primary equity interests – such as a share in a company or a unit or interest in a trust
- secondary equity interests – such as a right or option to be issued with a primary equity interest
- primary loan interests – such as a loan to a company or trust, and
- secondary loan interests – such as a right or option to acquire an existing primary loan interest.

Section 727-520

It is not necessary that the same category of interest both decrease and increase in value or be issued at a discount for there to be an entity interest direct value shift. The full range of interests between which value can be shifted is illustrated in figure 2-2.

Figure 2-2: Interests between which value can be shifted



Equity and loan interests in trusts

The rules apply to equity and loan interests in both fixed trusts and non-fixed trusts. However, the requirement that there be an increase or decrease in the market value of an interest means that, in practical terms, there will be limited application to non-fixed trusts. Interests in non-fixed trusts which, for instance, only entitle the holder to be considered by the trustee in exercising a power of appointment to distribute income or capital, would not be affected by the rules as such interests do not increase or decrease in value.

Bearing in mind the requirements for an entity interest direct value shift, the rules in practice will only apply to interests in trusts that meet the following three conditions:

- the interest is capable of being acquired and disposed of
- the interest is quantifiable, and
- the rights attaching to the interest are defined with particularity – for example, in the terms of the deed of settlement.

Loan interests

Changing the terms of an existing debt instrument may result in an entity interest direct value shift if it causes the value of the loan interest to increase or decrease and opposite impacts on the market values of other interests in the entity.

Example 2-2: Entity interest direct value shift – loan interest

The terms of an interest-free loan to a target entity are altered so that 10% interest becomes payable on the balance.

This causes the market value of the loan interest to increase (by an amount equal to the present value of the right to future payment of interest instalments) and the market value of the existing equity interests in the target entity to decrease.

There is an entity interest direct value shift which may have consequences under the entity interest direct value shifting rules.

There may also be an entity interest direct value shift where a loan interest is issued at a discount – for example, the grant of a loan where the interest payable by the target entity exceeds the prevailing market interest rate. An entity interest direct value shift will arise if the issuing of the loan interest at a discount causes the market value of the existing equity interests in the target entity to decrease.

An entity interest direct value shift will not arise if a loan interest is issued at a premium as the issue would not cause the value of other equity or loan interests in the target entity to decrease in value. An example of a loan interest being issued at a premium is the grant of an interest-free loan.

Secondary equity and loan interests (such as options and rights)
The entity interest direct value shifting rules also apply to value shifts involving secondary equity or loan interests in a target entity – such as options and rights.

Example 2-3: Entity interest direct value shift – secondary interest

A unit trust issues options to purchase further units for $2 per option. The strike price on exercise of the option is $10 per unit. The market value of the existing units of the class covered by the option is $100 per unit.

An entity interest direct value shift can arise because:

- the option is issued at a substantial discount (up to $88), and
- the high likelihood of the options being exercised will mean that the existing units in the trust will decrease in value at the time when the options are granted.

2.2.2 Is the entity interest direct value shift under a scheme?

The entity interest direct value shift is under a scheme involving *equity or loan interests* in the *target entity* if:

- the decrease and the increase in value or issue at a discount of the interests are reasonably attributable to a thing or things done under that scheme, and
- the decrease and increase in value or issue at a discount happen at or after the time when the first of those things happens under the scheme.

Whether the decrease and the increase or issue are reasonably attributable to a thing or things done under a scheme involving equity or loan interests is a question of fact. When the decrease, increase or issue is only partly attributable to such a scheme, the entity interest direct value shifting rules only apply to that extent. A thing that is done under a scheme can also include an omission – for example, a refusal to exercise a casting vote in a ballot.

Sections 725-145 and 725-165

Example 2-4: Decrease or increase that is reasonably attributable to a thing done under a scheme

In March 2003 the market value of the units held by Boris in the XYZ Trust decreases by:

- $10 per unit when the market value of an asset held by the trust falls in value, and
- an additional $6 per unit when further units in the XYZ Trust are issued at a discount.

The reduction in market value that occurs when the asset falls in value does not happen under a scheme that involves equity or loan interests in the trust. The entity interest direct value shifting rules would not apply in relation to this decrease in value.

The reduction that occurs when the units are issued at a discount does occur as a result of something done under a scheme that involves equity or loan interests in the trust – in this case, that 'something' is the issuing of the units at a discount. The entity interest direct value shifting rules may apply to the decrease in value that relates to the issue of the units.

Note that for the entity interest direct value shift to have consequences, the activity must be done by certain entities within the control framework (see 'The participants in the scheme test', section 2.3.2).

Subsection 725-65(1) and section 725-145

2.3 ARE THRESHOLD CONDITIONS MET SO THAT THERE ARE CONSEQUENCES FOR THE ENTITY INTEREST DIRECT VALUE SHIFT?

Not all entity interest direct value shifts will result in consequences under the rules. A range of limitations and exceptions apply to ensure that the entity interest direct value shifting rules are focused on significant value shifts that happen in relation to a target entity that is *controlled (for value shifting purposes)* by another entity.

For there to be consequences under the rules as a result of there being an entity interest direct value shift under a scheme, four conditions need to be met:

- the control test is satisfied
- the participants in the scheme test is satisfied
- there are affected owners of interests in the target entity, and
- no exception applies.

Section 725-50

2.3.1 The control test

The control test will be satisfied if an entity controls the target entity at some time during the period beginning when the scheme is entered into and ending when the scheme has been carried out. While the existence of one controller during this period is sufficient to satisfy the control test, it is possible that there may be more than one controller during that period.

See 'Control thresholds' (section 06) for an explanation of when an entity is taken to control a target entity.

Section 725-55

2.3.2 The participants in the scheme test

The participants in the scheme test looks at who did the things under the scheme that the decreases or increases in value of interests, or issues at a discount, were reasonably attributable to. The test will be satisfied if one or more of the following entities did that thing or those things under the scheme:

- the target entity itself
- a controller of the target entity
- an entity that is an associate of the controller at or after the time when the scheme was entered into, and
- an active participant in the scheme.

Subsection 725-65(1)

Active participants

Something done under a scheme by a participant who is not covered by any of the first three items above will not cause the participants in the scheme test to be satisfied unless that participant is an 'active participant' as defined in the law. A participant can only be an active participant if:

- at some time while the scheme was being carried out, the target entity was a *closely held entity*, and
- the active participant owned either a *down interest or an up interest* in the target entity or had an up interest issued to it at a discount in the target entity.

'Control thresholds' (section 06) explains when an entity is an active participant as defined in the law.

Subsection 725-65(2)

2.3.3 Affected owners of interests in the target entity

There will be consequences for an entity interest direct value shift under a scheme only if there is an affected owner or owners of:

- at least one *down interest* in the target entity, and
- at least one *up interest* in the target entity.

Affected owners of down interests
There will be an affected owner of a down interest in the target entity if one of the following entities owned the interest at the time it decreased in value under the scheme:

- the controller of the target entity
- an entity that was an *associate* of the controller at or after the time when the scheme was entered into, and
- an active participant in the scheme.

Section 725-80

Affected owners of up interests
There will not be affected owners of up interests in a target entity unless there is at least one affected owner of a down interest.

Where this threshold is satisfied, there will be an affected owner of an up interest in the target entity if one of the following entities owned the interest at the time it increased in value under the scheme or alternatively had an interest issued to it at a discount under the scheme:

- the controller of the target entity
- an entity that was an associate of the controller at or after the time when the scheme was entered into
- an entity that was, at or after the time when the scheme was entered into, an associate of an entity that is an affected owner of a down interest because it was an associate of the controller, and
- an active participant in the scheme.

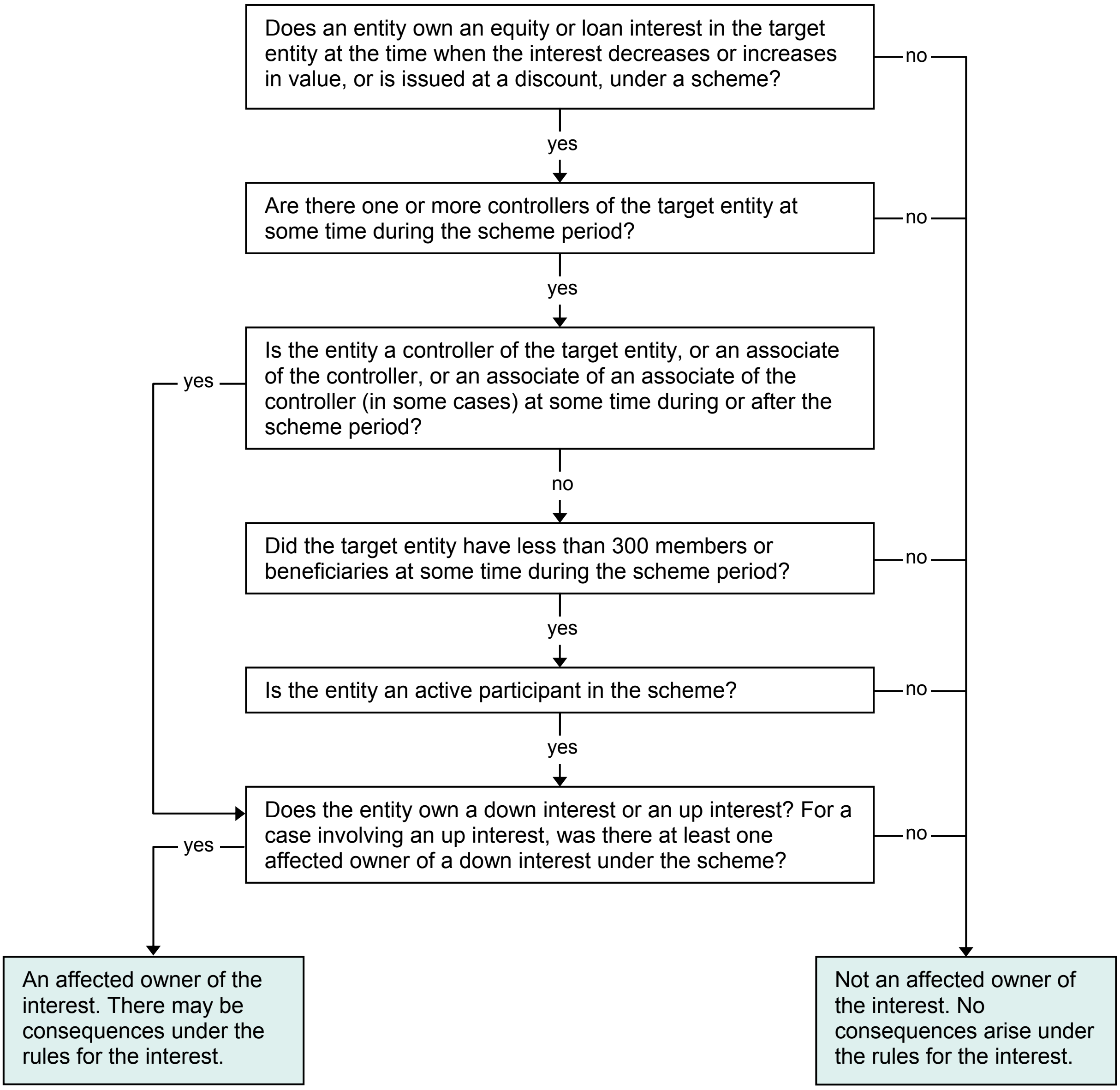
Section 725-85

There are no consequences under the entity interest direct value shifting rules for shifts in value to, or from, owners of interests outside this affected owners framework.

The following flowchart (figure 2-3) shows how the control and active participation concepts work to determine the affected owners for an entity interest direct value shift. 'Control thresholds' (section 06) explains when an entity is taken to:

- control a *target entity*, or
- *be an active participant in a scheme*.

Figure 2-3: Determining the affected owners



Sections 725–80 and 725-85

2.3.4 Does an exception apply?

There will be no consequences for an entity interest direct value shift under a scheme if either of the following two exceptions applies:

- the de minimis exception, or
- the reversal exception.

The de minimis exception

Under the de minimis exception, there are no consequences for an entity interest direct value shift under a scheme if the sum of the decreases in market value of all *equity and loan interests* in the *target entity* because of entity interest direct value shifts under the scheme is less than $150,000. This exception ensures the rules are only targeted at substantial shifts in value.

The de minimis exception will not apply if two or more entity interest direct value shifts happen under different schemes and it is reasonable to conclude that the sole or main reason for this was to access the benefit of the exception.

Section 725-70

Example 2-5: Entity interest direct value shift – de minimis exception

Pearl owns 15 of the 20 shares on issue in Small Co (market value of each share $15,000). She causes 10 shares to be issued to Larry for no consideration.

The market value of the 20 shares on issue decreases by $5,000 per share. The total decrease in the market value of shares as a result of the arrangement is $100,000 ($5,000 x 20).

Because the sum of the decreases in all equity and loan interests in Small Co under the scheme is less than $150,000, the de minimis exception will apply. There will be no consequences for the entity interest direct value shift as a result.

Example 2-6: Entity interest direct value shift – de minimis exception

The owners of the two shares in B Co are R Co and N Co.

In March 2003 the rights attaching to the shares are changed so that the market value of R Co's share is reduced by $100,000 and the value of N Co's share increases by $100,000.

Under a separate scheme in September 2003, the rights are again changed so that the market value of R Co’s share is reduced by $100,000 and the value of N Co's share increases by $100,000.

As the sum of the decreases in all equity and loan interests in B Co under each scheme is less than $150,000, the de minimis exception will apply in relation to both entity interest direct value shifts. However, if it is reasonable to conclude that the main reason the value shifts happened under different schemes was to access the benefit of the exclusion, the de minimis exception will not apply in relation to either entity interest direct value shift.

The reversal exception

Under the reversal exception, there are no consequences for an entity interest direct value shift under a scheme if it is more likely than not that, at the time the first of the things done under the scheme happens, the cause of the value shift will reverse within four years under the terms of the same scheme. The reversal exception applies to both:

- the initial entity interest direct value shift that happens under the scheme, and
- any entity interest direct value shift that subsequently occurs under that scheme within the four-year period because of the reversal of the earlier entity interest direct value shift.

The reversal exception will cease to apply, and be taken never to have applied, if:

- the reversal does not happen within the four-year period, or
- a *realisation event* happens to an interest in the target entity owned by an *affected owner* before the reversal happens.

Sections 725-90 and 725-95

Example 2-7: Entity interest direct value shift – reversal exception

Two classes of share are on issue in JK Co (A class and B class). Under a scheme, the dividend rights attaching to the A class shares are suspended for a three-year period. This causes a material decrease in the market value of the A class shares and an increase in the market value of the B class shares.

There is an entity interest direct value shift, for which the A class shares are down interests and the B class shares are up interests.

There are no consequences under the scheme because of the reversal exception. The reversal exception applies because when the dividend rights were suspended, it was more likely than not that the suspension would fully reverse within the four-year period.

The exception will cease to apply (and is taken to have never applied) if, before the reversal happens, the four-year period expires or an affected owner of either an A class interest or B class interest realises their interest.

2.4 WHAT ARE THE CONSEQUENCES FOR THE ENTITY INTEREST DIRECT VALUE SHIFT?

The final step in working out the impact of the entity interest direct value shifting rules is determining what the consequences are for the entity interest direct value shift. This step is only arrived at after it has been concluded that:

- there is an entity interest direct value shift, and
- the four threshold conditions are satisfied so that there will be consequences for that entity interest direct value shift.

Once these threshold conditions have been satisfied, the consequences for particular interests in the *target entity* are worked out. What these consequences are will depend on three features:

- who owns the interests – the entity interest direct value shifting consequences only apply for value shifts between interests held by *affected owners.* The consequences will usually be different where value shifts between the interests of an affected owner and where the shift is between the interests of two affected owners (section 2.4.1)
- what attributes the interests have – the entity interest direct value shifting consequences will be different where value is shifted between interests having different characters (eg trading stock, pre-CGT) (section 2.4.2), and
- for cases where the value shift involves shares bought back at less than market value or the issue of bonus interests at a discount, whether the consequences are modified to ensure that the entity interest direct value shifting rules interact properly with other provisions of the ITAA 1936 and ITAA 1997 (section 2.4.3).

There are other rules that tell you how the consequences for an entity interest direct value shift are applied:

- the mechanics of making the adjustments for interests in their characters as CGT assets, trading stock and revenue assets (section 2.5)
- the practical consequences that arise when value is shifted from a pre-CGT interest (section 2.5.1)
- the timing of adjustments – when adjustments are made and gains are included (section 2.5.2), and
- grouping of interests for calculation purposes (section 2.5.3).

2.4.1 Relevance of who owns the interests

There are only consequences under the entity interest direct value shifting rules for value shifts between:

- down interests that are owned by affected owners, and
- up interests that are owned by affected owners.

There are no consequences of an entity interest direct value shift for the owners of up interests or down interests, or both, that are not affected owners.

Note that in a case where a down interest for an entity interest direct value shift is owned by an affected owner being a company or trust, and another affected owner has up interests, there may also be an indirect value shift which could have consequences under the indirect value shifting rules (section 04).

Identifying the interests that value is shifted between

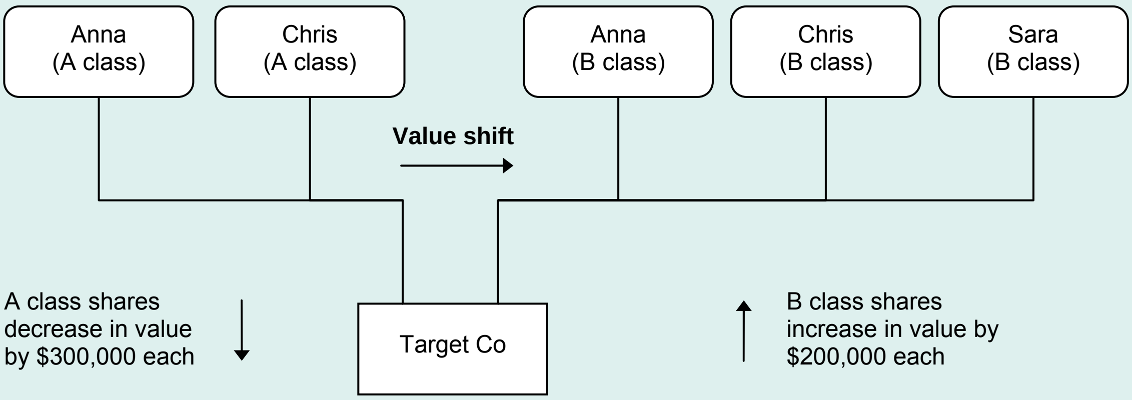
As consequences only arise for entity interest direct value shifts between interests owned by affected owners, it is necessary to identify those interests between which the value has been shifted. The rules address this issue by assuming that the value shift is from each of the down interests to each of the up interests. This means that it is not necessary to determine as a matter of fact the interest that value is shifted to or from.

Section 725-160

As a compliance cost saving measure, a different assumption applies where a value shift is neutral for a particular affected owner (that is, where the total of the market value decreases for their down interests is equal to the sum of the increases in market value and discounts received for their up interests). The consequences for that affected owner are worked out as if the value shifted from their down interests to their up interests (example 2-8).

Section 725-220

Example 2-8: Direct value shifts under an entity interest direct value shift



An entity interest direct value shift happens when the rights attaching to the two A class shares in Target Co (held by Anna and Chris) are altered. Each of these shares decreases in value by $300,000.

There is an increase in the market value of the three B class shares (held by Anna, Chris and Sara). Each of these shares increase in value by $200,000.

The entity interest direct value shifting rules operate on the basis that the following value shifts happen under the scheme:

Amount of entity interest direct value shift	Down interest	Up interest
$100,000	A class – Anna	B class – Anna
$100,000	A class – Anna	B class – Chris
$100,000	A class – Anna	B class – Sara
$100,000	A class – Chris	B class – Anna
$100,000	A class – Chris	B class – Chris
$100,000	A class – Chris	B class – Sara

Example 2-9: Entity interest direct value shift involving an interest holder that is not an affected owner

Continuing from example 2-8, assume that Anna and Chris control Target Co and that Sara is not their associate or an active participant in the scheme.

There will be consequences for the four value shifts that happen between shares held by affected owners Anna and Chris.

Sara is not an affected owner. There will be no consequences for the two value shifts that involve up interests held by Sara.

Example 2-10: Entity interest direct value shift – neutral value shift

T Co (three units) and W Co (two units) are the unit holders in the Shark Trust. The market value of each unit is $1 million.

Five further units are issued for no consideration (discount of $0.5 million each) to T Co (three units) and W Co's associate Kevin (two units).

The issue causes a reduction in the market value of the units held by T Co (of $1.5 million) and W Co (of $1 million).

Assume that there is an entity interest direct value shift that will have consequences for T Co, W Co and Kevin as affected owners.

The entity interest direct value shift is neutral for T Co, as the reduction in value for its down interests is equal to the total discounts on its up interests. T Co will work out the entity interest direct value shifting consequences of the scheme on the basis that the only value shift is the $1.5 million shifted from its down interests to its up interests.

W Co will be required to work out the consequences of the value shift in the normal way (ie on the basis that value has been shifted from its down interests to up interests held by Kevin and T Co).

2.4.2 Relevance of attributes of interests

There are two broad ways in which the entity interest direct value shifting rules may apply to particular interests: disposal treatment and rollover treatment.

Broadly, rollover treatment applies in cases where value is shifted between interests of the same character that are held by the same *affected owner* and disposal treatment applies to the other cases.

Example 2-11: Entity interest direct value shift – cases where disposal treatment or rollover treatment applies

Roger controls (for value shifting purposes) Surgical Co, the target entity for an entity interest direct value shift. To work out the consequences for a value shift that happens between:

- two post-CGT interests, both held on capital account by Roger, rollover treatment applies
- two post-CGT interests, both held on capital account, one owned by Roger and one owned by his associate Harry, disposal treatment applies (as the interests are owned by different entities), or
- two interests, one held on capital account and one held as a revenue asset, by Roger, disposal treatment applies (as the interests do not have the same character).

For more detail on cases where disposal treatment or rollover treatment applies, see the flowchart (figure 2-4) that identifies which entity interest direct value shifts are covered by disposal treatment or rollover treatment.

Subdivisions 725-D to 725-F

Disposal treatment

Disposal treatment applies to value shifts between *down and up interests* of:

- different *affected owners*
- the same affected owner where the interests have different characters (eg the down interest is held as trading stock and the up interest is not held as trading stock), or
- the same affected owner where the shift is from a post-CGT asset to a pre-CGT asset (neither of which is trading stock or a revenue asset).

The consequences under disposal treatment for down interests will differ depending on whether there is a pre-shift gain or pre-shift loss for the interest. A down interest has a pre-shift gain if its market value is greater than its *adjustable value* immediately before the time the market value of the interest decreased. Similarly, there is a pre-shift loss if the market value of the down interest is the same as, or less than, its adjustable value immediately before the time the market value of the interest decreased.

Example 2-12: Entity interest direct value shift – pre-shift gain and pre-shift loss

Immediately before the time when they decrease in value under a scheme, the market value of each of Sam's shares in A Co is $10 and their cost base and reduced cost base $8 per share.

There is a pre-shift gain of $2 for each of Sam's down interests for the purposes of working out the consequences for the down interests under disposal treatment.

Section 725-210

Consequences for down interests and up interests under disposal treatment

Table 2-1 describes the general treatment where disposal treatment applies to value shifted between the down interests and up interests of affected owners.

Table 2-1: Consequences under disposal treatment

	There is a pre-shift gain for the down interest	There is a pre-shift loss for the down interest
Consequences for the down interests	Decreases to adjustable value. Reduction based on proportion of market value of down interest shifted. Gain calculated based on the value shifted less decrease to adjustable value (above).	Decreases to adjustable value based on the amount of the value shifted.
Consequences for the up interests	Increases to adjustable value based on value shifted, but only to the extent that the amount of the increase is still reflected in the market value of the interest when a CGT event later happens to it.	Increases to adjustable value based on value shifted, but only to the extent that the amount of the increase is still reflected in the market value of the interest when a CGT event later happens to it.

The consequences for down interests under disposal treatment in a pre-shift gain case are:

- there is a *taxing event generating a gain,* and
- reductions are made to the adjustable value of the interests reflecting the proportion of adjustable value relating to the value shifted.

Where there is a pre-shift loss for the interest, the consequences are a reduction to the adjustable value of the interest equal to the amount of the value shifted.

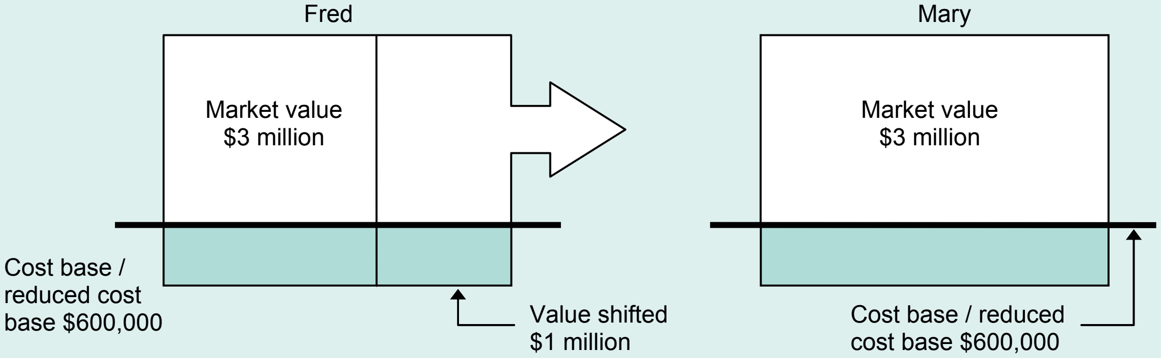
The consequences for up interests under disposal treatment are an increase to the adjustable value of the interest based on the value shifted to the interest. The value shifted is worked out with regard to the market value effects of the value shift on the down and up interests.

Example 2-13: Entity interest direct value shift – disposal treatment in a pre-shift gain case

Scheme

Fred and Mary hold the two shares on issue in Target Co on capital account. The cost base and reduced cost base of each share is $600,000.

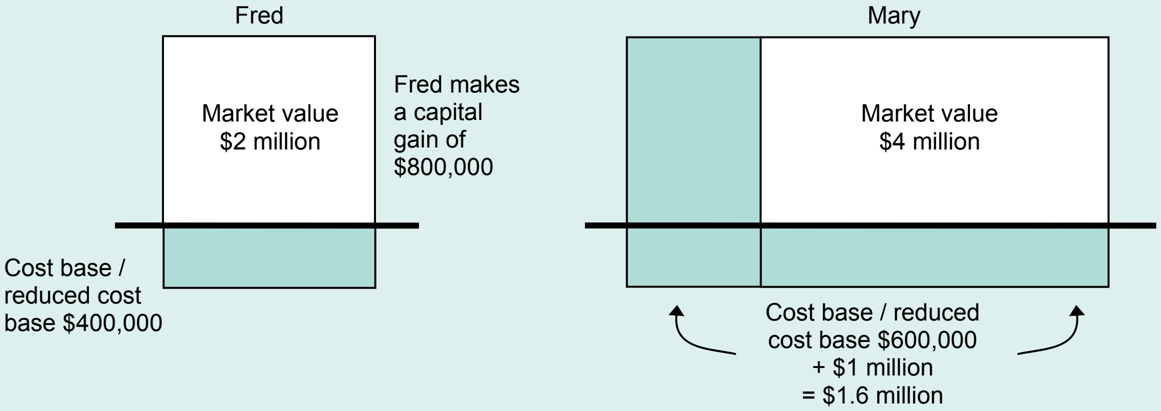
There is an entity interest direct value shift when the rights attaching to the share held by Fred are changed. There is a decrease in the market value of Fred's share (that falls from $3 million to $2 million). There is a corresponding increase in the market value of Mary's share from $3 million to $4 million. Both Fred and Mary are affected owners as they each control Target Co.



Consequences

Disposal treatment will apply to this case as value is shifted between interests that are owned by different affected owners. The broad consequences are as follows:

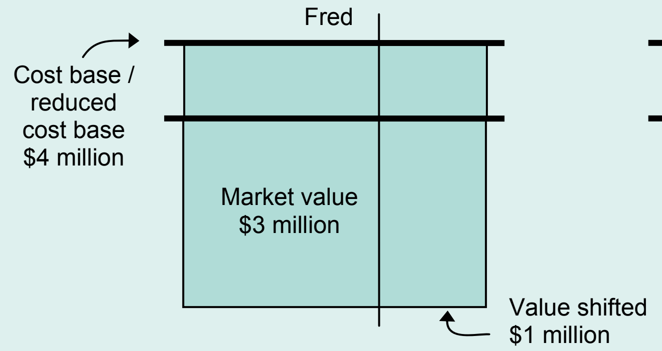
- For Fred, the consequences involve assessing a gain to him because he has shifted value out of a pre-shift gain interest to another affected owner. The amount of the gain is based on the value shifted from the share ($1 million) less a pro rata allocation (value shift / pre shift market value) of its cost base ($200,000). This is $800,000. The cost base and reduced cost base of the share is also reduced by the pro rata allocation of the cost base ($200,000).
- The cost base and reduced cost base of Mary's interest is increased by the value shifted ($1 million), provided that it is still reflected in the market value of the share when a CGT event later happens to it. This ensures that the value shifted to Mary's interest is not taxed again on the sale of that interest.



Example 2-14: Entity interest direct value shift – disposal treatment in a pre-shift loss case

Scheme

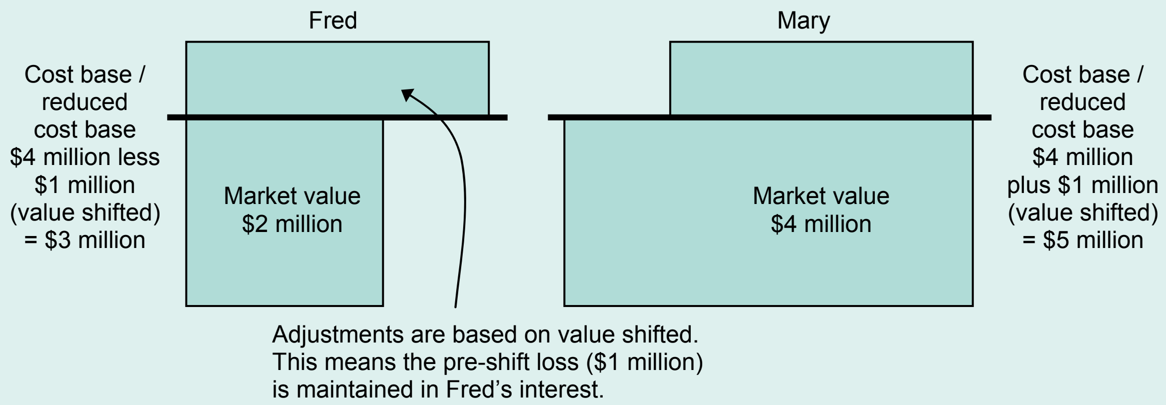
Assume the same facts as in example 2-13, except that the cost base and reduced cost base of the shares held by Fred and Mary are $4 million (ie there is an underlying loss of $1 million on each share).



Consequences

Disposal treatment will apply to this case as value is shifted between interests that are owned by different affected owners. The broad consequences are as follows:

- For Fred, a decrease in the cost base and reduced cost base of his interest based on the amount of value shifted ($1 million). By adopting this treatment (rather than making the adjustment based on a pro rata allocation of cost base, 1/3 of $4 million), the unrealised pre-shift loss that Fred has on his share is maintained.
- The cost base and reduced cost base of Mary's interest is increased by the value shifted ($1 million), provided that it is still reflected in the market value of the share when a CGT event later happens to it. This ensures that Mary's unrealised pre-shift loss position is maintained.



Rollover treatment

In general, rollover treatment applies in cases where value is shifted between interests of the same character that are owned by the same *affected owner.* An example would be where one owner holds both an *up interest and a down interest* as trading stock and both interests are post-CGT assets.

The consequences for the down interests are in most cases the same as under disposal treatment. However, there is no *taxing event generating a gain*.

The consequences for the up interests depend on whether there is a *pre-shift gain* or *pre-shift loss* for the down interest that value shifts from. Where there is a pre-shift gain for the down interest, the *adjustable value* of the up interest is increased by the proportion of the adjustable value reduction for the down interest that relates to the value shifted to the up interest.

Where there is a pre-shift loss, the approach is the same as under disposal treatment. That is, there are adjustable value increases based on the market value effects of the value shift.

Table 2-2: Consequences under rollover treatment

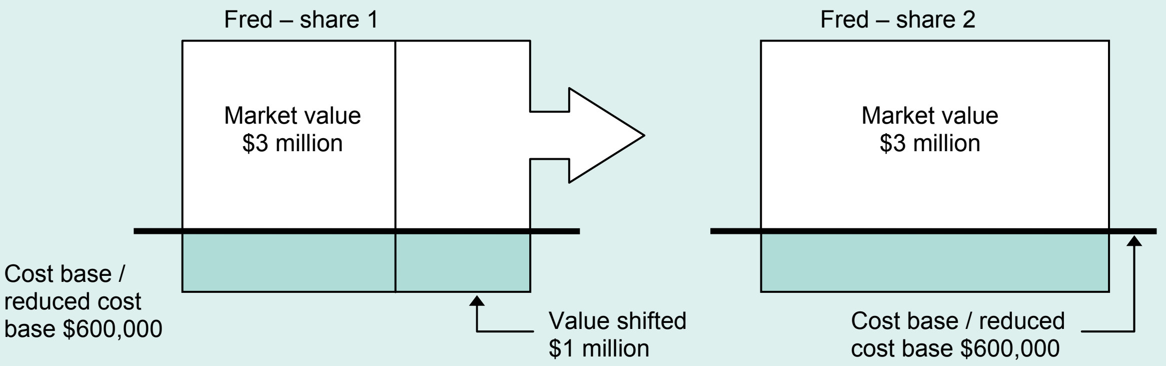
	There is a pre-shift gain for the down interest	There is a pre-shift loss for the down interest
Consequences for the down interests	Decreases to adjustable value. Reduction based on the proportion of market value of the down interest shifted.	Decreases to adjustable value based on the amount of the value shifted.
Consequences for the up interests	Increases to adjustable value based on reductions to adjustable values for down interests, but only to the extent that the amount of the increase is still reflected in the market value of the interest when a CGT event later happens to it.	Increases to adjustable value based on value shifted, but only to the extent that the amount of the increase is still reflected in the market value of the interest when a CGT event later happens to it.

Example 2-15: Entity interest direct value shift – rollover treatment in a pre-shift gain case

Scheme

Fred holds the two shares on issue in Target Co. They are both post-CGT shares and are not trading stock or revenue assets. The cost base and reduced cost base of each share is $600,000.

An entity interest direct value shift happens when the rights attaching to one of the shares are changed. There is a decrease in the market value of one share (from $3 million to $2 million) and a corresponding increase in the market value of the other share (from $3 million to $4 million).

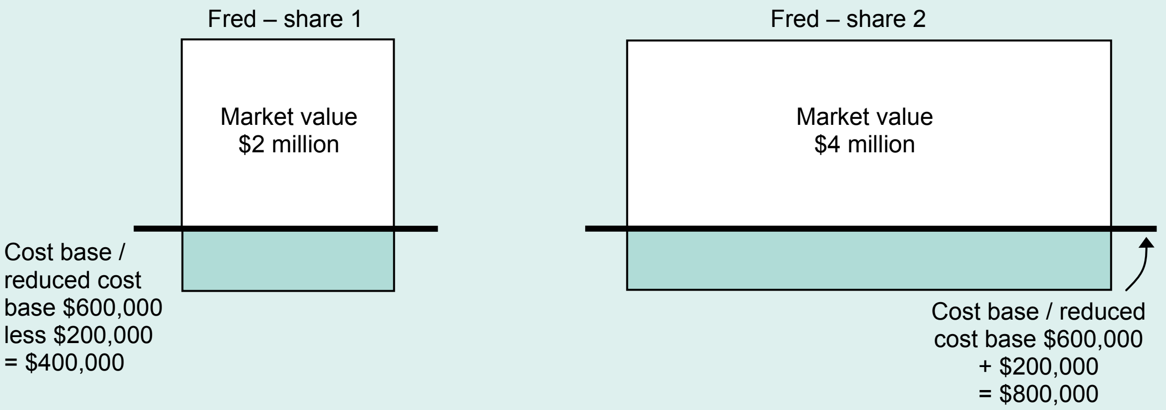


Consequences

Rollover treatment will apply to this case as value is shifted between interests having the same character that are both owned by the same affected owner.

The consequences are:

- For Fred's down interest, there is a cost base and reduced cost base reduction based on the proportion of the cost base and reduced cost base of the share that relates to the value shifted ($1 million / $3 million x $600,000 = $200,000).
- For Fred's up interest, there is a cost base and reduced cost base increase based on the proportion of the down interest's cost base and reduced cost base reductions that relate to the value shifted to the up interest ($200,000).



Summary of adjustments for disposal and rollover cases

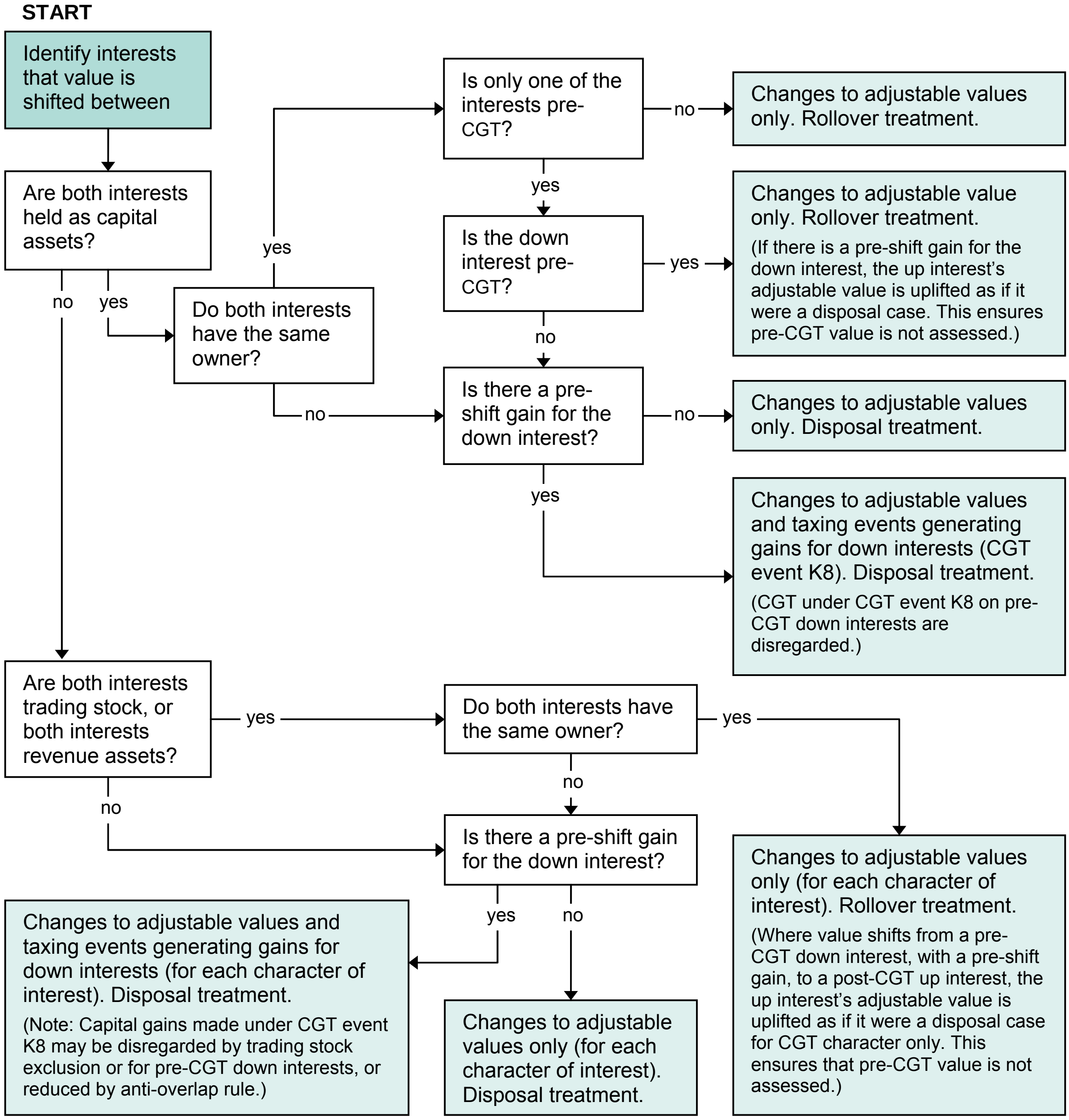
There are tables in Subdivisions 725-D, 725-E and 725-F of the ITAA 1997 that detail when and how adjustments are to be made to *adjustable values* under both disposal treatment and rollover treatment. The tables also outline when *taxing events generating a gain* happen and how they are calculated.

Figure 2-4 summarises the treatment for different value shifts between interests owned by *affected owners*:

- the rules for value shifts between interests in their character as CGT assets are contained in Subdivision 725-D, and
- the additional rules for value shifts between interests, some of which are trading stock or revenue assets, are contained in Subdivision 725-E.

Where an interest has more than one character, the interest's adjustable values are adjusted in each of its characters and a *down interest* can have a taxing event in each of its characters (eg CGT and revenue) – see 'How the adjustments are made – adjustments for interests in character as CGT assets, trading stock and revenue assets' (section 2.5).

Figure 2-4: Flowchart – treatment for different value shifts between interests owned by affected owners and that have a CGT character or are trading stock or revenue assets



2.4.3 Modified consequences for some value shifts that involve off market share buybacks at less than market value or the issue of bonus interests at a discount

The consequences of an entity interest direct value shift for an *affected owner* are modified to ensure that those rules interact properly with other provisions in the ITAA 1936 and the ITAA 1997 where:

- shares are bought back off market for less than market value, and the specific share buyback rules in Division 16K of the ITAA 1936 apply, or
- the entity interest direct value shift results from the issue to an affected owner of bonus interests at a discount in respect of interests that they already hold (see section 2.7).

Share buybacks at less than market value

There are no consequences under the entity interest direct value shifting rules for an entity that is an affected owner of *down interests* that are bought back off market at less than market value, and the specific share buyback rules in Division 16K of the ITAA 1936 apply. This is because the share buyback rules deal with the consequences for down interests.

Despite there being no consequences for the down interests under the entity interest direct value shifting rules, the affected owner may still calculate uplifts for their *up interests* under those rules.

Example 2-16: Entity interest direct value shift – share buyback at less than market value

Eric owns the 60 shares on issue in Mining Co. The cost base of each share is $900,000 and market value $1.2 million. Mining Co makes a one in six buyback offer for $500,000 per share, to be credited against share capital account.

The consequences for Eric's down interests are worked out under Division 16K of the ITAA 1936, which treats Eric as having received market value consideration (determined as if the buyback had not occurred and was not proposed to occur) of $ 1.2 million per share.

The consequences for the up interests held by Eric (the 50 shares that increase in value from $1.2 million to $1.34 million under the scheme) are worked out under the entity interest direct value shifting rules. The cost base uplifts of $140,000 per share (from $900,000 to $1.04 million) under those rules reflects the increase in market value of the shares that happens because of the off market buyback.

Section 725-230

2.5 HOW THE ADJUSTMENTS ARE MADE – ADJUSTMENTS FOR INTERESTS IN CHARACTER AS CGT ASSETS, TRADING STOCK AND REVENUE ASSETS

The entity interest direct value shifting rules change the *adjustable values* of each *down interest and up interest* of *affected owners* to take account of the market value changes and issues at a discount that happen under the scheme. In some cases there are *taxing events generating a gain*. There are method statements in Subdivision 727-F that are used to work out the amount of an adjustment or gain for an interest.

Where an *affected interest* has more than one character (CGT asset, trading stock, revenue asset) there are consequences for the interest in each of those characters. The following table summarises the methods that are used to adjust an interest's adjustable values.

Table 2-3: Methods to adjust an interest's adjustable values

Character	How adjustment is made
CGT asset	The cost bases and reduced cost bases are reduced (for down interests) or increased (for up interests) by the amounts calculated under Subdivision 727-F. Subsections 725-240(3) to (5)
Trading stock	The affected owner is treated as having sold their interest to a third party, at arm's length and in the ordinary course of business, for its *adjustable value* immediately before the time that it decreased (or increased) in value under the scheme, and then to have bought back the interest for its adjustable value as decreased or increased by the amounts calculated under Subdivision 727-F. Subsections 725-310(2) to (4)
Revenue asset	The affected owner is treated as having sold their interest to a third party for its *adjustable value* immediately before the time that it decreased (or increased) in value under the scheme, and then to have bought back the interest. Subsections 725-320(2) to (4)

CGT taxing events generating a gain happen at the time when an interest decreases in value. Gains relevant to trading stock and revenue assets are included in assessable income in the income year in which the interest's value decreases under the scheme.

Subsection 104-250(2) (CGT assets), subsection 725-310(5) (trading stock), subsection 725-320(5) (revenue asset)

Example 2-17: Entity interest direct value shift – consequences for an interest in more than one character

Business Co is formed in 2002 by Akiko, who controls Business Co for value shifting purposes. Another shareholder in Business Co, her spouse Randall, holds his one share as trading stock.

In May 2004 there is an entity interest direct value shift for which there are consequences under the entity interest direct value shifting rules when more shares are issued at a discount to Akiko. The relevant attributes of Randall's share are:

Cost base and reduced cost base	$500,000
Trading stock adjustable value – opening value for the 2003–04 income year (market value)	$1.8 million
Market value immediately before the issue of the shares	$2 million
Market value after the issue of the shares	$1.5 million

The decrease in value of Randall's share is wholly attributable to the value shift to the up interests that are issued to Akiko. The new shares are issued to Akiko at a discount that is equal to the sum of the decreases for the existing interests held in Business Co (by Akiko, Randall and others).

Randall is an affected owner for the entity interest direct value shift that happens in May 2004, as he is an associate of Akiko, controller of the target entity Business Co. Disposal treatment applies to Randall's down interest as value is shifted from that interest to an interest held by another affected owner. The consequences are worked out separately for each character.

As a **CGT asset** there is an adjustable value adjustment for the interest and, as there is a pre-shift gain of $1.5 million for the interest, a taxing event generating a gain. The amount of the gain is based on the value shifted from the share ($500,000) less a pro rata allocation (value shift / pre-shift market value) of its cost base ($125,000). This is $375,000. As Randall holds his interest as trading stock, the capital gain is disregarded under section 118-25 of the ITAA 1997. The cost base and reduced cost base of Randall's share are reduced by the pro rata allocation of cost base ($125,000) to $375,000.

As an item of **trading stock** there is an adjustable value adjustment for the interest and, as there is a pre-shift gain of $200,000 for the interest, a taxing event generating a gain. The amount of the gain is based on the value shifted from the share ($500,000) less a pro rata allocation (value shift / pre-shift market value) of its trading stock adjustable value ($450,000). This is $50,000. The gain is included in Randall's assessable income for the income year when the decrease in market value occurred (2003–04 income year).

The trading stock adjustable value of his share is reduced by the pro rata allocation of trading stock opening value ($450,000) to $1.35 million. This is effected by treating Randall as having sold his interest to a third party, at arm's length and in the ordinary course of business, for $1.8 million, and then to have bought back the interest for $1.35 million.

2.5.1 What happens when value is shifted from a pre-CGT interest?

The *Review of business taxation* recommended that recognition be given to value shifts that happen where value is shifted from pre-CGT interests.

The entity interest direct value shifting rules implement these recommendations and allow appropriate adjustments to be made in cases where value is shifted from pre-CGT interests. This means, for example, that uplifts will be available where value is shifted from a pre-CGT interest to a post-CGT interest, thereby ensuring no inappropriate gain arises for the holder of the *up interest* upon subsequent realisation of the interest.

Example 2-18: Adjustments where value is shifted from a pre-CGT interest

The H Unit Trust was formed in 1983. All the interests in the trust are held by associates Greg and Louise, with Greg holding his interests on capital account and Louise holding her interests as trading stock.

Unit holder	Attributes of units	Market value before rights changed
Greg	Five A class units (acquired 1983) CB/RCB $1 million per unit	$4 million per unit
	10 B class units (acquired 1997) CB/RCB $500,000 per unit	$1.2 million per unit
Louise	10 B class units (acquired 1997) CB/RCB $500,000 per unit	$1.2 million per unit
	Trading stock value (opening value) $1.2 million per unit	

CB = cost base; RCB = reduced cost base.

Under a scheme entered into in March 2003, the rights attaching to the A class units are changed so that they reduce in value (by $2 million) to $2 million per unit. The market value of each of the B class units increases by $0.5 million to $1.7 million.

The value shifted from Greg's A class units to his B class units involves a value shift from pre-CGT interests to post-CGT interests. The entity interest direct value shifting rules ensure that full uplifts are available in relation to this value shift. The cost base and reduced cost base of his B class units are increased by the amount of value shifted (that is, an increase of $0.5 million to $1 million each). For his pre-CGT A class units, there are adjustable value decreases and no taxing events generating gains.

The rules apply in the normal way for the value shifted from Greg's A class units to Louise's B class units held as trading stock.

There are full uplifts for Louise for the value shifted to her B class units from Greg's pre-CGT A class units. The uplifts involve a cost base and reduced cost base increase (of $0.5 million per unit to $1 million per unit) and an uplift to the units' trading stock value. This is achieved by a deemed disposal of the trading stock (for old adjustable value $1.2 million) and repurchase at a new adjustable value of $1.7 million. For Greg's A class units there are adjustable value decreases. A taxing event generating a gain happens for these interests, but the gain is disregarded as they are pre-CGT interests.

2.5.2 Timing of consequences – adjustments and gains

The consequences under the entity interest direct value shifting rules happen at the following times:

- for *down interests*, adjustments are made and *taxing events generating a gain* happen when the interests decrease in value under the scheme, and
- for *up interests*, adjustments are made when they increase in value or are issued at a discount under a scheme.

Example 2-19: Entity interest direct value shift – timing of adjustments and gains

Mum and Dad are the only shareholders in Family Co. At a meeting of the company on 30 June 2003, they resolve to issue new shares to their son George on his 21st birthday, to fall on 4 July of that year. No charge is to be made for the shares. On 4 July the new shares are issued to George at a substantial discount to market value.

There is an entity interest direct value shift for which there are consequences under the entity interest direct value shifting rules.

The adjustments and taxing events generating a gain for the down interests held by Mum and Dad are made relative to the time when their shares decrease in value under the scheme. This is a question of fact in the circumstances. It is possible that these interests will have decreased in value as at the time when Family Co was bound to issue shares at a substantial discount to market value (that is, 30 June 2003).

The adjustments for the up interests issued to George are made at the time when they are issued on 4 July 2003.

2.5.3 Grouping of interests for calculation purposes

The entity interest direct value shifting rules apply on the basis that value is shifted from each *down interest* to each *up interest*. To ease compliance costs associated with working out adjustments and gains under the measure, the rules allow the grouping of down and up interests that have the same attributes (eg *adjustable values*, character, decrease or increase in value).

Example 2-20: Grouping of interests

There are six shares on issue in Trusty Co, incorporated in 1996.

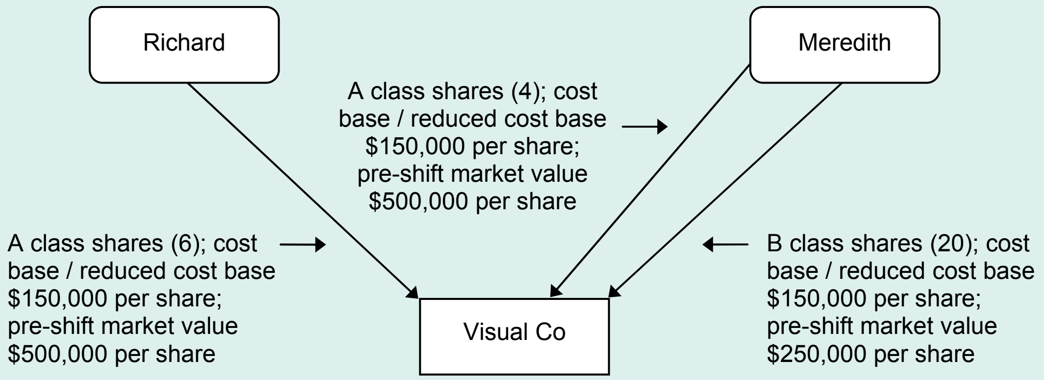
Nifty Co holds five A class shares. One was allotted to Nifty Co in 1996 (cost base $100,000). The other four were purchased in 2001 (cost base $800,000 each). Robert holds the one B class share. Robert is an associate of Nifty Co. All shares are held on capital account.

Under a scheme entered into in May 2004, the rights attaching to the A class shares are altered. This causes the market value of the A class shares to decrease (by $400,000 per share) and the B class share to increase. The market value of each A class share before the value shift was $1 million.

To work out the entity interest direct value shifting consequences of the scheme, the four A class shares acquired in 2001 by Nifty Co can be grouped. A separate calculation is required for the share allotted in 1996, as this share has a different adjustable value.

Step one in each of the method statements contained in Subdivision 725-F

2.6 WORKED EXAMPLE: ENTITY INTEREST DIRECT VALUE SHIFTING



This example illustrates the practical application of the entity interest direct value shifting rules in disposal treatment and rollover treatment cases.

There are 30 shares on issue in Visual Co, a company registered in 2001. Meredith and Richard (associates) control Visual Co for value shifting purposes. Meredith owns four A class shares, and all 20 of the B class shares. Richard holds the other six A class shares. All of the shares are held on capital account.

In March 2003, Meredith and Richard alter the rights attaching to the shares, which results in a decrease in the market value of the A class shares and an increase in the market value of the B class shares.

The relevant attributes of each of the shares (before and after the shift of value) are set out in the following table:

Type of share	Pre-shift adjustable value (cost base / reduced cost base)	Market value before rights changed	Market value after rights changed
Richard			
A class shares on capital account (six)	$150,000 per share	$500,000 per share	$300,000 per share
Meredith			
A class shares on capital account (four)	$150,000 per share	$500,000 per share	$300,000 per share
B class shares (20)	$150,000 per share	$250,000 per share	$350,000 per share

In this case, there is an entity interest direct value shift under a scheme that will have consequences for Meredith and Richard because:

- there is an entity interest direct value shift under a scheme (section 2.2) – there is a decrease in the value of the A class shares (down interests) and an increase in the value of the B class shares (up interests), and the decrease and increase are reasonably attributable to the thing done under a scheme (altering the share rights)
- the control test (section 2.3.1) is satisfied – Meredith and Richard are controllers of Visual Co
- the participants in the scheme test (section 2.3.2) is satisfied – Meredith and Richard's acts caused the decreases and increases in the market values of the interests under the scheme
- there are affected owners of down and up interests in the target entity (section 2.3.3) – Meredith is an affected owner of down and up interests, and Richard is an affected owner of down interests, and
- no exception applies (section 2.3.4) – the de minimis exception does not apply as the decrease in the A class shares ($2 million) exceeds the $150,000 threshold and the reversal exception will not apply as the value shift will not reverse within four years.

The consequences for the down interests and the up interests are worked out by applying the tables in Subdivision 725-D as all of those interests are held on capital account. When applying these tables, it is important to note that there are pre-shift gains for all of the down interests held by Meredith and Richard.

The consequences are set out below.

(a) For the value shift between Meredith's A class shares and B class shares
As value is shifted between post-CGT shares held by the same owner, that are of the same character, rollover treatment applies (ie changes to adjustable value and no *taxing event generating a gain*).

The relevant item in the table in Subdivision 725-D (in this case item 1 in the table in subsection 725-250(2)) identifies the method statements to be applied to work out the increases and decreases in adjustable values.

Decreases for Meredith's A class shares
Meredith's A class shares are grouped to calculate the decreases as they all have the same attributes (step 1). The value shifted from Meredith's A class shares to her B class shares under step 2 of the method statement in section 725-365 is:

> sum of market value decreases for Meredith's A class shares x sum of market value increases for Meredith's B class shares / sum of market value increases for all B class shares
>
> $800,000 x $2 million / $2 million = $800,000

The notional adjustable value under step 3 is:

> sum of pre-shift adjustable values for Meredith's A class shares x value shifted under step 2 / sum of pre-shift market value for Meredith's A class shares
>
> $600,000 x $800,000 / $2 million = $240,000

The decrease in adjustable value to each of Meredith's A class shares under step 4 is:

> notional adjustable value / number of shares in the group
>
> $240,000 / 4 = $60,000

As discussed above, the application of this formula leads to a decrease in cost base / reduced cost base, based on the proportion of market value shifted.

Increases for Meredith's B class shares
Under step 1 of the method statement in section 725-370, Meredith's 20 B class shares will be grouped together as they all have the same attributes.

The part of the notional adjustable value that relates to the value shifted from Meredith's A class shares (step 2 – as worked out in step 3 above) and that is attributable to the value shifted to her B class shares is worked out under step 3 of section 725-370:

> notional adjustable value x sum of post-shift market value of the B class shares in the group / sum of post-shift market values of Meredith's B class shares
>
> $240,000 x $7 million / $7 million = $240,000

The increase in adjustable value for each of Meredith's B class shares under step 4 of section 725-370 is:

> step 3 amount / number of shares in the group
>
> $240,000 / 20 = $12,000

As discussed above, this equates to the proportion of cost base / reduced cost base that relates to the value shifted to each of her up interests.

(b) For the value shift between Richard's A class shares and Meredith's B class shares
As value is shifted between different affected owners, disposal treatment applies (ie changes to adjustable value and a taxing event generating a gain). This is appropriate as, following the shift, the value can no longer be taxed to Richard. The value shift represents an economic disposal.

Decreases and taxing events generating gains for Richard's A class shares
The table items that apply to Richard are item 4 in the table in section 725-245 (which identifies that there is a taxing event generating a gain and how to calculate it) and item 6 in the table in subsection 725-250(2) (which identifies that there is an adjustable value decrease for the shares and how to calculate it).

The adjustable value decrease and capital gain for each of Richard's A class shares is worked out under the method statement in section 725-365.

Richard's shares are grouped for calculation purposes as they all have the same attributes (step 1).

The value shifted from Richard's A class shares to Meredith's B class shares under step 2 is:

> sum of market value decreases for Richard's A class shares x sum of market value increases for Meredith's B class shares / sum of market value increases for all B class shares
>
> $1.2 million x $2 million / $2 million = $1.2 million

The notional adjustable value under step 3 of the method statement is:

> sum of pre-shift adjustable values for Richard's A class shares x value shifted under step 2 / sum of pre-shift market values for Richard's A class shares
>
> $900,000 x $1.2 million / $3 million = $360,000

The decrease in adjustable value for each of Richard's A class shares is:

notional adjustable value / number of shares in the group

$360,000 / 6 = $60,000

The capital gain under CGT event K8 for each of Richard's A class shares is worked out under step 5 in the method statement:

(value shifted under step 2 – notional adjustable value) / number of Richard's shares

($1.2 million – $360,000) / 6 = $140,000

As discussed above, this equates to the value shifted less the proportion of cost base that relates to the value shift, for each interest.

Therefore Richard makes capital gains of $840,000 in respect of the entity interest direct value shift.

Increases for Meredith's B class shares
For Meredith's B class shares, item 8 in the table in subsection 725-250(2) identifies that there is an adjustable value increase and that section 725-375 is to be applied to calculate it.

Meredith's B class shares are grouped for calculation purposes as they all have the same attributes (step 1).

The value shifted from Richard's A class shares to Meredith's B class shares under step 2 of the method statement is:

sum of increases in market value of Meredith's B class shares x sum of decreases in market value of Richard's A class shares / sum of decreases in market value of all A class shares

$2 million x $1.2 million / $2.0 million = $1.2 million

The increase in adjustable value for each of Meredith's B class shares is:

value shifted / number of shares in the group

$1.2 million / 20 = $60,000

Summary consequences
Richard will include a capital gain of $140,000 for each A class share that he holds in Visual Co in working out his net capital gain or net capital loss for the 2003 income year.

The post-shift adjustable values of the shares in Visual Co are:

Type of share	Post-shift adjustable value
A class – Richard (six)	$90,000 per share
A class – Meredith (four)	$90,000 per share
B class – Meredith (20)	$222,000 per share

2.7 INTERACTION BETWEEN THE ENTITY INTEREST DIRECT VALUE SHIFTING RULES AND THE BONUS INTEREST RULES

Specific rules ensure that the entity interest direct value shifting rules and the bonus interest rules interact properly. They deal with:

- when a bonus interest is taken to be issued at a discount for the purposes of the entity interest direct value shifting rules, and
- modified consequences for entity interest direct value shifts that involve the issue of bonus interests to an interest holder in respect of their existing interests.

2.7.1 When is a bonus interest issued at a discount?

There are special rules for working out if a bonus interest covered by another provision of the tax law (eg section 6BA of the ITAA 1936) is issued at a discount.

To work out if the bonus interest has been issued at a discount:

- where Subdivision 130-A of the ITAA 1997 applies, and some or all of the bonus equities are a dividend or otherwise assessable income, the issuing entity (not a *public trading trust* or a *corporate unit trust*) is taken to have received an amount equal to the cost base of the interest when issued (this includes the dividend or other assessable amount, plus any amounts paid on the bonus equities), or
- where section 6BA of the ITAA 1936 applies, and the bonus shares are taken to be a dividend under subsection 6BA(2), they are taken to have been purchased from the issuing entity for the consideration worked out under this subsection (that is, the amount of the dividend, to the extent that it is included in the taxpayer's assessable income and is not rebatable).

If this amount is less than the market value of the bonus equity when issued, it will be issued at a discount in terms of the entity interest direct value shifting rules. These rules can then apply if the other requirements of those rules are met.

This will ensure that the entity interest direct value shifting rules and the other provisions work together.

In cases not covered by one of the dot points above, subsection 725-150(1) applies normally to work out if the bonus interests were issued at a discount.

Subsections 725-150(3) to (7)

Example 2-21: Bonus interest issued at a discount

RZ Co is the controller of FG Co, holding 2 million of the 3 million shares on issue. On 11 February 2003, FG Co declares a dividend of $500,000 to be satisfied by the issue of 200,000 bonus interests.

For the purposes of working out whether there is an issue at a discount (and what that discount is) under the entity interest direct value shifting rules, the amount of the dividend included in assessable income (and that is not rebatable) is apportioned across the shares under subsection 6BA(2) ($500,000). So FG Co is taken to have received $2.50 for each of the shares.

At the time of the issue of the interests the market value of the bonus shares is $4 each. Therefore, the bonus interests are taken to be issued at a discount of $1.50 per share ($4 market value less $2.50 deemed consideration for issue). The total discount under the scheme is $300,000 (200,000 shares x $1.50 discount/share).

2.7.2 Bonus interests – modified consequences

In broad terms, the entity interest direct value shifting rules would normally apply where bonus interests (eg bonus shares and bonus units) are issued at a discount to an entity in relation to original *equity interests* owned by that or another entity.

For cases where a bonus interest is issued at a discount to market value to an entity in relation to an original interest that they own, the entity interest direct value shifting consequences are modified to ensure the rules interact appropriately with other provisions that deal with bonus interests. The modifications ensure:

- there are no consequences for either *down or up interests* in some circumstances, and
- there are no consequences for up interests in others.

No consequences for down or up interests

There will be no consequences under the rules for either the down or up interests of an *affected owner* where other provisions of the income tax law apply upon issue of the bonus interests to effectively spread the cost of the original equity interests in the *target entity* across both the original interests and the bonus interests held by the same entity. It is not necessary for the rules to apply in these circumstances as both the decreases to the *adjustable values* of the original equity interests and the increases to the adjustable values of the bonus interests are achieved by spreading the cost of the original equity interests over all the interests.

The circumstances where a provision of the income tax law applies to spread the cost of the original equity interests across both those interests and the bonus interests are:

- where Subdivision 130-A of the ITAA 1997 applies and:
  - none of the bonus interests are a dividend or otherwise assessable, and
  - the original equity interests were acquired post-CGT, or
- section 6BA of the ITAA 1936 applies and the bonus interests:
  - were issued for no consideration and are not a dividend, or
  - are dividends rebatable under section 46 or 46A.

No consequences for up interests

Where the bonus interests are issued to an entity that holds the original interests and another provision of the income tax law applies to set the adjustable values of the bonus interests at an amount equal to their market value, there will be no consequences under the rules for the up interests (ie the bonus interests). As the adjustable values of the up interests have been set at market value, it is not necessary for the rules to apply in relation to these interests. Despite the rules not applying in relation to the up interests, the normal consequences for the down interests (ie the original interests) will continue to apply under the rules.

The circumstances where a provision of the income tax law applies to set the cost of the bonus interests at market value are:

- where Subdivision 130-A of the ITAA 1997 applies to the issue of bonus interests in respect of a pre-CGT original equity interest and:
  - none of the bonus interests are a dividend or otherwise assessable, and
  - the entity is required to pay, and pays, an amount for the bonus interest.

Section 725-225

Example 2-22: Interaction of entity interest direct value shifting and bonus interest provisions

Don holds all of the 400 shares (original interests) on issue in Bull Co, a company incorporated in 1989. The cost base and reduced cost base of each of the shares is $120,000. Don holds the shares on capital account.

In March 2004 Bull Co resolves to issue one bonus share for every two shares held in Bull Co. Don will receive 200 bonus shares (bonus interests) for his original interests. The bonus and original interests are of the same type. The market value of each of the original interests immediately before the issue is $75,000 a share. No part of the bonus issue is a dividend or taken to be a dividend.

Subdivision 130-A of the ITAA 1997 applies to the issue, and the cost base of the original and bonus interests is worked out by spreading the cost base and reduced cost base of the original interests over both the original and bonus interests in a reasonable way. The cost bases and reduced cost bases of the original interests are reduced to $80,000 per share, and the cost base and reduced cost base of the bonus interests are $80,000 per share.

There is no need for the entity interest direct value shifting rules to apply as the object of the rules is achieved by spreading the cost base of the original interests over both the original and bonus interests.

2.7.3 Matter under consideration

The current bonus interest provisions in the entity interest direct value shifting rules only apply to value shifts between the original and bonus interests of an affected owner. That is, the rules do not cover value shifts from an affected owner's original interest to another affected owner's bonus interest. The explanatory memorandum for the bill that introduced the entity interest direct value shifting rules notes that further rules will be developed to deal with this (see paragraph 8.101 of the Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002).

2.8 ENTITY INTEREST DIRECT VALUE SHIFTING RULES – OLD LAW TO NEW LAW COMPARISON

Old law	New law
Applies only to companies.	Applies to *target entities* being companies and trusts.
Applies only to controllers of a target entity and to their associates.	Also applies to entities that are *active participants* in a scheme and who hold interests in the target entity, but only in *closely held* target entities that are controlled.
Applies to *equity interests*.	Also applies to debt interests.
Low de minimis threshold (less than 5% market value decrease on an interest basis and $100,000 on a scheme basis), especially on the percentage limit.	More realistic de minimis threshold ($150,000 on a scheme basis).
No special relief is available where a value shift reverses on its own terms.	Provision for special relief where a value shift reverses on its own terms.
Only material uplifts are allowed (as a compliance cost saving measure).	No materiality requirement for uplifts – taxpayers may choose to calculate small uplifts (there must still be a material decrease for the Division to apply).
Addresses CGT consequences only for interests.	Also addresses revenue consequences for interests held as trading stock or revenue assets.
No uplifts for shifts from pre-CGT interests.	Uplifts available for shifts from pre-CGT interests.
No uplifts available for off-market buybacks at under value.	Uplifts available for off-market buybacks at under value.
Excludes interest holder from gain treatment in a neutral value shift only if the shift is neutral for *all* affected holders.	Excludes interest holder from gain treatment where value shift is neutral for that holder, even if it is not neutral for other affected holders.

CREATED RIGHTS DIRECT VALUE SHIFTING RULES 03

This part of the guide includes:

- a brief introduction to the measure, including commencement dates
- a flowchart you can use to work through the issues and navigate to relevant information, and
- a detailed explanation of the created rights direct value shifting rules.

3.1 INTRODUCTION

What is the measure?

The created rights direct value shifting rules address the inappropriate tax outcomes that can arise where an entity creates in an *associate* a right out of, or over, an existing asset (the 'underlying asset') for less than market value and the market value of that asset decreases as a result. Without the created rights direct value shifting rules, these arrangements could allow the creation of artificial losses through the realisation of the underlying asset at a reduced value.

The rules operate by reducing a loss that would otherwise be made upon realisation of an underlying asset as a result of value having been shifted out of the asset through the creation of a right out of, or over, the asset. No reductions are made, however, to the extent the value shifted has been taxed on the creation of the right or in certain cases where the right is realised for a gain.

When does the measure start?

These rules apply when the creation of a right out of, or over, an asset and the realisation of the asset happen on or after 1 July 2002.

> Section 723-1 of the *Income Tax (Transitional Provisions) Act 1997*

What entities are affected under the measure?

The rules can affect entities that grant rights over assets they own to an *associate* for less than market value where the value shifted out of the asset is not taxed on the granting or subsequent realisation of the right. Certain related entities that purchase such assets or receive replacement assets under rollover can also be affected.

Are there any assets, or created rights, that are excluded from the measure?

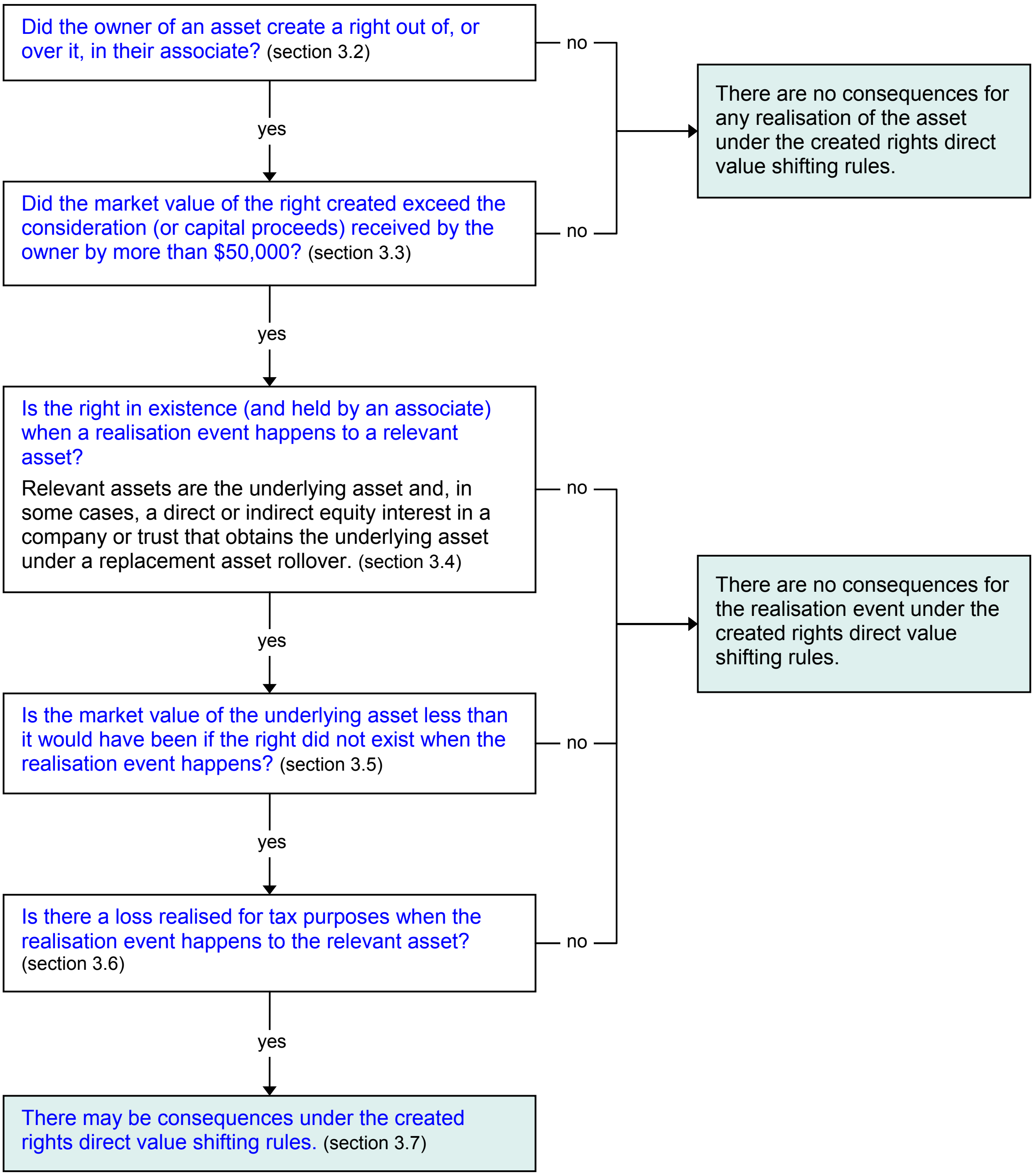
The created rights direct value shifting rules will apply to a right created over any CGT asset other than a *depreciating asset*. Where the asset over which the right is created has more than one character – for example an asset held as trading stock – there may be multiple consequences.

The rules will not apply where the right created is a *conservation covenant* or, broadly, where a right is created on the death of the asset's owner.

Where can I find the rules?

The created rights direct value shifting rules can be found in Division 723 of the ITAA 1997.

Figure 3-1: Flowchart – Created rights direct value shifts



3.2 DID THE OWNER OF AN ASSET CREATE A RIGHT OUT OF, OR OVER IT IN THEIR ASSOCIATE?

There are three issues under this threshold condition:

- what asset can the right be created out of or over
- what rights do the rules apply to, and
- when must the associate test be met?

3.2.1 What asset can the right be created out of or over?

The asset over which the right is created (the underlying asset) can be any asset other than a *depreciating asset*. The rules will apply to assets that have rights created in respect of them regardless of their character for tax purposes. This means the consequences under the rules will not be confined to assets held as capital assets but will also extend to those held as trading stock or otherwise held as revenue assets.

Paragraphs 723-10(1)(a) and 723-15(1)(a) and section 723-40

3.2.2 What rights do the rules apply to?

The rules will apply where any type of right is created out of or over an asset other than:

- a *conservation covenant* over land, or
- broadly, a right created on the death of the owner of the asset (eg a life tenancy created under a will).

Section 723-20

3.2.3 When must the associate test be met?

The creator and the entity it creates the right in must be *associates* at the time the right is created.

3.3 DID THE MARKET VALUE OF THE RIGHT CREATED EXCEED THE CONSIDERATION (OR CAPITAL PROCEEDS) RECEIVED BY THE OWNER BY MORE THAN $50,000?

One of the basic requirements of the created rights direct value shifting rules is that there is a shortfall on creating the right. A shortfall will exist on creating the right if the market value of the right when created exceeds the capital proceeds for the CGT event that involved the creation of the right.

In working out whether a shortfall exists, the relevant amount is the capital proceeds that are received for CGT purposes. That amount may differ from the actual consideration received because, for instance, a market value substitution rule may apply to increase the proceeds received for tax purposes. Where a market value substitution rule applies for tax purposes, the created rights direct value shifting rules will not apply as no shortfall will exist on the creation of the right. This outcome is appropriate as the difference between the actual capital proceeds received and the market value of the right would be taxed at the time the right is created.

Paragraphs 723-10(1)(e) and 723-15(1)(c)

Example 3-1: Shortfall on creating the right

G Co owns asset A, a non-depreciating asset having a cost base and reduced cost base of $2.5 million.

In 2005, G Co grants a right to the G Trust for exclusive use of asset A for a 10-year period for no consideration. The market value of the right at that time is $500,000. CGT event D1 happens because of the creation of the right but no amount is assessable to G Co as a capital gain (no market value substitution rule applies under CGT event D1 where no capital proceeds are received). There is a shortfall on creating the right of $500,000.

Note that the creation of a right for less than market value consideration will involve an unequal exchange of economic benefits. So, if the creator of the right is a company or trust, there may also be consequences under the indirect value shifting rules. See the indirect value shifting rules (section 04).

3.3.1 Shortfall on creating the right of more than $50,000

A de minimis exception will apply if the shortfall on creating the right is $50,000 or less. This ensures the rules are only targeted at substantial value shifts.

Paragraphs 723-10(1)(f) and 723-15(1)(d)

The de minimis exception does not apply if multiple rights are created, and it is reasonable to conclude that the sole or main reason they were created was so that the exception could apply.

Section 723-35

3.4 IS THE RIGHT IN EXISTENCE AND HELD BY AN ASSOCIATE WHEN A REALISATION EVENT HAPPENS TO A RELEVANT ASSET?

There are three issues under this threshold condition:

- what is a realisation event?
- what is a relevant asset?, and
- how is the associate test applied?

3.4.1 What is a realisation event?

A realisation event happens:

- for a CGT asset, where a CGT event (other than events E4 or G1) happens
- for an asset held as trading stock, where the item is disposed of or at the end of an income year, and
- for a revenue asset, where an entity disposes of or ceases to own, or otherwise realises the asset.

Division 977

A realisation event can happen to part of an underlying asset and includes where an interest in the asset is created. For example, CGT event A1 will happen where the creator of the right transfers 50% of the underlying asset to another entity.

Section 723-25

3.4.2 The relevant asset: What asset does the realisation event need to happen to and what are the consequences?.

Realisation event	Consequences
Basic case: The underlying asset is *realised at a loss* by the creator when immediately before the time of the realisation event it is still subject to the right held by their associate. The realisation event can happen at the same time as the right is created – for example, where CGT event A1 happens at the time the change in ownership of the asset occurs and the right is created at that time. For a case where the realisation event happens at the same time as the right is created, the creator and recipient need to be associates at that time. Sections 723-10, 723-15 and 723-25	Possible reduction to loss that is made when realisation event happens (created rights direct value shifting – basic case method, section 3.7.1).
Same asset rollover case: The underlying asset (or part) is realised at a loss by an entity that obtained it directly or indirectly from the creator of the right under an unbroken chain of CGT *same asset rollovers*. For each rollover, the transferor and transferee must have been associates immediately after the CGT event covered by the rollover. Just before the time of the realisation event the right must still be in existence and held by an associate of the entity that realises the asset. This extension of the rule is necessary as a transferee that takes the underlying asset with the same reduced cost base attributes as the transferor will have the same capacity to realise a loss, referable to the created rights direct value shift, on a subsequent realisation. Subsections 723-10(1) and (2), 723-15(1) and section 723-25	Possible reduction to loss that is made when the realisation event happens. The method for making the reductions is the same as for the basic case. **Example 3-2: Same asset rollover case** The Trustee of the V Trust creates a valuable right over an underlying asset in D Co, its associate at the time, for no consideration. Market value proceeds are not taken to have been received for tax purposes. The trustee of the V Trust later transfers the underlying asset to a company, Z Co, in exchange for all of the shares in Z Co, and rollover is chosen under Subdivision 122-A. Z Co is an associate of the V Trust immediately after the rollover. If Z Co sells the underlying asset for a loss and just before that time the right is still in existence and held by its associate, there may be consequences under the created rights direct value shifting rules.

Realisation event	Consequences
Replacement asset rollover case: A loss is made when a CGT event happens to certain direct or indirect interests in a company or trust. Interests can be affected where: • they are a replacement interest obtained directly or indirectly under rollover(s) as a replacement asset for an asset now owned by the company or trust (the underlying asset), and • if the underlying asset were realised by the company or trust, a loss would be realised for tax purposes and reduced under the basic or same asset rollover cases. This rule is necessary as the reduced cost base of the interests received under a *replacement asset rollover* is derived from the reduced cost base of the underlying asset, and this creates the potential for the unrealised loss on the underlying asset to be duplicated on the interests. Section 723-105	Where a loss would be realised on the replacement interest, the reduced cost base of the interest is reduced just before the CGT event by an amount determined under one of two methods. The first method involves the use of a formula (see replacement asset rollover case, section 3.7.2). The second method is used if the formula method cannot be used or it provides for inappropriate reductions. Under this method reductions are made having regard to the amount by which any loss on the underlying asset would have been reduced if it, rather than the replacement interest, had been realised. **Example 3-3: Replacement asset rollover case** Assume that on the base facts in example 3-2, the trustee of the V Trust sells the replacement shares in Z Co, rather than Z Co selling the underlying asset. The reduced cost bases of the replacement shares are to be reduced immediately before they are realised in accordance with the formula or, if the formula cannot be applied, by a reasonable amount having regard to the amount by which any loss on the underlying asset would have been reduced if it, rather than the replacement shares, had been realised. In rare cases, these rules can also apply to the realisation of replacement assets for the shares in Z Co if they were the subject of a replacement asset rollover.

3.4.3 How are the associate tests applied when a realisation event happens to an asset?

Just before the time of the realisation event (or, for a case where the right is created at the time of the realisation event, at that time) the right must be held by an associate of the holder of the underlying asset. This means that for the replacement asset rollover case, the associate relationship will need to be established between the holder of the right and the entity that holds the underlying asset (that is, not the person realising the direct or indirect *equity interest*).

3.5 IS THE MARKET VALUE OF THE UNDERLYING ASSET LESS THAN IT WOULD HAVE BEEN IF THE RIGHT DID NOT EXIST WHEN THE REALISATION EVENT HAPPENS?

There is a deficit on realisation if the market value of the underlying asset at the time when it is realised is less than it would have been if the right no longer existed at that time, or less than it would have been if the right had not been created at that time. The amount of the difference is the deficit on realisation.

Paragraphs 723-10(1)(g) and 723-15(1)(e)

Example 3-4: Deficit on realisation

In 2005, G Co granted a right to the G Trust for exclusive use of asset A for a 10-year period for no consideration. G Co sells asset A in 2010 at a time when the market value of the asset is $2.1 million. If the right were not in existence, the market value of the asset would have been $2.3 million.

There is a deficit on realisation of $200,000.

3.6 IS THERE A LOSS REALISED FOR TAX PURPOSES WHEN THE REALISATION EVENT HAPPENS TO THE RELEVANT ASSET?

The created rights direct value shifting rules reduce a loss that would otherwise be realised for tax purposes when the underlying asset is realised. A loss is realised for tax purposes in the following ways.

Table 3-1: Realisation of loss for tax purposes

For an underlying asset that is:	There will be a loss realised for tax purposes when:
A CGT asset	An entity makes a capital loss from a CGT event that happens to the asset. Section 977-10
Trading stock	The trading stock is: • disposed of for less than its cost in the year in which it first became trading stock on hand • disposed of for less than opening value in a later income year, or • the income year ends, and the closing value of the item is less than its opening value for the start of the income year or, if none, its cost. Sections 977-25 and 977-30
A revenue asset	An entity makes a loss when it disposes of, ceases to own or otherwise realises the asset. The loss must be one which would be taken into account in calculating assessable income or a tax loss, otherwise than as a capital loss, or as trading stock or a *depreciating asset*. Section 977-55

3.7 WHAT METHOD IS USED TO MAKE A REDUCTION?

Where the general conditions are satisfied it is necessary to work out the amount by which a loss on the *underlying asset* is to be reduced. There are methods for:

- the basic case and same asset rollover case (where the loss on the asset is reduced directly), and
- the replacement asset rollover case (where the reduced cost base of the replacement interest is reduced immediately before the *realisation event*).

The meaning of ‘basic case’, ‘same asset rollover case’ and ‘replacement asset rollover case’ is set out in section 3.4.2.

3.7.1 Reduction methodology – basic and same asset rollover cases

For the basic case (that is, a realisation of the *underlying asset* by the creator of the right) or a same asset rollover case, the maximum reduction to the loss realised on the underlying asset is worked out by using this formula:

The lesser of the deficit on realisation and shortfall on creating the right

less

The amount of any gain (other than a gain that is disregarded) made on the realisation of the right by an associate at any time up to four years after the time when the *realisation event* for the asset happens

The associate relationship with the owner of the asset must exist just before the time the asset is realised.

The reduction for gains derived on the realisation of the right ensures there will be no reduction to the loss on the asset to the extent that the value shifted has been brought to tax when the right is realised.

Subsections 723-10(3) and (4) and 723-15(2) and (3)

Example 3-5: Reduction where a gain has been made on realisation of right

In 2005, G Co granted a right to its associate the G Trust for exclusive use of asset A for a 10-year period. No consideration was received for the grant, resulting in a shortfall on creating the right of $500,000. In 2010, G Co sold the asset for $2.1 million, resulting in a loss and deficit on realisation of $200,000.

Prior to the sale the G Trust transferred the right to Geoff for its market value ($195,000) and realised a capital gain of $195,000.

The maximum reduction under the created rights direct value shifting rules for G Co's loss on sale of the asset will be $5,000. That is, the maximum reduction for a loss is $200,000 (lesser of deficit on realisation and shortfall on granting the right) less $195,000 (gain made on the realisation of the right by the G Trust).

Basic and same asset rollover cases method – reduction method where the created right is held as trading stock or a revenue asset

If the right created in respect of an underlying asset is also trading stock or a revenue asset, and a gain is realised on the right within four years of the realisation of the underlying asset, then the gain taken into account in the reduction formula is:

- if the right is trading stock – the gain on realisation of the item of trading stock, and
- if the right is a revenue asset – the gain on realisation of the right as a revenue asset or as a CGT asset, whichever is the greater.

Section 723-50

Example 3-6: Created rights direct value shifting – character of right

In 2005, G Co granted a right to its associate the G Trust for exclusive use of asset A for a 10-year period. No consideration was received for the grant, resulting in a shortfall on creating the right of $500,000. In 2010, G Co sold the asset for $2.1 million, resulting in a loss and deficit on realisation of $200,000.

Prior to the sale the G Trust transferred the right to Geoff for $205,000, being $10,000 more than the market value of the right. The right had been held by the G Trust as a revenue asset.

The amount that the G Trust includes as a revenue amount in working out net income ($205,000) is applied in the reduction formula.

Therefore there will be no consequences for the loss G Co makes on sale of the asset.

Basic and same asset rollover cases method – reduction methodology where underlying asset is partially realised

The created rights direct value shifting rules also apply where a loss is made when some part of the underlying asset is realised (eg a disposal in part) or an interest is created in the underlying asset.

In determining how much to reduce the loss on the part or interest realised, the shortfall on creating the right and deficit on realisation are each multiplied by the fraction:

$$\frac{\text{Market value of the part realised or interest created}}{\text{Market value of the underlying asset just before the realisation time}}$$

This has the effect that the adjustment to the loss incurred is based not on the whole reduction in value resulting from the earlier creation of a right over the asset, but on only so much of that reduction in value as is reflected in the part of the asset realised or interest created.

Section 723-25

Example 3-7: Reduction methodology – partial realisation

Simone is the owner of Lossborough, a non-depreciating asset with a cost base / reduced cost base of $5 million.

Simone grants to her sister Anne a right over Lossborough for nil consideration. Existing tax rules do not impute market value consideration to Simone for the grant. The market value of the right when granted is $1 million.

At a later time Simone disposes of 40% of Lossborough for its market value of $1.3 million and realises a loss of $700,000. Just before the realisation, the market value of Lossborough is $3.25 million and if the right had not existed its market value would have been $900,000 greater.

To work out if a reduction is to be made to the loss realised on the part disposal of Lossborough:

- the shortfall on granting the right is $400,000 ($1 million x ($1.3 million / $3.25 million), and
- the deficit on realisation is $360,000 ($900,000 x ($1.3 million / $3.25 million).

The capital loss that Simone makes on the disposal of the 40% interest is reduced by $360,000 to $340,000.

3.7.2 Reduction methodology – replacement asset rollover cases

For a replacement asset rollover case, the created rights direct value shifting rules apply when a *realisation event* happens to a replacement interest and a loss is realised for tax purposes.

The adjustment method available depends on whether there is a *direct replacement asset rollover* or an *indirect replacement asset rollover*.

Direct replacement asset rollover and indirect replacement asset rollover

A direct replacement asset rollover is one where a CGT replacement asset rollover applies directly to a transfer of the *underlying asset* to a company or trust. Losses made on the realisation of the replacement interests received may be subject to reduction.

An indirect replacement asset rollover is one where a CGT replacement asset rollover applies when a CGT event happens to a replacement interest that has been obtained under a prior replacement asset rollover that was covered by these rules.

Section 723-110

Example 3-8: Direct replacement asset rollover and indirect replacement asset rollover

The assets of a business carried on by Ken include asset T, over which he had, in March 2003, created a right in favour of his associate Ken Co. There is, for the purposes of the created rights direct value shifting rules, a shortfall on creating the right as no charge is made and the existence of the right reduces the value of the asset by $9 million.

Ken transfers all of the assets of his business (including asset T) to Venture Co in exchange for all of the shares in Venture Co, and rollover is chosen under Subdivision 122-A. This is a direct replacement asset rollover.

If Ken later exchanges his shares in Venture Co for shares in Takeover Co, under an arrangement that qualifies for Subdivision 124-M scrip for scrip rollover, there will be an indirect replacement asset rollover.

In both cases, the cost base and reduced cost base of the replacement interest is or could be derived in part from the cost base and reduced cost base of asset T. Where this happens the created rights direct value shifting rules may apply if the replacement interest is realised at a loss. Note that the rules only apply on the realisation of an interest obtained in an indirect replacement asset rollover if a loss would still be made despite the adjustment made at the time of the first indirect replacement asset rollover.

Reduction method for direct replacement asset rollover

For a direct replacement asset rollover, a formula is used to work out the reduction to the reduced cost base of the realised replacement interest. The formula takes account of the amount by which a loss made on the realisation of the underlying asset would be reduced (if it had been realised just before the realisation event) under the created rights direct value shifting rules. This reduction is called the underlying asset loss reduction amount.

$$\frac{\text{Reduced cost base of interest}}{\text{Total of reduced cost bases of direct rollover replacements}} \times \text{Underlying asset loss reduction}$$

A non-formula adjustment can be made in cases where the above adjustment does not appropriately reflect the underlying asset loss reduction and the quantum of the interest relative to all direct replacement interests and indirect replacement interests that the transferor owns or has previously owned. In such cases, the reduction is an amount that is appropriate having regard to the factors just mentioned.

Subsection 723-105(2)

Example 3-9: Direct replacement asset rollover adjustment – formula method

Gabriel commences as a sole trader in 2001.

In March 2003 he creates a right over asset A used in his business in favour of his associate Emma. The cost base and reduced cost base of asset A is $5.4 million. The shortfall on granting the right is $5 million.

In April 2003, Gabriel transfers all of the assets of his business to Gabriel Co in exchange for the issue of the 10 shares in that company. A Subdivision 122-A rollover is obtained for the transfer, so that the cost base and reduced cost base of the shares that Gabriel receives is worked out on the basis of the cost bases and reduced cost bases of the assets transferred (including asset A).

In May 2003, Gabriel sells eight of his 10 shares in Gabriel Co and calculates a capital loss of $3 million (that is, a capital loss of $375,000 per share).

An adjustment under the created rights direct value shifting rules will only be required if:

- asset A is still held by Gabriel Co
- there would be a loss for income tax purposes if asset A was realised just before the time that the shares were realised, and
- that loss would be reduced under the created rights direct value shifting rules (the underlying asset loss reduction).

A proportionate share of the underlying asset loss reduction will reduce the reduced cost base for each share. For example, if the underlying asset loss reduction was $5 million, the reduced cost base of each share realised would be reduced by $500,000. As a result, no capital losses would be obtained by Gabriel on realisation of the shares.

Adjustment method – indirect replacement asset rollover

For an indirect replacement asset rollover, an adjustment is made based on the quantum of the interest relative to all direct replacement interests and indirect replacement interests that the transferor owns or has previously owned, and the underlying asset loss reduction.

Subsection 723-105(4)

INDIRECT VALUE SHIFTING RULES 04

This part of the guide includes:

- a brief introduction to the measure, including commencement dates
- a flowchart you can use to work through the issues and navigate to relevant information
- a detailed explanation of the indirect value shifting rules
- a summary of the advantages and disadvantages of alternative adjustment methodologies
- summary tables and worked examples comparing the adjustment methodologies, and
- a comparison of the old and new laws.

4.1 INTRODUCTION

What is the measure?
The measure affects transactions and other dealings not at arm's length undertaken for other than market value consideration. These dealings usually shift value between entities, where the values of the interests held in one entity decrease, and the values of interests in the other entity increase. The value shifting is 'indirect' because it is an incidental effect of the value shifted directly between the entities in which the interests are held.

In the absence of value shifting rules, inappropriate losses and gains could arise when the interests in those entities are later realised.

Note that the measure may also apply where there is only a decreased value entity (eg where value is shifted out of a company or trust to its individual controller reducing the value of the controller's interests in that entity).

The indirect value shifting rules:

- apply mostly to transactions and other dealings that involve the unequal provision of economic benefits between entities under common control (for *closely held entities*, the rules may also apply to entities that have a high level of common ownership)
- require adjustments to *adjustable values* of *equity and loan interests* that are held, directly or indirectly, in those entities, or require reductions of gains and losses on later realisation of the interests
- make the adjustments for these interests in each of their tax characters as applicable (eg capital asset, revenue asset, trading stock), and
- include safe harbours, exceptions and a choice of adjustment methodologies to limit compliance costs.

When does the measure start?
The rules ordinarily apply to indirect value shifts and *presumed indirect value shifts* that happen under *schemes* entered into on or after 1 July 2002.

As a transitional measure, the rules can also apply to schemes entered into on or after 27 June 2002 where:

- the *indirect value shifting time* for the indirect value shift or the presumed indirect value shift happens on or after 1 July 2002, and
- Divisions 138 and 139 do not apply to the scheme.

Section 727-1 of the *Income Tax (Transitional Provisions) Act 1997*

Example 4-1: Indirect value shift – transitional rules

The head company of the Seven Wonders Group (not a consolidated group), Pyramid Co, announces on 27 June 2002 that, as part of a group restructure, a member of the group, Hanging Gardens Co, will be transferring a number of assets to various group entities for less than market value consideration. However, although heads of agreement are drawn up and the assets to be transferred are specified, the actual transferees and transfer prices are not specified.

On 20 July 2002 Hanging Gardens Co transfers one of its assets (market value $1 million) to group member Colossus Co for $100,000.

There is an indirect value shift to which Division 727 could apply. The conditions for the application of the transitional rule are met as:

- there is a scheme entered into on or after 27 June 2002 (that is, it is entered into on 27 June 2002)
- there is no indirect value shift time for the indirect value shift before 1 July 2002 – the entity to which the benefits are to be provided (Colossus Co) and the benefits to be provided in return are not determined until 20 July 2002, and
- there is no trigger event under Division 138 that happens before 1 July 2002.

Why is this measure needed?

The comprehensive indirect value shifting rules:

- remove inconsistencies in the treatment of value shifting between different types of entities and different types of transactions
- ensure the taxation system treats value shifting within and outside consolidated groups consistently (the indirect value shifting rules apply only outside consolidation – consolidation has its own rules to address intragroup value shifting)
- remove anomalies and inconsistencies that in some cases lead to unfavourable outcomes for taxpayers under the old value shifting rules, and
- reduce compliance costs for taxpayers by introducing reasonable de minimis conditions and practical safe harbours.

The indirect value shifting rules replace previous value shifting rules in Divisions 138 and 139 of the ITAA 1997*.* A new law to old law comparison table is contained below (section 4.7).

Impacts on taxpayers

The new rules affect taxpayers in different ways where value is shifted between a *losing entity and a gaining entity.*

Entities affected by an indirect value shift will need to determine whether an exclusion or safe harbour applies so that the value shift has no consequences for them. These include:

- rules to exempt taxpayers eligible for the simplified tax system and those that meet the CGT small business maximum net asset value threshold from making adjustments under the rules
- automatic exclusions for most distributions made by entities, transfers of assets at cost, transfers of depreciating assets at book written down value and the provision of services at cost
- a method that enables value shifts of less than $500,000 that happened more than four years before an interest is realised to be disregarded, and

- rules covering value shifts involving services that ensure only very significant and observable indirect value shifts are taken into account.

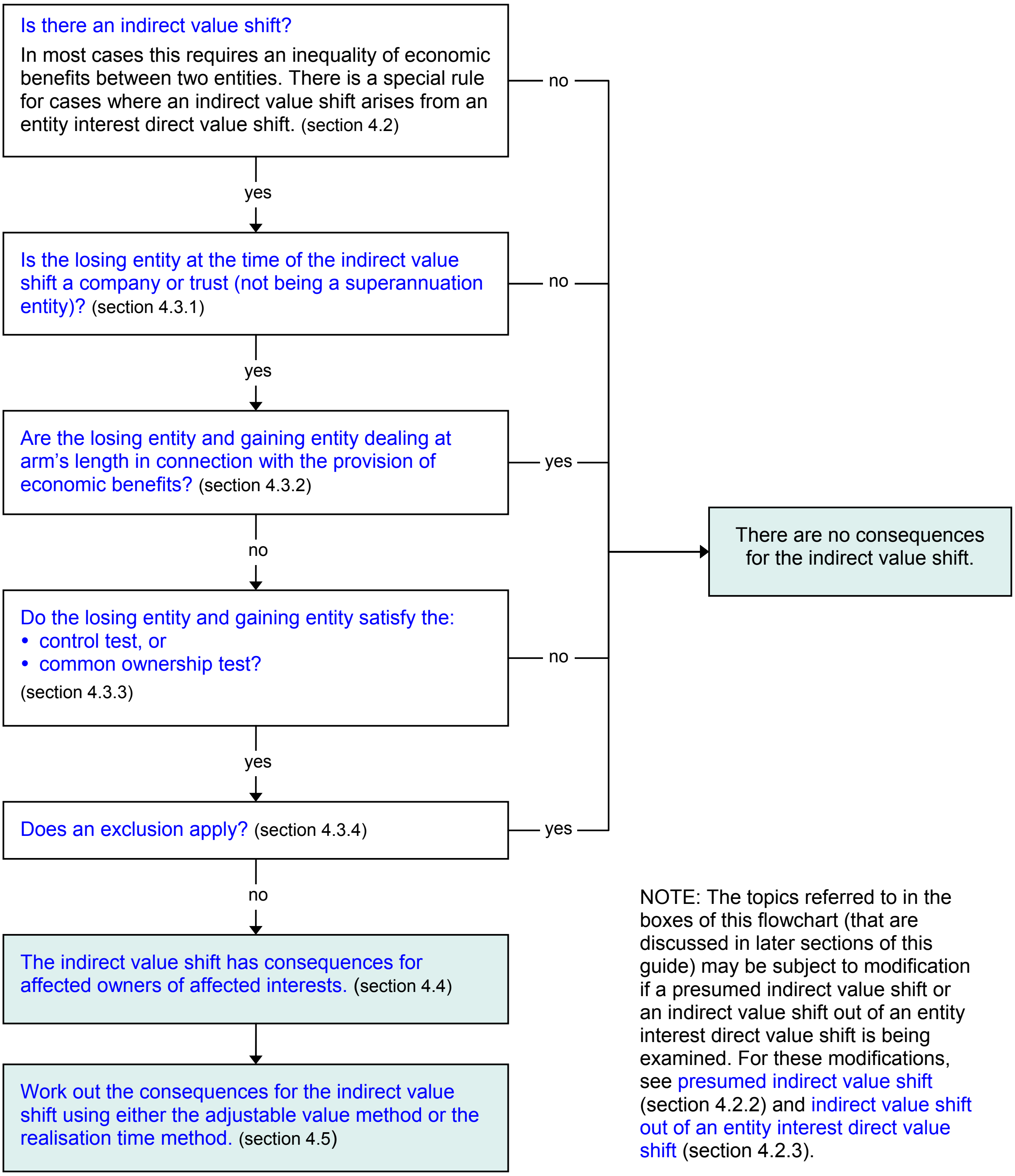
Where no exclusion or safe harbour applies, the following entities with direct or indirect interests in the losing entity or gaining entity may be required to make adjustments under the measure:

- controllers of the entities and their *associates* and, if the entities are closely held, common owners and their associates and entities who actively participate in a value shifting scheme
- such entities with interests in trusts need to determine the effect of transactions that shift value to and from the trusts – however this only applies to interests in a trust that are capable of having a market value, and
- such holders of interests that are trading stock or revenue assets may be required to make adjustments for these interests both as trading stock or revenue assets and for CGT purposes.

Are there any ways that the consequences of the rules can be avoided?
Dealings at arm's length or for market value do not have any consequences under the rules.

Where can I find the rules?
These rules can be found in Division 727 of the ITAA 1997.

Figure 4-1: Flowchart – indirect value shifts



NOTE: The topics referred to in the boxes of this flowchart (that are discussed in later sections of this guide) may be subject to modification if a presumed indirect value shift or an indirect value shift out of an entity interest direct value shift is being examined. For these modifications, see presumed indirect value shift (section 4.2.2) and indirect value shift out of an entity interest direct value shift (section 4.2.3).

4.2 IS THERE AN INDIRECT VALUE SHIFT?

There are three types of indirect value shifts for which there are consequences under the GVSR.

The basic case is where there is an unequal provision of economic benefits between parties not dealing at arm's length.

There are two less common cases that may have consequences:

- a presumed indirect value shift, where an interest in an entity is realised at a loss before all of the parameters of the indirect value shift are known, and
- an indirect value shift resulting from an entity interest direct value shift, that is, where interests are held in an entity that holds interests in another entity and those latter interests are the subject of an entity interest direct value shift.

4.2.1 Basic case

There will be an indirect value shift if the economic benefits provided (or to be provided) by one entity (the *losing entity*) to another entity (the *gaining entity*) under a scheme are of greater market value than the economic benefits (if any) provided by the other entity in return.

Some common examples of dealings between related entities that may cause an indirect value shift to happen are:

- the transfer of an asset for less than or greater than market value
- the provision of interest-free finance
- the forgiveness of valuable debt, and
- the provision of services other than on a commercial basis.

Note that, because of exceptions or safe harbours, there may be no consequences for the value shift.

The time at which the existence of an indirect value shift is to be determined (the indirect value shifting time) is the first time when all gaining and losing entities under the scheme are in existence and can be identified, and all of the economic benefits to be provided under the scheme can be identified and do not depend on the satisfaction of any contingency. In working this out, a contingency that is artificial, or is almost certain to be satisfied, is disregarded. An example may be a contingency whose satisfaction is under the control of one or more of the affected entities.

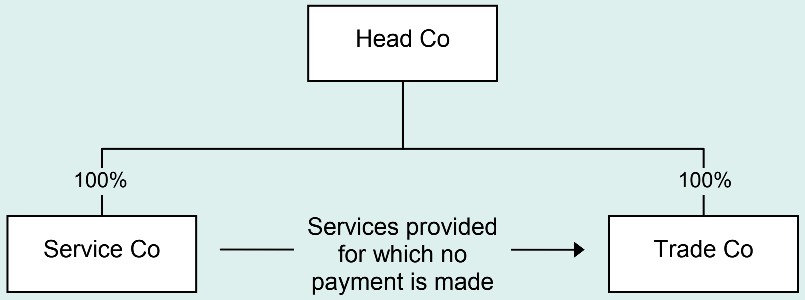
Economic benefits are benefits of a commercial or economic value to the recipient – for example, services performed for an entity's benefit, the right to have services performed, or property received or receivable by an entity. An economic benefit can be provided if it is allowed, conferred, given, granted or performed.

The amount of an indirect value shift is the excess of the market value of the economic benefits provided by the losing entity over the market value of any economic benefits provided by the gaining entity. There will not be an indirect value shift if parties provide market value consideration for the economic benefits that they receive.

There will be no consequences for an indirect value shift if the parties are dealing at arm's length (section 4.3.2).

Section 727-150

Example 4-2: Indirect value shift



Head Co owns 100% of Service Co and 100% of Trade Co, and the companies are not consolidated. Service Co agrees to provide services to Trade Co for no charge. The companies are not dealing at arm's length. The market value of the right to have the services performed is $1 million.

There is an indirect value shift for which Service Co is the losing entity and Trade Co the gaining entity. Service Co has provided an economic benefit (services, or the right to services) and has received no economic benefits in return.

The amount of the indirect value shift is $1 million.

Note: As the indirect value shifting rules look at an inequality of economic benefits under a scheme, there will also be consequences for 'overvalue' transfers. For example, if Trade Co had paid Service Co $2 million for the services, there would be an indirect value shift for which Trade Co would be the losing entity and Service Co the gaining entity.

Example 4-3: Indirect value shifting time – contingency almost certain to be satisfied

The B Unit Trust, formed to conduct a business venture for the B Group, requires low interest finance to meet working capital requirements.

In June 2004, B Co (a member of the B Group) lends $10 million interest free to the B Unit Trust. The term of the loan is one year. At the option of the borrower, the term of the loan can be extended to five years. Assume that the loan and option constitute a single scheme for value shifting purposes.

As a question of fact, also assume that the exercise of the option by the borrower is a contingency that is almost certain to be satisfied, so that the economic benefits to be provided under the scheme can be identified:

- the economic benefits provided by B Co to the B Unit Trust are the right to obtain and use the loan funds, and
- the economic benefit provided by the B Unit Trust to B Co is the promise to repay the loan principal in five years time.

The indirect value shift time happens in June 2004.

Note that if the contingency was not almost certain to be satisfied, there would not be an indirect value shifting time in June 2004, as there are some economic benefits that will be provided under the scheme if the contingency is met. There may however be a *presumed indirect value shift* if an interest in B Co is realised at a loss for tax purposes before the contingency is satisfied.

Indirect value shift – key points

To understand the practical application of the rules, it is important to remember that:

- there must be an unequal exchange of economic benefits, so a dealing at market value will ensure that the rules will not apply, and
- there are no consequences under the rules for arm's length dealings (section 4.3.2).

Market value of economic benefits

The market value of an economic benefit is a question of objective fact. You need to consider a hypothetical transaction in a notional market place and ask what payment would be agreed between willing but not anxious parties for the economic benefit that is sought to be valued. In working this out:

- the market value of a non-cash benefit is not affected by anything that prevents or restricts the conversion of the benefit into money
- appropriate assumptions can be made about the market in question (for example, a large volume of goods sold would be expected to attract a discount; each item would have a lower market value in such a situation than if it had been sold alone), and
- where there is no actual market for the economic benefit, one is assumed to exist.

Compliance cost saving rule for depreciating assets

The indirect value shifting measures include a rule that usually allows the *adjustable value* of a *depreciating asset* to be used as a proxy for its market value. This applies to assets that cost less than $1.5 million, and for which write-off is available under Division 40 of the ITAA 1997. If the value given to an asset in the books of an entity that transfers the asset is higher than the adjustable value, the book value is used instead.

The rule can also apply to groups of depreciating assets, as well as to a right to have a single depreciating asset, or a group of them, transferred. Both entities involved in the transfer must choose to use the rule.

The proxy is allowed only where it is reasonable to conclude that the actual market value of the asset is within 20% of the greater of its adjustable value and book value. Where a number of depreciating assets are transferred or are to be transferred, the total of their market values must be within 20% of the total of their adjustable values or book values (summing the greater value as applicable for each depreciating asset transferred).

Section 727-315

Example 4-4: Market valuation proxy for depreciating asset

In October 2004 Max Co sells a depreciating asset to its parent company Head Co for its adjustable value (tax written down value) of $800,000. At that time the value for the asset shown in the books of Max Co is $700,000.

The asset was purchased for $1.1 million in 2000, and the latest market valuation for the asset (obtained in 2002) was $900,000.

It is reasonable to assume that the actual market value of the asset is within 20% of the adjustable value.

Max Co and Head Co can jointly choose to use the adjustable value as a proxy for market value. If they do, there will be no indirect value shift for the transfer, as the asset has been transferred for its assumed market value (adjustable value).

Other exclusions for dealings not at market value

Not all non market value dealings are affected by the rules. As a further compliance cost saving measure, there are exclusions for small value shifts (ie for indirect value shifts of $50,000 or less) and for certain cases involving the provision of economic benefits for at least their cost and for not more than a commercially realistic price. (See general exclusions, section 4.3.4.)

4.2.2 Presumed indirect value shift

The existence of an indirect value shift is determined at the time (indirect value shifting time) when all of the parties to the scheme and all the economic benefits to be provided have been identified.

A value shifting scheme can affect the market value of interests in an entity before such a time. In particular, the market value of interests in a prospective losing entity (the entity that will become the losing entity when the indirect value shifting time happens) can be reduced.

Where this happens, losses can be realised when a direct or indirect *equity or loan interest* in the prospective losing entity is realised before the indirect value shifting time happens. Broadly, the rules dealing with presumed indirect value shifts prevent losses that result from the value shifting scheme – from the commencement of the scheme to the indirect value shifting time – being recognised for tax purposes when the interests are realised during this period.

Subsection 727-850(1)

As a presumed indirect value shift deals with a scheme, some of the parameters of which are not known, the ordinary threshold conditions (for example, about control or common ownership) are tested on a 'reasonable to conclude basis' given the information known about the prospective gaining entity. There are other provisions in Subdivision 727-K that modify the threshold conditions that must be satisfied before a presumed indirect value shift will have consequences. Assumptions are also allowed in applying the general exclusions and realisation time method exclusions.

You will need to refer to these provisions in conjunction with the general provisions to work out if there are consequences for a presumed indirect value shift.

Sections 727-855 and 727-860

Example 4-5: Presumed indirect value shift

Swann Co and the Head Trust are controlled by Marcel.

Swann Co enters into a 10-year agreement with the Head Trust to provide services at less than cost to any entity nominated by the Head Trust. As a factual matter, it is reasonable to conclude that the services would be provided to entities also controlled by Marcel.

The effect of entering into the agreement is that the interests in Swann Co (the prospective losing entity) decrease in value.

There will be no indirect value shifting time until the service recipient is nominated, as it will not be possible to identify the economic benefits or their recipient until that time.

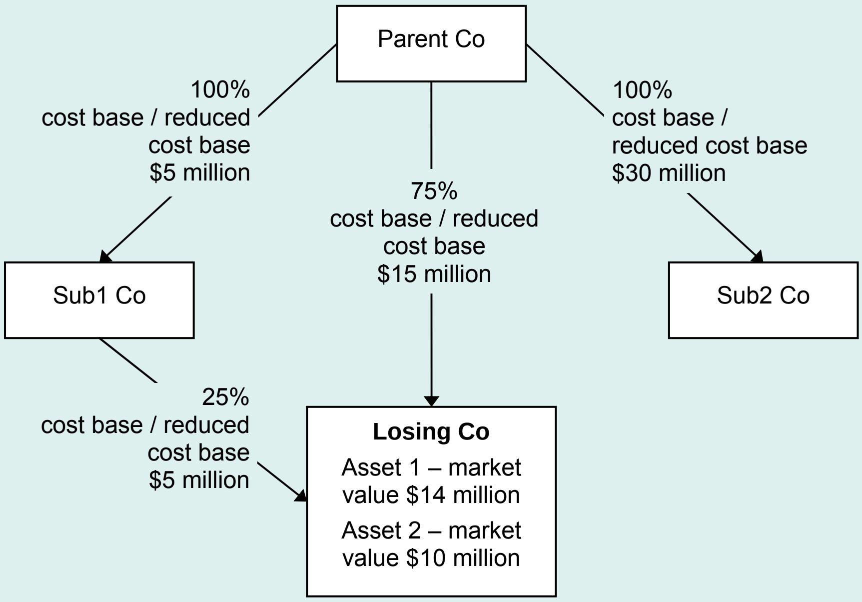
However, if Marcel realises his equity interests in Swann Co at a time before a service recipient is nominated, he may realise a loss that reflects, in part, the reduction in value that happens when the agreement is entered into. The presumed indirect value shifting rules would apply in such a case.

As at least one of the matters required to determine the consequences of the indirect value shift is unknown, it would not be possible to make full adjustments for the value shift (particularly if the *adjustable value method* were chosen).

The rules about presumed indirect value shifts reduce realised losses on interests by amounts that are reasonable with regard to the scheme's impact on the market value of the interests in the prospective losing company. No adjustments are made at that time to other (unrealised) interests in the prospective losing company (or to any interests in a prospective gaining entity, if known). However, the reductions made may be taken into account in determining other adjustments when the indirect value shifting time later happens.

Subdivision 727-K

Example 4-6: Presumed indirect value shift



Losing Co is a member of a 100% owned, but non-consolidated, group. In May 2004, it enters into an agreement with the parent entity to transfer an item of property for no consideration to another group company to be nominated by the parent entity at a specified date.

In August 2004, Parent Co would otherwise realise its interest in Losing Co at a loss of $7.5 million. No entity has been nominated by Parent Co to this point. At that time the market value of the property subject to the agreement is $14 million.

It is determined as a question of fact that the scheme has had the effect of reducing the market value of Parent Co's interest in Losing Co by $10.5 million.

In the circumstances, it will be appropriate to reduce the loss by $7.5 million to nil.

This reduction may be relevant to the determination of the adjustments in relation to interests in the gaining entity when the indirect value shifting time later happens for the scheme.

4.2.3 Indirect value shift resulting from an entity interest direct value shift

An entity interest direct value shift may affect the market value of interests held indirectly in the *target entity*, so that the market value of interests in a *down interest* holder may decrease in value, and the market value of interests in an *up interest* holder may increase in value.

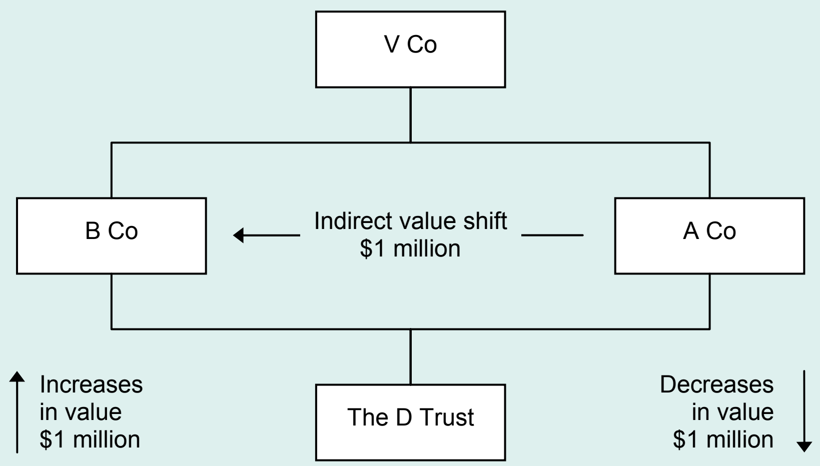
The basic indirect value shifting rules may not apply to these arrangements because there are no economic benefits as defined passing between the entity holding down interests and the entity holding up interests.

Subdivision 727-L contains special rules to ensure that appropriate indirect value shifting adjustments are made for these cases. Under these rules there can be an indirect value shift where there is an entity interest direct value shift that has consequences under the entity interest direct value shifting rules (or would have consequences apart from the rules about direct value shifts that reverse on their own terms). Note that if the $150,000 de minimis threshold is not met for the entity interest direct value shift, there will be no consequences under Subdivision 727-L, but if there would be an indirect value shift under the ordinary indirect value shifting rules and the concept of economic benefits as defined there, there may be consequences where the $50,000 threshold is exceeded.

The amount of the indirect value shift will often be equal to the total of the value shifted between the interests of those entities under the entity interest direct value shift.

Subdivision 727-L

Example 4-7: Indirect value shift resulting from an entity interest direct value shift



A Co and B Co hold all of the interests in the D Trust. V Co holds a controlling shareholding in A Co as well as in B Co. The entities are not consolidated. Under a scheme, the rights attaching to trust interests are varied (without causing a resettlement of the trust) with the result that B Co's interests in the D Trust increase in value and A Co's interests in the D Trust decrease in value.

The total value shifted under the entity interest direct value shifting scheme is $1 million.

The entity interest direct value shift will also affect the market values of V Co's shares in A Co and V Co's shares in B Co. To work out the indirect value shifting consequences for V Co's interests, the losing entity A Co is taken to have provided economic benefits with a market value of $1 million to the gaining entity B Co.

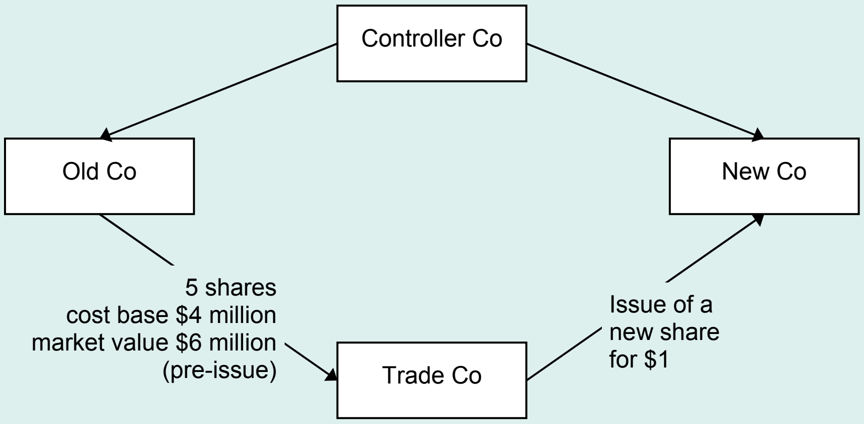
Other key points – indirect value shift out of entity interest direct value shift
Special rules apply to ensure that an indirect value shift resulting from an entity interest direct value shift is properly treated under the rules:

- the entities are treated as not dealing with each other at arm's length in relation to the benefits provided (that is, the non arm's length dealing requirement is taken to be satisfied)
- the benefits that are taken to be provided under the scheme are treated as not being *services* (ie no services-based exclusions or safe harbours can be applied), and

- in the case of the issue of new interests at a discount, there is the potential for the entity interest direct value shifting and the indirect value shifting rules to make adjustments in respect of the same interests. This potential duplication is avoided by allowing Division 727 to apply only in the manner specified by Subdivision 727-L. (See example 4-8.)

Subdivision 727-L

Example 4-8: Entity interest direct value shifting and indirect value shifting rules – anti-overlap relief



In 1995 Controller Co capitalises Old Co with $4 million. Old Co capitalises Trade Co with $4 million. Old Co has five shares with a total cost base of $4 million and a total current market value of $6 million.

In March 2003, Trade Co issues one share to New Co for nominal consideration (say $1).

There is an entity interest direct value shift, as the market value of Old Co's shares in Trade Co is reduced by almost $1 million to $5 million, and the new share is issued at a discount to market value of almost $1 million. Old Co's shares in Trade Co are down interests that will be subject to the adjustments and taxing events in the rules dealing with entity interest direct value shifts. See 'What are the consequences for the entity interest direct value shift?' (section 2.4).

There is also a potential indirect value shift under the basic rules. There is an unequal provision of economic benefits between commonly controlled entities – Trade Co (that has provided New Co with economic benefits having a market value of $1 million) and New Co (that has provided $1 in return). Old Co's interests in Trade Co are affected interests in the losing entity that would, apart from anti-overlap relief, be subject to adjustment under the rules.

This would be inappropriate, as Old Co's interests are also adjusted under the entity interest direct value shifting rules.

As outlined above, only Controller Co's interests in Old Co and its interests in New Co will be subject to adjustment under the indirect value shift resulting from the entity interest direct value shift. Subdivision 727-L ensures that, despite the provision of unequal economic benefits between Trade Co and New Co, no adjustments are required under the indirect value shifting rules for Old Co's interests in Trade Co.

4.3 THRESHOLD CONDITIONS

An indirect value shift under a scheme will not have consequences unless all of the following conditions are satisfied:

- the *losing entity* is a company or trust (other than a *superannuation entity*) at the *indirect value shifting time*
- the *losing entity and the gaining entity* did not deal at arm's length in the provision of at least one of the *economic benefits*
- the losing entity and gaining entity did satisfy the control test or the common ownership nexus test, and
- no exclusion applies.

Note that if the indirect value shift that is being examined is a presumed indirect value shift or an indirect value shift out of an entity interest direct value shift, the threshold conditions may be applied in a modified way. Please read in conjunction with 'Presumed indirect value shift' (section 4.2.2) or 'Indirect value shift resulting from an entity interest direct value shift' (section 4.2.3).

4.3.1 The losing entity is a company or trust at the time of the indirect value shift

This test must be satisfied at the *indirect value shifting time*. The *gaining entity* can be any type of entity, including a *superannuation entity*.

Paragraph 727-100(a)

Example 4-9: Losing entity is a company or trust at the time of the indirect value shift

The Henry Unit Trust agrees to provide valuable services to Henry, the controller of the trust. There is no charge for the services.

There is an indirect value shift for which the Henry Unit Trust is the losing entity, and the requirement that the losing entity is a company or trust at the time of the indirect value shift is satisfied. There will be consequences for the indirect value shift provided that the other threshold conditions are satisfied (for example, no exclusion applies).

Note that there is an exclusion that applies to an indirect value shift where the economic benefits provided by the losing entity consist of a distribution to the gaining entity (or the right to a distribution), where the whole of the distribution is taken into account for tax purposes.

4.3.2 There are no consequences for arm's length dealings

The application of the indirect value shifting rules can always be avoided by ensuring that entities deal with each other on an arm's length basis, even if strictly a value shift may have occurred because the market value of benefits provided and received are unequal.

It is necessary to show that all benefits that are provided in connection with the scheme from which the indirect value shift results have been provided on an arm's length dealing basis.

The question of whether entities have dealt with each other at arm's length is a question of fact to be decided in all circumstances. An important feature of the arm's length dealing tests is that it is the dealing that is examined, rather than the relationship between the parties. This means that related parties can deal at arm's length, and unrelated parties can engage in a non arm's length dealing.

Paragraph 727-100(b)

4.3.3 Control and common ownership tests

The range of entities that can be involved in the provision of *economic benefits* in connection with a scheme is large. However, there are only consequences if the losing and gaining entities are under the same control (or common ownership, if both entities are *closely held*).

The control and common ownership tests mean that the rules only impact on the interests of entities (including associates, and sometimes *active participants*) that can control or shape the events that give rise to the indirect value shift.

The control test will be satisfied if at some time during the *indirect value shifting period*:

- there is an *ultimate controller* of the losing entity that is also the ultimate controller of the gaining entity at that time or at another time during the indirect value shifting period
- the gaining entity is the ultimate controller of the losing entity, or
- the losing entity is the ultimate controller of the gaining entity.

The common ownership test will be satisfied if the losing entity and gaining entity have a common ownership nexus at some time (or at all times) during the indirect value shifting period.

For a discussion of the concepts relevant to the control and common ownership tests, see 'Control thresholds' (section 06).

Sections 727-105 and 727-110

4.3.4 General exclusions

Although indirect value shifts occur in a wide range of situations, the measure is targeted only at shifts that have particular significance to the tax system. Integrity outcomes are balanced against compliance costs, recognising that Part IVA can still apply in cases where a scheme of value shifting has the sole or dominant purpose of obtaining a tax benefit.

De minimis thresholds and specific exclusions, as well as the exemption of most small business taxpayers from the indirect value shifting measure (section 4.4), reflect this approach.

In some cases (such as the de minimis thresholds) entities may need to work out the approximate amount of the shift to determine whether an exception applies. In other cases it is the type of transaction or manner in which the transaction is conducted that attracts an exception. Consequently, compliance costs can be saved by referring to the exceptions when contemplating a transaction or before undertaking any detailed calculations.

There are general exclusions for:

- small value shifts – the amount of the indirect value shift does not exceed $50,000
- the transfer by the losing entity of an asset for at least the greatest of its cost base, its cost, or its market value just before an affected owner last acquired a direct or indirect equity interest in the losing entity
- in most cases, value shifted down a wholly owned chain of entities
- a distribution to the gaining entity (or the right to a distribution), where the whole of the distribution is taken into account for tax purposes, and
- services provided for at least their direct cost, and for not more than a commercially realistic price.

In addition to the general exclusions, there are:

- transitional exclusions for shifts that happen before the beginning of the losing entity's 2003–04 income year (for 30 June balancers), and
- realisation time method exclusions if the *realisation time method* is chosen to work out the consequences for the indirect value shift.

Transitional exclusions
Amendments to the law, contained in *Taxation Laws Amendment Act (No. 2) 2004*, provide that there are no consequences for most indirect value shifts involving services provided by the losing entity to the gaining entity that happen before:

- the beginning of a losing entity's 2003–04 income year, or
- if a losing entity's 2002–03 income year ends before 30 June 2003, the beginning of the losing entity's 2004–05 income year.

> Section 727-230 of the *Income Tax (Transitional Provisions) Act 1997*

The amendments are intended to:

- ease compliance costs for groups that make a choice to consolidate during the exclusion period, and
- allow entities that do not consolidate extra time to establish systems to identify and track significant service-related indirect value shifts for which adjustments may be required under the GVSR.

Part IVA may be applied if a significant service-related value shift happens under a scheme entered into during the period of transitional relief, and the dominant purpose of entering into that scheme is obtaining a tax benefit.

The amendments implement changes announced in the Minister for Revenue and Assistant Treasurer's media release C014/2003 (March 6, 2003). The amendment was passed by the Parliament on 8 March 2004 and received Royal Assent on 23 March 2004.

Realisation time method exclusions
If the *realisation time method* is chosen to work out the consequences for the indirect value shift, there are other exclusions that apply so that there are no consequences for the realisation of particular interests:

- the four-year/$500,000 exclusion (section 4.5.3) – the indirect value shift happens at least four years before a particular interest in the *losing entity* is realised, and the amount of the value shift is less than $500,000, and

- the realisation time method services exclusion for most services (section 4.5.3) – where the value shift is a 95% services indirect value shift and it is not a specially targeted services arrangement.

The de minimis threshold is met – the amount of the indirect value shift does not exceed $50,000
An indirect value shift is disregarded entirely if the amount of it does not exceed $50,000.

Section 727-215

Example 4-10: De minimis threshold

H Co transfers an asset (not being a *depreciating asset*) to B Co for $40,000. The market value of the asset is $20,000. H Co and B Co did not deal with each other at arm's length in relation to the transaction and both companies are controlled by Z Co.

There is an indirect value shift of $20,000 for which B Co is the *losing entity*. However, the de minimis exception is satisfied and there will be no consequences for the indirect value shift.

Note, however, that if H Co had transferred other assets to B Co in non arm's length, non market value dealings, under the same scheme the *economic benefits* provided and received in those transactions would also be relevant to working out the amount of the indirect value shift.

The de minimis exception does not apply if indirect value shifts happen under different schemes involving the same losing entity and, in all the circumstances, it can reasonably be concluded that the main reason or the only reason for the different schemes was to keep the indirect value shift for any one scheme under $50,000.

For example, using the situation in example 4-10, if H Co transferred two assets to B Co at different times and under different contracts, but within a short period of each other, then if this was not part of one scheme, the de minimis exclusion might not be available if the sole or main reason for H Co's approach was to bring the transactions within the exclusion.

The only economic benefit provided by the losing entity is the transfer of an asset for at least the greatest of its cost base, its cost, or its market value just before an affected owner last acquired a direct or indirect equity interest in the losing entity
The indirect value shifting rules remove inappropriate losses on interests that can arise when value is shifted from a *losing entity* under a scheme. There is very limited potential for losses on interests to be realised when an entity transfers an asset for an amount that is less than its market value, but is at least the greatest of its cost or cost base, or its market value just before an *affected owner* last acquired an interest.

The exclusion will only apply to a transfer or disposal (alienation) of an asset (or a right to have the asset transferred). It does not apply where a right is created over an asset (eg a licence or a lease). The exclusion does not extend to a situation where property is transferred for more than its market value. In these cases, there is likely to be an indirect value shift from the transferee to the transferor.

Section 727-220

Example 4-11: Transfer of asset by losing entity

In 2001 Hound Co is formed. Two shares are issued to Dino for $500,000 each. Hound Co acquires one asset for $1 million.

In 2003 Hound Co transfers the asset to the Dino Family Trust for $1 million (that is, equal to the greater of cost base or cost). The market value of the asset at the time of transfer is $1.6 million. At that time, the two shares in Hound Co are still held by Dino. No further shares have been issued or created. Dino controls Hound Co and the Dino Family Trust.

The indirect value shift of $600,000 that happens when the asset is transferred has no consequences under the rules.

Example 4-12: Transfer of asset by losing entity

In August 2004, Simple Co transfers its only asset for $30 million to a sister subsidiary under common control. The asset was acquired in May 2000 at cost / cost base of $30 million. The shareholdings in Simple Co in August 2004 are:

Shareholder	Cost base	Time of acquisition
Controller – 10 shares	$1.875 million per share	May 2000
Associate – six shares	$ 2.5 million per share	August 2002

The market value of the asset at August 2002 was $40 million.

The exclusion does not apply as the proceeds on disposal ($30 million) are less than the market value of the asset ($40 million) just before the time of the most recent purchase of shares by an affected owner.

It would be inappropriate for the exclusion to apply because, following the disposal of the asset, Associate could sell each of its shares for $1.875 million and realise a $625,000 loss.

Value is shifted down a wholly owned chain of entities

This exclusion applies where a *losing entity* wholly owns (directly or indirectly) the *gaining entity* for the *indirect value shift period* under which the value is shifted.

Generally, a value shift down a wholly owned chain of entities does not affect the market value of interests in a losing entity. The market value decrease for interests in the losing entity caused by the value shift is offset by an increase in the market value of interests in the gaining entity.

Section 727-260

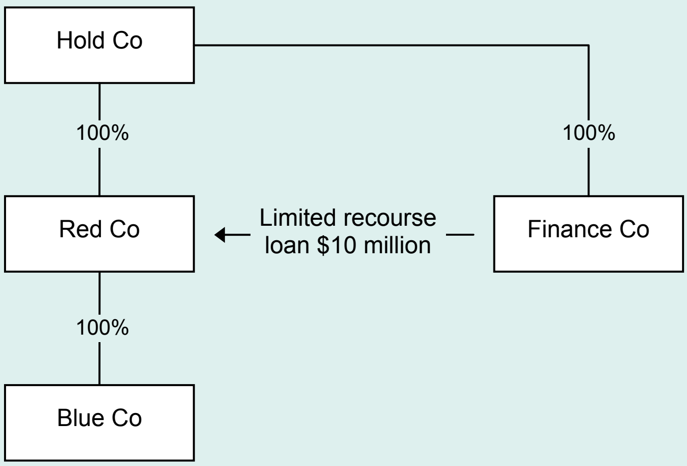
Example 4-13: Value shifted down a wholly owned chain of entities

Loss Co holds 100% of the shares in Sub Co and 60% of the shares in Gain Co. Sub Co holds the other 40% of the shares in Gain Co. The companies are not consolidated. Loss Co leases a property it holds to Gain Co for less than its market value.

The indirect value shift is disregarded. Although the value of the property to Loss Co has been reduced, there has been a corresponding increase in the value of its shareholdings in Sub Co and Gain Co and Sub Co's shareholding in Gain Co.

The exclusion does not apply if the value shift causes a *disaggregated attributable decrease* in the market value of a *loan interest* held by an *affected owner* in the losing entity or in an entity that holds a *primary equity interest* (directly or indirectly) in the losing entity. In broad terms, this means the exclusion does not apply if, as a result of the indirect value shift, the value of a loan to the losing entity, or a loan to an entity that has a direct or indirect equity interest in the losing entity, is less than it would otherwise have been. In determining whether the value of a loan is less, any change in the value due to factors other than the value shift is ignored.

Example 4-14: Value shifted down a wholly owned chain of entities



The companies in the above group are not consolidated. The assets of Red Co are asset A (market value $10 million) and a 100% shareholding in Blue Co. Finance Co has loaned $10 million to Red Co, limited in recourse to asset A or to proceeds from its sale while these are held by Red Co.

Red Co transfers asset A to Blue Co (with Finance Co's consent) in a non arm's length dealing for less than market value.

The effect of the transfer may be that there is a disaggregated attributable decrease in the market value of Finance Co's limited recourse loan to Red Co, as the pool of available assets to satisfy the loan obligation (the proceeds from the sale of asset A) has been reduced.

The exclusion will not apply.

The only economic benefit provided by the losing entity is a distribution to the gaining entity (or the right to a distribution) and the whole of the distribution is taken into account for tax purposes

The purpose of this exclusion is to prevent double counting. For example, the indirect value shifting rules strictly could apply if a company declares a dividend and pays an amount to a shareholder, as the shareholder (having no right to receive the dividend before it is declared) has provided no *economic benefits* in return for the right to receipt. The application of the measure would not be appropriate if the distribution is taken into account for tax purposes (for example, included in the shareholder's assessable or exempt income). The exclusion applies in such cases and the indirect value shift is disregarded.

Section 727-250

The distribution of income or capital must be made to a *gaining entity* because they hold primary equity interests in the *losing entity*. Primary equity interests are:

- for a losing entity that is a company, a share in the company or interest as a joint owner (including as tenant in common) in a share in a company, and
- for a losing entity that is a trust, an interest in trust income or trust capital, any other interest in the trust, or an interest as joint owner (including as tenant in common) of one of these interests.

A distribution is taken into account for tax purposes (and therefore may potentially be disregarded under this exception) in any of the following ways:

- an amount of the distribution is included in the gaining entity's assessable income or exempt income because of the distribution
- the distribution results in an adjustment to cost bases or reduced cost bases of some or all of the shares or other primary equity interests that the gaining entity has in the losing entity (eg CGT events E4 or G1)
- when working out the capital proceeds from a CGT event that happened to primary equity interests the gaining entity held in the losing entity (eg a distribution might be the consideration the losing entity provides in a buyback of its shares)
- in working out whether a gain or loss arises on the realisation of primary equity interests that the gaining entity held in the losing entity as revenue assets or as trading stock, or
- in working out a capital gain an entity makes from CGT event E4 or G1 happening during an income year to one or more of those primary equity interests.

Example 4-15: Distribution that is taken into account for tax purposes

A company declares a dividend in favour of its controlling shareholders. The dividend is fully included in the shareholders' assessable income.

Apart from the exclusion for distributions, the measure could inappropriately apply. The exclusion for distributions applies and the indirect value shift is disregarded.

Services exclusions

There are two safe harbour exclusions for value shifts involving the provision of services (or a right to services). They are the 'direct cost' exclusion and the 'commercially realistic price' exclusion. These apply in addition to the de minimis threshold. Services must comprise at least 95% of the total market value of the economic benefits provided under the scheme by the *losing entity* (for the direct cost exclusion) or by the *gaining entity* (for the commercially realistic price exclusion).

The *services* to which the safe harbours apply are listed in the indirect value shifting rules.

Section 727-240

The exclusions apply to:

- services provided by a losing entity to a gaining entity for at least the present value of the direct cost to the losing entity for providing the services, and
- services provided by a gaining entity to a losing entity for a price that does not exceed the total of present values of the direct costs and indirect costs of providing the service (or a reasonable allocation of them) plus a commercially realistic mark-up.

Services provided by a losing entity to a gaining entity for at least the direct cost to the losing entity of providing the services

The value of an entity that provides services may be affected if it offers those services to related parties for less than their market value. Its value may fall because its profits are not being maximised. The recipient of the services gains value through outlaying less than the true worth of the services. However, such transactions may not necessarily lead to losses for interest holders in the entity providing the services.

Therefore a direct cost exclusion disregards dealings of this kind providing the losing entity recovers at least the direct costs of providing the services.

The direct costs of providing a service are to be determined according to generally accepted accounting concepts. A direct cost is one that is reasonably capable of being traced to the provision of the services and can include a fixed or variable cost element.

Section 727-230

Example 4-16: Services provided by the losing entity for at least their direct cost

Figures Co is a service entity that provides actuarial and specialist investment advice to related and unrelated entities. The direct costs for Figures Co of providing these services include salary and wages, professional indemnity insurance, key person insurance premiums for Figures Co's two actuaries and a reasonable proportion of office costs referable to the provision of advice.

Example 4-17: Services provided by the losing entity for at least their direct cost

Guard Co is a provider of mobile and electronic security services for related and unrelated parties. Guard Co benchmarks at cost the contract price for services it provides the related parties. The direct costs include:

- the direct costs (eg labour and transport) of making specific call-outs, and of doing requested guard and dog surveillance, and
- the direct costs of inspecting security monitoring devices installed on the guarded premises.

So long as Guard Co recovers from the related parties the direct cost of providing services to them, and so much of the cost of all of the security services it provides as can reasonably be attributed to the services to related parties, any indirect value shift resulting from those dealings is disregarded.

Services provided by a gaining entity to a losing entity for a price that does not exceed the total of the present values of the direct costs and indirect costs of providing the service (or a reasonable allocation of them) plus a commercially realistic mark-up

An indirect value shift can result from an entity paying a price for services that is higher than their market value.

Entities entering into an arrangement for the provision of services may not be aware, however, that it could result in a value shift. For example, an entity contracting with related parties to provide services that it does not provide to arm's length parties may have difficulty establishing their market value. The commercially realistic price exclusion may help in such cases. Its effect is that an indirect value shift is disregarded if the price paid is no greater than the gaining entity's total costs of providing the services, plus a commercially realistic mark-up.

There are rules for determining a commercially realistic mark-up. If there is a mark-up (or range of mark-ups) on costs that would be an arm's length mark-up based on industry practice, then that mark-up (or if there is a range, the top of the range) provides the upper limit for working out the commercially realistic price under this safe harbour. In the absence of a specific mark-up based on industry practice, a standard mark-up of 10% is acceptable.

Section 727-235

Example 4-18: Services provided by a gaining entity for not more than a commercially realistic price

Superb Co is a member of a group of entities under common control. It provides branding and interior decoration advice to entities in the group that are in the hotel and resort trade. Superb Co has no dealings with independent parties, and does not deal with members of the hotel chain in an arm's length manner.

Superb Co calculates the direct costs and share of indirect costs it incurs in providing its services to be $120 per hour. A market rate equivalent mark-up on such costs for the type of advice that Superb Co provides is 17%. Thus, provided Superb Co does not charge related entities more than $140.40 per hour for its services, it can take advantage of this safe harbour.

Alternatively, it can benchmark its services at market value, in which case the safe harbour would not be required.

It is necessary under the services exclusions for the present value of the relevant costs to be worked out in determining the direct cost or commercially realistic price. The present value of the costs is determined using the discount rate under section 109N of the ITAA 1936.

Subsection 727-245(3)

Direct or indirect costs do not include:

- for the provider of a loan, the amount of the loan, and
- for an entity that leases or hires an asset, the cost of purchasing the asset or an interest in the asset to provide the services.

Subsection 727-245(2)

Example 4-19: Services provided by a gaining entity for not more than a commercially realistic price

The Service Trust will meet the equipment leasing requirements of Harvesting Co for the next five years, in return for which Harvesting Co will make a single prepayment.

To benchmark services at a commercially realistic price:

- the direct costs of making the service may include (but are not necessarily limited to):
  - the ongoing cost of finance for the purchase of the equipment and other facilities, and
  - the ongoing insurance cost for the equipment
- to the extent that these costs relate to a future time, a calculation of the present value of the costs using the discount rate under section 109N of the ITAA 1936 is required.

The purchase price for the equipment is not a direct or indirect cost for the provision of the leasing service.

Example 4-20: Services provided by a gaining entity for not more than a commercially realistic price

Service Co wants to benchmark services it provides to related entities at a commercially realistic price. The direct costs and indirect costs are listed in the table. The indirect value shifting time is in the 2004 income year – the benchmark interest rate for that year is 7%. The industry standard for mark-up of the types of services is 14%.

Year	Amount	Less discount calculation (discount rate x number of years)	Relevant cost
2007	$6.4 million	($6.4 million x 3 x 7%) ($1.344 million)	$5.056 million
2006	$1.6 million	($1.6 million x 2 x 7%) ($224,000)	$1.376 million
2005	$1.6 million	($1.6 million x 1 x 7%) ($112,000)	$1.488 million
Total cost for purposes of commercially realistic price exclusion			$7.920 million
Increased by the industry standard mark-up (14%)			$9.029 million

Therefore, provided not more than $9.029 million is charged for the services, the exclusion will apply. (For simplicity, the discount above is worked out not taking into account the effect of compounding, and this is an acceptable approach. Strictly, 'present value' requires discounting on a compounding basis and that methodology may always be used if desired.)

4.4 WHAT ENTITIES ARE AFFECTED BY THE RULES?

The consequences apply to *affected interests* that *affected owners* hold in the *losing or gaining entity* immediately before the *indirect value shifting time*.

Affected owners are generally:

- ultimate controllers of the losing and gaining entity
- entities that control the losing or gaining entity, and are controlled by an ultimate controller
- for closely held entities, ultimate owners that are common owners
- entities through which the ultimate owners' common ownership is traced, and
- active participants in the scheme (only if the losing and gaining entities are closely held).

Associates of these entities (other than associates of active participants) and the losing and gaining entities are also affected owners.

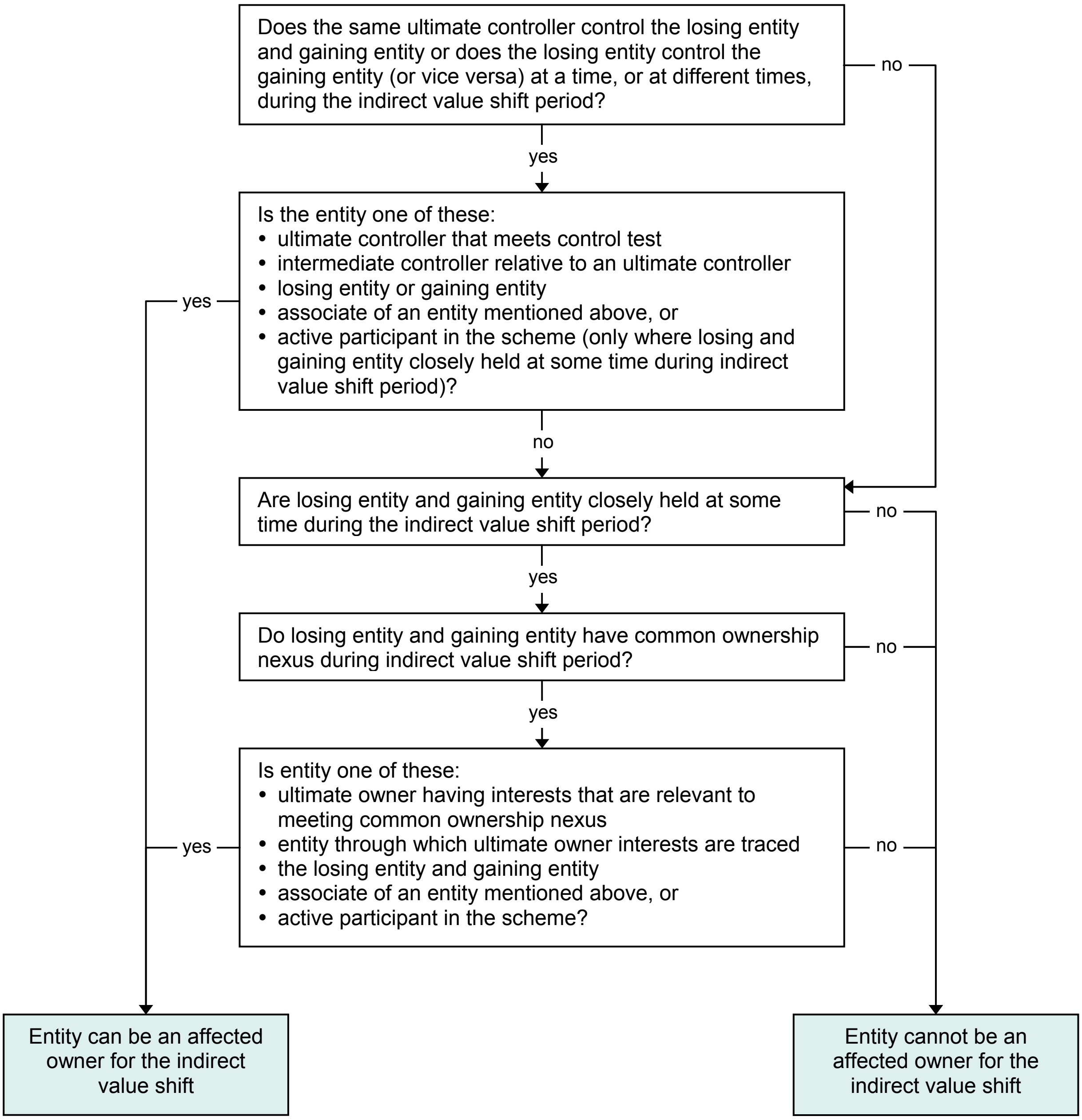
Section 727-530

Entities that are eligible to enter the *simplified tax system* or that meet the $5 million or less CGT small business maximum net asset value threshold do not have to make any indirect value shifting adjustments.

Section 727-470(2)

For a discussion of the concepts of control, common ownership and active participation, see 'Control thresholds' (section 06).

Figure 4-2: Affected owners for an indirect value shift scheme



Section 727-530

4.5 WORK OUT THE CONSEQUENCES FOR THE INDIRECT VALUE SHIFT

The consequences apply to affected owners' affected interests in the losing entity or gaining entity ('What entities are affected by the rules?', section 4.4). The consequences are limited to:

- reductions to any resulting loss on interests in the losing entity, and to gains on interests in the gaining entity, or
- changes to the *adjustable values* of direct and indirect *equity and loan interests* in the losing entity and in the gaining entity.

The adjustments apply to those affected interests held on capital account, as revenue assets or as trading stock.

4.5.1 What methods can be applied to make the adjustments?

There are two methods that can be applied to work out what adjustments (if any) are required for an indirect value shift:

- the realisation time method, and
- the adjustable value method.

Generally, if the realisation time method is used then any loss that is made on the realisation of an affected interest in the losing entity may be reduced. Any increased gain that is made on the realisation of an affected interest in the gaining entity may also be reduced.

Alternatively, if the adjustable value method is chosen, the adjustable values of interests in the losing entity may be reduced. The adjustable values of interests in the gaining entity may be increased. These adjustments are generally effected just before the time of the value shift. The adjustable value method is worked out on a *loss focused basis* unless a choice is made not to use that basis.

You need to make a choice to apply the adjustable value method and, if so, whether to apply the method on a *non loss focused basis*. If no choice is made to apply the adjustable value method, the realisation time method applies. For more information, see 'How to make a choice to apply the adjustable value method' (section 4.5.2).

Example 4-21: The methods in operation

In March 2004 there is an indirect value shift when Losing Co agrees to transfer an asset having a market value of $5 million to Gaining Co for no consideration in a non arm's length dealing. The arrangement is one that has consequences under the indirect value shifting rules.

There are two shareholders in Losing Co and Gaining Co, Annie and Bob. They are common owners of Losing Co and Gaining Co. There are no other affected owners or interests for the indirect value shift. The shareholdings of Annie and Bob are set out below:

	Cost base / reduced cost base of each share	Market value before the value shift	Market value after the value shift
Bob in Losing Co (one share acquired in 2001)	$3 million	$7 million	$4.5 million
Annie in Losing Co (one share acquired in 2003)	$7 million	$7 million	$4.5 million
Bob and Annie in Gaining Co (one share each – acquired when Gaining Co was formed in 2003)	$1 per share	$1 per share	$2.5 million per share

If the **realisation time method** is applied, then if Annie and Bob realise (eg sell) their shares they will need to make reductions to any losses made on the shares in Losing Co and any gains made on the shares in Gaining Co, to the extent that those losses and gains are reasonably attributable to the value shift. However gain reductions are capped to the level of loss reductions already made, so no gain reduction will be available if an interest in Gaining Co is realised before any interest in Losing Co is realised.

If the **adjustable value method** is applied on a **loss focused basis**, then the adjustable values (cost bases and reduced cost bases) of each of their shares are reduced by a calculated amount that is based on the market value impact of the shift, but the reduction amount for any interest is limited to the amount necessary to ensure that a loss would not be made on the interest if realised at the indirect value shift time. So no adjustment is made for Bob's share as its market value after the indirect value shifting time is greater than its reduced cost base. The cost base and reduced cost base of Annie's share in Losing Co would be reduced by $2.5 million to $4.5 million. The maximum increases for interests in the gaining entity are also based on the market value impact of the shift. However, these increases are capped by reference to the total of decreases for interests in the losing entity (that is, $2.5 million in this case). The adjustable values of both shares in Gaining Co would be increased by $1.25 million providing that amount was still reflected in the value of the shares when realised.

If the **adjustable value method** is applied on a **non loss focused basis**, then the adjustable values of Bob's share and Annie's share in Losing Co are reduced by a calculated amount that reflects the market value impact of the shift. The cost base and reduced cost base of each share is reduced by $2.5 million (that is, the cost base and reduced cost base of Annie's share is reduced to $4.5 million, and the cost base and reduced cost base of Bob's share is reduced to $0.5 million). The adjustable values of Bob's share and Annie's share in Gaining Co are all increased to reflect the market value impact of the shift (that is, by $2.5 million) on the same assumption above as to retained value. The increases are not capped.

As shown in example 4-21, the choice of adjustment method will need to be worked out on a case-by-case basis, as it depends on the particular circumstances of the case. For example, if Annie and Bob were intending to sell their interests in Gaining Co shortly after the *indirect value shifting time*, then the method that gives the greatest uplifts (the adjustable value method applied on a non loss focused basis) would likely be preferred.

The factors relevant to the choice (for example, how the adjustments are calculated, and the practical exclusions for some value shifts where the realisation time method is chosen) are discussed further in the sections on the realisation time method (section 4.5.3) and adjustable value method (section 4.5.4). Following the detailed discussion, there are further materials that may help in deciding which method is best for your particular circumstances:

- a summary table that compares the methods (section 4.5.6)
- a table that shows the main advantages and disadvantages for each method (section 4.5.5), and
- detailed examples that apply the calculation methods in a practical context (section 4.6).

4.5.2 How to make a choice to apply the adjustable value method

The *realisation time method* applies to determine the adjustments (if any) that are required where there is an indirect value shift. The realisation time method will apply if a choice has not been made to apply the *adjustable value method*.

In general, if the *common ownership nexus test* is met, the *ultimate owners* who have common ownership of the *losing and gaining entities* must make the choice jointly. Otherwise, if the ultimate controller test is met, a sole *ultimate controller* must make the choice. If there is more than one ultimate controller, the choice must be made by them jointly unless one is an ultimate controller in its own right (that is, disregarding interests of its associates), in which case that controller must make the choice.

A choice to adopt the adjustable value method need not be made until after the first realisation of an *affected interest* in the losing or gaining entity that happens at or after the time for the indirect value shift. Once the first realisation occurs, the choice must be made within two years from that time. Note that this two-year period allows an entity that had planned to adopt the realisation time method to change to the adjustable value method in respect of the shift. This may be of use, for example, if there was no realised loss or a small loss on the realisation and interests in the gaining entity are unexpectedly sold.

The choice binds all affected owners for the indirect value shift.

Section 727-550

Example 4-22: Choice to apply the adjustable value method

There is an indirect value shift in May 2004 when X Co agrees to provide services (having a market value of $3 million) to Y Co for no consideration. The entities are not dealing at arm's length.

The G Trust, the ultimate controller of X Co and Y Co, is the only affected interest holder for the scheme. The G Trust does not realise any interest in X Co or Y Co until April 2009, when an interest in the gaining entity Y Co is realised at a substantial gain.

The G Trust can make the choice to apply the adjustable value method, and the related choice not to apply that method on a loss focused basis, at any time up until April 2011 (that is, two years after the realisation of the first affected interest). If no choice is made by that time, the realisation time method will apply for the indirect value shift.

An entity that makes a choice to apply the adjustable value method is required to provide a notice to all entities that it knows to be affected owners for the indirect value shift about the content of the choice.

This notice must be provided within one month of the choice, or within such further period as the Commissioner allows.

A choice to work out adjustments on a *non loss focused basis* is made in the same way as the choice to apply the adjustable value method (that is, the same notice requirements apply and the choice binds all affected owners).

Section 727-555

4.5.3 Realisation time method – how it works

Where the realisation time method applies, consideration must be given to making adjustments whenever an *affected interest* in the *losing entity* is *realised at a loss for tax purposes*. Broadly speaking, adjustments are only required for a particular affected interest when it is first realised at or after the *indirect value shifting time*. A loss that arises is to be reduced by an amount that is reasonable, having regard to the extent to which the indirect value shift reduced the market value of the interest.

Similar principles are applied to determine whether a reduction to a gain is appropriate whenever an affected interest in the *gaining entity* is realised. The amount of reduction to a gain is also affected by the amounts of reductions to losses that have been made.

The key points for the realisation time method are:

- knowing there are practical exclusions for some value shifts under the realisation time method (p. 84)
- knowing what a reasonable reduction is for the purposes of the rules (see 'How are loss reductions worked out under the realisation time method?' on p. 95, and 'How are gain reductions worked out under the realisation time method?' on p. 97), and
- knowing the special rules that apply where an interest is held as trading stock or as a revenue asset, or is an interest in the losing entity and the gaining entity ('Special rules', p. 100).

Practical exclusions for some value shifts under the realisation time method

Some value shifts are not taken into account if the *realisation time method* is chosen. An indirect value shift has no consequences for the realisation of an *affected interest* where the realisation time method is applied if:

- the indirect value shift happens at least four years before that affected interest in the losing entity is realised, and the amount of the value shift is less than $500,000, or
- the value shift is a 95% services indirect value shift, and it is not a specially targeted value shift.

These exclusions apply in addition to the general exclusions previously discussed (section 4.3.4).

The indirect value shift happens at least four years before a particular interest in the losing entity is realised, and the amount of the value shift is less than $500,000 (the four-year $500,000 exclusion)

This exclusion is intended to limit compliance costs. Except in the case of value shifts of $500,000 or more, entities using the *realisation time method* will only need to keep records of transactions that shift value between them for approximately the same length of time as they would have to keep them for other tax purposes.

Paragraph 727-610(2)(d)

Example 4-23: Realisation time method – four-year/$500,000 exclusion

A Co holds 100% of the shares in B Co and in C Co (not a consolidated group). In 2004, B Co transfers an asset to C Co for less than its market value, resulting in an indirect value shift of $200,000. The arrangement is one that has consequences under the indirect value shifting rules. The adjustable value method is not chosen.

A Co sells 20% of the shares in the losing entity B Co in 2005, and another 40% in 2010.

If A Co makes a loss on the shares sold in 2005, then the realisation time method could reduce the loss made. No reduction would be required for a loss made on the shares sold in 2010.

Example 4-24: Realisation time method – four-year/$500,000 exclusion

Jack Pty Ltd and Jill Pty Ltd are members of a wholly owned group for which a choice to consolidate has not been made.

Jack Pty Ltd provides information technology services to Jill Pty Ltd in 2003. No charge is made for the services. There is an indirect value shift of $750,000. The arrangement is one that has consequences under the indirect value shifting rules. In 2008, a group member realises its interests in Jack Pty Ltd. No choice is made to apply the adjustable value method to make the value shifting adjustments.

The four-year exclusion will not apply, as the amount of the indirect value shift exceeds $500,000.

Loss reductions made on the sale of interests in a losing entity may be taken into account in working out gain reductions whenever interests in the *gaining entity* are realised (see 'Realisation time method – cap on uplifts', p. 98). Note that gains realised outside the four-year period may be reduced (subject to sufficient reductions having been made) notwithstanding that losses may not be reduced outside that period.

The value shift is a 95% services value shift and it is not a specially targeted value shift

The exclusion for a 95% services indirect value shift recognises that value shifts involving *services* are more likely to occur between related parties than value shifts involving property and that services are often more difficult to value than property. The exclusion ensures that the measure appropriately targets substantial value shifts involving services that are more readily observable. These are ones where there is a disqualifying condition (that is, a loss of the exclusion).

Section 727-700

What is a 95% services indirect value shift?

A 95% services indirect value shift is one where services (or a right to services) comprise at least 95% of the market value of the relevant *economic benefits* that are provided by the *losing entity*. Value shifts involving a mix of property and services from the perspective of the losing entity will usually not qualify for the exception under the *realisation time method*. Arrangements may be structured to take advantage of the exclusion, for example by separating out service agreements from transactions involving the provision of property or assets. Such structuring undertaken to take advantage of this exclusion would not be susceptible to application of the general anti-avoidance provisions in Part IVA.

Subsection 727-700(2)

Example 4-25: 95% services indirect value shift

GH Engineers provides engineering advice to the GH Building Group. The incidental property provided (eg paper copies of plans) is less than 5% of the market value of the economic benefits provided under the scheme. The realisation time method services exclusion may be available for the services provided by GH Engineers to the GH Group.

Example 4-26: 95% services indirect value shift

Atrium Co sells hydraulic lifting equipment to related entities in the transport industry for less than market value. The entities do not deal at arm's length. As part of the terms of sale, Atrium Co will install and repair and service equipment for the term of its effective life.

The market value of the economic benefits provided by Atrium Co is made up of transfer of property (30%) and services (70%). The realisation time method exclusions cannot apply to the services provided under the contract, as the services do not comprise at least 95% of the market value of the services provided under the contract.

Atrium Co can access the benefit of the realisation time method exclusions for the services by splitting the transfer of the property and the installation and service aspects into separate parts.

What are the disqualifying conditions?
There are four disqualifying conditions.

Disqualifying condition 1 – amount included in assessable income
The first disqualifying condition is where there is an adjustment to an income tax return lodged by the *losing entity or gaining entity* that relates to *services* and affects the taxable income or losses of one or both of those entities. An example is the exclusion of an amount included in a return because of a determination under the transfer pricing rules in the ITAA 1936. The amount included or excluded must be at least $100,000.

Section 727-705

Example 4-27: Realisation time method disqualifying condition – amount included in assessable income

In 2004 Subco 1 provides services to a sister subsidiary Subco 2 for no consideration. In the return of income for the 2004 income year, Subco 1 claims a deduction for costs in providing the services ($800,000). The arrangement is one that has consequences under the indirect value shifting rules.

Following an audit of Subco 1, the $800,000 deduction is denied (as there is no assessable income derived from the expenditure) and an amended assessment is issued. The disqualifying condition applies, and the realisation time method exclusion does not apply.

The other three disqualifying conditions apply where the value shifts relating to services provided by a losing entity meet certain thresholds. The thresholds are summarised in table 4-1.

Table 4-1: Realisation time method disqualifying conditions 2–4

The disqualifying condition applies (and the realisation time method exclusion does not apply to the value shift) if:	
The losing entity is:	**And this threshold is breached when an affected owner realises an interest (the realisation year):**
Any company or trust	Ongoing or recent service arrangement exclusion (p. 87) Total decrease in market value of *primary interests* in the losing entity held by *affected owners* just before the realisation, because of the value shift, together with predominantly services value shifts that happened in the realisation year or the preceding year, exceeds the greater of $100,000 and an amount (not exceeding $500,000) that is equal to 5% of the *adjustable values* of those interests.
A group service provider	Group service provider exclusion (p. 89) Total decrease in market value of primary interests in the losing entity held by affected owners just before the realisation, because of predominantly services value shifts, exceeds the greater of: • $500,000, and • the lesser of 5% of adjustable values of affected owners' interests and $5 million per year.
Not a group service provider	Non group service provider exclusion (p. 92) Total decrease in market value of primary interests in the losing entity held by affected owners just before the realisation, because of predominantly services value shifts, exceeds the greater of $500,000 and an amount (not exceeding $5 million) equal to 5% of the adjustable values of the primary interests .

Sections 727-710 to 727-720

Predominantly services indirect value shifts
In determining whether one of these disqualifying circumstances has arisen, it is sometimes necessary to take into account not only value shifts where the greater benefits comprise only services but also any indirect value shifts that were predominantly for services. 'Predominantly' means more than 50% in terms of value. In determining the thresholds, services value shifts for which there are no consequences, because one of the general exclusions (section 4.3.4) or the four year/$500,000 exclusion (p. 84) applies, are not taken into account.

Section 727-725

Disqualifying condition 2 – ongoing or recent value shifting arrangement
The second disqualifying condition involves an examination of the effect of recent value shifting arrangements that have affected the market values of interests held by *affected owners* in the *losing entity*.

The 95% services indirect value shifts to which the disqualifying condition can be applied are those that arise under recent arrangements for which some or all of the *services* have not yet been provided, or are provided in the income year of the *realisation event* or the income year before that year.

To determine if the threshold is breached, besides the 95% services indirect value shift, other arrangements by the losing entity must be taken into account that predominantly (more than 50%) involve services and for which some or all of the services have not yet been provided, or are provided in the income year of the realisation event or the income year before that year.

Section 727-710

Example 4-28: Ongoing or recent value shifting arrangement

The L Trust and B Co are controlled by Linda. The L Trust enters into an arrangement not at arm's length with B Co to provide services for the period 2004 to 2008. There is an indirect value shift under the arrangement for which there may be consequences under the indirect value shifting rules. Services, pursuant to the agreement, are provided during 2004 to 2008.

In 2007, Linda sells her interests in the L Trust and realises a loss of $1 million. No choice is made to apply the adjustable value method. The indirect value shift is not taken into account under the second disqualifying condition as some of the services have been provided earlier than the income year preceding the income year of realisation (that is, earlier than the 2006 income year).

The threshold for ongoing or recent value shifting arrangements is breached if it can be reasonably concluded that, as a result of the arrangement and other predominantly services indirect value shifts, the market value of affected owners' *primary interests* is reduced by at least:

- $100,000 if the total of *adjustable values* immediately before the realisation event is less than or equal to $2 million
- 5% of adjustable values if the total of adjustable values is greater than $2 million and less than or equal to $10 million, and
- $500,000 if that total is greater than $10 million.

Example 4-29: Realisation time method disqualifying conditions – ongoing or recent value shifting arrangement

A non-consolidated group sells off CL Co, a 100% controlled entity that has entered into an arrangement to provide services to the group at less than their full value. This arrangement depresses the total market value of the shares in CL Co by $300,000.

Immediately before the sale the total of adjustable values of shares held by affected owners in CL Co is $4 million. In this case the threshold for CL Co in respect of the recent value shifts is $200,000 (that is, 5% of $4 million). Because the effect of the value shift is more than this, adjustments may be required for losses that are incurred on the sale of interests in CL Co by the group.

Example 4-30: Realisation time method disqualifying conditions – ongoing or recent value shifting arrangement

The shareholders in Olive Co at May 2007 are as follows:

Name	% interest	Total adjustable values	Date of purchase
Hillary	75%	$750,000	2000
Ginger (Hillary's associate)	15%	$3 million	2002
Justin (unrelated and not an active participant)	10%	$2 million	2002

In May 2007, Ginger sells her shares for $2.6 million and realises a loss of $400,000. Up to that time, Olive Co has been the losing entity for a number of 95% services indirect value shifts involving non arm’s length dealings with other entities controlled by Hillary.

Indirect value shifting time	Amount of shift	Time when services are to be provided
June 2004	$75,000	2004–05 income year
June 2005	$25,000	2005–06 income year
June 2006	$175,000	2006–07 income year

No realisation time method adjustments are required for the loss that Ginger realises on her interests.

As the total of adjustable values of affected owner’s primary interests in the losing entity for the indirect value shifts is $3.75 million (Ginger $3 million and Hillary $750,000), the threshold for the services exclusion is 5% of those adjustable values: $187,500.

The only indirect value shift that is taken into account in working out if the threshold has been exceeded is the June 2006 indirect value shift ($175,000).

The indirect value shift in June 2004 is not taken into account as none of the services are to be provided in the income year when the interest is realised or the previous income year. The indirect value shift in June 2005 is not taken into account as it is absolutely excluded under the general de minimis exclusion (that is, it does not exceed $50,000).

Disqualifying condition 3 – group service provider

The third disqualifying condition involves the disposal of an interest in an entity at a loss after intragroup service arrangements have reduced the value of that interest.

The entity, the interests in which are disposed of at a loss, must satisfy the group service provider criterion at some time during the period the interests disposed of are owned. This criterion will be met at a particular time when the sole or dominant activity of the entity (*losing entity*) is the provision of services to one or more entities that are the *gaining entity* or an *affected owner* under an indirect value shift, or to an entity having the same *ultimate controller* as the service provider or the gaining entity, or a *common ownership nexus* with the service provider or the gaining entity.

The entity's predominantly services indirect value shifts over the whole period for which the affected owner owned the interests must be examined, except for value shifts that are:

- generally excluded (section 4.3.4), or
- less than $500,000 that happened at least four years before the interest is realised (section 4.5.3).

If the total decreases in market values of affected owners' primary interests in the group service provider, because of the value shifts taken into account, are more than the threshold, the disqualifying condition applies.

The threshold above which this third disqualifying condition applies starts at $500,000. It may be increased to the lesser of:

- 5% of the *adjustable values* of primary interests held by affected owners in the losing entity, or
- $5 million for each year for which the affected owner held the interest in the losing entity, subject to a $25 million maximum for periods of ownership over four years.

Section 727-715

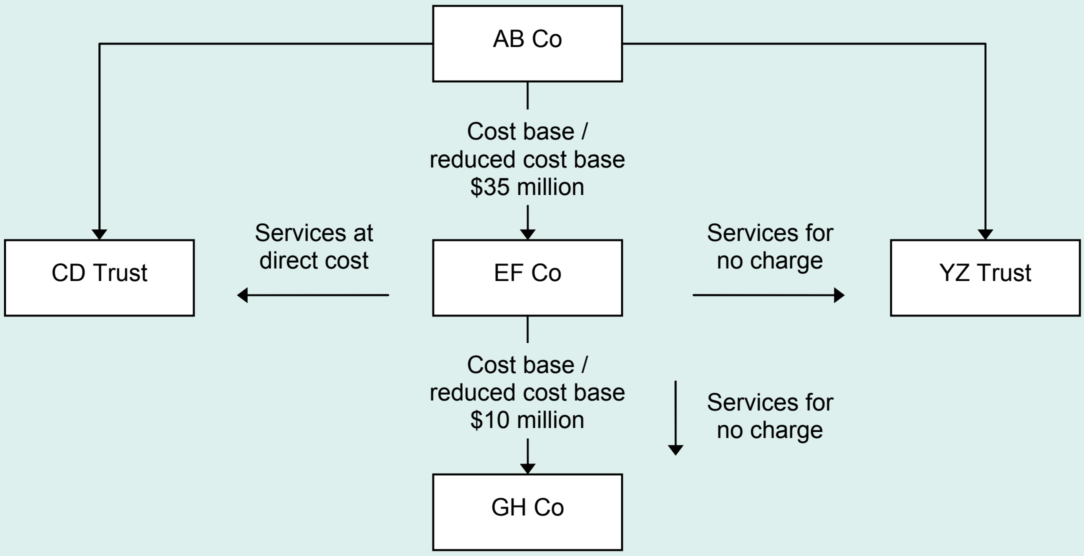
Example 4-31: Realisation time method disqualifying conditions – group service provider

H Co (a member of a non-consolidated group) is a group service provider involved in 95% services indirect value shifts. The total of adjustable values of affected interests in H Co total $160 million.

If an affected interest acquired on 6 September 2003 is realised on 6 September 2004, the relevant threshold is $5 million (that is, the lesser of 5% of the adjustable values held by affected owners (5% of $160 million equals $8 million) and $5 million per year).

If that interest were acquired instead on 6 September 2002, the relevant threshold would be $8 million (as the annualised $10 million threshold is higher).

Example 4-32: Realisation time method disqualifying conditions – group service provider



On 15 April 2005 AB Co registers EF Co with $35 million capital to be:

- the finance provider for the AB Group (not a consolidated group), and
- the holder of an investment ($10 million) in another group entity, GH Co.

As group financier, EF Co provides financial accommodation on a non arm's length basis:

- to the CD Trust at direct cost (cost of funds plus a reasonable proportion of the other costs of conducting business), and
- to GH Co and the YZ Trust interest free.

In the relevant period EF Co obtains all of its funds for on-lending at market value rates from unrelated parties. EF Co is sold on 23 August 2007 to an independent party for $15 million. A capital loss of $20 million would (but for the GVSR) be made on those shares. There has been no choice to apply the adjustable value method.

To work out whether an adjustment to the loss under the realisation time method is needed:

- the indirect value shifts that happen when EF Co provides financial accommodation to the CD Trust for its direct cost are disregarded under the general exclusion for services provided for at least their direct cost, and
- the indirect value shifts that happen when EF Co provides financial accommodation to GH Co are disregarded absolutely as the losing entity (EF Co) is providing financial accommodation to a 100% wholly owned subsidiary, and there are no loan interests in either EF Co or AB Co.

Therefore only the indirect value shifts that happen when interest-free finance is provided to the YZ Trust are relevant. These are:

Time of value shift	Amount of value shift
September 2005	$5 million
September 2006	$4 million
March 2007	$6.4 million

Applying the formula method for the group service provider disqualifying condition, the extent to which these predominantly services value shifts have reduced the market value of affected interests in the losing entity is compared to the thresholds.

It is reasonable to conclude that, as at the commencement of the income year in which the shares are realised (the 2008 income year), the predominantly services value shifts have reduced the market value of the interests in EF Co by $15.4 million.

This is greater than $500,000. It is also greater than the other threshold, the lesser of 5% of the adjustable values of primary interests in the losing entity owned by affected owners ($1.75 million) and the amount worked out under the table in paragraph 727-715(3)(b): $5,000,000 x 860 (days in the period) / 365 = $11,780,821.

The disqualifying condition applies. Adjustments will be required under the realisation time method.

Disqualifying condition 4 – non group service provider

The fourth disqualifying condition applies to service arrangements outside the ordinary course of an entity's business that reduce the value of the interests in the entity by at least $500,000. The entity must not be a group service provider.

The threshold is applied by determining the impact on the market value of *affected interests* in the *losing entity* caused by:

- the 95% services indirect value shift that happens under the arrangement, and
- other predominantly services indirect value shifts for which it is the losing entity (other than indirect value shifts of less than $500,000 that happened more than four years before the *realisation event*). These value shifts must happen under a different arrangement (scheme) from the 95% service indirect value shift, and it must be reasonable to conclude that the sole or main reason why they happened under a different arrangement was to prevent one of the disqualifying conditions from applying.

The threshold is breached if it can be concluded that the total market value of *affected owners*' *primary interests* in a losing entity is less than it would have been by at least:

- $500,000 if the total of the *adjustable values* of those primary interests immediately before the realisation event is less than or equal to $10 million
- 5% of adjustable values if the total is more than $10 million and less than or equal to $100 million, and
- $5 million if the total of those adjustable values is greater than $100 million.

Section 727-720

Example 4-33: Realisation time method disqualifying conditions – not a group service provider

The adjustable value of affected interests in losing entity D Co, not a group service provider, is $9 million. The threshold is $500,000. The adjustable value of affected interests in losing entity C Co, also not a group service provider, is $32 million. The threshold is $1.6 million.

Example 4-34: Realisation time method disqualifying conditions – not a group service provider

Josef holds all of the interests in and controls the Property Trust. The principal business activity of the trust is property investment. In 2006, Property Trust lends additional funds ($15 million) to Invest Co, another entity controlled by Josef. The Property Trust and Invest Co are not dealing at arm's length in relation to the loan transaction. As a result of the loan, there is an indirect value shift of $1.8 million involving services for which Property Trust is the losing entity. The arrangement is one that has consequences under the indirect value shifting rules. There are no other indirect value shifts for which Property Trust is the losing entity.

At a later time Josef's interests in Property Trust are to be cancelled. Immediately before that time:

- the total of the adjustable values of interests held by Josef (that were also held at the indirect value shift time) is $25 million, and
- it can reasonably be concluded that the market value of those interests has been reduced by $1.8 million because of the value shift.

The threshold is breached. As the total of adjustable values exceeds $10 million, but is less than $100 million, the appropriate threshold is 5% of adjustable values of affected owners' primary interests, ie $1.25 million. The effect of the indirect value shift on the market values of affected interests just before the time of the later realisation ($1.8 million) breaches this threshold.

Example 4-35: Realisation time method disqualifying conditions – not a group service provider

LBG Co (not a group service provider) has been the losing entity for indirect value shifts involving the provision of services and property for no consideration to different entities in the LBG group (not a consolidated group). The entities do not deal at arm's length in relation to the provision of services and property. It is not reasonable to conclude that the value shifts have happened under different schemes to obtain the benefit of the realisation time method services exclusions. The adjustable value method has not been chosen for any of the value shifts.

Year	Details of indirect value shifts
2003	$400,000 – 100% services
2005	$250,000 – property (30%) and services (70%)
2006	$1.2 million – 100% services

The shareholders in LBG Co are A Co (75% of shares – cost base $30 million) and B Co (25% of shares – cost base $10 million). A Co is the controller of LBG Co and the gaining entities for the indirect value shifts. B Co is not an affected owner for any of the value shifts, as it is not an associate of the controller, otherwise involved in the control framework, nor an active participant for any of the schemes.

In 2008, A Co proposes to sell its shares in LBG Co. A Co will make a loss on the disposal. To work out if the loss is reduced under the realisation time method:

- no adjustment is required for the $400,000 95% services indirect value shift in 2003 – the shift is absolutely excluded under the realisation time method as a value shift of less than $500,000 that happened more than four years before the realisation time
- adjustment will be required for the $250,000 indirect value shift in 2005 – the shift is not 95% or more services and does not qualify for any other general exclusion (section 4.3.4), and
- work out if the adjustment for the $1.2 million value shift in 2006 is required because a disqualifying condition has been met.

The threshold for the value shifts will be $1.5 million (5% of the adjustable values of affected owners' primary interests, that is, $30 million). As it is not reasonable to conclude that the value shifts in 2003 and 2005 have happened under different schemes to obtain the benefit of the realisation time method services exclusions, they are not taken into account to see if the threshold is breached. Adjustment is not required for the $1.2 million value shift in 2006. The value shift that happened in 2003 would not be aggregated in any case, because it is less than $500,000 and happened more than four years before the realisation time.

How are loss reductions worked out under the realisation time method?

When is a loss reduced on an interest in the losing entity?
Consideration must be given to making adjustments whenever an *affected interest* in the *losing entity* is *realised at a loss for tax purposes*. In general, it is only on the first occasion at or after the *indirect value shift time* when the interest is realised (realisation event) that an adjustment may be required. As discussed in the four-year/$500,000 exclusion (p. 84), adjustment is not required for an interest in the losing entity more than four years after the indirect value shifting time for an indirect value shift that is less than $500,000.

Subsection 727-610(2)

When applying the realisation time method, there is an exception to the rules about the first *realisation event* being the relevant one for an interest held as trading stock that is:

- purchased during the income year when the indirect value shifting time occurs, or was valued at cost at the commencement of that year, and
- valued at cost at the end of that year.

No loss attributable to the value shift arises at the end of the year. The relevant realisation event for that interest is, instead, the time at which the interest is sold, or the first occasion when it is valued at other than cost under Division 70 of the ITAA 1997.

Example 4-36: Realisation time method – application for trading stock

The Trading Trust holds an interest in Venture Co as trading stock. At the commencement of 2003–04, the interest is valued at its cost: $1 million. The market value of the interest is $1.1 million.

Venture Co is the losing entity for an indirect value shift in the 2003–04 year. The arrangement is one for which there are consequences under the rules, as the threshold conditions are satisfied and no exclusion applies. The shift causes the market value of Trading Trust's interest in Venture Co to decrease by $500,000 (from $ 1.1 million to $600,000).

If Trading Co values its interest at cost at the end of 2003–04, then no indirect value shift adjustments will be appropriate at that time. Adjustments may be required if a loss arises when the interest is sold, or at the first time at which the interest is valued at market selling value for Division 70 purposes.

There is an exception to the rule about when you realise a loss for tax purposes. An owner makes a loss for the purposes of the indirect value shifting rules, even if the loss is disregarded under the capital gains provisions because a CGT rollover applies or because Subdivision 170-D applies to the realisation. There are also different consequences for these cases. For more information, see special rules – application of realisation time method (p. 100).

What factors are taken into account in working out a reasonable reduction?

A loss that arises is to be reduced by an amount that is reasonable with regard to the extent to which the indirect value shift reduced the market value of the interest. A reasonable estimate may be made of the extent to which the indirect value shift reduced the market value of the interest. The following points are relevant:

- A reasonable reduction will reduce the loss by an amount necessary to ensure that it does not reflect any reduction in market value that resulted from the indirect value shift (example 4-37).
- The relevant criterion is the extent to which the indirect value shift has reduced the interest's market value. Where an interest is also an interest in the *gaining entity*, the adjustment will need to be worked out on a net basis taking into account the extent to which any increase in the market value of the interest relating to the value shift is still reflected in the market value at the time at which the interest is realised (example 4-38).
- Where the interest is held in more than one character (for example as a revenue asset and as a CGT asset) the Division applies to the interest in each of those characters.
- If the value of an interest is reduced by more than the amount of the loss, the loss is reduced to nil.

Subsection 727-610(4) and section 727-615

Example 4-37: Reductions under the realisation time method

Head Co owns five million shares in a wholly owned subsidiary, Transfer Co. The companies are not consolidated. The adjustable value of each share is $1 and the market value $0.95.

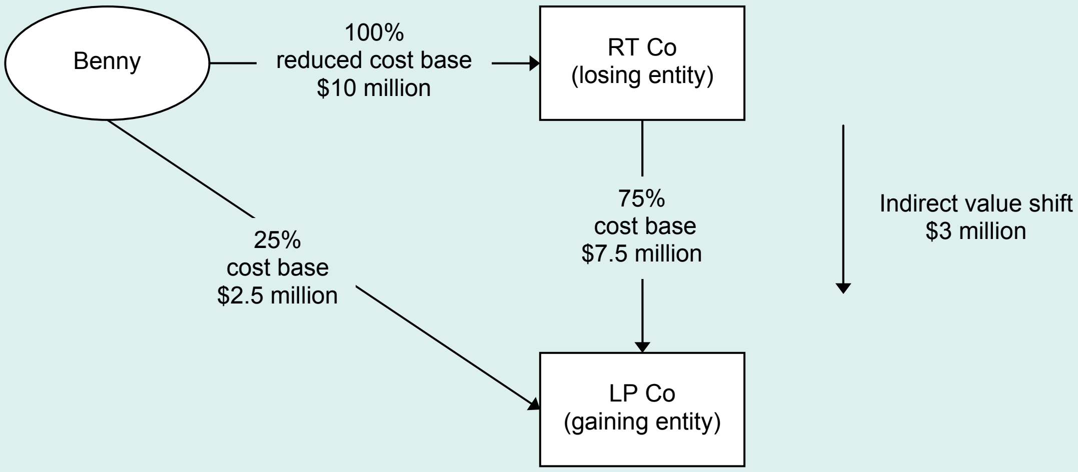
Transfer Co sells an asset with a cost base of $1.5 million and a market value of $2 million to an associate in return for $1 million cash in a non arm's length dealing. There is an indirect value shift for which there are consequences under the arrangement, as the threshold conditions are satisfied and no exclusion applies.

Following the transaction, the market value of Head Co's shares in Transfer Co is $0.75 a share.

Six months later Head Co sells three million shares in Transfer Co for $0.77 a share, realising a loss of $0.23 a share. $0.20 of this loss is attributable to the indirect value shift. A reasonable reduction under the realisation time method would be $0.20 a share, reducing Head Co's loss to $0.03 a share.

Example 4-38: Realisation time method – affected interest in gaining and losing entity

Benny is the controller of RT Co and LP Co. The capital structure of the group is as follows:



There is an indirect value shift ($3 million) in 2004–05 for which RT Co is the losing entity and LP Co is the gaining entity. There are consequences for the indirect value shift as the threshold conditions are satisfied. There is no exclusion that applies to allow Benny to disregard the effects of the shift.

The shift causes the market value of Benny's interests in RT Co to decrease in value from $8 million to $7.25 million. On the following day, Benny realises his interests in RT Co for that amount. Benny's interests in RT Co are direct equity interests in the losing entity, and indirect equity interests in the gaining entity.

To work out an appropriate reduction to the loss that Benny would realise for tax purposes, the net effect of the value shift is taken into account. That is, the loss is reduced by a reasonable amount having regard to the net reduction in value (that is, the loss is reduced by $0.75 million to $2 million).

Note that in working out the net decrease in value, an increase in value that is no longer reflected in the interest when it is realised is disregarded. For example, if before the time when Benny sold his interest in RT Co, the $3 million additional value in LP Co that resulted from the value shift is distributed to Benny directly or through RT Co, then the appropriate reduction is worked out by disregarding that increase (that is, on the basis that the net decrease is $3 million).

How are gain reductions worked out under the realisation time method?

The purpose of making adjustments to gains made on the realisation of interests in the *gaining entity* is to prevent the holder of the interests from being inappropriately assessed on a gain arising solely because of an indirect value shift, in circumstances where adjustments have been made to realised losses on interests in the *losing entity*. The key issues in working out an appropriate adjustment are:

- subject to the caps discussed below, any gain should be reduced by the amount that is reasonable having regard to the extent to which the value shift increased the market value of the interests

- a reasonable adjustment will take into account whether the value that is shifted to the gaining entity is still reflected in the value of an *affected interest* when it is later realised. For example, no adjustments will be appropriate where the increased value is removed before the *realisation event* by the entity making a distribution
- as with the rules about reductions for interests in the losing entity, the adjustments are made when an interest is realised at a gain when the first realisation event happens at or after the *indirect value shifting time* – there are exceptions for interests held as trading stock and where CGT rollover applies to the realisation of the interest
- where an interest in the gaining entity is also an interest in the losing entity, reductions are made on a net basis, and
- adjustments are only made in respect of interests in the gaining entity if it is a company or trust and not a *superannuation entity*.

Subsection 727-610(3) and section 727-620

Realisation time method – cap on uplifts
The amount of the adjustments that may be made in respect of an interest in the gaining entity is limited by reference to the adjustments that have been made on realisation of interests in the losing entity. This cap is necessary to prevent *affected owners* from benefiting from an adjustment in respect of interests in the gaining entity that is not matched (because of the *loss focused approach*) by reductions in interests in the losing entity. In applying the caps:

- the total adjustments made on realisation of interests in the gaining entity to a point in time must not exceed the total reductions made up until that time on realisation of interests in the losing entity – a formula method is applied to limit the reductions where there is an excess
- the total reductions for interests in the losing entity include adjustments made for realisation of interests before the indirect value shifting time (that is, under a presumed indirect value shift)
- where an interest realised in the losing entity or the gaining entity is a revenue asset, the greater of the reduction that applies to it as a revenue asset and the reduction that applies to it as a capital asset is used in applying the cap formula, and
- where an interest realised in the losing entity or gaining entity is held as trading stock, the reduction in that character is used in applying the cap formula.

Sections 727-625 and 727-630

Example 4-39: Realisation time method – cap on uplifts

Harry holds all of the units in the X Trust and the Y Trust, the losing entity and gaining entity respectively for an indirect value shift. The arrangement is one that has consequences under the rules, as the threshold conditions are satisfied and no exclusion applies.

Harry sells his units in the Y Trust before any of his interests in the X Trust have been realised at a loss. No adjustments can be made under the realisation time method.

Example 4-40: Realisation time method – cap on uplifts

There is an indirect value shift in May 2003 for which T Co is the losing entity and P Co is the gaining entity. The arrangement is one that has consequences under the rules, as the control and other thresholds are satisfied and no exception applies. The amount of the indirect value shift is $400,000.

In 2005, an affected interest in T Co is realised for a loss of $100,000. The loss is reduced to nil by a realisation time method adjustment. In 2009, another affected interest in T Co is realised at a loss. However, there is no realisation time method adjustment as the indirect value shift, being less than $500,000 ($400,000), happened more than four years before the time of the realisation event.

In 2010, a gain is made when an affected interest in P Co is realised. The reduction for the gain is limited to $100,000 – the total of realisation time method reductions for affected interests in the losing entity T Co.

Example 4-41: Realisation time method – cap on uplifts – presumed indirect value shifts

In May 2004, Head Co, the head company of the Big Group, determines that in December its subsidiary IP Co, the entity that holds the intellectual property rights for the group, is to transfer all of those rights to a sister subsidiary, New IP Co, at a discount to market value that will exceed 50%. Head Co will determine the exact discount percentage at the time of the transfer.

There is a presumed indirect value shift in July 2004 when Head Co realises 10% of its interests in IP Co and makes a capital loss of $1 million. There are consequences for the presumed indirect value shift, and the loss is reduced to nil.

There is an indirect value shift in December 2004 when Head Co determines that the transfer consideration payable by New IP Co is 30% of market value. The amount of the indirect value shift is $9 million. There are consequences for the indirect value shift as the threshold conditions are satisfied and no exception applies.

In January 2005, Head Co sells 20% of its interests in New IP Co and realises a capital gain of $1.8 million. The capital gain is wholly attributable to the indirect value shift. No other interests in the losing entity IP Co have been realised following the announcement of the scheme.

To work out if a cap applies for the gain reductions, the total of loss reductions will include the $1 million reduction made for the presumed indirect value shift in July 2004. The gain can be reduced to $800,000.

Example 4-42: Realisation time method – cap on uplifts – interests having different characters

Ron is the controller of L Co and B Co, the losing and gaining entities respectively for an indirect value shift. The arrangement is one that has consequences under the rules, as the threshold conditions are satisfied and no exclusion applies. He holds his interests in L Co on revenue account. There are no other holders of affected interests.

Ron sells his interests in L Co. The losses that would be realised on the happening of this realisation event (assume these to be a $1 million deduction and a $700,000 capital loss) are reduced to nil on the application of the realisation time method.

The cap for uplifts (gain reductions) if Ron later realises his interests in B Co will be $1 million, the greater of the realisation time method reductions.

Realisation time method – special rules

The realisation time method contains specific rules regarding the adjustments that are required where:

- a rollover applies to the realisation of the interest by an affected owner
- a loss that would otherwise be made on the realisation of an affected interest in the losing entity is deferred under Subdivision 170-D of the ITAA 1997, and
- affected interests are split or merged.

Realisation time method – what happens where CGT rollover applies to a realisation event?

The kind of adjustments that are contemplated by the realisation time method (involving reductions to losses and gains) will have no effect where a CGT rollover applies to the first *realisation event* that happens to an interest at or after the *indirect value shifting time*. For these cases, adjustments to *adjustable value* are made to the *affected interest* based on the reductions that would have been made apart from the rollover. The adjustments are set out in the following table.

Table 4-2: Adjustments to affected interests for which rollover applies

Affected interest for which rollover applies	Adjustment
Interest in *losing entity* where a loss on realisation is disregarded because a rollover applies.	Reduced cost base is reduced by the amount of the adjustment that would have applied to the loss (if there were no rollover).
Interest in *gaining entity* where a gain on realisation is disregarded because a rollover applies.	Cost base is increased by the amount of the adjustment that would have applied to the gain (if there were no rollover).

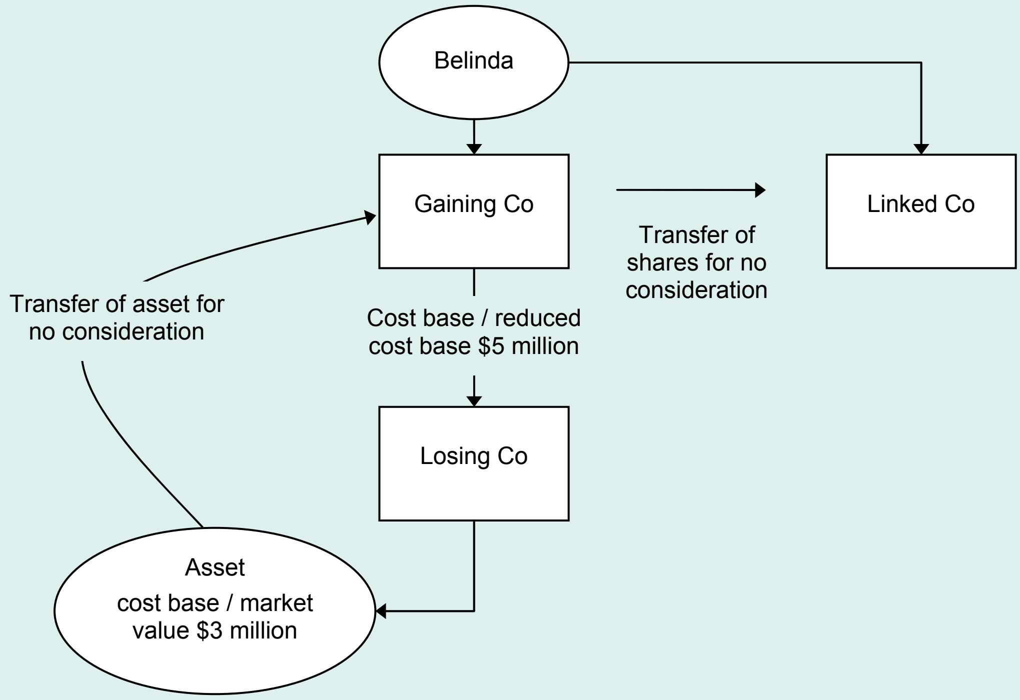
The adjustments take effect at the time of the CGT event for which there is rollover. This means that the realisation time method adjustment that would otherwise have been made to the loss or gain on realisation is reflected in the cost base or reduced cost base of the succeeding interest obtained under the rollover. For example, for the new owner (if it is a *same asset rollover*), or for the cost base or reduced cost base of a replacement asset (if it is a *replacement asset rollover*).

Section 727-645

Realisation time method – what happens where a loss made on the realisation of an affected interest in the losing entity is deferred under Subdivision 170-D of the ITAA 1997?

For the purposes of applying the realisation time method, an owner of an affected interest makes a loss on an interest in the losing entity even where the loss will be deferred under Subdivision 170-D of the ITAA 1997. Realisation time method adjustments are made, then any loss remaining after the application of the realisation time method reduction is deferred under those provisions.

Example 4-43: Realisation time method adjustments – interaction with Subdivision 170-D



Belinda is the controller of Gaining Co, a company she set up in 1992. Gaining Co capitalises Losing Co in 1994 with $5 million. From 1997 onwards, Losing Co has only held one asset (the cost base, reduced cost base and market value of which is $3 million).

In August 2004, Losing Co transfers the asset to Gaining Co, and no payment is received in return. The CGT rules deem market value capital proceeds to have been received by Losing Co in respect of the transfer, so no gain or loss is made on the transfer of the asset.

There is an indirect value shift under the arrangement for which there are consequences under the indirect value shifting rules. Losing Co is the losing entity. The amount of the indirect value shift is $3 million. No choice to apply the adjustable value method is made.

In October 2004, Gaining Co transfers its shares in Losing Co for no consideration to another entity controlled by Belinda, Linked Co. At that time Losing Co has no realised or unrealised losses.

To work out the consequences of the transfer of interests in Losing Co, Division 727 adjustments are made before the operation of Subdivision 170-D, so that:

- the loss that Gaining Co makes on the transfer of the shares is reduced under the realisation time method (ie by $3 million to $2 million), and
- the rules in Subdivision 170-D apply to the remaining $2 million loss so that it is deferred until a particular event happens (eg the membership interests in Losing Co, or Losing Co itself leaves the linked group).

Subsection 170-270(2)

Realisation time method – what happens when affected interests are split or merged?
Provisions are included for making adjustments where *equity or loan interests* are split or merged between the time of the value shift and the first realisation of an affected interest. Broadly, adjustments must be made to the new interests as if they had existed at the time of the value shift and had been affected by it to the same extent as the previous interests were affected.

Adjustments are made based on a reasonable proportion of the adjustments that would have been appropriate for the original interest, had it still existed, or based on the aggregate of the adjustments that would have been appropriate (in the case of merged interests).

Sections 727-635 and 727-640

Example 4-44: Realisation time method – adjustments – split

The market value for a share in the losing entity for an indirect value shift is reduced by $100. There is a share split, so that the interest becomes two separate interests (of equal value) without a realisation event happening.

The indirect value shift consequences are worked out for the split interests on the basis that they were in existence at the time of the shift, and there was a $50 reduction in the market value of each as a consequence of the shift.

4.5.4 Adjustable value method – how it works
You can choose to apply the adjustable value method to determine the adjustments (if any) that are required in respect of an indirect value shift.

Where the method applies, adjustments are made to *affected interests* immediately before the indirect value shift time. The adjustable value method uses the market value effects of an indirect value shift on interests held by *affected owners* to determine the adjustments. The adjustments to the adjustable values of affected interests in the *losing entity* can be made:
- on a loss focused basis, which requires that reductions be made to the *adjustable values* only if a loss would have arisen had the interest been realised at the indirect value shifting time, or
- on a non loss focused basis, where reductions are made in every case reflecting the effect of the indirect value shift on the market value of affected interests.

Similar principles apply to work out the uplifts for affected interests in the *gaining entity*. However, there is no gain focused basis for uplifts and they are generally made with regard to the total amount of reductions because of the indirect value shift.

The key issues for the adjustable value method are:
- how are reductions worked out under the adjustable value method
- how are uplifts worked out under the adjustable value method, and
- what special rules apply.

How are reductions worked out under the adjustable value method?
Whether adjustments are required under the adjustable value method, and their extent, may depend on whether a choice is made not to adopt the loss focused approach. Broadly, the loss focused approach only requires reductions to be made to the *adjustable values* of interests in the *losing entity*

if a loss would have arisen had the interest been realised at the *indirect value shifting time*. On a non loss focused basis, adjustments are made in every case reflecting the effect of the indirect value shift on the market value of *affected interests*.

Working out the adjustable value method adjustments involves:

- determining whether there is a disaggregated attributable decrease for the interest, and
- working out the reduction for an interest based on this amount.

A safeguard is included in case the reduction calculated is unreasonable in the circumstances, bearing in mind the objectives of the indirect value shift measures. In that event a smaller reduction may be substituted.

Subsection 727-770(6)

Disaggregated attributable decrease

The *disaggregated attributable decrease* is worked out by comparing two amounts – the notional resulting market value and the old market value.

The notional resulting market value is the market value of the interest at the *indirect value shifting time*, disregarding:

- market value effects from the time just before the scheme was entered into except effects reasonably attributable to the indirect value shift, and
- (if applicable) the effect that the indirect value shift had on the market value of the interest in its character as an interest in the *gaining entity*.

Subsections 727-775(2) and (3)

Example 4-45: Disaggregated attributable decrease – notional resulting market value

H Co holds 20 of the 60 shares on issue in P Co, the losing entity for an indirect value shift. The market value of these interests at the indirect value shifting time is $210,000 per share. The arrangement is one that has consequences under the rules, as the threshold conditions are satisfied and no exclusion applies.

From the commencement of the indirect value shifting scheme to the indirect value shifting time, the market value of H Co's interest in P Co is affected by the decrease in the market value of one of P Co's assets – from $1 million to $700,000 – which is unrelated to the indirect value shift scheme. This unrelated decrease reduces the market value of H Co's interest by $100,000.

This reduction is disregarded in working out the notional resulting market value, which is $310,000.

The old market value is the market value immediately before the time when the scheme was entered into or, if the owner began to own the interest after this time, the market value when that ownership started.

The disaggregated attributable decrease is the excess of old market value over notional resulting market value. If there is no excess, there is no disaggregated attributable decrease and the interest's adjustable value is not reduced because of the indirect value shift.

Adjustable value method reductions based on disaggregated attributable decrease

The reductions that are made depend on whether a choice is made *not* to adopt the loss focused approach. If this choice is not made, and so the loss focused method applies, adjustments are only made if the notional resulting market value is less than the adjustable value of a particular affected interest immediately before the indirect value shifting time (the old adjustable value). The adjustments for the loss focused approach are shown in table 4-3.

Table 4-3: Adjustments for loss focused approach

Circumstance	Adjustment to adjustable value
If notional resulting market value is less than old adjustable value, and old market value is less than old adjustable value.	Reduced by disaggregated attributable decrease.
If notional resulting market value is less than old adjustable value, and old market value is greater than or equal to old adjustable value.	Reduced to notional resulting market value.
Notional resulting market value is greater than or equal to the old adjustable value.	No adjustment.

Section 727-780

All of these adjustments are focused on preventing the indirect value shift from leading to the realisation of a loss for the affected interest. The adjustment in the first circumstance above preserves the loss that would be made apart from the indirect value shift.

If the choice is made not to adopt the loss focused method, adjustable values are reduced by the disaggregated attributable decrease. No account is taken of whether the indirect value shift might result in a loss on the realisation of the interests.

Subsection 727-770(5)

Example 4-46: Adjustable value method reductions – loss focused and non loss focused method compared

There is an indirect value shift from L Co to G Co. The arrangement is one that has consequences under the rules, as the threshold conditions are satisfied and no exclusion applies.

Before the start of the arrangement the market value of H Co's interests in L Co is $100,000 (reduced cost base $80,000). At the indirect value shifting time for the scheme, the market value of those interests is $50,000. The value shift under the arrangement is the sole cause for the reduction in value. H Co is an affected owner under the scheme.

Under the loss focused approach, the required reduction for H Co's interests in L Co is limited to $30,000, the excess of the reduced cost base of the interests over notional resulting market value. No adjustment is required for the unrealised gain element ($20,000) of the shift.

If the loss focused approach is not applied, the full adjustment ($50,000) is required for H Co's interests in L Co.

How are uplifts worked out under the adjustable value method?

If there has been a reduction to the *adjustable values* of interests in the *losing entity*, uplifts may be made to the adjustable values of interests in the *gaining entity*.

Calculating those uplifts involves working out:

- if there is a disaggregated attributable increase for the interest, and
- if a cap applies to reduce the uplift below the amount of the *disaggregated attributable increase* (apply caps to work out uplifts).

An uplift is only available to the extent that the value shifted is still reflected in the market value of the interest at a time when a later *realisation event* happens for the interest. This could not be demonstrated, for example, if a realisation event happens after the value shifted has been brought to account by the gaining entity as a profit and distributed to shareholders.

Subsections 727-830(3), 727-835(4) and 727-840(4)

As was the case for interests in the losing entity, a different adjustment may be substituted if the uplift worked out under the adjustable value method is unreasonable in the entity's particular circumstances, considering the object of the indirect value shifting measures. The substituted uplift (which can only be a greater one) must be worked out on a reasonable basis having regard to the object of the measures.

Subsection 727-800(7)

Disaggregated attributable increase

The first step in working out the uplift for a particular interest is working out if there is a disaggregated attributable increase. It is similar to the *disaggregated attributable decrease*. Two sums are compared – the notional resulting market value and the old market value.

The notional resulting market value is the market value of the interest at the *indirect value shifting time*, disregarding:

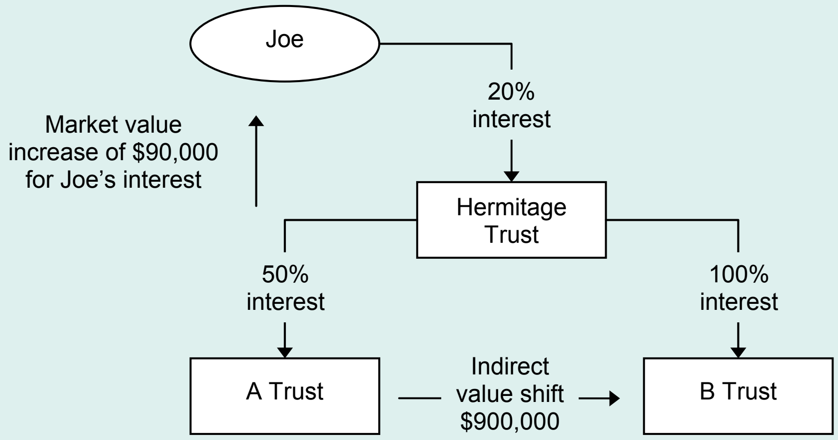
- market value effects from the time just before the scheme was entered into except effects reasonably attributable to the indirect value shift, and
- (if applicable) the effect that the indirect value shift had on the market value of the interest in its character as an interest in the losing entity.

The old market value is the market value immediately before the time when the scheme was entered into or, if the owner began to own the interest after this time, the market value when that ownership started.

The disaggregated attributable increase is the excess of notional resulting market value over old market value. If there is no excess, there is no disaggregated attributable increase and the interest's adjustable value is not uplifted because of the indirect value shift.

Section 727-805

Example 4-47: Disaggregated attributable increase



An indirect value shift happens when the A Trust transfers an asset (market value $1 million) to the B Trust in exchange for a payment of $100,000. The arrangement is one that has consequences under the rules, as the threshold conditions are satisfied and no exclusion applies.

Joe (an affected owner) holds one of the five units on issue in the Hermitage Trust, which in turn holds a 50% interest in the A Trust and all of the units in the B Trust.

The market value of Joe's interest at the indirect value shifting time is $90,000 greater than its market value immediately before the scheme was entered into. The disaggregated attributable increase is worked out by disregarding the impacts on the market value of the interest that are caused by it being an affected interest in the losing entity. It can reasonably be estimated that the reduction in value of the losing entity as a result of the indirect value shift reduced the market value of Joe's interest by $90,000.

The disaggregated attributable increase is therefore $180,000.

Apply caps to work out uplifts

There are two caps that are applied to work out the uplifts for an interest in the gaining entity:

- a scaling down formula that limits the uplifts to the extent that the decrease in market value of affected owners' interests in the losing entity is not adjusted for (eg because the *loss focused approach* is used to work out the decrease adjustments), and
- a further cap to ensure that no uplifts are available for interests in the gaining entity for value that is shifted from interests in the losing entity that are not affected interests.

Uplifts – adjustable value method – scaling down formula
Where the market value effects of the indirect value shift for affected interests in the losing entity are not fully adjusted for (that is, the total of reductions is less than the total of disaggregated attributable decreases), the uplift for a particular interest is reduced by the proportionate shortfall. A scaling down formula ensures that no uplifts are available for value that is shifted from affected interests when no reduction has been made. The formula to be applied is:

$$\text{Disaggregated attributable increase} \times \frac{\text{Total reductions for affected interests}}{\text{Total disaggregated attributable decreases}}$$

where

> ‘total reductions for affected interests’ means the total of all reductions made because of the indirect value shift to the adjustable values of affected owners' *equity and loan interests* in the losing entity and any reductions that have been made to losses in respect of the disposal of affected interests for the scheme before the indirect value shifting time (that is, reductions made under the *presumed indirect value shifting* rules)

and

> ‘total disaggregated attributable decreases’ means the total of all disaggregated attributable decreases that the indirect value shift has produced in the market values of all affected equity and loan interests (including indirect interests) in the losing entity. Where presumed indirect value shift reductions have been made to realised interests, the total disaggregated attributable decreases will also include the disaggregated attributable decreases the presumed indirect value shift produced in those realised interests.

This may be a significant cap, particularly when the loss focused method is applied to work out reductions.

Subsection 727-800(4) and section 727-810

Example 4-48: Uplifts – adjustable value method – scaling down formula

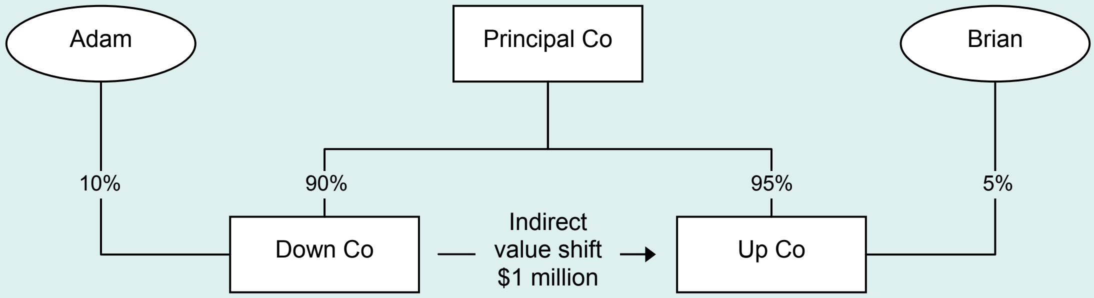
> The disaggregated attributable increase for a particular interest in the gaining entity is $1,480. The total reductions to adjustable values for affected interests is $18,000 and the total disaggregated attributable decreases is $50,000. No interests were realised before the indirect value shifting time. The maximum uplift that can be obtained on the interest in the gaining entity is
> $1,480 x $18,000 / $50,000 = $533.

Uplifts – adjustable value method – cap on excess uplifts
There is a further cap to prevent owners of affected interests in the gaining entity from obtaining uplifts for value that is shifted from interests in the losing entity that were not held by affected owners.

A cap is worked out based on the total amount of adjustments made to the adjustable values of direct affected interests held in the losing entity.

Subsection 727-800(6)

Example 4-49: Adjustable value method – cap on excess uplifts



There is an indirect value shift from Down Co to Up Co of $1 million. The arrangement is one that has consequences under the rules, as the threshold conditions are satisfied and no exclusion applies.

Principal Co owns 90% of the shares in Down Co and 95% of the shares in Up Co. The remaining 10% of the shares in Down Co and 5% of shares in Up Co are owned by Adam and Brian respectively, who are not associates of Principal Co or active participants in the scheme.

The value shift causes the value of Principal Co's interest in Down Co to fall by $900,000 and its interest in Up Co to increase in value by $950,000. Adam's shares in Down Co have lost $100,000 value, and this is reflected in an increase in value in both Principal Co's and Brian's interests in Up Co.

The uplift available for Principal Co's interests in Up Co is capped at 95% of $900,000 (that is, $855,000).

Special rules – adjustable value method

The adjustable value method contains special rules about the way that adjustments are made:

- where an *affected interest* in the *losing entity or gaining entity* is held as trading stock or as a revenue asset (adjustable value method – relevance of character of interest), and
- to an interest that is an affected interest in the gaining entity and the losing entity for the indirect value shift (adjustable value method – interest in losing and gaining entity).

Adjustable value method – relevance of character of interest

To meet the objectives of the indirect value shifting rules, the adjustable value method requires that adjustments to *adjustable values* of interests are made so that inappropriate losses and gains cannot be obtained on their later realisation.

The methods for making these adjustments differ depending on the character in which the interest is held. There are rules for CGT purposes, interests held as trading stock and interests held as revenue assets. Where an interest is held in more than one character, adjustments are made in each of those characters.

For **CGT** purposes, both the cost base and reduced cost base of the interest are reduced or uplifted immediately before the *indirect value shifting time* if the adjustable value method provides for the adjustable value to be reduced or uplifted. For the purpose of applying the method, the adjustable value of the interest is assumed to be both its reduced cost base and its cost base.

Section 727-830

For **trading stock**, the adjustable value is taken to be its value under Division 70 or, if none, its cost. Where a reduction or increase is calculated for an interest held as trading stock, the entity is treated as if it had sold the interest to someone else in the ordinary course of business for its adjustable value and afterwards bought back the interest for its increased or reduced adjustable value.

This prevents the entity from being treated as having sold the interest at its market value, and effectively adjusts the deduction available for the opening balance or cost under Division 70 of the ITAA 1997.

Section 727-835

Example 4-50: Adjustable value method – trading stock

An interest held by an entity that is trading stock with a value under Division 70 of $20,000 has its adjustable value reduced under the indirect value shifting rules by $5,000. The entity is taken to have disposed of the trading stock for $20,000 (and therefore it derives $20,000 assessable income, which offsets the deduction available in respect of the opening Division 70 value) and immediately after that time the trading stock is taken to be reacquired for a cost of $15,000.

For an interest held as a **revenue asset**, the total of the costs that would be taken into account in determining any profit or loss on disposal of the interest is treated as the interest's adjustable value. The same methodology as for trading stock (that is, a notional sale and repurchase) is used to effect the adjustable value method adjustment.

Section 727-840

Adjustable value method – interest in the losing entity and the gaining entity

If a value shift produces both a *disaggregated attributable decrease* and a *disaggregated attributable increase* in the interest, the adjustable value is not, in general, uplifted if it is not also reduced, and if it is reduced, is not uplifted by more than the reduction. The purpose of having this limitation is to deal with cases where an interest decreases and increases in value and, because the loss focused method limits the reductions to adjustable values, the total tax that would be payable on realisation of affected interests would be less, if a full uplift were allowed, than if the value shift had not happened.

Example 4-51: Uplifts – cap where uplift exceeds decrease adjustment

There is an indirect value shift up a wholly owned chain of entities. The arrangement is one that has consequences under the rules, as the threshold conditions are satisfied and no exclusion applies.

A particular affected interest (a direct equity interest in the gaining entity and an indirect equity interest in the losing entity) has a pre-shift adjustable value of $10 and a market value of $12. The indirect value shift increases the market value of the interest by $3, and decreases the market value of the interest by $3.

A choice is applied to use the adjustable value method on a loss focused basis. The adjustable value of the interest is reduced by $1 to the notional resulting market value ($9).

The adjustable value of the interest is not uplifted by more than $1. If it were uplifted by more than $1, part of the $2 gain that would have arisen had the interest been realised before the indirect value shift would be eliminated.

This limitation may be subject to variation if it does not produce a reasonable outcome in particular circumstances.

Subsection 727-800(5)

If an interest is both an interest in the gaining entity and an interest in the losing entity, the adjustable value method requires that you:

- work out the separate increase adjustments and decrease adjustments for the interest, and
- make an adjustment to adjustable value of the particular interest on a net basis.

Where the uplift is no longer available as the increase is not reflected in the market value of the interest, the net adjustment to adjustable value is worked out by disregarding that increase.

Subsections 727-830(5), 727-835(5) and 727-840(5)

Example 4-52: Adjustable value method – interest in a gaining entity and a losing entity

An interest is an affected interest in the losing entity and the gaining entity for an indirect value shift. An increase adjustment of $871 and a decrease of $1,000 are calculated for the interest under the adjustable value method. The adjustable value of the interest is reduced by $129.

4.5.5 Realisation time method and adjustable value method – main advantages and disadvantages

Having alternative methods for making indirect value shifting adjustments helps to limit compliance costs because affected parties can examine their circumstances and decide which method better suits them.

Table 4-4 identifies some advantages and disadvantages for using each method, together with examples of factors that may be relevant for choosing a method.

Table 4-4: Advantages and disadvantages of realisation time method and adjustable value method

Method	Advantages	Disadvantages
Realisation time method	• do not need to take into account value shifts of less than $500,000 that happen more than four years before an interest in the *losing entity* is realised • applies on a *loss focused basis* so that requirement to adjust is only triggered where a *loss is realised* on an interest in the losing entity • a wider range of exclusions apply to service-related value shifts	• reductions in gains are capped to the level of loss reductions, so no gain reduction is made where an interest in the *gaining entity* is realised before an interests in the losing entity • may realise a large gain on an interest in the gaining entity unexpectedly after having realised only a small loss on an interest in the losing entity (but note that a choice to use the *adjustable value method* may be made within two years from the time of the first realisation) • continuing record keeping requirements may be more extensive in some cases
Adjustable value method	• maximises options as it allows choice between a *loss focused method* and a *non loss focused method* • non loss focused method makes a full set of value shifting adjustments so that effect of the value shift is wholly removed from the system in one set of adjustments • allows certainty as reductions can be determined at the shift time; uplifts can be calculated subject to the requirement that the value shift is still reflected in the interest at the time of a later realisation • full uplifts are generally available where the non loss focused basis is applied • where either method is applied, there is no need to realise interests in losing entity to obtain benefit of uplifts on the realisation of interests in gaining entity	• choice and notice requirements • may end up making adjustments which do not have any practical effect (eg because an entity becomes a member of a consolidated group and the transitional method is chosen to determine the costs of that entity's assets for tax purposes) • market value effects may have to be determined for a large number and type of interests (eg potentially higher up-front compliance costs) • no access to realisation time method exclusions and safe harbours

Example 4-53: Basic example illustrating the advantages of the methods

Sell Co transfers an asset to Buy Co for less than market value. There is an inequality of economic benefits of $400,000. No interests in Sell Co or Buy Co are expected to be transferred in the four years following the sale.

The controller of the entities does not want to make indirect value shifting adjustments, and there is no prospect of any interest being sold at a loss. The realisation time method would be a better method for the parties, as the requirement to make adjustments would be excluded.

4.5.6 Summary comparison tables – how the methods work

Table 4-5 and table 4-6 summarise the basic operation of the adjustment methods.

Table 4-5: Basic operation of adjustment methods

	How reductions are worked out for affected interests in the losing entity		
	Realisation time method	**Adjustable value method (loss focused)**	**Adjustable value method**
How does the method apply to *affected interests* in the losing entity?	Consideration must be given to reducing a loss whenever an interest *is realised at a loss for tax purposes.*	Reductions are made on a disaggregated basis to the *adjustable values* of an interest if a loss would have arisen had the interest been realised at the *indirect value shifting time*.	Reductions are made on a disaggregated basis to adjustable values to reflect the effect of the value shift on the market value of the interests.
How are the reductions calculated?	A loss that arises when a particular affected interest in the losing entity is realised is reduced by the amount that is reasonable, having regard to the extent to which the indirect value shift reduced the market value of the interest. A reasonable estimate may be made of the extent to which the indirect value shift reduced the market value of the interest.	A reduction to adjustable value is only made if the market value of the interest after the value shift is less than its adjustable value. The amount of reduction is: • the *disaggregated attributable decrease* if the old market value of the interest is less than its adjustable value just before the shift (eg reduced cost base) – this will preserve any pre-existing loss on the interest, or • an amount sufficient to reduce adjustable value to the new market where the old market value exceeded or was equal to the adjustable value just before the shift – this stops a loss arising on a later sale of the interest due to the shift. There is no adjustment where the resulting market value equals or exceeds the pre-shift adjustable value.	The disaggregated attributable decrease is worked out for each interest (broadly, this is the decrease in market value caused by the value shift or, for an interest that is acquired after the commencement of the *indirect value shifting scheme*, the reduction in market value from that later time). The adjustable value of the interest is reduced by this amount.

Example 4-54: Indirect value shifting methods – comparative reductions

Y Co is the ultimate controller of Z Co, the losing entity for an indirect value shift. Immediately before the commencement of the indirect value shifting scheme, the market value of Y Co's interests in Z Co was $800,000. The combined cost bases or reduced cost bases of the interests was $650,000.

The market value of the interests at the indirect value shifting time is $400,000 (there are no market value impacts on the interests apart from the indirect value shift during the indirect shifting period).

If the adjustable value method is applied on a non loss focused basis, the adjustable values of Y Co's interests are reduced in total by $400,000 to $250,000 (that is, by the disaggregated attributable decrease of $400,000).

If the adjustable value method is applied on a loss focused basis, the adjustable value of Y Co's interest is reduced by only $250,000 to $400,000 (that is, the post-shift market value of $400,000 is less than the pre-shift adjustable value of $650,000 and the adjustable value is reduced to that amount).

If the realisation time method were applied, no adjustments would be made just before the indirect value shifting time. Adjustments would be required however if Y Co realised a loss for tax purposes when it sold its interests in Z Co. For example, if it sold them for $400,000, the loss it would otherwise make of $250,000 would be reduced to nil.

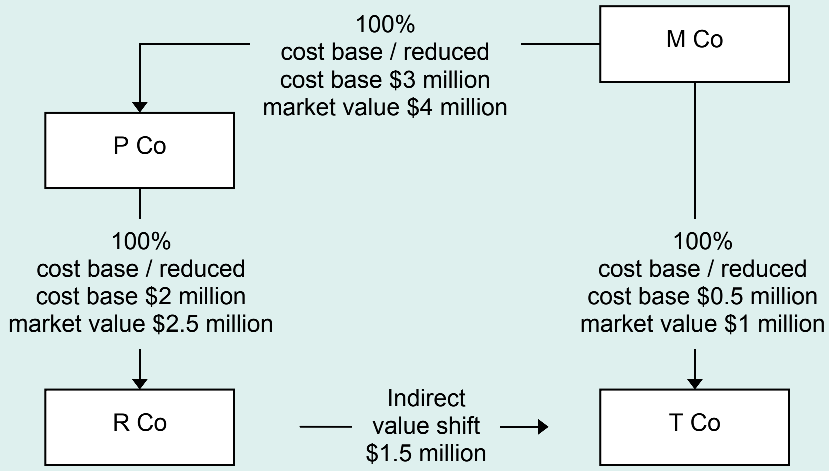
Table 4-6: Working out increases for affected interests in the gaining entity

	How increases are worked out for affected interests in the gaining entity	
	Realisation time method	**Adjustable value method**
How does the method apply to affected interests in the gaining entity?	Reduces gains made on the realisation of interests in the *gaining entity*.	Increases (uplifts) the adjustable values of affected interests in the gaining entity. The uplifts are made just before the indirect value shifting time. The same method for working out uplifts is applied whether or not a choice is made to use the non loss focused method for the decrease adjustments. However, the choice of that method may mean that larger uplifts are made.
How are the adjustments calculated?	As reasonable, having regard to the extent to which the value shift affected the market value.	A formula method is applied based on the *disaggregated attributable increase* for an interest (generally the increase in market value caused by the value shift or, for an interest that is acquired after the commencement of the indirect value shifting scheme, the increase in market value from that later time).
What are the caps on the increases?	Total adjustments made on realisation of affected interests in gaining entity to a point in time must not exceed the total reductions for losses made up to that time (including adjustments for realised interests affected by the presumed indirect value shifting rules). A formula method is used to scale down the increase adjustments if there is an excess. The increase in market value caused by the indirect value shift must still be reflected in the market value of the interest when it is realised.	(1) A scaling down formula (p. 107) applies to reduce the available uplift where, for affected interests in the losing entity, the total reductions (including loss reductions made for affected interests in a presumed indirect value shift for the scheme) are less than the total disaggregated attributable decreases. (2) A cap on excess uplifts (p. 107) applies to prevent uplifts from exceeding the decrease adjustments that are made under a scheme where, for example, interests in the losing entity are held by entities that are not *affected owners*. (3) A further cap on uplifts where an affected interest in the gaining entity is also an affected interest in the losing entity – generally an uplift that is greater than the decrease adjustment for the interest will not be allowed in these circumstances. (4) The increase in market value for which adjustment has been made must still be reflected in the market value of the interest when it is realised.

4.6 INDIRECT VALUE SHIFTING ADJUSTMENTS – DETAILED EXAMPLES

The following detailed examples compare the operation of the indirect value shifting adjustment methodologies in a practical context.

Example 4-55: Detailed example – TRPM group



Assume the following facts for an arrangement involving the TRPM Group (not a consolidated group):

- R Co is the *losing entity* and T Co the *gaining entity* for an indirect value shift that happens in the 2003 income year
- there are consequences for the indirect value shift as threshold conditions are satisfied and no exclusions (general exclusions or realisation time method exclusions) apply
- all of the *affected interests* for the indirect value shift (listed in the table below) are held on capital account, and
- at all times during the 2003 income year, R Co is not the originating company for a Subdivision 170-D deferred loss, and has no realised or unrealised losses (capital or otherwise).

The indirect value shift impacts on the affected interests in the following way:

Interest	Pre-shift adjustable value	Effect on market value
P Co in R Co (direct *primary equity* in losing entity)	$2 million	Reduced by $1.5 million (from $2.5 million to $1 million)
M Co in P Co (indirect primary equity in losing entity)	$3 million	Reduced by $1.5 million (from $4 million to $2.5 million)
M Co in T Co (direct primary equity in gaining entity)	$0.5 million	Increased by $1.5 million (from $1 million to $2.5 million)

The indirect value shifting adjustments that would be made under each method are as follows.

Realisation time method
If immediately after the *indirect value shifting time* P Co sells R Co, the loss of $1 million would be reduced to nil. If M Co sells P Co, the loss of $0.5 million would be reduced to nil.

Reductions to gains that are made when M Co sells T Co would not be available unless the sale happened after one or both of the events mentioned above. Where it does take place after these times, the total reductions to gains must not exceed the total of the reductions made for interests in the losing entity R Co.

Adjustable value method – non loss focused
The *disaggregated attributable decrease* for both of the interests in the losing entity is $1.5 million. The *adjustable values* of the interests would be reduced by this amount (that is, the cost base and reduced cost base of P Co's shares in R Co reduced to $0.5 million, and cost base and reduced cost base of M Co's shares in P Co reduced to $1.5 million).

The adjustable value of the interest held by M Co in T Co is increased by the *disaggregated attributable increase* (that is, cost base and reduced cost base uplifted by $1.5 million to $2 million).

Note that the adjustable value caps on increases have no practical application for this case as:

- the sum of the total reductions to affected interests in the losing entity equals the sum of the disaggregated attributable decreases for those interests, and
- all of the direct interests in the losing entity are:
  - held by *affected owners*, and
  - adjusted to the full extent of the disaggregated attributable decrease.

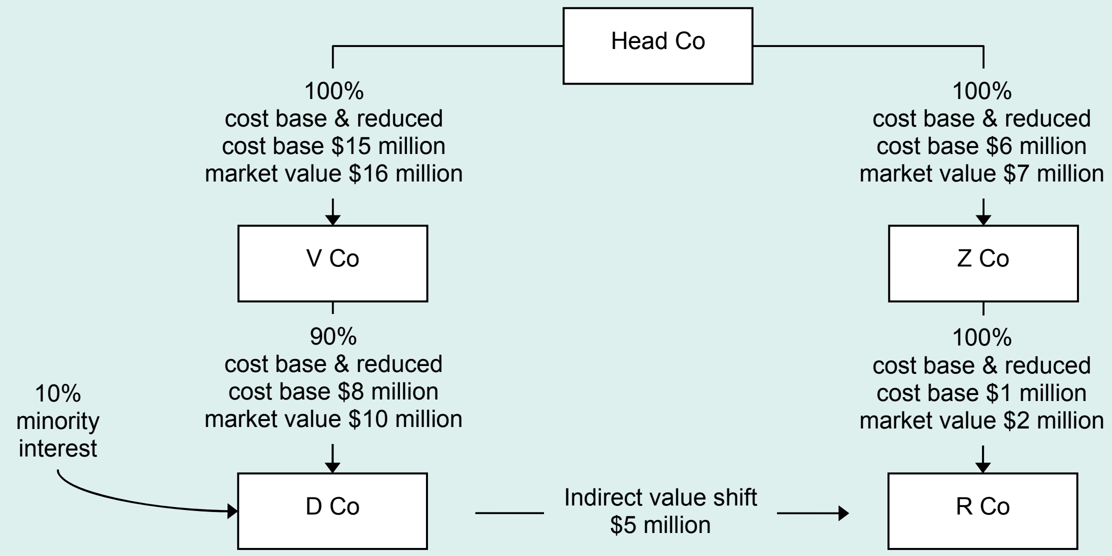
Adjustable value method – loss focused
The *notional resulting market values* for P Co's shares in R Co and M Co's shares in P Co are respectively $1 million and $2.5 million. These are less than the respective pre-shift adjustable values for the interests. Therefore, adjustable values are reduced to the notional resulting market values (that is, the cost base and reduced cost bases of P Co's shares in R Co are reduced by $1 million to $1 million, and the cost base and reduced cost base of M Co's shares in P Co are reduced by $0.5 million to $2.5 million).

The scaling down formula is applied as the first step in working out the uplifts for M Co's shares in T Co:

> $1.5 million (sum of disaggregated attributable increases) x $1.5 million (sum of reductions for affected owners' interests in losing entity) / $3 million (sum of disaggregated attributable decreases for affected interests in losing entity) = $0.75 million

The further cap does not apply as this sum does not exceed the total reductions for direct affected interests in the losing entity. Therefore, an uplift of $0.75 million to the cost base and reduced cost bases of M Co's shares in T Co will be available provided this is still reflected in the market value of the shares when they are realised.

Example 4-56: Detailed example – Head Co group



Assume the following facts for an arrangement involving a group of entities (that are not consolidated) controlled by Head Co:

- D Co is the *losing entity* and R Co the *gaining entity* for an indirect value shift of $5 million that happens in the 2003 income year
- there are consequences for the indirect value shift as threshold conditions are satisfied and no exclusions (general exclusions or *realisation time method* exclusions) apply
- all of the *affected interests* for the indirect value shift (listed in the table below) are held on capital account
- at all times from the commencement of the 2003 income year to the time immediately after Head Co sells its interests in V Co:
  - D Co is not the originating company for any Subdivision 170-D deferred losses, and has no realised or unrealised losses (capital or otherwise), and
  - V Co is not the originating company for any Subdivision 170-D deferred losses, has no realised losses (capital or otherwise), and no unrealised losses apart from an unrealised loss on its investment in D Co.

The effect of the shift on the affected interests is set out here:

Interest that is held by	Pre-shift adjustable value	Effect of value shift on market value
V Co in D Co (direct *primary equity* in losing entity)	$8 million	Reduced by $4.5 million (from $10 million to $5.5 million)
Head Co in V Co (indirect primary equity in losing entity)	$15 million	Reduced by $4.5 million (from $16 million to $11.5 million)
Z Co in R Co (direct primary equity in gaining entity)	$1 million	Increased by $ 5 million (from $2 million to $7 million)
Head Co in Z Co (indirect primary equity in gaining entity)	$6 million	Increased by $5 million (from $7 million to $12 million)

The indirect value shifting adjustments that would be made under each method are as follows.

Realisation time method

If, immediately after the *indirect value shifting time*, V Co sells its interests in D Co, the loss of $2.5 million would be reduced to nil. This $2.5 million loss reduction balance is available to reduce gains on interests in the gaining company.

For example, if Z Co later sells R Co, the $6 million gain realised would be reduced to $3.5 million. This would exhaust the loss reduction balance and no adjustment would be made to the gain realised when Head Co later sells Z Co ($6 million).

Note that in these circumstances if Head Co had sold its interests in V Co at a loss before the sale of Z Co, its $3.5 million loss on the sale would have been reduced to nil, creating a further loss reduction balance of $3.5 million which would allow the gain on interests in Z Co to be reduced to $2.5 million.

No gain reductions under the realisation time method would be available if the interests in Z Co or R Co are realised before any interest in the losing entity.

Adjustable value method – non loss focused

Interests in the losing entity

The *disaggregated attributable decrease* for both of the interests in the losing entity would be $4.5 million. The adjustable values of these interests will be reduced by this amount, that is, the cost base and reduced cost base of V Co's shares in D Co would be reduced to $3.5 million, and the cost base and reduced cost base of Head Co's shares in V Co would be reduced to $10.5 million.

Interests in the gaining entity

The first step in working out the uplifts for the interests in the gaining entity involves applying the scaling down formula.

For Z Co's shares in R Co:

> $5 million (*disaggregated attributable increase*) x $9 million (total reductions for affected interests in losing entity) / $9 million (total disaggregated attributable decreases) = $5 million

The formula applies in the same way (with the same result) for Head Co's shares in Z Co.

For each of the interests in the gaining entity, the available uplifts are then capped to the amount that Head Co or Z Co would receive on a successive distribution of the total amount of reductions made to direct primary equity interests in D Co. This is $4.5 million. The uplift is only available where the value shifted is still reflected in the interest when it is later realised.

Adjustable value method – loss focused

Interests in the losing entity

The *notional resulting market values* for V Co's shares in D Co and Head Co's shares in V Co are $5.5 million and $11.5 million respectively. These are less than the pre-shift adjustable values for the interests. Therefore, adjustable values are reduced to the notional resulting market values (that is, the cost base and reduced cost base of V Co's shares in D Co are reduced by $2.5 million to $5.5 million, and the cost base and reduced cost base of Head Co's shares in V Co are reduced by $3.5 million to $11.5 million).

Interests in the gaining entity

The first step in working out the increase adjustments for the interests in the gaining entity involves applying the scaling down formula.

For Z Co's shares in R Co:

> $5 million (disaggregated attributable increase) x $6 million (total reductions for affected interests in losing entity) / $9 million (total disaggregated attributable decreases) = $3.33 million.

The formula applies in the same way with the same result for Head Co's shares in Z Co.

For each of the interests in the gaining entity, the available uplifts are then capped to the amount that Head Co or Z Co would receive on a successive distribution of the total amount of reductions made to direct primary equity interests in D Co. This is $2.5 million. The uplift is only available where the value shifted is still reflected in the interest when it is later realised.

4.7 INDIRECT VALUE SHIFTING RULES – OLD LAW TO NEW LAW COMPARISON TABLE

Old law	New law
Applies only to 100% commonly owned companies (including group companies).	Applies to companies and trusts where control or common ownership tests are satisfied. Common ownership test applies only to *closely held entities*.
Only *equity and loan interests* on capital account covered.	Equity and loan interests on capital account, trading stock or revenue account are covered.
Applies only to asset transfers and creations, and debt forgiveness.	Applies to the full range of value shifting by way of provision of economic benefits.
If assets are transferred or created, applies only to transfers or creations at under value.	Also captures over-value transfers.
Inconsistent treatment of rights created at under value (eg rights subject to CGT event D1, leases and options).	Consistent treatment of creation of rights depending on economic substance rather than legal form.
No de minimis exclusion.	De minimis exclusions.
No exclusion for distributions.	Exclusion for distributions.
No arm's length dealing exclusion.	Arm's length dealing exclusion.
Safe harbours for depreciable asset transfers, grouped asset transfers and (generally) assets transferred for not less than cost base (or market value if less).	More extensive safe harbours than in current law, particularly for value shifts involving provision of *services*.

INTERACTION OF THE GVSR WITH CONSOLIDATION 05

Important consequential amendments relating to the interaction of the GVSR with the consolidation regime are contained in the *New Business Tax System (Consolidation and Other Measures) Act 2003*.

The main areas of GVSR interaction with consolidation, including a brief discussion of these amendments, are covered below.

The main areas are:

- the single entity rule, the entry history rule and extensions to the rule (section 5.1)
- tax cost setting on formation of, or entry to, a consolidated or multiple entry consolidated (MEC) group (section 5.2)
- the indirect value shifting rules as they apply to consolidated and multiple entry consolidated groups during consolidation (section 5.3), and
- the loss reduction method, which may supplant the regime in some instances (section 5.4).

5.1 SINGLE ENTITY RULE – EFFECT

The effect of the *single entity rule* is that intragroup value shifts are disregarded for the purposes of determining the tax liability or amount of losses of the head company. Value shifting integrity is generally achieved within a consolidated or *MEC group* by the combined operation of the single entity rule and tax cost setting (including pooling) rules. For example, the tax cost setting reconstruction rules for membership interests and loans when an entity leaves a consolidated group have regard to assets that leave with the entity (and therefore disregard assets that may have left the entity in a value shifting transaction).

Broadly speaking, Divisions 723, 725 and 727 have no impact for group members in respect of intragroup value shifts dealt with by these Divisions.

5.1.1 Direct value shifting – rights

The created rights direct value shifting rules in Division 723 have no application, because of the single entity rule, where rights are created within consolidated or MEC groups. The implications of such transactions are determined under consolidation rules.

5.1.2 Direct value shifting – entity interests

The single entity rule ensures that the entity interest direct value shifting rules in Division 725 are not required to address intragroup direct value shifts on *equity or loan interests* of one group member in another. Reconstruction rules on leaving ensure appropriate outcomes.

For Division 725 purposes, the consolidated or MEC group is treated as a single entity (eg where a group member is affected by an entity interest direct value shift in respect of an interest in a non-group associate).

5.1.3 Indirect value shifting – entity interests

The single entity and *entry history rules* are extended with the effect that, for example, where a subsidiary member engages in a non arm's length dealing with a non-group *associate* shifting value to it, the head company is taken to have provided the benefits (and received any in return).

The indirect value shifting rules are not needed for intragroup value shifts where the cost reconstruction (including pooling) rules address any impacts of the shifts.

5.1.4 Pre-consolidation effects

Note, however, that the effects of certain value shifts entered into before consolidation may have impacts under the entry history rule (eg for created rights direct value shifting) or for tax cost setting purposes (as discussed below).

5.1.5 Extended application of the single entity rule

Prior to the introduction of the amendments in the *New Business Tax System (Consolidation and Other Measures) Act 2003*, the single entity rule was limited in application to the head company and its subsidiaries. From their perspectives, for certain purposes the group comprises a single taxpayer (the head company) of which the subsidiary members effectively formed divisions. But the perspective of non-group members is not addressed.

If, for example, an associate of the head company, being a non-group member, deals with a subsidiary member of the group, what 'entity' is it dealing with? Or if the associate had made a loan to a subsidiary member, was the loan to the subsidiary member or to the head company?

Measures contained in the *New Business Tax System (Consolidation and Other Measures) Act 2003* provide that the single entity rule (and entry history rule) are extended for the purposes of the GVSR with the result that the head company is the relevant entity in respect of group dealings and transactions with external parties, from the perspective of those external parties.

Subsection 715-410(1)

Practically, it was never a viable option to apply the GVSR to non-group members affected by group events and transactions by ascertaining their impacts on a legal entity basis (that is, effectively deconsolidating the group).

Therefore, the measures in the *New Business Tax System (Consolidation and Other Measures) Act 2003*:

- recognise the group as a single entity (the head company) for the application of the GVSR, thereby extending the single entity rule for these purposes but without making direct or indirect interests held by non-group members in a consolidated or MEC group subject to the consolidation rules themselves, and
- recognise that the standard general value shifting approach could not be applied on a head company basis unless, broadly, the interests were directly or indirectly in the head company where that head company was the pinnacle of the group and would reflect underlying group value shifts and losses. Thus a different approach (a loss reduction method – section 5.4) was needed for interests in subsidiary members of consolidated groups (including associate loans to such members and direct and indirect interests in such loans held by other related entities) and for many of the interests in MEC groups because the head company, not being a common pinnacle, would usually only reflect value shift effects in a certain strand of the group.

5.2 TAX COST SETTING

The GVSR (or the previous value shifting rules) may have been relevant to a transaction entered into by a member of a consolidated group before consolidating. These may have to be taken into account when the group forms or an entity joins the group.

The standard tax cost setting rules for allocating the cost of equity and loans to assets when entities become subsidiary members of consolidated groups contain a number of rules to deal with value shifting interactions. These affect, mainly, step 1 (cost of membership interests in the joining entity) and, less commonly, step 2 (liabilities of the joining entity) in working out allocable cost amount.

For the purposes of step 1, the following amounts are summed for each membership interest that members of the joined group hold in the joining entity at the joining time:

- if its market value equals or exceeds its cost base, its cost base
- if its market value is between its reduced cost base and its cost base, its market value, and
- if its market value is less than or equal to its reduced cost base, its reduced cost base.

There are a number of modifications to cost base or reduced cost base before the comparison above is made, some of which are relevant for the GVSR and predecessor value shifting provisions.

5.2.1 Outstanding value shifting adjustments

Most value shifting adjustments (eg to the tax costs of interests in entities) will already have been done before consolidation. But some may not have been required until an interest was disposed of. Consolidation may not result in any disposal of the interest so modifications are required to ensure that outstanding adjustments are taken into account. Any outstanding value shifting adjustments to the cost base or reduced cost base of a membership interest that would have been made if a CGT event had happened to the interest, are made in applying step one. For example, the need for a reduction to an indirect interest under Division 138 or an increase to a direct or indirect interest under the same Division may need to be tested just before the joining time. If these adjustments were not made, the cost setting for assets would not reflect the true characteristics of the equity to be pushed down.

Subsection 705-65(3)

A new rule enacted in the *New Business Tax System (Consolidation and Other Measures) Act 2003* deals with adjustments under the *realisation time method* of the indirect value shifting rules. Again, there is a notional disposal of the membership interest for market value consideration. If there would have been a loss that would have been reduced by an amount under the indirect value shifting rules, then the reduced cost base of the interest is similarly reduced by that amount in determining the step one amount.

Subsection 705-65(3AA)

Once these adjustments have been made, there is no ongoing value shifting implication for things that may happen to the interests after the joining time.

5.2.2 Broadly equivalent rules for intragroup liabilities

Broadly equivalent rules to those set out above apply in respect of intragroup liabilities where such liabilities are relevant to cost setting.

5.2.3 Joining, formation, acquisition of group etc covered

The above rules apply in single entity joining cases and (with modifications) in formation cases where one consolidated group is purchased by another and where multiple entities linked by membership interests join an existing consolidated group.

5.3 HOW THE INDIRECT VALUE SHIFTING RULES APPLY DURING CONSOLIDATION

The indirect value shifting rules do not deal with the effects of value shifts on interests in group members where the impacts are addressed by consolidation rules. However, there may be an impact of such shifts on related non-group entities, and there may be shifts in value out of the entire group that impact on the value of interests in the group held by controllers of the group that are not consolidated (eg non-residents that directly own resident head companies).

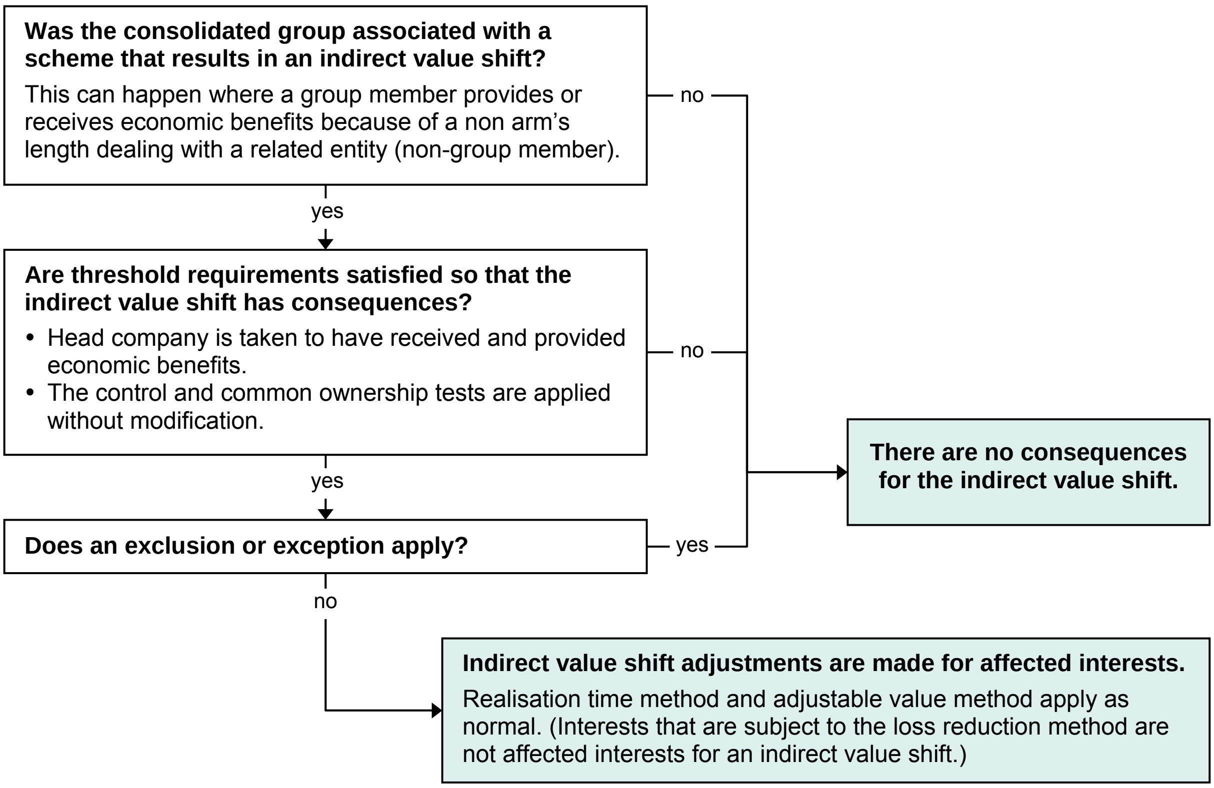
It is therefore useful to summarise how the rules enacted in the *New Business Tax System (Consolidation and Other Measures) Act 2003* address these issues.

5.3.1 Indirect value shifting rules – consolidated groups

Generally, the indirect value shifting rules will apply normally, but it should be noted that:

- only the head company can be a *losing or gaining entity*
- the loss reduction method (section 5.4) is to apply to interests not in the head company, and
- the *realisation time method* and *adjustable value method* are available – these operate by examining the market value effects of value shifts on interests in the head company.

Figure 5-1: Flowchart – indirect value shifting and consolidated groups



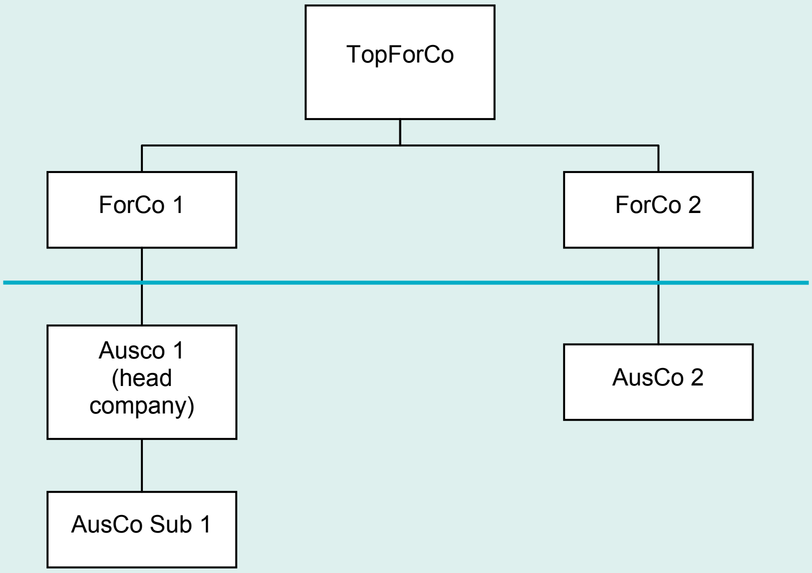
5.3.2 Indirect value shifting rules – multiple entry consolidated groups

Again, generally, the indirect value shifting rules apply normally, but it should be noted that:

- as with consolidated groups, only the head company can be a losing entity or gaining entity
- the only *affected interests* are interests in the top company or pooled interests in eligible tier-1 members of MEC groups
- all other equity or loan interests in eligible tier-1 companies are covered by the loss reduction method (section 5.4) or Division 711, and
- both the realisation time method and adjustable value method are available for interests in the top company, and
- the consequences for pooled interests in eligible tier-1s are:
  - where the head company is a losing entity, cost base and reduced cost base pooled cost amounts are reduced by the amount of the indirect value shift,
  - where the head company is a gaining entity, pooled cost amounts are increased by the amount of the indirect value shift, and
  - adjustments happen for the first trigger time for pooled interests at or after the indirect value shift.

Section 719-755

Example 5-1: MEC group



A MEC group is established as follows: TopForCo has 100% of ForCo 1 and Forco 2. Forco 1 has 100% of Ausco 1 and Forco 2 has 100% of Ausco 2. Ausco 1 and Ausco 2 are eligible tier-1s and Ausco 1 is the head company. Ausco 1 has 100% of Ausco Sub 1. Assume that value is shifted from Ausco 1 (head company) to TopForCo 1 in a non arm's length dealing. Ausco 1 is the losing entity for this shift. TopForCo1 is the gaining entity and ultimate controller of Ausco 1. Any affected owner (for example, associates of TopForCo) with equity or loan interests in TopForCo would have interests in a losing entity and in a gaining entity to adjust for. The pooled cost amounts relevant to the interests in the eligible tier-1s would be reduced by the amount of the indirect value shift.

What happens if there is a value shift from Ausco Sub 1 to Ausco 1 and Ausco Sub 1 is later sold off? There is no application of the indirect value shifting rules for this intragroup shift. Division 711 deals with the tax cost setting for the interests in Ausco Sub 1.

Figure 5-2 and figure 5-3 illustrate the interactions between the indirect value shifting rules and MEC groups.

Figure 5-2: Interaction of indirect value shifting rules and MEC groups

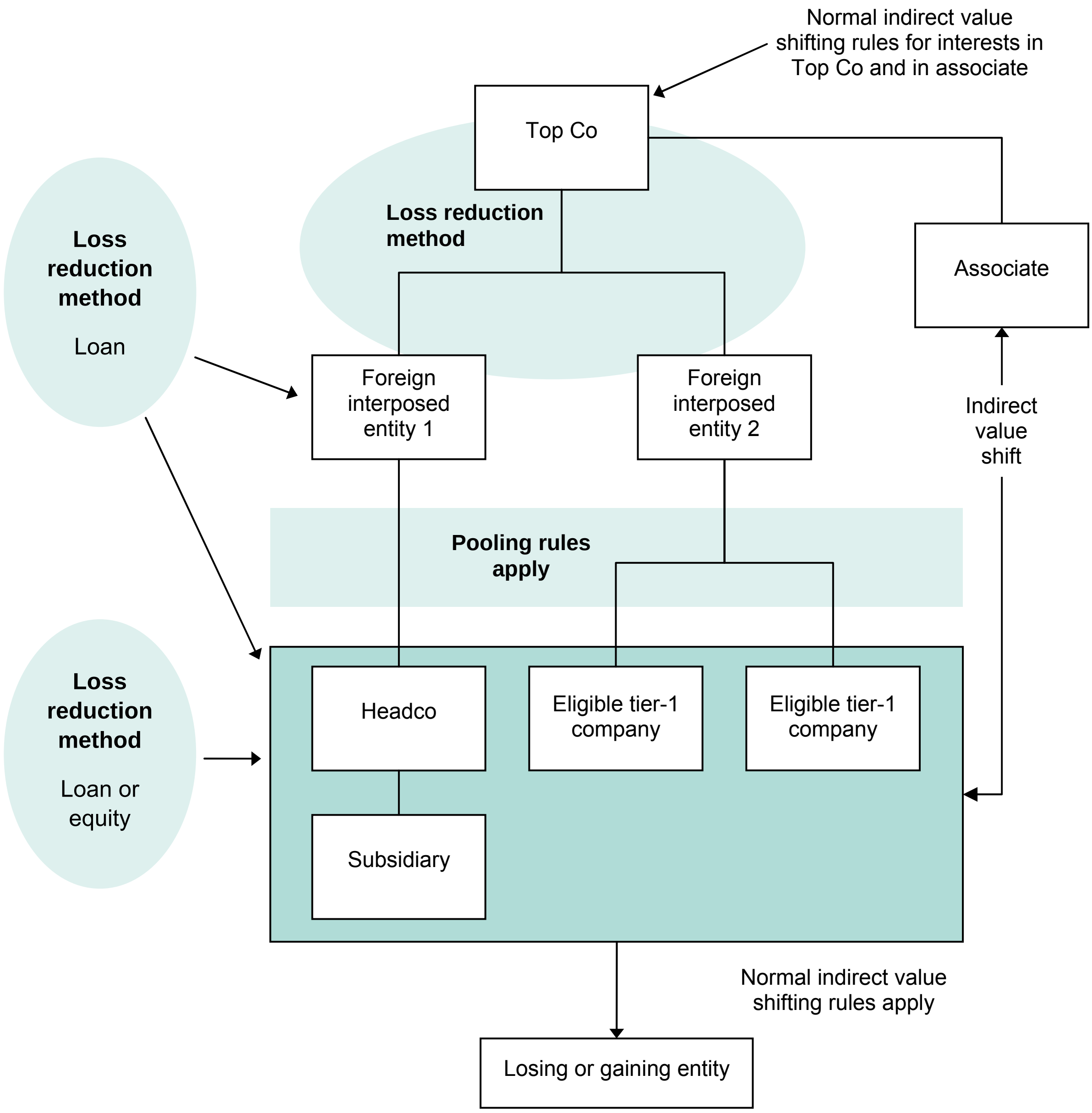
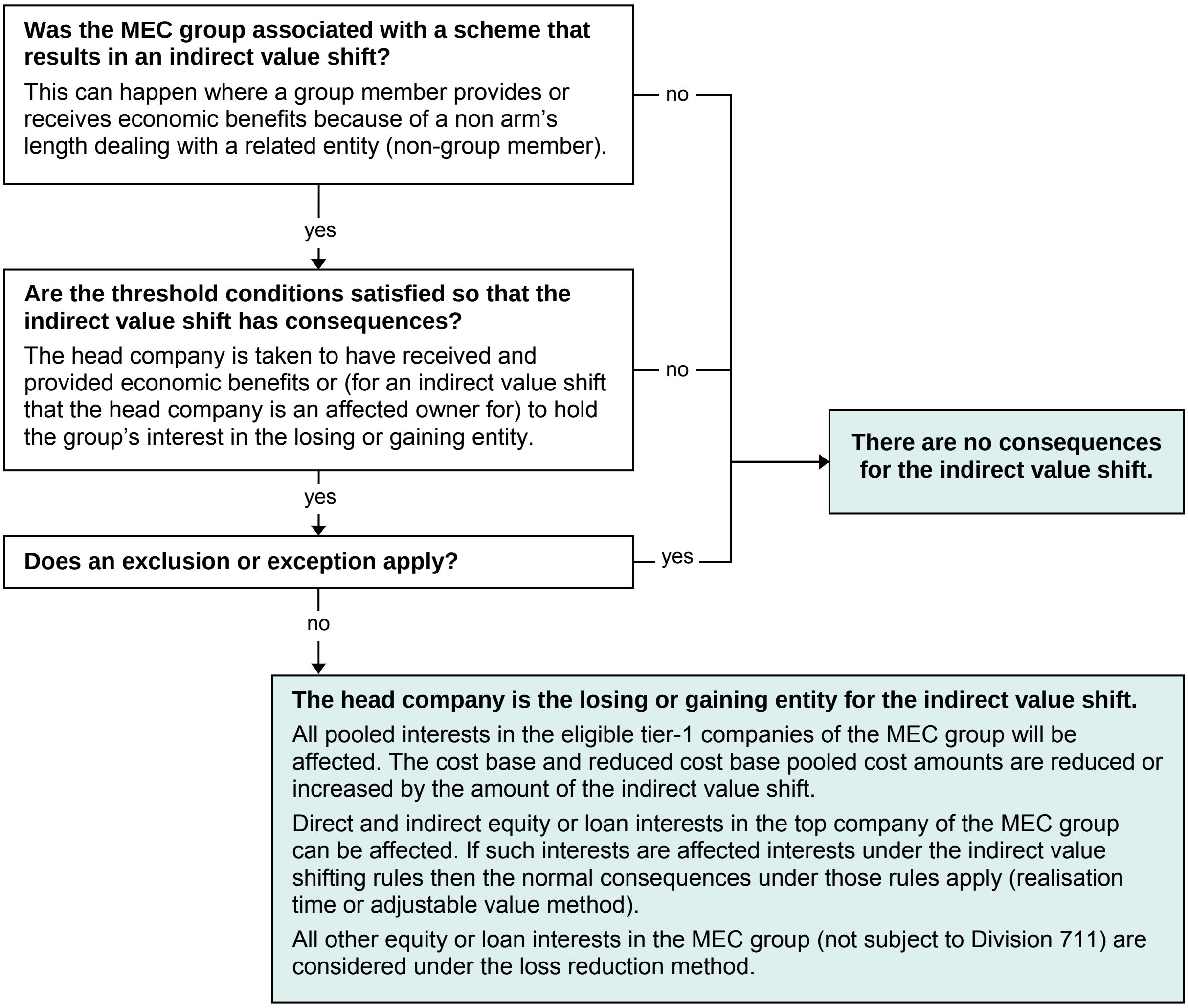


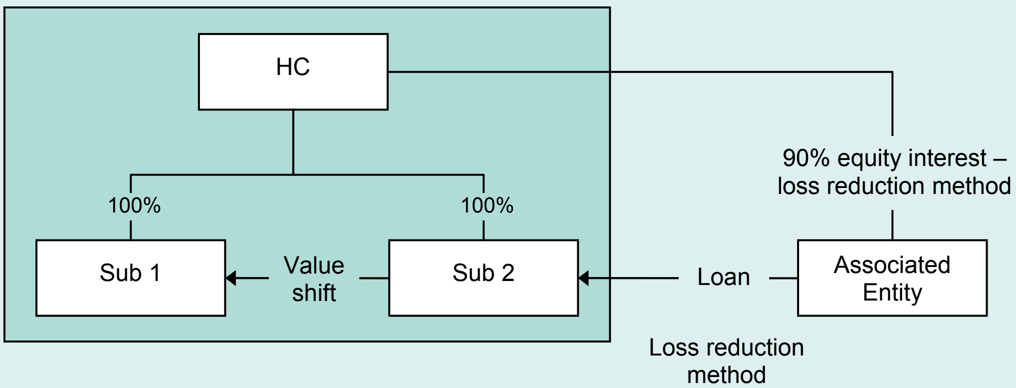
Figure 5-3: Flowchart – indirect value shifting rules and MEC groups



5.4 LOSS REDUCTION METHOD

The loss reduction method, introduced in the *New Business Tax System (Consolidation and Other Measures) Act 2003*, preserves the integrity of the indirect value shifting rules (and loss integrity rules) where consolidation makes it impossible or unrealistic to determine the market value effects of losses or value shifts involving the group on interests that would normally be subject to the indirect value shifting rules.

Example 5-2: Loss reduction method



Assume that HC, Sub 1 and Sub 2 are consolidated. It can be seen that the market value of Associated Entity's loan to Sub 2 may well be affected by a value shift out of Sub 2 to Sub 1 or to HC (subject to other factors, eg the funds of Sub 2, other claims on its assets and the possible existence of guarantees).

But from the perspective of the group as a single entity, the value shift has not occurred. It would not be appropriate to require the unbundling of transactions undertaken by group members to determine the impacts on interests in group members of non-group members.

Therefore, Associated Entity's loan to Sub 2 and HC's shares in Associated Entity are subject to the loss reduction method.

Broadly, the approach under the loss reduction method is to reduce losses to nil (gains are not affected) on such interests. However, losses may be reduced to a lesser extent where it can reasonably be shown that the loss is attributable to something other than an indirect value shift, if the indirect value shifting rules applied to members of the group, and a group member would have been a losing or gaining entity for the shift. In a similar way, denied losses cannot be attributable to losses of the group that Subdivision 165-CD would apply to but for consolidation.

Sections 715-610 (consolidated groups) and 719-775 (MEC groups)

Situations where it may be possible to demonstrate that a loss is attributable to something else are when:

- part of the loss is attributable to a period when the interest was not an interest in the group, other than for interests in eligible tier-1 companies of a MEC group, or
- the interest is an indirect interest in the group and the loss relates to an interposed non-group entity.

If applying the last dot point, account would need to be taken of any operation of the GVSR (or loss integrity measures) in respect of such non-group entities.

That is, the loss reduction method effectively results in losses on certain interests being regarded as attributable to value shifts (or losses), while leaving it open for the contrary to be demonstrated.

Sections 715-620 (consolidated groups) and 719-795 (MEC groups)

Example 5-3: Loss reduction method

Consider a consolidated group with Headco, Subsidiary 1 and Subsidiary 2. Headco has 90% of the equity in Associate 1, which has 80% of the equity in Associate 2, which makes a loan to Subsidiary 2. No value is shifted out of Subsidiary 2 and it would have no losses if unconsolidated but the value of Headco's 90% equity in Associate 1 decreases and it is sold at a loss. The loss is because of certain features of Associate 1, which do not represent losses, or value shifts adjusted for outside consolidation. The loss reduction method does not deny the loss.

The loss reduction method applies to the interest of an entity where:

- the realisation of the interest results in a loss for income tax purposes
- the interest was an *equity or loan interest*, or indirect equity or loan interest, in a member of a consolidated group or MEC group at some time during the period the entity owned it (some interests are excluded), and
- the entity was the head company of the group, a controller of the head company, or an associate of the head company or such a controller, at some time during the period the interest was owned.

Interests in consolidated groups and MEC groups not covered by the loss reduction method are:

- direct and indirect equity or loan interests in the head company of a consolidated group
- equity interests that are pooled interests in relation to a MEC group
- direct and indirect equity or loan interests in the top company for a MEC group, and
- membership interests in, or liabilities owed by, an entity leaving the group. This covers interests where special rules apply when an entity leaves the group (for example, Division 711).

Sections 715-615 (consolidated groups) and 719-780 to 719-790 (MEC groups)

Interests affected are generally those in a subsidiary member of a consolidated or MEC group, or in entities (below the top company for a MEC group) with pooled interests in eligible tier-1 companies of the group. For example, loans to subsidiary members of a consolidated group, and direct and indirect interests in the entities with such loans.

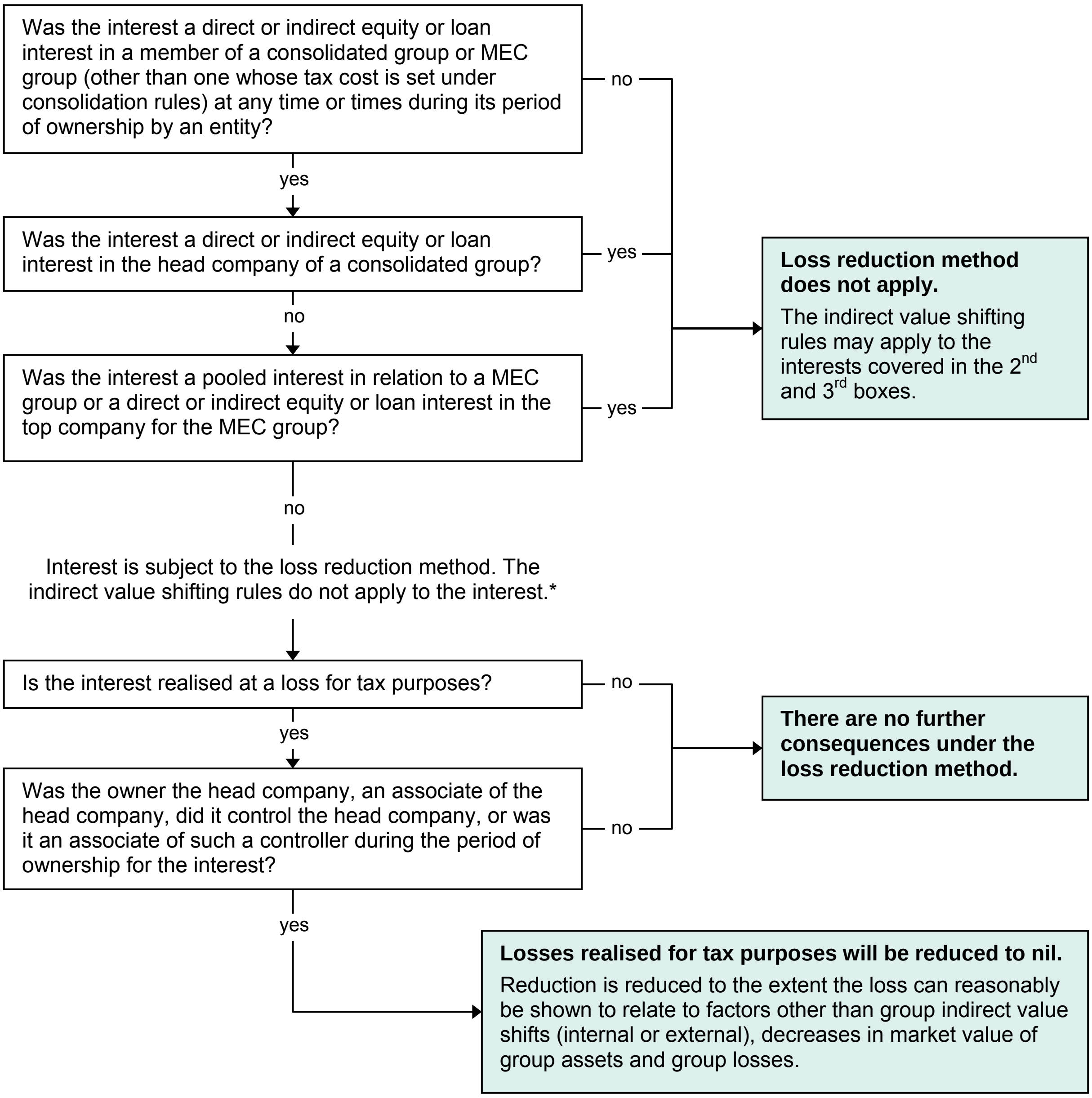
In practice, this means that interests of the top company for a MEC group, and of entities interposed between it and the eligible tier -1 companies of the group, will be covered by the loss reduction method (except for pooled interests). This is appropriate because the top company will *control (for value shifting purposes)* the head company and other entities will be associates of it or the head company.

These rules also cover interests in most direct or indirect interests in transitional foreign-held subsidiaries of a consolidated or MEC group. Membership interests in a transitional foreign-held subsidiary are covered by Division 711.

Reductions made under the loss reduction method cannot be taken into account in working out uplifts and gain reductions under the indirect value shifting rules.

Figure 5-4 explains the loss reduction method.

Figure 5-4: Flowchart – application of loss reduction method



* This statement (that the indirect value shifting rules do not apply to the interest) relates to the fact that it is an interest in a group that may have been involved in an indirect value shift (internal or external). The indirect value shifting rules could apply in other situations – for example, an interest in an associate with interests in a group member, and the associate is involved in an indirect value shift with another non-group member.

CONTROL THRESHOLDS 06

Control threshold tests are an important feature of the GVSR as they ensure the rules are properly targeted at entities (affected owners) that can shape the transactions that create the value shift, or that are related to such entities. Where a value shift affects an asset or interest held by an entity that is not within this framework, any increase or decrease in its value is treated as a windfall for which there are no consequences under the regime.

Control tests are relevant for the entity interest direct value shifting rules and the indirect value shifting rules. Control tests are not relevant to the created rights direct value shifting rules.

The following table summarises the relationship between the control thresholds and the entities that are affected by a value shift.

Table 6-1: Control thresholds and affected entities

For this measure:	Where the following control threshold is satisfied:	These are the affected owners to which the regime may apply:
Entity interest direct value shifting rules	the entity in which the interests are held (called the *target entity*) is controlled for value shifting purposes by one or more controllers at some time during the *scheme*	• controllers of the target entity • their *associates* • associates of an associate (for up interests only), and • where the entity has fewer than 300 members, active participants in the scheme
Indirect value shifting rules	• the control test is satisfied (ie the *losing entity and the gaining entity* have the same *ultimate controller*), or • the losing entity is the ultimate controller of the gaining entity, or • the gaining entity is the ultimate controller of the losing entity	• each *ultimate controller* • any intermediate controller • the losing entity and the gaining entity • an associate of any of the above entities at any time after the commencement of the scheme, and • if the losing and gaining entities each have fewer than 300 members, an active participant in the scheme
Indirect value shifting rules	the losing entity and the gaining entity each have fewer than 300 members and the common ownership nexus test is satisfied	• ultimate owners of both the gaining entity and the losing entity • entities through which ownership interests have been traced to establish the common ownership nexus • the gaining entity and the losing entity • an associate of any of the above entities, and • an active participant in the scheme

Concepts in the table that are discussed below are:

- the control concept – what is control for value shifting purposes (section 6.1)
- how the control concept is applied in the entity interest direct value shifting context (section 6.2)
- how the control concept is applied in the indirect value shift context (including a discussion of when an entity is an ultimate controller or an intermediate controller) (section 6.3)
- common ownership nexus (including a discussion of when an entity is an ultimate owner) (section 6.4), and
- active participation (section 6.5).

For a comparison of the control thresholds applied in the GVSR and the control thresholds in former value shifting rules in Divisions 138, 139 and 140 of the ITAA 1997, see the old law to new law table (section 6.6).

6.1 CONTROL FOR VALUE SHIFTING PURPOSES

Control tests are relevant for the entity interest direct value shifting rules and the indirect value shifting rules. As these rules apply to interests in companies and trusts, there are separate tests for determining whether an entity controls:

- a company
- a fixed trust, and
- a non-fixed trust.

6.1.1 Company

There are three alternative tests for determining whether an entity controls a company for value shifting purposes:

- the 50% stake test
- the 40% stake test, or
- the actual control test.

The 50% stake test

An entity will control a company under the 50% stake test if that entity, either alone or with its associates, has (directly or indirectly) at least 50% of voting, dividend or capital rights in the company.

The 40% stake test

An entity will control a company under the 40% stake test if that entity (called the first entity), either alone or together with its associates, has (directly or indirectly) at least 40% of voting, dividend or capital rights in the company. The 40% stake test will not be satisfied however if another entity (not being the first entity or one of its associates), either alone or together with its associates, controls the company.

Actual control test

An entity will control a company under the actual control test if that entity, either alone or together with its associates, actually controls the company. An example is where an entity owns a 30% interest in a company whose board of directors is accustomed to acting on that entity's instructions. Such an entity controls the company for value shifting purposes.

Section 727-355

6.1.2 Fixed trust

There are two sets of tests for determining whether an entity controls a fixed trust:

- the 40% stake test, or
- other tests.

The 40% stake test
An entity controls a fixed trust under the 40% stake test if that entity, either alone or together with its associates, has the right to receive (directly or indirectly) at least 40% of any distribution of income or capital of the trust.

Other tests
The other tests are based on the degree of an entity's control of the trustee and control of the trust income or capital. Under these tests, an entity will control a fixed trust if that entity, or an associate, whether alone or with other associates, has:

- the ability to appoint or remove the trustee
- the power to obtain the beneficial enjoyment of the trust's income or capital
- control of the application of the trust income or capital, or
- the ability under a scheme to gain beneficial enjoyment, or control the application, of the trust income or capital.

An entity will also control a fixed trust if a trustee is accustomed, or under an obligation, or might reasonably be expected to act in accordance with the entity's directions, instructions or wishes.

Section 727-360

6.1.3 Non-fixed trust

There are two sets of tests for determining whether an entity controls a non-fixed trust:

- the trustee tests, or
- the control of the trust income or capital tests.

The trustee tests
An entity controls a non-fixed trust under the trustee tests if:

- that entity, or an associate, is the trustee of the trust, or
- that entity, either alone or together with its associates, has the power to appoint or remove the trustee of the trust.

An entity will also control a non-fixed trust if the trustee is accustomed to act, is under some formal or informal obligation to act or might reasonably be expected to act in accordance with their directions, instructions or wishes. It does not matter if the directions, instructions or wishes are those of the entity or its associate alone, or together with any other entities.

The control of the trust income or capital tests
An entity controls a non-fixed trust under the control of the trust income or capital tests if the entity, either alone or with its associates, has:

- the power to obtain the beneficial enjoyment of trust income or capital
- the power to control in any way the application of trust income or capital
- the ability, under a scheme, to gain the beneficial enjoyment, or control the application, of trust income or capital, or
- the right to receive (directly or indirectly) at least 40% of any distribution of income or capital of the trust.

An entity will also be taken to control a non-fixed trust under these tests if that entity, or any of its associates, can benefit under the trust otherwise than because of a fixed entitlement. This means, for instance, that any object of a discretionary trust would be taken to control that trust.

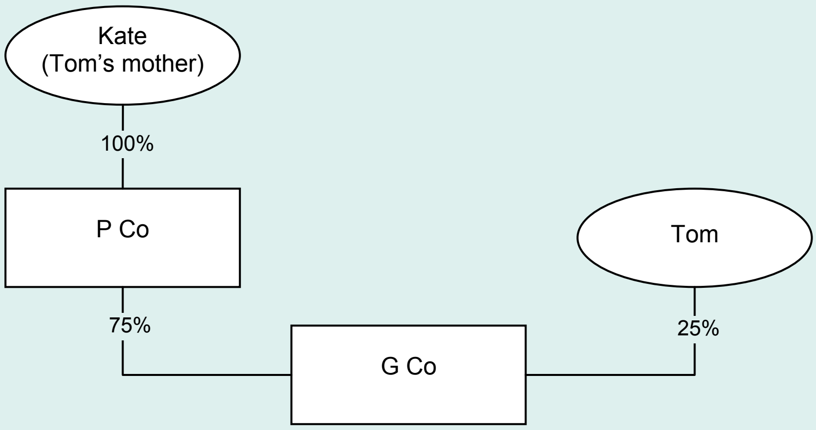
Section 727-365

6.2 HOW THE CONTROL CONCEPT IS APPLIED IN AN ENTITY INTEREST DIRECT VALUE SHIFT CONTEXT

There will only be consequences under the entity interest direct value shifting rules where an entity controls for value shifting purposes (section 6.1) the target entity at some time during the period starting when the scheme was entered into and ending when the scheme had been carried out. There can be more than one controller during the period.

Paragraph 725-50(b) and section 725-55

Example 6-1: Control in an entity interest direct value shifting context



G Co is the target entity for an entity interest direct value shift. The shares in G Co are held by Tom (25%) and P Co (75%). All of the shares in P Co are held by Tom's mother Kate.

Tom, Kate and P Co are associates according to section 318 of the ITAA 1936.

P Co and Tom both control G Co for value shifting purposes, as together with associates each can control more than 50% of the rights (voting, dividend and capital) in G Co. P Co and Tom are affected owners for the entity interest direct value shifting scheme.

6.3 HOW THE CONTROL CONCEPT IS APPLIED IN AN INDIRECT VALUE SHIFT CONTEXT

The indirect value shifting rules may have consequences where the control test is satisfied in relation to the losing entity and the gaining entity (called the ultimate controller test).

The ultimate controller test will be satisfied if at some time during the *indirect value shifting period*:

- there is an *ultimate controller* of the losing entity that is also the ultimate controller of the gaining entity at that time or at another time during the indirect value shifting period
- the gaining entity is the ultimate controller of the losing entity, or
- the losing entity is the ultimate controller of the gaining entity.

Section 727-105

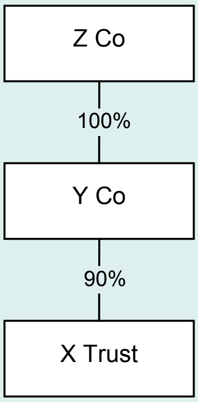
Whether a trust or company is controlled by an entity is relevant to determining who is an ultimate controller. An entity will be the ultimate controller of another entity if it controls the other entity and there is no other entity that controls both the entities. Therefore to find the ultimate controller it is necessary to trace through entities.

Section 727-350

An intermediate controller is an entity that at some time during the indirect value shifting period controls either the losing entity or the gaining entity, and is itself controlled by another entity that is an ultimate controller of the losing entity or gaining entity.

Subsection 727-530(2)

Example 6-2: Ultimate controller and intermediate controller



90% of the interests in the X Trust are held by Y Co, a subsidiary of listed public company Z Co. Z Co has not made a choice to form a consolidated group. There is no entity that controls Z Co.

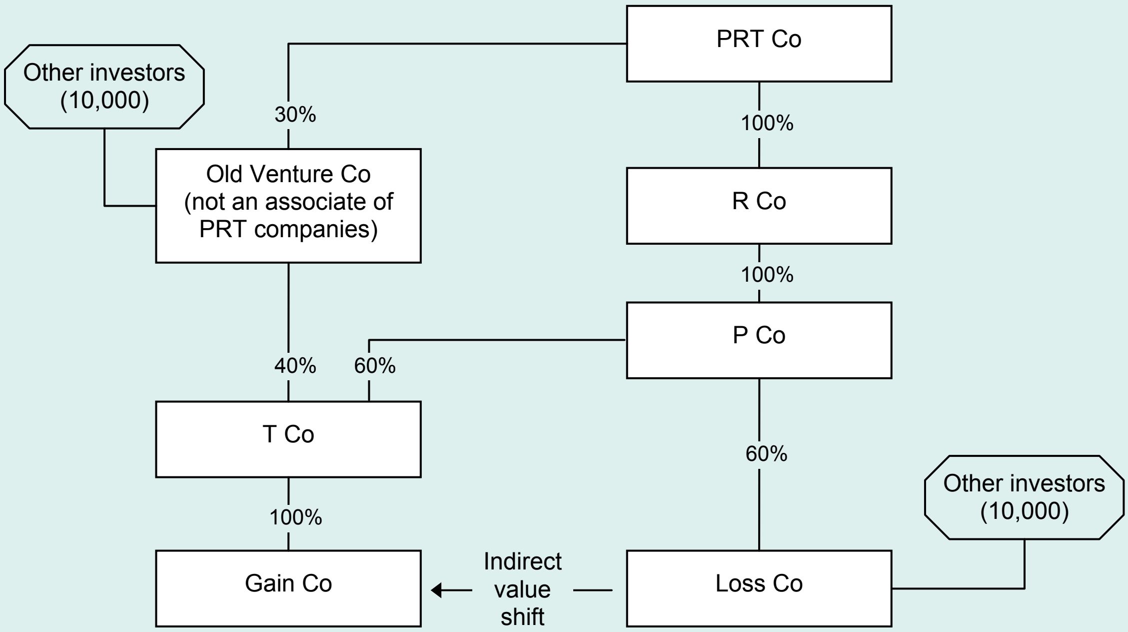
Z Co is the ultimate controller of the X Trust and Y Co because it controls both of those entities and is not itself controlled by another entity. Y Co is an intermediate controller of the X Trust.

The ultimate controller test would be satisfied for an indirect value shift for which:

- Y Co is the losing entity and the X Trust is the gaining entity (or vice versa), as those entities have the same ultimate controller
- Z Co is the gaining entity and either Y Co or the X Trust is the losing entity, as the gaining entity is the ultimate controller of the losing entity, and
- Z Co is the losing entity and either Y Co or the X Trust is the gaining entity, as the losing entity is the ultimate controller of the gaining entity.

Note that the exclusion for value shifts down a wholly owned chain of entities (section 4.3.4) may apply to the indirect value shift in the third dot point, for which Y Co is the gaining entity.

Example 6-3: Control in an indirect value shift context – complex



Assume that none of the entities in the diagram above are members of a consolidated group.

Loss Co and Gain Co are the losing entity and gaining entity for an indirect value shift. The direct and indirect equity interests in Loss Co and Gain Co, that give an entitlement to voting and capital and dividend distributions, are set out in the diagram above.

PRT Co (a widely held listed public company) is the ultimate controller of Loss Co and Gain Co, as it has itself a greater than 50% stake in both of those companies – a 60% stake in Loss Co (traced through P Co and R Co) and a 72% stake in Gain Co – 60% traced through P Co, R Co and T Co, and an additional 12% traced through Old Venture Co and T Co.

P Co, R Co and T Co are all intermediate controllers that control the losing entity or gaining entity (or both) at a time when they are controlled by the ultimate controller PRT Co.

The affected owners for the indirect value shift scheme are PRT Co, P Co, R Co and T Co.

Old Venture Co does not control Gain Co (it satisfies the 40% stake test, but there is another entity that controls Gain Co) and is not an associate of any other entity that controls Gain Co or Loss Co. The active participation rules are not relevant as Loss Co has more than 300 members.

6.4 COMMON OWNERSHIP NEXUS

Under the indirect value shifting rules, the common ownership nexus test supplements the control tests to ensure that value shifts between entities that are not commonly controlled, but nevertheless have a high degree of commonality of ownership, are covered.

There are three key elements in applying the common ownership nexus test:

- the losing entity and gaining entity must be closely held (less than 300 members) at some time during the scheme
- the threshold common ownership nexus is satisfied, and
- for cases where the losing and gaining entities are companies or fixed trusts, or a combination of these, other conditions are met.

6.4.1 The losing entity and gaining entity are closely held at some time during the scheme

The common ownership nexus test is only applied if at some time during the *indirect value shifting period*, neither the *gaining nor losing entities* have 300 or more members (in the case of a company) or 300 or more beneficiaries (in the case of a trust).

A company will be regarded as not having 300 or more members if

- it has less than 300 members, or
- it is taken to not have 300 or more members under the assumptions in section 124-810 of the ITAA 1997.

A fixed trust will be regarded as not having 300 or more beneficiaries if:

- it has less than 300 beneficiaries, or
- it is taken to not have 300 or more beneficiaries under the assumptions in section 124-810 of the ITAA 1997.

A non-fixed trust will always be taken not to have 300 or more beneficiaries.

Section 727-110

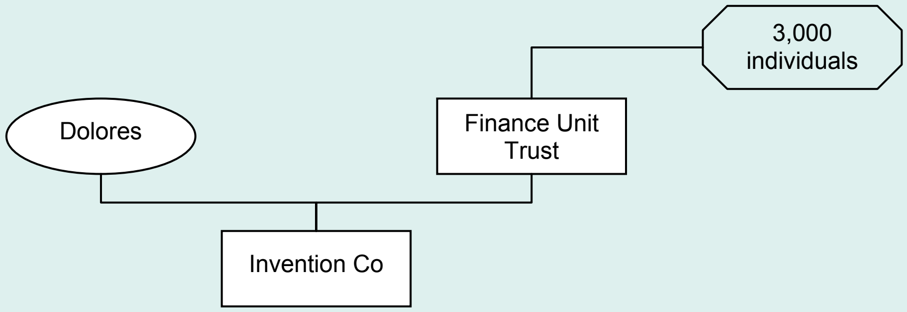
6.4.2 The threshold common ownership nexus is satisfied

The common ownership nexus looks at who holds particular rights that are incidental to the ownership of two entities. Where the same *ultimate owners* hold at least one of these rights in excess of certain thresholds during the indirect value shifting period, the entities are taken to have a common ownership nexus.

For a gaining or losing entity that is a company or fixed trust, the threshold is measured according to the percentage interests in rights that particular ultimate owners hold, called ultimate stakes. For a gaining or losing entity that is a non-fixed trust, the relevant threshold is based on the ultimate owners' control of the entity (see control of a non-fixed trust, section 6.1.3).

An ultimate owner is an entity referred to in subsection 149-15(3) of the ITAA 1997. It includes individuals, certain governments and companies whose constitutions prevent them from making any distributions to members.

Example 6-4: Common ownership nexus – ultimate owners



The shareholders in Invention Co are Dolores and Finance Unit Trust. The units in the Finance Unit Trust are held by 3,000 individuals, none of whom are associates or hold their units as trustees.

The ultimate owners of Invention Co for common ownership nexus purposes are Dolores and the 3,000 individual unit holders in the Finance Unit Trust.

The entities tested for common ownership are companies, trusts and non-fixed trusts. There are several combinations of common ownership, all of which are considered in table 6-2.

Table 6-2: Combinations of common ownership

Combination	Test to be satisfied by ultimate owners during an indirect value shifting period
Company and company	Two or more ultimate owners must hold, directly or indirectly, at least 80% of one of the following rights in each company at some time during the period: • voting rights • rights to dividends, or • rights to capital distributions.
Fixed trust and fixed trust	Two or more ultimate owners must hold, directly or indirectly, at least 80% of one of the following rights in each trust at some time during the period: • rights to receive distributions of income, or • rights to receive distributions of capital.
Company and fixed trust	Two or more ultimate owners must hold, directly or indirectly, at some time during the period: • at least 80% of the voting rights, rights to dividends or rights to capital distributions in the company, and • at least 80% of the rights to receive distributions of income or capital in the trust.
Company and non-fixed trust	Two or more ultimate owners must at some time during the period: • hold at least 80% of the voting rights, rights to dividends or rights to capital distributions in the company, and • control the non-fixed trust.
Fixed trust and non-fixed trust	Two or more ultimate owners must at some time during the period: • hold at least 80% of the rights to receive distributions of income or capital in the fixed trust, and • control the non-fixed trust.

Section 727-400

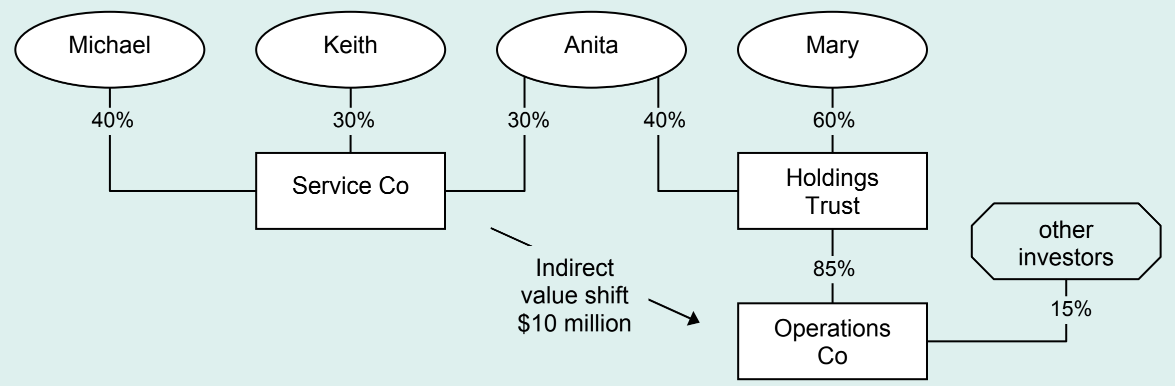
In applying the tests mentioned in the table and the other conditions for companies and fixed trusts below:

- tracing is to be done through any interposed entities
- where ownership rights are held by entities jointly or in common, the entities are each treated as holding a proportion of the rights, and
- to work out if ultimate owners together have ultimate stakes that meet the common ownership nexus, the ownership or particular rights held ultimately by an ultimate owner (directly or indirectly) are aggregated with those held by associate ultimate owners.

Section 727-415

The rule in the third dot point prevents the common ownership nexus from being avoided by splitting rights among associates.

Example 6-5: Common ownership nexus test – tracing and aggregation



There is an indirect value shift when Service Co agrees to provide services to Operations Co in a non arm's length dealing. The amount of the indirect value shift is $10 million. No exclusion applies to the indirect value shift.

All of the direct interests in Service Co are owned by ultimate owners. They hold the ownership and other rights in the following percentages: Michael (40%), Keith (30%) and Anita (30%). Keith and Anita are associates.

The Holdings Trust owns 85% of the direct interests in Operations Co. Anita, who holds 40% of the units in the Holdings Trust, can trace a 34% ultimate stake in each of the ownership rights in Operations Co. Mary, an associate of Michael's, holds 60% of the units in the Holdings Trust, and can trace a 51% ultimate stake in each of the ownership rights in Operations Co. The other direct interests in Operations Co are widely held through a listed public company.

Michael has an ultimate stake of 40% in Service Co, and an ultimate stake of 51% in Operations Co (that is, aggregated with the ultimate stake of his associate Mary). Mary has ultimate stakes in the same percentages. Anita has an ultimate stake of 60% in Service Co, and an ultimate stake of 34% in Operations Co. Keith has ultimate stakes in the same percentages.

Michael, Mary, Keith and Anita each have ultimate stakes that, taken together with another ultimate owner, satisfy the common ownership nexus threshold. For example, Anita and Michael have 100% ultimate stakes in Service Co and 85% ultimate stakes in Operations Co.

6.4.3 Other conditions for companies and fixed trusts

When companies and fixed trusts are being considered, the common ownership nexus test will only be met where further conditions are satisfied:

- for companies or fixed trusts, an ultimate owner's ultimate stake must be established for the same right, and
- further threshold conditions ensure that the common ownership nexus test is targeted at groups of entities that may have a relevant level of control over what happens in a dealing between two entities.

6.4.4 Commonality must be established for the same right

Where the entities being tested for a common ownership nexus are companies or fixed trusts (or a combination of these), the ultimate stake for an ultimate owner must be established for the same type of right in each entity.

Section 727-400

Example 6-6: Common ownership nexus test – commonality established for the same right

Paula is the ultimate controller (for value shifting purposes) of A Co and B Co. She holds 100% of the voting rights and 60% of the rights to capital and dividend distributions in A Co. She holds 50% of the voting rights and 40% of the rights to dividend and capital in B Co. While the ultimate controller test is satisfied, so that there can be consequences for an indirect value shift involving A Co and B Co, it is necessary to apply the common ownership nexus test to determine if Mika (not an associate of Paula) would be an affected owner.

Mika holds 30% of the rights to capital and dividend distributions in A Co. She holds 30% of the voting rights, and rights to capital and dividend distributions in B Co.

The remaining interests in A Co are held by Jack and the remaining interests in B Co are held by Bill. They are not associates of each other, or of Paula or Mika.

Mika is not an ultimate owner who meets the common ownership test. Mika does not have an ultimate stake in the voting rights in A Co, so the common ownership nexus test cannot be met for that type of right.

Mika and Paula have ultimate stakes totalling 90% in the capital and dividend rights in A Co, and 70% in the capital and dividend rights in B Co. They cannot apply their ultimate stakes totalling 80% of the voting rights in B Co to meet the test.

Mika could be an affected owner for an indirect value shift involving A Co and B Co if the active participant test is satisfied.

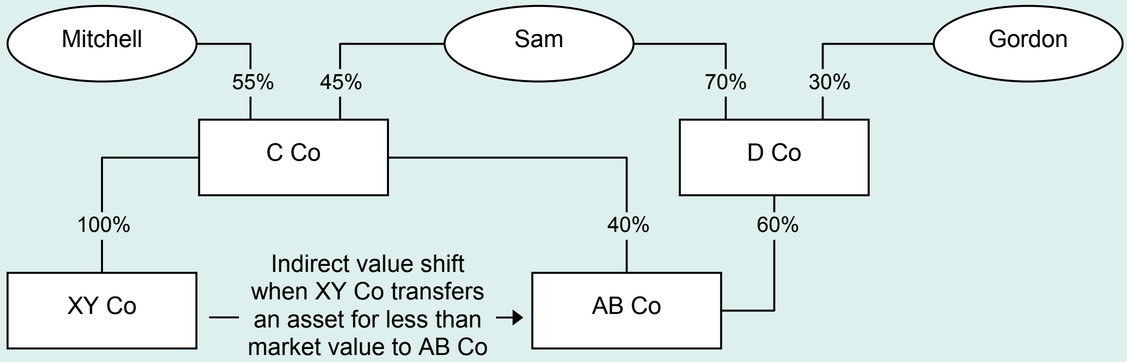
6.4.5 Further threshold conditions

Further threshold conditions have been included as a compliance cost saving measure. One of the further conditions must be met for establishing a common ownership nexus between companies, fixed trusts or a combination of these. The further conditions are:

- one of the ultimate owners has ultimate stakes of at least 40% in each entity
- each ultimate owner holds the same percentage of ultimate stakes in each entity, and
- 16 or fewer ultimate owners have the 80% stakes that satisfy the 80% or more ultimate stake requirement.

Subsections 727-400(2) to (5)

Example 6-7: Common ownership nexus test



An indirect value shift occurs when XY Co transfers an asset to AB Co for less than market value consideration in a non arm's length dealing. The ultimate owners of XY Co and AB Co (Mitchell, Sam and Gordon) are not associates.

The control test is not satisfied. There is one ultimate controller of XY Co (the losing entity) – Mitchell. He is the controller of C Co (intermediate controller), the controller of XY Co. Sam is not an ultimate controller of XY Co. (Note that C Co has not made an election to form a consolidated group). While he does hold 45% of the voting, capital and dividend rights in C Co, he does not satisfy the 40% stake test because Mitchell actually controls C Co. Sam is the only ultimate controller of AB Co (the gaining entity) – he controls D Co, which in turn controls AB Co.

The common ownership nexus test will apply as the 80% common ownership nexus is met (Mitchell and Sam are ultimate owners that have ultimate stakes of 100% of the voting rights, and rights to capital and dividend distributions in XY Co and 82% of those rights in AB Co). The additional threshold conditions for meeting the common ownership nexus test threshold are satisfied as:

- Sam holds ultimate stakes (for each of the rights) of at least 40% in both companies (a 45% ultimate stake in XY Co and a 60% ultimate stake in AB Co), and
- in the alternative, there are less than 16 ultimate owners taken into account in working out the satisfaction of the common ownership nexus.

Mitchell and Sam, and the entities through which they trace their ultimate stakes (C Co and D Co) are affected owners for the indirect value shift.

As there are less than 300 members in the losing and gaining entities, Gordon will be an affected owner if he is an active participant in the scheme that resulted in the indirect value shift.

6.5 ACTIVE PARTICIPATION

The GVSR implements recommendation 6.13(iii) in the *Review of business taxation* to extend the application of the indirect value shifting rules and entity interest direct value shifting rules to interest holders that are not part of the relevant control or ownership frameworks but participate in the scheme under which value is shifted.

These interest holders are properly within the scope of the value shifting rules as, although they do not hold controlling interests, they have nevertheless exercised influence over the scheme under which value is shifted. It is not appropriate to treat the benefits that they obtain from the value shift as windfalls.

6.5.1 What is an active participant?

Broadly, an entity is an *active participant* in a scheme if they participated in, or directly facilitated, the entering into or carrying out of the scheme. Active participation and direct facilitation are intended to take on their ordinary and natural meaning. Whether or not an interest holder is an active participant, or a direct facilitator, is a question of fact with regard to all of the circumstances. In both cases, some degree of knowledge of the scheme is required.

Active participation requires something more than simply receiving the benefits from the scheme and may involve doing something that is capable of exerting influence over the scheme. Direct facilitation can occur when some act or omission helps forward the scheme or makes it easier or less difficult for the scheme to be entered into or carried out.

6.5.2 When are active participants affected by the regime?

An active participant in a scheme that involves an entity interest direct value shift will be an affected owner where the target entity is controlled for value shifting purposes (section 6.1), and has less than 300 members, at some time during the scheme. The active participant must have a *down or up interest* in the target entity.

Subsection 725-65(2)

An active participant in a scheme that involves an indirect value shift will be an affected owner where the losing entity and gaining entity are commonly controlled or meet the common ownership nexus, and each entity has less than 300 members at some time during the *indirect value shifting period*. The active participant must have an interest in the losing or gaining entity.

Subsection 727-530(3)

Example 6-8: Active participants – affected owners in a scheme

There are three interest holders in Exploration Co – Mary (4 million A class shares), Trung (2.5 million B class shares) and Richard (3.5 million B class shares). They are not associates. The shares confer voting rights, and rights to dividend and capital distributions.

Mary controls Exploration Co for value shifting purposes as she holds 40% of the voting rights and no other entity controls Exploration Co. A change in the capital rights attaching to the shares is approved (as required by the memorandum and articles of Exploration Co) by a meeting of shareholders.

An entity interest direct value shift happens under the scheme as there is a material decrease in the market value of B class shares, and an increase in value of the A class shares. As Trung and Richard are not controllers or associates, they could only satisfy the conditions in section 725-80 for their down interests if they are active participants in the scheme.

Trung's or Richard's support for the proposal will amount to active participation as, in view of the level of control that Mary has over the meeting of the company (40%), their support has been critical to the implementation of the scheme.

As there is at least one *affected owner* of a down interest, and Mary is the controller of Exploration Co, Mary will be an affected owner of an up interest under the scheme.

Example 6-9: Active participants – affected owners in a scheme

Assume the facts in the example above and assume that:

- Richard is not a shareholder
- the other 3.5 million shares are held instead by 10,000 investors (none of whom are associates of Mary, Trung, or each other), and
- it is not possible to aggregate a group of 20 shareholders (ie Mary, Trung and 18 others) that hold 75% of the relevant interests in Exploration Co.

Trung will not be an *affected owner* – the active participant test will not apply to him as Exploration Co is not a *closely held entity*. That is, Exploration Co has more than three hundred members, both actually and on the assumptions in section 124-810. As there is no affected owner of a down interest under the scheme, Mary will not be an affected owner.

6.6 CONTROL THRESHOLDS AND AFFECTED OWNERS – OLD LAW TO NEW LAW COMPARISON TABLE

Old law	New law
Share value shifting rules (Division 140) apply only to controllers of a company and to their associates.	Entity interest direct value shifting rules (Division 725) also apply to active participants in a scheme that holds interests (debt or equity) in the target entity (where it is closely held).
Asset stripping rules and debt forgiveness rules (Divisions 138 and 139) apply to direct and indirect interests in 100% commonly owned companies (including group companies).	Indirect value shifting rules (Division 727) apply to companies and trusts where control or common ownership tests are satisfied. The common ownership nexus test only applies to closely held entities. *Affected owners* are controllers, common owners, interest holders through which control or common ownership is traced, associates and (if entities are closely held) active participants.

GLOSSARY 07

Active participant
In some circumstances where an entity involved in a value shift is closely held, the affected owners for the scheme will include active participants: interest holders that do not control or commonly own the entity, but actively participate in the scheme that effects the value shift.

An active participant is one who has actively participated in or directly facilitated the entry into the scheme, or has actively participated in the conduct of the scheme.

What amounts to active participation is discussed further in 'Control thresholds' (section 06).

> Subsection 725-65(2) (entity interest direct value shift) or subsection 727-530(3) (indirect value shift)

Adjustable value
The adjustable value of an asset is the value that would be used to work out whether a gain or loss is made when the asset is realised. An asset may have different adjustable values depending on whether the gain or loss is worked out under the CGT provisions, the revenue provisions or the trading stock provisions of the tax law. The adjustable value is:

- when applying the CGT provisions, the cost base or reduced cost base
- when applying the revenue provisions, the total of the amounts that would be subtracted from the gross disposal proceeds in calculating any profit or loss on disposal, and
- when applying the trading stock provisions, the asset's latest opening value for an income year or, if none, its cost.

The adjustable value of a depreciating asset has the meaning given by section 40-85 of the ITAA 1997.

> Definition of 'adjustable value' in subsection 995-1(1)

Adjustable value method
The adjustable value method is one of the methods that can be chosen to work out the consequences of an indirect value shift for particular interests. The method involves making reductions, and sometimes increases, to adjustable values of direct and indirect equity and loan interests in the *losing entity or gaining entity* as applicable. The other method is the realisation time method.

> Subdivision 727-H
> 'Adjustable value method – how it works', section 4.5.4

Affected interests
There can be consequences under the indirect value shifting and entity interest direct value shifting rules for *affected owners* of affected interests.

For the indirect value shifting rules, you must be an affected owner of:

- a loan to the *losing entity or gaining entity* (or interest as a joint owner in a loan)
- for a losing entity or gaining entity that is a company, a share (or an interest as joint owner in a share)
- for a losing entity or gaining entity that is a trust, an interest in income or capital, or any other interest in the trust (or an interest as joint owner)
- a right to purchase an interest mentioned above (for example, a call option), and

- an indirect interest – one of the interests mentioned above held in an entity that has a direct or indirect interest in the gaining or losing entity. For example, A Co holds all of the shares in B Co. B Co owns all of the shares in D Co. A Co has an indirect equity interest in D Co.

Sections 727-520 and 727-525

Note however that an interest you hold will not be an affected interest (so you will not be required to make any adjustments) if you are eligible to join the simplified tax system for each year that includes any of the indirect value shifting period, or would satisfy the CGT maximum net asset value test throughout the indirect value shifting period.

Subsection 727-470(2)

For the entity interest direct value shifting rules, you must be an affected owner of one of the following interests in the *target entity*:

- a loan (or interest as joint owner of a loan)
- for a target entity that is a company, a share (or interest as joint owner in a share)
- for a target entity that is a trust, an interest in income or capital, or any other interest in the trust (or an interest as joint owner), and
- a right to purchase an interest mentioned above (eg a call option).

Section 725-155 and 727-520

Affected owners

There can be consequences under the indirect value shifting and entity interest direct value shifting rules for affected owners of *affected interests*.

For the indirect value shifting rules, the affected interest must be held by:

- an *ultimate controller* or an *intermediate controller* of the *losing entity or gaining entity*
- an *ultimate owner* that holds interests taken into account in working out that the *common ownership nexus test* has been satisfied, or an entity through which their ownership rights are traced
- the losing entity and the gaining entity
- an *associate* of any of the above, and
- where the losing entity and gaining entity are closely held, each *active participant* in the scheme (other than an active participant that holds an indirect interest in the gaining or losing entity traced through a mere active participant).

Sections 727-460 and 727-465

For the entity interest direct value shifting rules, the affected interest must be held by:

- a controller – an entity that controls (for value shifting purposes) the *target entity*
- an associate of the controller
- (if an up interest) an associate of an associate of the controller that holds a down interest, or
- if the target entity is closely held, each active participant in the scheme.

Sections 725-80 and 725-85

Allocable cost amount
The amount that is allocated to the assets of an entity joining a consolidated group, or to the assets of a member of a consolidated group on formation, to determine the tax costs of those assets at that time. The allocable cost amount reflects the cost to the joined group of purchasing the joining entity.

Associate
Some of the consequences under the GVSR are applied to interest holders who are associates of others involved in a transaction or dealing. The tax law contains rules about when one entity is an associate of another. For example, the associates of natural persons include:

- their relatives
- if a partner in a partnership, partners and their spouses and children
- the trustee of a trust that they or any of their other associates can benefit under, and
- companies that they and their associates (alone or together) control the majority voting interest in or sufficiently influence.

There are also rules for determining the associates of a company, a trustee or a partnership.

Section 318 of the *ITAA 1936*

Bonus interests
Bonus interests are

- shares that a company issues to you in relation to shares you already own in that company, and
- units in a unit trust that a trustee issues to you in relation to units you already own in that trust.

Label for bonus equities at subsection 130-20 (1)

CGT asset
CGT assets include shares, units in a unit trust, collectables (such as jewellery), assets for personal use (such as furniture or a boat) and other assets (such as an investment property).

The GVSR mainly affects CGT assets that are interests in companies and trusts (for example, shares, units in a trust, or a loan to a company or trust).

Section 108-5

CGT event
A CGT event happens when a transaction takes place such as the sale of a CGT asset. The result is usually a capital gain or capital loss.

CGT events are listed in Division 104

Closely held entities
The indirect value shifting rules and the entity interest direct value shifting rules have a wider application where value is shifted between closely held entities, or interests in a closely held entity:

- interests held by active participants may be affected by the indirect value shifting rules and the entity interest direct value shifting rules, and
- the indirect value shifting rules may apply to value shifts between entities under common ownership (instead of only applying where the ultimate controller test is satisfied).

A closely held entity is a company that has fewer than 300 members, or a trust that has fewer than 300 beneficiaries. In applying these tests:

- a non-fixed trust is treated as having fewer than 300 beneficiaries, and
- a company or trust is treated as having fewer than 300 members or beneficiaries if 20 or fewer people own, directly or indirectly, interests conferring a right to the distribution of at least 75% of the income or capital, or the exercise of at least 75% of the voting rights.

Common ownership nexus test
The common ownership nexus test is relevant to working out whether there are consequences for an indirect value shift and, if there are, who are the *affected owners*.

A *losing and gaining entity* will satisfy the common ownership nexus test where there is significant commonality of ultimate ownership. Where this happens, the affected owners will include the ultimate owners who together share ultimate ownership of the losing and gaining entity, and certain entities through which they trace their ultimate control. There are different tests for companies, fixed trusts and non-fixed trusts. See 'Common ownership nexus' (section 6.4).

Section 727-400

Conservation covenant
A conservation covenant between a land owner and another party that:

- restricts or prohibits particular activities on the land that could degrade the environmental value of the land
- is permanent (where possible, the covenant is to be registered on the title to land), and
- is approved by the minister for environment or heritage.

Section 31-5

Control for value shifting purposes
There will only be consequences under the entity interest direct value shifting rules where a *target entity* is controlled (for value shifting purposes) at some time during the *scheme*. There will only be consequences under the indirect value shifting rules if the *losing entity and the gaining entity* are controlled by the same entity or a common ownership nexus is satisfied.

To work out if an entity controls (for value shifting purposes) a company, there are tests about the exercise of voting power, the rights to capital and dividend distributions, and actual control.

To work out if an entity controls (for value shifting purposes) a fixed trust, there are tests about the right to receive distributions of trust income or trust capital, the power to obtain the beneficial enjoyment of, or control the application of, trust capital or trust income, and control over the trustee.

To work out if an entity controls (for value shifting purposes) a non-fixed trust, there are tests about the extent to which the trustee is controlled, the power to obtain the beneficial enjoyment of, or control the application of, trust income or capital, capacity to benefit under the trust, and the right to receive distributions of any trust income or trust capital.

The tests are explained in more detail in 'Control thresholds' (section 06).

Where these threshold conditions are satisfied, the controller, their associates and entities through which they trace control will be *affected owners* for the scheme. There may also be other affected owners. See *Active participant*.

Subdivision 727-E

Corporate unit trust
A unit trust is a corporate unit trust in relation to an income year if the following conditions are satisfied:

- during the income year any of its units are either listed on a stock exchange or offered to the public, or the units are held by 50 or more persons, and
- under a prescribed arrangement the unit trust becomes the owner of property formerly owned by, or a business formerly carried on by, a company.

(A prescribed arrangement is one that involves a shareholder in the company being given a preference or advantage in relation to the acquisition or allocation of units).

Section 102J of the *ITAA 1936*

Deficit on realisation
One of the requirements for there to be consequences under the created rights direct value shifting rules is a deficit on realisation for the underlying asset.

There is a deficit on realisation if the market value of the underlying asset at the time when it is realised is less than it would have been if a right no longer existed over the asset at that time; or (for a case where the right is created at the realisation time) the market value is less than it would have been if the right had not been created at that time. The amount of the difference is the deficit on realisation.

Paragraphs 723-10(1)(g) and 723-15(1)(e)

Depreciating asset
A depreciating asset is an asset that has a limited effective life and can reasonably be expected to decline in value over the time it is used. Land, trading stock and some intangible assets cannot be depreciating assets.

Section 40-30

Direct replacement asset rollover
There may be consequences under the created rights direct value shifting rules when a loss is realised for tax purposes on an asset obtained under a direct replacement asset rollover.

A direct replacement asset rollover is one where a CGT replacement asset rollover applies directly to a transfer of the underlying asset to a company or trust. Losses made on the realisation of the replacement interests received may be subject to reduction.

Subsection 723-110(1)

Direct value shift
Broadly, a direct value shift happens where something is done that results in the market value of an asset decreasing with usually a resulting increase in the market value of another asset.

The GVSR contains two sets of rules that address direct value shifts:

- entity interest direct value shifting rules (section 02), and
- created rights direct value shifting rules (section 03).

Disaggregated attributable decrease
Working out whether there is a disaggregated attributable decrease for an interest in the *losing entity* is a step in determining whether an adjustment is required for that interest under the *adjustable value method* in the indirect value shifting rules.

The disaggregated attributable decrease is:

> market value of the interest at the start of the *indirect value shifting period* (or if the owner last began to own that interest during the indirect value shifting period – when the owner last began to own the interest)
>
> less
>
> market value of the interest at the indirect value shifting time, disregarding any impact on the market value of the interest during the indirect value shifting period that was caused by reasons other than the indirect value shift, or by the interest being an interest in the gaining entity.

There is no disaggregated attributable decrease if this formula provides a negative result.

Section 727-775

Disaggregated attributable increase
Working out whether there is a disaggregated attributable increase for an interest in the *gaining entity* is a step in determining whether an adjustment is required for that interest under the *adjustable value method*.

The disaggregated attributable increase is:

> market value of the interest at the *indirect value shifting time*, disregarding any impact on the market value of the interest during the *indirect value shifting period* that was caused by reasons other than the indirect value shift, or by the interest being an interest in the losing entity
>
> less
>
> market value of the interest at the start of the indirect value shifting period (or if the owner last began to own that interest during the indirect value shifting period – when the owner last began to own the interest).

If this formula leads to a negative result there is no disaggregated attributable increase.

Section 727-805

Down interest and up interest
A down interest is an equity or loan interest in the *target entity* that decreases in value when one or more things are done under an entity interest direct value shifting scheme. The decrease in value must happen at or after the time the first thing is done.

An up interest is an equity or loan interest in the target entity that:

- increases in value when something is done under an entity interest direct value shifting scheme, or
- is issued at a discount under an entity interest direct value shifting scheme.

The increase in market value or issue at a discount of the up interests must be referable to the same thing or things as the decrease in market value for the down interests.

Section 725-155

Economic benefits
Economic benefits are benefits of a commercial or economic value to the recipient – for example, services performed for an entity's benefit, the right to have services performed, or property receivable or received by an entity. An economic benefit can be provided if it is allowed, conferred, given, granted or performed.

Section 727-155

Entry history rule
The entry history rule identifies the history that an entity takes with it into a consolidated group. This history can affect the future tax liabilities of the group.

For most purposes, a consolidated group inherits the tax history of its joining subsidiaries. Specifically, the entry history rule ensures that everything that happened in relation to an entity before joining a consolidated group is taken to have happened in relation to the head company for the purposes of calculating the head company's future tax liabilities.

Equity or loan interests
Where control and other threshold tests are met, there may be consequences for equity and loan interests held directly and indirectly in the *losing entity and gaining entity* for an indirect value shift, or held directly in the *target entity* for an entity interest direct value shift.

Equity and loan interests are *primary equity interests*, *primary loan interests*, *secondary equity interests* and *secondary loan interests*.

Section 727-520

Gaining entity
See *Losing entity and gaining entity*.

Indirect replacement asset rollover
There may be consequences under the created rights direct value shifting rules when a loss is realised for tax purposes on an asset obtained under an indirect replacement asset rollover.

An indirect replacement asset rollover is one where a CGT replacement asset rollover applies when a CGT event happens to an interest in a company or trust, and that interest was obtained under a prior replacement asset rollover (that is, a direct replacement asset rollover or an indirect replacement asset rollover) that was covered by the created rights direct value shifting rules.

Subsection 723-110(3)

Indirect value shifting period
The indirect value shifting period is the period starting immediately before an indirect value shifting scheme is entered into and ending at the indirect value shifting time.

Subsection 727-150(7)

Indirect value shifting scheme
An indirect value shifting scheme is a scheme that effects a value shift between two entities.

Indirect value shifting time
The indirect value shifting time is the first time at which:

- all of the benefits that are to be provided in connection with a scheme can be identified
- the providers and recipients of those benefits are all in existence and can be identified, and
- the provision, or non-provision of benefits under the scheme is not subject to the satisfaction of any contingency.

Subsection 727-150(2)

Intermediate controller
An intermediate controller of the losing entity or gaining entity can be an *affected owner* for an indirect value shift.

An intermediate controller is an entity that *controls (for value shifting purposes)* a losing entity or gaining entity, but is itself controlled by the *ultimate controller*.

For example, the A Trust (widely held) owns all of the shares in G Co, which in turn holds 80% of the shares in H Co. If H Co is the losing entity for an indirect value shift for which another entity controlled by the A Trust is the gaining entity, then the A Trust is the ultimate controller, and G Co is an intermediate controller, of H Co.

Subsection 727-530(2)

Loan interest
See *Equity or loan interests*.

Losing entity and gaining entity
An indirect value shift happens when value is shifted between a losing entity and a gaining entity. A losing entity is an entity that provides *economic benefits* to another entity under a scheme, the market value of which exceeds the market value of economic benefits (if any) that are provided in return. The other entity is the gaining entity.

Subsection 727-150(3)

Loss focused basis
If a choice is made to apply the adjustable value method to make indirect value shifting adjustments, the loss focused basis is one of the methods available for making adjustments to affected interests in the losing entity. Broadly, the loss focused basis only requires the adjustable values of interests in the losing entity to be reduced if a loss would have arisen had the interest been realised at the indirect value shifting time.

The loss focused basis is applied unless a choice is made to apply the non loss focused basis.

Section 727-780

Loss reduction method
This method is applied to certain interests in a member of a consolidated group or *MEC group*, the allocated costs of which are not reconstructed on exit from the group.

Under the method, losses cannot be obtained on the realisation of the interests unless it can be shown that they are attributable to something other than indirect value shifts or losses within the group.

Subdivision 715-H
'Loss reduction method', section 5.4

Maximum net asset value test
There is a limit of $5 million on the net value of the CGT assets that a small business entity and related entities can own and still qualify for the small business CGT concessions. The $5 million limit is not indexed for inflation. This $5 million limit is called the maximum net asset value test.

A small business entity satisfies the maximum net asset value test if the total net value of CGT assets owned by:
- the small business entity
- any small business CGT affiliates of the small business entity
- any entities connected with the small business entity, and
- any entities connected with a small business CGT affiliate of the small business entity

does not exceed $5 million just before the CGT event that results in the capital gain for which the concessions are sought.

Note: the assets of a small business CGT affiliate are not included in the maximum net asset value test if those assets are not used, or held ready for use, in a business carried on by the small business entity or by an entity connected with the small business entity.

Section 152-15

Multiple entry consolidated (MEC) group
Where two or more eligible Australian-resident companies (and their wholly owned subsidiaries, if any) are wholly owned by a common foreign parent company, and do not have a common Australian parent company, they may choose to form a MEC group. A MEC group is treated as a consolidated group for income tax purposes.

Section 719-5

Non loss focused basis
If a choice is made to apply the adjustable value method to make indirect value shifting adjustments, the non loss focused basis is one of the methods available for making adjustments to affected interests in the losing entity. Broadly, the non loss focused basis involves making adjustments to the adjustable values of affected interests in the losing entity in every case reflecting the effect of the indirect value shift on the market value of those interests.

You need to make a separate choice to apply the non loss focused basis.

Subsection 727-775(5)

Notional resulting market value
The notional resulting market value of an interest in the *losing entity or gaining entity* for an indirect value shift is relevant where the *adjustable value method* is used.

The notional resulting market value of an interest in the losing entity is the market value of the interest at the *indirect value shifting time*, disregarding effects on the market value of the interest in the *indirect value shifting period* that are not attributable to the indirect value shift, and effects that happen because the interest is also an interest in the gaining entity.

The notional resulting market value of an interest in the gaining entity is the market value of the interest at the indirect value shifting time, disregarding effects on the market value of the interest in the indirect value shifting period that are not attributable to the indirect value shift, and effects that happen because the interest is also an interest in the losing entity.

Subsections 727-775(2) and 727-805(2)

Pre-CGT asset
A pre-CGT asset is, generally, an asset that was last acquired before 20 September 1985.

However, there are some circumstances where an asset acquired before this date will not be a pre-CGT asset – for example, because it is taken to be acquired on or after 20 September 1985.

Section 149-10

Pre-shift gain
There are different consequences for an entity interest direct value shift where there is a pre-shift gain for an *affected interest* in the *target entity*. For example, in some circumstances there will be a taxing event generating a gain in addition to a change to the adjustable values for that interest. An interest has a pre-shift gain if, immediately before the value shift, its market value was greater than its *adjustable value*.

Where an interest has more than one adjustable value, these values may differ. The existence of a pre-shift gain will need to be worked out for each adjustable value. For example, the adjustable values of an interest held as trading stock will be cost base, reduced cost base and trading stock opening value (or if none, cost).

Subsection 725-210(2)

Pre-shift loss
There are different consequences for an entity interest direct value shift where there is a pre-shift loss for an *affected interest* in the *target entity*. For example, the change to *adjustable value* is the full amount of value shifted, and not a proportional change to the adjustable value. An interest has a pre-shift loss if immediately before the value shift its market value was equal to or less than its adjustable value.

Where an interest has more than one adjustable value, these values may differ. The existence of a pre-shift loss will need to be worked out for each adjustable value. For example, the adjustable values of an interest held as trading stock will be cost base, reduced cost base and trading stock opening value (or if none, cost).

Subsection 725-210(3)

Presumed indirect value shift
A value shifting scheme can affect the market value of interests in an entity before the indirect value shifting time. In particular, the market value of interests in the entity that will become the losing entity when the indirect value shifting time happens (called the prospective losing entity) can be reduced.

Where this happens, losses can be realised when a direct or indirect *equity or loan interest* in the prospective losing entity is realised. Broadly, the rules dealing with presumed indirect value shifts prevent losses that result from the value shifting scheme, from the commencement of the scheme to the indirect value shifting time, being recognised for tax purposes, when the interests are realised during this period.

For more information see 'Presumed indirect value shift' (section 4.2.2).

Subdivision 727-K

Primary equity interests
The primary equity interests in a company are a share in the company or an interest as a joint owner in a share in the company. The primary equity interests in a trust are an interest in the trust income or trust capital, any other interest in the trust or an interest as joint owner in one of these.

Subsection 727-520(3)

Primary loan interests
The primary loan interests in an entity are a loan to the entity or an interest as joint owner of a loan to the entity.

Subsection 727-520(4)

Public trading trust
A unit trust is a public trading trust for an income year if all the following conditions are satisfied:

- any of its units are either listed on a stock exchange or offered to the public, or the units are held by 50 or more persons
- it carries on a trading business, or controls the carrying on of a trading business by another person, and
- it is a resident unit trust for that year, or satisfied the public trading trust definition for a prior income year.

Section 102R of the *ITAA 1936*.

Realisation event
Some of the consequences under the GVSR only apply where there is a realisation event that happens to an asset or interest. For example:

- the creation of rights rules will only apply where a realisation event that happens to the *underlying asset* (or in a case involving a CGT replacement asset rollover, that is taken to happen to an underlying asset) would realise a loss for tax purposes, and
- where no choice has been made to apply the *adjustable value method*, the indirect value shifting rules will only have consequences for an interest in the *losing entity* where a realisation event happens to it, and the event would realise a loss for tax purposes.

A realisation event is:

- a CGT event (except CGT events E4 and G1) that happens to a CGT asset
- for an item of trading stock, a disposal of the item or the ending of an income year, or
- for a revenue asset, disposing of, ceasing to own, or otherwise realising the asset.

Section 977-5 (CGT asset), section 977-20 (trading stock) and paragraph 977-55(a) (revenue asset)

Realisation time method
The realisation time method is applied to work out the consequences of an indirect value shift for particular interests unless the *adjustable value method* is chosen. The application of the method involves making adjustments to losses or deductions that arise on realisation of direct and indirect interests in the *losing entity*, and adjustments to gains or income that arise on direct and indirect interests in the *gaining entity*. See ‘Realisation time method – how it works’ (section 4.5.3).

Subdivision 727-G

Realise a loss for tax purposes
Some of the consequences under the GVSR only apply when a realisation event happens to an asset, and the event would realise a loss for tax purposes:

- the creation of rights rules only apply where a *realisation event* that happens to the *underlying asset* (or in a case involving a CGT replacement asset rollover, that is taken to happen to an underlying asset) would realise a loss for tax purposes, and

- for the indirect value shifting rules:
  - where no choice has been made to apply the *adjustable value method*, the indirect value shifting rules will only have consequences for an interest in the *losing entity* where a realisation event happens to it, and the event would realise a loss for tax purposes, and
  - there will only be consequences for a *presumed indirect value shift* if there is a loss realised for tax purposes on the realisation of an affected interest in the prospective losing entity.

A realisation event will realise a loss for tax purposes where:

- an entity makes a capital loss on a CGT asset from that event
- for an asset that is trading stock:
  - the item is disposed of for less than its cost in the same year it became part of the trading stock on hand of the entity disposing of it, or
  - the item is disposed of in a later income year for less than its value as trading stock on hand at the start of that income year, and
- for an asset that is a revenue asset, there is a loss on the happening of a realisation event.

> Subsection 977-10(1) (CGT asset), sections 977-25 and 977-30 (trading stock) and paragraph 977-55(b) (revenue asset)

Replacement asset rollover
A replacement asset rollover is a CGT rollover that allows the deferral of a capital gain or capital loss from a CGT event until a later event happens where your ownership of one CGT asset ends and you acquire another one.

> For a list of replacement asset rollovers, see section 112-115

Same asset rollover
A same asset rollover is a CGT rollover that allows you to disregard a capital gain or capital loss that you make from a CGT event.

> For a list of same asset rollovers, see section 112-150

Scheme
A scheme is any arrangement or any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise. It is a term of wide meaning.

From more information, see the definitions of scheme and arrangement in subsection 995-1(1) of the ITAA 1997.

Secondary equity interest
A secondary equity interest in an entity is a right or option to acquire a *primary equity interest* in the entity, or to have the entity issue such an interest.

> Subsection 727-520(6)

Secondary loan interest
A secondary loan interest in an entity is a right or option to acquire an existing *primary loan interest* in the entity, or to have the entity issue such an interest.

Subsection 727-520(7)

Services
The indirect value shifting rules provide a number of exclusions and safe harbours that apply specifically to value shifts where the benefits provided by one of the entities are, to the extent of at least 95% of their market value, services or the right to have services provided:

- a safe harbour for services provided by the losing entity for at least their direct cost (section 4.3.4)
- a safe harbour for services provided by the gaining entity for no more than a commercially realistic price (section 4.3.4), and
- where the realisation time method applies, an exclusion for value shifts where the losing entity provides services, unless a disqualifying condition is met (section 4.5.3).

The services to which these exclusions and safe harbours apply are limited to:

- doing work (including professional work and providing professional advice)
- providing facilities for entertainment, recreation or instruction
- leasing, renting, hiring, or allowing the use of, any asset
- packaging, transport or storage of property
- providing insurance
- banking services (in the ordinary course of a banking business), and
- lending money or providing financial accommodation.

Section 727-240

Shortfall on creating the right
There are consequences under the created rights direct value shifting rules only if there is a shortfall on creating the right.

A shortfall on creating the right will exist if the market value of the right when created exceeds the capital proceeds for the CGT event that involved the creation of the right.

In working out whether a shortfall exists, the relevant amount is the capital proceeds that are received for CGT purposes. That amount may differ from the actual consideration received because, for instance, a market value substitution rule may apply to increase the proceeds received for tax purposes. Where a market value substitution rule applies for tax purposes, the created rights direct value shifting rules will not apply as no shortfall will exist on the creation of the right. This outcome is appropriate as the difference between the actual capital proceeds received and the market value of the right would be taxed at the time the right is created.

Paragraphs 723-10(1)(e) and 723-15(1)(c)

Simplified tax system taxpayer
An entity is eligible to use the simplified tax system in an income year where it:

- is carrying on a business
- has an STS average turnover of less than $1 million, and
- has depreciating assets that have been written down to less than $3 million at the end of the income year.

Section 328-435

Single entity rule
A consolidation core rule under which the members of a consolidated group are taken to be parts of the head company of the group for certain income tax purposes.

Section 701-1

Superannuation entity
A superannuation entity is a complying superannuation fund, a non-complying superannuation fund, a complying approved deposit fund, a non-complying approved deposit fund or a pooled superannuation trust.

Section 727-125

Target entity
The entity interest direct value shifting rules are applied to value shifts that happen between interests in a single entity, called the target entity.

For example, there is an entity interest direct value shift when new interests in the Corn Trust are issued at a substantial discount to market value (and, as a result, the market values of the other interests in the trust decrease in value). The Corn Trust is the target entity for the entity interest direct value shift.

Subsection 725-145(1)

Taxing event generating a gain
Taxing events that generate a gain can arise where value is shifted out of certain *affected owners' down interests* under an entity interest direct value shift. Such taxing events happen to each down interest individually.

Where there is a taxing event generating a gain for a down interest in its character as a CGT asset, there is an amount included as a capital gain under CGT event K8. Where there is a taxing event generating a gain for a down interest in its character as trading stock or as a revenue asset, there is an amount included in assessable income.

Section 104-250 (CGT asset), subsection 725-310(5) (trading stock), subsection 725-320(5) (revenue asset)

Ultimate controller
An ultimate controller of the losing entity and gaining entity for an indirect value shift can be an affected owner.

An ultimate controller is an entity that *controls (for value shifting purposes)* the losing entity and gaining entity at some time during the indirect value shifting period, that is not itself controlled (for value shifting purposes) by any other entity.

Section 727-350

Ultimate controller test
The ultimate controller test is one of the alternative control threshold tests for the indirect value shifting rules. It will be satisfied if at some time during the indirect value shift period:

- there is an ultimate controller of the losing entity that is also the ultimate controller of the gaining entity at that time or at another time during the indirect value shift period;
- the gaining entity is the ultimate controller of the losing entity; or
- the losing entity is the ultimate controller of the gaining entity.

Where the ultimate controller test is satisfied, the ultimate controller will be one of the affected owners for the indirect value shifting scheme.

Section 727-105

Ultimate owner
The common ownership nexus test in the indirect value shifting rules takes into account the percentage ownership interests that particular ultimate owners hold in companies and fixed trusts.

The ultimate owners of an entity are, broadly, individuals, non-profit organisations and government bodies that hold interests in an entity, either directly or through one or more other entities.

Subsection 149-15(3)

Underlying asset
The created rights direct value shifting rules may apply where a right is created over an asset in favour of an associate for less than market value. The asset over which the right is created is called the underlying asset.

For example, if a lease is granted over land, the land is the underlying asset.

Paragraph 723-10(1)(a) and 723-15(1)(a)

Up interests
See *Down interest and up interest.*

FREQUENTLY ASKED QUESTIONS 08

8.1 FREQUENTLY ASKED QUESTIONS WHERE THE COMMISSIONER HAS A PRELIMINARY VIEW

This section contains frequently asked questions about the general value shifting regime (GVSR) and preliminary responses – where the Commissioner has a preliminary view.

1 General value shifting regime:

Are there any circumstances in which the rules in Divisions 138, 139 and 140 can apply to a value shift that happens under a scheme entered into on or after 1 July 2002?

No.

Divisions 138, 139 and 140 of the ITAA 1997 have not been repealed from a particular date (ie 27 June 2002) and technically are repealed only from the date of commencement (ie from Royal Assent to the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* on 24 October 2002). Literally, both the old and new provisions might *prima facie* apply until that time, but the intention is clearly that the old are replaced by the new and that, for example, a value shift excepted under the new value shifting rules would not still be captured by the old rules.

2 Entity interest direct value shifting:

***Does the control threshold test need to be met where there are* active participants *in a* scheme?**

Yes.

Adjustments are only required under the entity interest direct value shifting rules if the control threshold is satisfied for a *target entity*.

If the threshold is satisfied, and the target entity has less than 300 members, active participants are included as *affected owners* if they have *down or up interests* in the target entity.

3 Entity interest direct value shifting – issue of shares at a premium:

Do the entity interest direct value shifting rules apply where it is proposed that, at the time when an entity is formed, interests are to be issued at a discount to a person who will contribute expertise in the running of the entity's business?

No.

Cases have been raised where it is proposed that an entity be formed by two parties – a financier and a business manager. The financier is to contribute capital only – the business manager is to contribute capital and expertise in the conduct of the entity's business.

In recognition of their expected contribution of expertise, *equity interests* are to be issued to the business manager at a discount (the market value of the issued interests will be greater than the payment made for them).

The entity interest direct value shifting rules will not apply to arrangements of this type as it is not possible to identify an interest that reduces in value as a result of the scheme. That is, the market values of the issued interests will not change as a result of carrying out the proposal. The market value will reflect the elements of the proposed scheme. On issue, the financier's interests will have a market value less than their issue price. They are issued at a premium. They do not, as required by Division 725 of the ITAA 1997, reduce in value under the scheme.

4 Entity interest direct value shifting – reversals:

If an entity interest direct value shift involves a temporary grant of a preferential dividend right, does the payment of a dividend before the right comes to an end mean that the reversal exception cannot apply?

No.

One of the elements for applying the reversal exclusion in section 725-90 is that the state of affairs, but for which the value shift would not have taken place, ceases to exist within certain time parameters.

In a case involving a preferential right to dividends, the state of affairs that causes the value shift to happen (ie causes the reductions and increases in the market value of interests) is the existence of preferential rights for one class of shareholders.

The state of affairs will cease to exist when the preferential rights cease to exist, and the conditions in section 725-90 could be satisfied whether or not a dividend has been paid.

5 Neutral entity interest direct value shifts:

Is it a requirement for a neutral entity interest direct value shift that all of the interests are of the same type?

No.

The requirement for a neutral entity interest direct value shift for a particular interest holder is that the sum of the market value decreases for down interests that they hold is equal to the sum of the market value increases and discounts for their up interests.

This could cover interests of different types (for example, different classes of shares, options and *loan interests*).

6 Entity interest direct value shifting – adjustments:

Can the interests of a discretionary object or a default beneficiary in a discretionary trust be subject to adjustment under the entity interest direct value shifting rules?

Not usually.

Such interests will only be subject to adjustment if they are down or up interests in relation to the discretionary trust.

Interests in a discretionary trust could only be down or up interests if their value is capable of being affected by a value shift. The value of an interest would not normally be affected if the interest holder can only benefit from the trust through the exercise of the trustee's discretion.

7 Entity interest direct value shifting – taxing events generating a gain – down interests held by exempt entities:

What happens when there is an entity interest direct value shift for which there is a* taxing event generating a gain *for an entity the income of which is exempt for tax purposes?

The rules will apply without modification.

The nature of the exempt entity does not affect the way in which the tables and formulae in Subdivisions 725-D to 725-F apply. However, any taxing event generating a gain for the exempt entity will usually be exempt from tax.

This will mean that where value is shifted from an interest held by an exempt entity, full uplifts are available in respect of the interests to which the value is shifted. This will prevent underlying gains that are not taxed in the hands of the exempt entity from being later taxed in the hands of the holder of the up interest.

8 Entity interest direct value shifting – taxing events generating a gain – application to down interests held by a company:

Why does the disposal treatment approach apply to a shift in value between a revenue character down interest and a capital character up interest of a company? Companies cannot benefit from the CGT discount.

The value shift could benefit the company in other ways if rollover treatment applied. In particular, in a case involving shifts of value from interests held on revenue account to interests held only on capital account, the company might have capital losses available for offset against any increased capital gain made on realisation.

9 Entity interest direct value shifting – loan interest – pre-shift loss:

If there is a scheme to which Division 725 of the ITAA 1997 applies, and value is shifted out of a debt which has a cost base and reduced cost base equal to its market value just before the time of the shift, does the debt down interest have a* pre-shift loss*?

The interest is treated as if it had a pre-shift loss.

Subsection 725-210(3) provides that an interest has a pre-shift loss if, immediately before the decrease time, its market value was *equal to*, or less than, its *adjustable value*. As a result there will be consequences for the adjustable value of the debt – see the tables in sections 725-250 and 725-335.

10 General value shifting regime – definition of loan:

A number of GVSR consequences apply to loan interests. Is there a definition of loan?

There is not intended to be a definition of loan. Loan is intended to take its general law meaning.

Note: The asterisking of the reference to loan in paragraph 727-520(4)(a) was corrected by the *New Business Tax System (Consolidation and Other Measures) Act 2003*.

11 Indirect value shifting – exclusions:

There is an exclusion in section 727-250 for indirect value shifts that result from the payment of dividends and distributions – does this exclusion extend to dividends deemed to have been paid under Division 7A of the ITAA 1936?

Yes.

The exclusion applies to 'distributions of income or capital' that are made to an entity because they hold *primary equity interests* in the distributing entity.

There is a specific provision (subsection 727-250(5)) that extends the term distribution of income or capital to dividends and deemed dividends.

12 Indirect value shifting – exclusions:

Does the exclusion in section 727-220 for the transfer of an asset for at least its cost apply when the cost for which an asset is transferred is greater than its market value?

No.

The exclusion only applies when the *losing entity* transfers an asset at cost, and the market value of the asset is greater than that cost. If the asset is transferred at greater than market value, the transferor will be the *gaining entity.*

13 Indirect value shifting adjustments:

Can the interests of a discretionary object or a default beneficiary in a discretionary trust be* affected interests *in a* losing entity or gaining entity *for an indirect value shift?

Yes, there is no specific exclusion.

It is important to note, however, that interests in a discretionary trust could only be subject to adjustment if their value is capable of being affected by a value shift. The value of an interest would not normally be affected if the interest holder can only benefit from the trust through the exercise of the trustee's discretion.

8.2 MATTERS THAT ARE UNDER CONSIDERATION

1 Entity interest direct value shifting – taxing events generating a gain:

Are controlled foreign companies required to include amounts in attributable income as a result of taxing events generating a gain?

Explanation:
Consideration is being given to this topic.

2 Entity interest direct value shifting – adjustments – interaction with ESAS provisions

Can a participant in an employee share acquisition scheme, who is entitled to a cost base uplift under subdivision 130-D of the ITAA 1997, also obtain an uplift as the holder of an up interest under the entity interest direct value shifting rules?

Explanation:
An employee share acquisition scheme may involve a value shift where interests are issued to employees at a discount, and there is a corresponding reduction in the market values of existing interests in an entity.

There may be consequences for the value shift under Division 725 of the ITAA 1997 where the entity is controlled and, broadly, the employees are affected owners with up interests in the entity. Employees will be such affected owners where they are:

- controllers of the entity or *associates of controllers*
- associates of an associate that holds a down interest, or
- in a case where the target entity is *closely held*, active participants in the scheme.

It is not intended that a value shifting uplift (over and above the excess of market value over issue price) be available in these circumstances. It is argued that the terms of the enacted law may allow this, as there may be an uplift under Subdivision 130-D, and a separate uplift under Division 725. However, it is also arguable that only one uplift would in practice be available for the same value shift.

MORE INFORMATION

FURTHER READING ABOUT THE GENERAL VALUE SHIFTING REGIME

- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002*; Explanatory Memorandum Chapters 7–12 and 14
- *New Business Tax System (Consolidation and Other Measures) Act 2003*; Explanatory Memorandum Chapter 11
- *Taxation Laws Amendment Act (No. 2) 2004*; Explanatory Memorandum Chapter 2
- Treasurer's media release No. 58, 21 September 1999, attachment K
- Minister for Revenue and the Assistant Treasurer's media release No. 57, 14 May 2002, and
- Minister for Revenue and the Assistant Treasurer’s media release C014/2003, 6 March 2003.

TECHNICAL ENQUIRIES

If you have tax technical enquiries about the general value shifting regime, you can:

- phone the Business Tax Reform Infoline on **13 24 78** or
- for tax agents, phone the Tax Agent Infoline on **13 72 86**, **FKC 2 5**, or
- email your request to **btradvice@ato.gov.au**.

INTERNET

- Visit **www.ato.gov.au** – download publications, rulings and other general tax information for businesses.
- Business Entry Point **www.business.gov.au** – this is an interactive service providing easy access to business information and transactions with government. It can be used to register for an ABN and GST, or to apply for a tax file number.

PHONE

- General business enquiries phone **13 28 66** – most small business tax issues, including PAYG instalments, PAYG withholding, GST rulings, Australian business number (ABN), deductions from employees’ wages, business deductions, preparation of activity statements, account information for activity statement lodgment and payment, wine equalisation tax, fuel schemes and issues for non-profit organisations.
- Superannuation enquiries phone **13 10 20**.
- Personal enquiries phone **13 28 61** – individual income tax and general personal enquiries.

FAX

Get information faxed to you about business and individual taxes and the Higher Education Contribution Scheme (HECS). Phone **13 28 60** and follow the instructions to order a catalogue or to be sent information.

OTHER SERVICES

If you do not speak English well and want to talk to a tax officer, phone the Translating and Interpreting Service on **13 14 50** for help with your call.

If you have a hearing or speech impairment and have access to appropriate TTY or modem equipment, phone **13 36 77**. If you do not have access to TTY or modem equipment, phone the Speech to Speech Relay Service on **1300 555 727**.