

FOR DISCUSSION PURPOSES

**TAX VALUE METHOD
WORKING DRAFT (Version 1- May
2001)**

EXPLANATORY MATERIAL

Table of contents

Glossary	5
Status of the working draft.....	7
Chapter 1 What is the Tax Value Method?	9
Chapter 2 The relationship between the Tax Value Method and the current income tax law	21
Chapter 3 Why change to the Tax Value Method?	29
Chapter 4 The core components of the Tax Value Method	35
Chapter 5 How to work out income tax liability ... [to come later]	
Chapter 6 How to work out taxable income	[to come later]
Chapter 7 Core rules for assets	[to come later]
Chapter 8 Core rules for liabilities	[to come later]
Chapter 9 Cost and proceeds rules.....	[to come later]
Chapter 10 Splitting and merging rules	[to come later]
Chapter 11 Non-cash transaction rules	[to come later]
Chapter 12 Private or domestic	[to come later]
Chapter 13 Taxable income adjustments	[to come later]
Chapter 14 Net exempt income	[to come later]

Chapter 15 Depreciating assets and liabilities..... [to come later]

Chapter 16 Financial assets and liabilities [to come later]

Chapter 17 Capital gains treatment [to come later]

Glossary

The following abbreviations and acronyms are used throughout this explanatory material.

<i>Abbreviation</i>	<i>Definition</i>
ATSR	<i>A Tax System Redesigned: Overview, Recommendations, Estimated Impacts</i>
CGT	Capital gains tax
ITAA 1922	<i>Income Tax Assessment Act 1922</i>
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
TOFA	Taxation of financial arrangements

Status of the working draft

1. This explanatory material that is accompanying the draft Tax Value Method (TVM) legislation has been prepared under the auspices of the Board of Taxation. It will form part of a broader legislative framework that the Board is seeking to develop to effectively demonstrate the TVM concept and to allow comprehensive evaluation and testing of it. Depending on outcomes, the Board ultimately will make recommendations to the Government as to whether the TVM should or should not proceed.
2. As such, the draft legislation and this explanatory material have not been endorsed by the Treasurer or any other Minister, nor does it reflect the official views of the Treasury, the Australian Taxation Office, the Office of the Parliamentary Counsel or the Board of Taxation.

Work in progress

3. The draft legislation and this explanatory material are works in progress ('prototypes'). They are not being put forward as the final product or even as what the final product would look like. Rather, they are being exposed as the present state of the draft TVM legislation. Significant additions and deletions may be made to these drafts.
4. It is important to recognise also that in developing the TVM legislative framework it has been necessary, in some circumstances, to make assumptions about the taxation treatment of particular transactions. As with the structure of the legislation itself, those assumptions may be subject to change with further consideration of the issues, and should be regarded as in no way prejudicing any future consideration the Government may give to the relevant issues.
5. Further elements of the draft TVM legislative framework and associated explanatory material will be released on this website as and when they are developed.

Comments Welcome

6. It is uncommon for legislation to be exposed at this early stage of its preparation. That it is being exposed reflects a broader consultative approach being taken to this particular piece of legislation by the Board of Taxation because of its potential importance to the income tax system and because of the Board's wish to be able to evaluate the best possible product.

7. Comments on this draft explanatory material and the draft legislation are welcome. Comments in writing should be addressed to:

The Board of Taxation
C/- The Treasury
Langton Crescent
PARKES ACT 2600

8. Alternatively, comments can be e-mailed to the Board of Taxation Secretariat through this website.

Chapter 1

What is the Tax Value Method?

Outline of Chapter

- 1.1 This Chapter explains what the Tax Value Method is and how it taxes income.

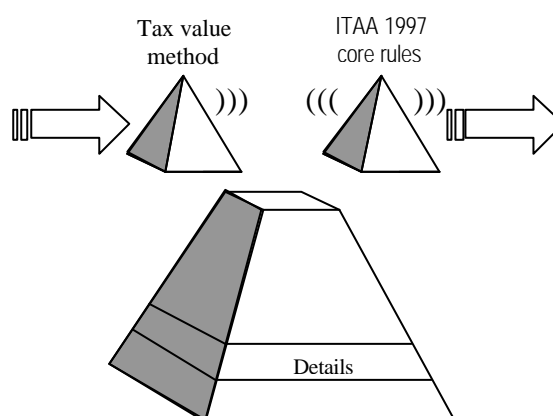
The Tax Value Method provides a new structure for the income tax law

In short

- 1.2 The Tax Value Method is a way of *structuring* our income tax law. In particular, it is a framework for expressing in legislation how to determine a taxpayer's *taxable income*. It would mean extending the asset-based approach used in the trading stock provisions right across the law.

New core rules

- 1.3 The essence of the restructuring provided by the Tax Value Method is a proposed set of new *core rules* for the income tax law. They would replace the core rules of the current law, which can be found in Divisions 4, 6 and 8 of the ITAA 1997. If the income tax law were a pyramid, what is proposed would look like this:



- 1.4 The core rules would consist mostly of:

- rules to work income tax liability;
- rules to work out taxable income;
- rules to work out net income;
- rules to work out the taxable income adjustment; and
- core concepts to support the calculation of net income, such as asset and liability definitions, holding rules for assets and liabilities, basic tax value rules, uniform cost and proceeds rules, splitting and merging of assets and liabilities rules, and non-cash transaction rules.

1.5 Detailed rules that form the vast bulk of the income tax law would still be necessary. However, those rules, in so far as they describe the tax base (i.e. what is assessable income and what is a deduction), would necessarily differ from what is currently there. For example, it is anticipated that their quantity would be significantly reduced because:

- the Tax Value Method core rules would do directly the job that existing detailed rules are needed to do; and
- the number of disparate rules that currently exist would be reduced by standardising the treatment of assets and liabilities under the Tax Value Method.

Taxable income under the Tax Value Method

1.6 'Taxable income' is the amount that income tax is levied on. The concept already exists under the ITAA 1997 but it would be worked out in a new way under the Tax Value Method. Instead of being:

assessable income - deductions

like it is in the ITAA 1997, taxable income under the Tax Value Method would be:

net income + taxable income adjustment – unused tax losses

1.7 The 'unused tax losses' is just the same as the deduction that is already available under the ITAA 1997 for prior year revenue losses.

1.8 The 'taxable income adjustment' is a mechanism to vary outcomes, mainly for policy reasons. It is discussed further below.

1.9 The real work of the Tax Value Method, though, is done in the ‘net income’ part of taxable income. This is the net income formula:¹

$$\left[\text{Receipts} - \text{Payments} \right] + \left[\begin{array}{l} \text{Closing} \\ \text{tax value} \\ \text{of assets} \end{array} - \begin{array}{l} \text{Opening} \\ \text{tax value} \\ \text{of assets} \end{array} \right] - \left[\begin{array}{l} \text{Closing} \\ \text{tax value} \\ \text{of liabilities} \end{array} - \begin{array}{l} \text{Opening} \\ \text{tax value} \\ \text{of liabilities} \end{array} \right]$$

The Tax Value Method would apply to all taxpayers

1.10 Given that the Tax Value Method would modify the income tax law at its most fundamental level, it is clearly applicable to all income taxpayers, including individuals and Simplified Tax System (STS) taxpayers. Nevertheless, it is likely that most individual and STS taxpayers would not even notice that their income was being calculated under the new approach. Individuals whose primary source of income is employment related and/or derived from interest and dividends would continue to use a primarily cash basis of accounting. Similarly, the STS would continue to operate in a manner consistent with the way it is intended to work within the current law.

How the Tax Value Method recognises gains and losses

1.11 So, the Tax Value Method is a system in which a taxpayer’s liability to tax is determined by reference to their cash flows and assets and liabilities, subject to excluding private or domestic transactions and other modifications made for policy reasons. The structure of the Tax Value Method applies to all transactions, other than private or domestic transactions.

Receipts and payments

1.12 The first component of net income is net annual cash flows of taxpayers. Putting aside private or domestic transactions, this is essentially the difference between a taxpayer’s opening cash and closing cash (i.e. the change in their cash assets).

Unmatched receipts and payments

1.13 Under the Tax Value Method receipts and payments may create immediate consequences for taxable income if they are not matched by an offsetting change in the tax value of assets or liabilities. These are called ‘unmatched’ receipts and payments. Examples include receipt of money for services performed by a business and payment of salaries to staff. Such receipts increase taxable income while such payments reduce taxable income.

¹ Most private or domestic amounts are excluded. Assets included in the second element of the formula exclude money.

Matched receipts and payments

1.14 Alternatively receipts and payments may not create immediate consequences for taxable income because they may give rise to offsetting changes in the tax value of assets and liabilities. These are called ‘matched’ receipts and payments. Examples include receipt of money from drawing down a business loan and the payment for a business asset.

Tax values of assets and liabilities

1.15 The other component of the Tax Value Method is that a taxpayer’s assets and liabilities, other than private assets and liabilities, are recognised. It does this by assigning them a tax value.

1.16 In some cases, the tax value of an asset or liability can change without the existence of an offsetting receipt or payment or offsetting change in the tax value of another asset or liability. This allows any taxing points relating to the assets and liabilities to be recognised.

1.17 In so far as assets are concerned, this will almost always result in a loss being recognised (a ‘deduction’ in current language). An example is a decline in value of a depreciating asset over its effective life (e.g. a business truck). Only in the case of a limited range of financial assets will an unmatched increase in tax value occur.²

How common cases are treated under the Tax Value Method

1.18 It’s not necessarily apparent, just from looking at the net income formula (see paragraph 1.9), that it will produce the same outcomes as the current law but, in fact, it usually will. What follows explains how the current income tax *law* compares to the proposed Tax Value Method *law* in producing tax outcomes, and illustrates the discussion at paragraphs 1.11 to 1.17. How taxpayers prepare their tax returns in practice is expected to follow the same pattern as now (more on that at paragraphs 1.37 to 1.41).

Simple revenue expense

1.19 First, let’s look at the simple case of a revenue expense. It can sometimes be difficult under the current law to work out which expenses are revenue expenses (and, therefore, deductible) and which are capital expenses (and usually not deductible). But there are some expenses that are clearly revenue, so the first case chooses one of those.

² This is part of the policy recommendations dealing with the taxation of financial arrangements (TOFA) – see section 9 of *ATSR*

Example 1.1

Suppose you pay someone \$500 to clean your office. You pay the amount, the cleaning is done and, under the current law, you can claim a deduction for the \$500.

In the same transaction, the net income formula would apply like this:

$$\left[\begin{array}{c} \text{Receipts} \\ - \\ \text{Payments} \end{array} \right] + \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of assets} & \text{of assets} \end{array} \right] - \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of liabilities} & \text{of liabilities} \end{array} \right]$$

$$[0 - 500] + [0 - 0] - [0 - 0] = -500$$

The payments side of the formula has increased, so that ‘deductions’ have gone up. The result is the same because a payment under the Tax Value Method is treated in exactly the same way as a revenue expense under the current law.

Prepayments

1.20 Now, let’s look at simple cases where the revenue expense is paid in one year for something to be done in a later year. In one sense, this can be seen as a capital expense because the expense procures a business asset - the right to future services. Most people, though, would conclude that a revenue expense stays a revenue expense even if prepaid. That being so, the law would allow an immediate deduction.

1.21 However, that result is not sustainable from a taxation policy perspective because divorcing the timing of deductions from the time the benefits of the expenditure are consumed may lead to a focus on taxation, rather than commercial, advantages. To address that concern, the current law contains a number of special rules³ to defer the deduction until the intended benefit is obtained. Those rules apply except in some limited circumstances.

Example 1.2

In the same transaction, suppose you pay the cleaner this year for cleaning to be done in later years. Without the special rules, the outcome would be the same as the payment for the current year’s cleaning. However, the special rules (section 82KZM et al) defer the deduction until the year(s) that the cleaning is done.

The Tax Value Method will produce that outcome as part of the generic rules dealing with depreciating assets and liabilities. In the year of the transaction, the pre-payment has this effect on net income:

³ For example, section 82KZM et al of the ITAA 1936 and section 70-15 of the ITAA 1997.

$$\left[\begin{array}{c} \text{Receipts} - \text{Payments} \end{array} \right] + \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of assets} & \text{of assets} \end{array} \right] - \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of liabilities} & \text{of liabilities} \end{array} \right]$$

$$[0 - 500] + [500 - 0] - [0 - 0] = 0$$

The payment is matched by an asset with a tax value equal to the payment. That asset is the right to the future cleaning services. The ‘deduction’ is obtained as the services are provided because the tax value of that right will decline as services are consumed. That might take several years but let’s suppose the services are being provided entirely in the second year:

$$[0 - 0] + [0 - 500] - [0 - 0] = -500$$

The ‘deduction’ appears because the tax value of the right has declined from \$500 to nil during that year. A decline in the tax value of assets produces a ‘deduction’.

1.22 The result is that special prepayment rules are not needed to get the desired outcome under the Tax Value Method.

1.23 However, a special rule is needed to get to the result achieved under the current law’s limited exceptions to the prepayments rules. That special rule is to give a zero tax value to the right to future benefits for taxpayers in those limited circumstances. Effectively, it puts them on a cash receipts basis. That will apply, for instance, to people who elect into the Simplified Tax System.

1.24 It is also worth looking at the position from the viewpoint of the taxpayer who receives a payment for providing future benefits.

Example 1.3

Under the current law, the cleaner would probably be able to defer assessment of the prepayment until the cleaning was done, because of the decision in *Arthur Murray (NSW) Pty Ltd v FCT*.⁴ The issue would be whether the income was ‘derived’ before the cleaning was done or, indeed, whether it was ‘income’ at all before that time.

The Tax Value Method will get the cleaner to the same result without having to interpret the words ‘derived’ and ‘income’. In the year of the prepayment, the result under the Tax Value Method would look like this:

$$\left[\begin{array}{c} \text{Receipts} - \text{Payments} \end{array} \right] + \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of assets} & \text{of assets} \end{array} \right] - \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of liabilities} & \text{of liabilities} \end{array} \right]$$

$$[500 - 0] + [0 - 0] - [500 - 0] = 0$$

⁴ (1965) 114 CLR 314

The receipt would be matched by the liability to provide the future cleaning services. In the year that the services are provided, the result would look like this:

$$[0 - 0] + [0 - 0] - [0 - 500] = 500$$

The tax value of the liability declines as the services are provided. A decline in the tax value of a liability produces a taxable gain.

Credit transactions

1.25 Now let's look at cases where current benefits are paid for, not with cash, but with a promise to pay later. This is a credit transaction. It doesn't much matter here whether there is a direct promise to pay, or an indirect promise via a credit card.

1.26 The existing law would probably treat you as having 'incurred' the outgoing and give you a deduction immediately (subject to the prepayment rules, of course). It would not give you another deduction when you made the payment because you would not have incurred anything at that time.

1.27 How would the Tax Value Method work in these cases? Again, it gets to the same result because, even though there isn't any increase in payments, there is an increase in liabilities.

Example 1.4

Suppose you promise to pay the cleaner next year for this year's cleaning rather than paying straight away. The effect of the transaction in the first year is this:

$$\left[\text{Receipts} - \text{Payments} \right] + \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of assets} & \text{of assets} \end{array} \right] - \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of liabilities} & \text{of liabilities} \end{array} \right]$$

$$[0 - 0] + [0 - 0] - [500 - 0] = -500$$

As you can see, the \$500 'deduction' comes, not from the payment part of the formula (as it would under the current law), but from the liability part. In the next year, when you make the payment, there would be no tax effect, just as there isn't under the present law:

$$[0 - 500] + [0 - 0] - [0 - 500] = 0$$

The \$500 payment you make in the second year is negated by the \$500 decline in the tax value of your liabilities.

Capital gains

1.28 A claim sometimes made about the Tax Value Method is that it will tax unrealised gains. Indeed, if the ‘value’ part of the net income formula meant ‘market value’ it would do exactly that. It would also allow deductions for unrealised losses. But this is the *Tax Value* Method, not the *market value* method, and therein lies a world of difference.

1.29 In most cases, the *tax value* of an asset will be its cost. That will achieve the same outcomes as the current law. For instance, if you make a capital gain or loss under the current law, you only make it (usually) *when you dispose* of the CGT asset.

Example 1.5

Let’s say that you buy a block of land for \$100,000 and hold it for 10 years. At that time, its market value has risen to, say, \$250,000. The current law doesn’t tax you as the value goes up, it only taxes you when you realise the gain by, typically, selling the land.

The Tax Value Method would treat the land as an asset with a tax value equal to its cost, \$100,000. And it would stay at that value until you stopped holding the land because, in almost all cases, the tax value of CGT assets is their cost.⁵ So, the transaction in the year you bought the land would look like this:

$$\left[\begin{array}{c} \text{Receipts} \\ - \\ \text{Payments} \end{array} \right] + \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of assets} & \text{of assets} \end{array} \right] - \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of liabilities} & \text{of liabilities} \end{array} \right]$$

$$[0 - 100,000] + [100,000 - 0] - [0 - 0] = 0$$

Note how, instead of deciding deductibility by asking whether an expense was income or capital, the Tax Value Method allows a ‘deduction’ for *all* payments but brings any matching asset to account, thus producing a neutral effect. This, in effect, gives the correct treatment to ‘capital’ items.

In the second year of this transaction, you would get this result:

$$[0 - 0] + [100,000 - 100,000] - [0 - 0] = 0$$

Because there is no change between the opening and closing *tax values* of the land, there is no gain or loss to account for. It makes no difference what has happened to the market value of land during the year - only the tax value is accounted for.

⁵ The tax value of such an asset could increase (because its cost would increase) if payments are made to improve it. However, this increase is *matched* by the payments, so there is no effect on taxable income.

Now see what happens when the land is sold in the tenth year:⁶

$$[250,000 - 0] + [0 - 100,000] - [0 - 0] = 150,000$$

The gain is brought to account on disposal of the land, exactly as the current law would do.

1.30 In the case of capital gains, though, a number of special rules are needed to achieve particular policy objectives. The two main ones are:

- capital gains made by individuals and some other entities should be discounted if the asset has been held for at least 12 months; and
- capital losses should be quarantined to prevent them offsetting non-capital gains.

1.31 Like most policy variations, those objectives would be achieved through taxable income adjustments. So, in the example above, if the taxpayer was eligible for the 50% CGT discount on the asset, there would be a downwards adjustment to taxable income of \$75,000 to ensure only half the gain was taxed.

Depreciation

1.32 Although most assets will maintain a tax value equal to their cost, some types of asset do have variable tax values. Depreciating assets are a good example. Under the current law, plant and some other assets ‘depreciate’. The present system recognises appropriate capital expenses by allowing the amount of depreciation as a deduction.

Example 1.6

Suppose you buy a printing press with a 10 year life for \$15,000 and depreciate it using the prime cost (or straight line) method. Under the current law, you would get a \$1,500 deduction in each of those 10 years.

The Tax Value Method achieves exactly the same result. However, rather than making the amount of depreciation a deduction, it reduces the tax value of the press by that amount. The decline in the press’s tax value produces a net ‘deduction’ in the year you acquired it:⁷

$$\left[\text{Receipts} - \text{Payments} \right] + \left[\begin{array}{c} \text{Closing} \\ \text{tax value} \\ \text{of assets} \end{array} - \begin{array}{c} \text{Opening} \\ \text{tax value} \\ \text{of assets} \end{array} \right] - \left[\begin{array}{c} \text{Closing} \\ \text{tax value} \\ \text{of liabilities} \end{array} - \begin{array}{c} \text{Opening} \\ \text{tax value} \\ \text{of liabilities} \end{array} \right]$$

$$[0 - 15,000] + [13,500 - 0] - [0 - 0] = -1,500$$

⁶ Assume the sale proceeds go into cash on hand and are not used to buy a new asset.

⁷ These calculations assume that the press got a full year’s depreciation in each year. In the first year, that means that you began to use it on the first day of the year.

The deduction is equal to the difference between the amount paid for the press and its tax value at the end of the income year after it has been depreciated. And, in the next year:

$$[0 - 0] + [12,000 - 13,500] - [0 - 0] = -1,500$$

Here, the deduction arises because the press's tax value has declined. And so on for each of the next 8 years until the tax value reaches zero.

Now suppose that you sell the press in the third year for \$12,500. The current law would work out a balancing charge equal to the difference between the press's depreciated value and the \$12,500 sale price. It would treat that amount as assessable income.

Under the Tax Value Method, you would get the same outcome because any gain or loss on disposal of the press would be recognised simply as the difference between what is received for the disposal and the tax value the press had at the start of the year. So, being sold for \$12,500 during the third year, the transaction would look like this:⁸

$$[12,500 - 0] + [0 - 12,000] - [0 - 0] = 500$$

The \$500 gain, comes in as a normal incident of the Tax Value Method. No special balancing adjustment rules are needed.

Trading stock

1.33 Trading stock under the Tax Value Method hardly needs to be explained because the current law already uses a version of the Tax Value Method (see paragraphs 2.24 to 2.26). It produces a net amount for trading stock that is either added to assessable income or is a deduction. Nothing much will change for trading stock under the Tax Value Method.

1.34 However, one area that does require a special rule under the current law is where you pay for stock that is neither sold nor 'on hand' at the end of the year. Without that special rule, such cases would produce a deduction that would not be matched by proceeds or by an increase in stock on hand. The special rule defers the deduction until the stock turns up⁹.

1.35 The Tax Value Method doesn't need that special rule to get the intended result.

Example 1.7

Suppose you pay \$1,000 in an income year for trading stock that is delivered in the next year. You get this outcome:

⁸ Again, assume the sale proceeds go into cash on hand and are not used to buy a new asset.

⁹ See subsection 70-15(3) of the ITAA 1997.

$$\left[\begin{array}{c} \text{Receipts} \\ - \\ \text{Payments} \end{array} \right] + \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of assets} & \text{of assets} \end{array} \right] - \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of liabilities} & \text{of liabilities} \end{array} \right]$$

$$[0 - 1,000] + [1,000 - 0] - [0 - 0] = 0$$

Here the closing asset figure represents your *right to get the stock*, not the stock itself. When you actually get the stock, the right vanishes but is replaced by the actual stock at the same \$1,000 tax value.

1.36 As with the present trading stock regime, the tax value of trading stock is variable. At the taxpayer’s choice, the closing tax value of each item of stock on hand at the end of a year can be set at cost, replacement price or market selling value.¹⁰

How will the Tax Value Method affect the way tax returns are prepared in practice?

1.37 The income tax system is designed to provide a result: taxable income. The Tax Value Method is a *scheme* in the law for explaining that result.

1.38 As a scheme, the Tax Value Method *explains* taxable income, but it does *not* prescribe the practical way in which taxpayers compute taxable income. Therefore, there is a distinction to be drawn between the concepts that work together to explain taxable income (as set out in the examples above) and its practical derivation.

1.39 For example, the scheme of the current law is assessable income less deductions, but most business taxpayers do not work out their taxable income in that way. Instead, they start with their accounting profit and reconcile it to taxable income.

1.40 With this in mind, it is anticipated that the Tax Value Method will not be accompanied by increases in the cost of working out taxable income. Such costs should remain the same, particularly in the case of taxpayers who currently work out their taxable income by reconciling from accounting profit. The same sort of calculations should be necessary; the same sort of results should be obtained; however, those results would be explained using different conceptual building blocks, with some consequent changes in language. This is demonstrated in the paper ‘Preparing income tax returns under the TVM’ circulated to working group members in February.

1.41 This proposition needs to be tested further as the Tax Value Method is developed.

¹⁰ This assumes a continuation of the current trading stock valuation methods. *ATSR* recommended different valuation methods (see recommendation 4.17).

Chapter 2

The relationship between the Tax Value Method and the current income tax law

Outline of Chapter

2.1 This chapter broadly explains how the Tax Value Method has evolved out of our current income tax law and compares it to the way the current law sets out the tax base.

The evolution of our income tax law

Our early income tax law

2.2 The British government enacted the world's first income tax law during the Napoleonic wars in the late eighteenth century. The Commonwealth of Australia (as opposed to the States) enacted its first income tax law in 1915.

2.3 That 1915 income tax law used the 'income' model that had been used by the various colonies before it:

Taxable income equals income less deductions.

2.4 The same model was used in each later income tax law, including the ITAA 1936 (although the core rules migrated to the new Act in 1997).

2.5 The courts have interpreted that model by reference to trust law ideas that distinguished between income (which belonged to the life tenant) and capital (which belonged to the remainderman).

2.6 This put a lot of pressure on the law because the *form* of a gain was crucial. This caused many disputes over whether a gain was 'income' or not. Of course, it also failed to recognise many losses, leaving unsuspecting taxpayers without appropriate tax relief for legitimate business expenditure. This is because deductions were generally allowed only if there was a nexus to the production of 'income', and capital expenditure was normally not deductible.

2.7 The American courts, in contrast, recognised early on that a broader notion of gain should be recognised and not just gains that conformed to the trust law ‘income’ form.¹¹

The reaction to early problems

2.8 This emphasis on form over substance led to a seemingly endless series of changes to the law all moving towards ensuring that what was taxed was gains, not just ‘trust law income’. For the most part, those changes dealt with assets.

2.9 One early example was the rule to tax the profits made on the sale of property acquired for a profit-making sale or made from a profit-making scheme (paragraph (ba) of the definition of ‘income’ in section 4 of the ITAA 1922; paragraph 26(a) of the ITAA 1936). But before tax reform in 1985, these changes were generally made within the ‘trust law income’ paradigm.

2.10 The addition of the capital gains regime in 1985 cemented a new paradigm that gains, not just ‘income’, should be taxed. Even then, however, there was still a distinction based on the form of a gain because capital gains were discounted for general inflation while we still taxed nominal ‘income’ gains.

2.11 But this wasn’t all one-sided. The Parliament has been very busy adding rules to allow deductions that couldn’t be claimed under the pure general deduction rules that went with the ‘trust law income’ model.

2.12 The clearest examples of these have been the capital allowance regimes that, at last count, were approaching 40 different regimes (although the Government has announced that a uniform capital allowance regime will soon replace many of them).

2.13 The Courts too have recognised the deficiencies of the ‘trust law income’ model. In *Whitford’s Beach Pty Ltd v FCT*¹² and cases like it, the Courts decided that a *gain* on disposal of an asset could in some cases be income, even without special rules. However, they had to say that only the gain (not the full proceeds) was income because there was no rule to allow a deduction for the purchase price.

¹¹ See, for example, *Merchants’ Loan & T. Co. v Smietanka* (1921) 255 U.S. 509, *Eldorado Coal & Mining Co. v Mager* (1921) 255 U.S. 525 and *Walsh v Brewster* (1921) 255 U.S. 537 (all cited in Krever, R, “The Ironic Australian Legacy of *Eisner v Macomber*”, (1990) 7 *Australian Tax Forum*, page 191).

¹² 82 ATC 4,031.

Where are we now?

2.14 So, we have been changing our income tax law ever since 1915 because it didn't recognise what the Parliament thought it should be recognising. It is only the dramatic acceleration of that process in the last 20 years or so that has made the trend really obvious.

2.15 The result of those changes though is that our 'income' tax is not really a tax on what lawyers would have called 'income' in 1915. Truly, it is now more a tax on an economic concept of income.

2.16 The Ralph proposals for a consistent treatment of assets and liabilities would, if adopted, move us even further away from the trust law income tax base (whether implemented within the current structure or a Tax Value Method structure). The TOFA proposals, for instance, would bring to account gains and losses on some financial assets on an accruals basis.

2.17 What became clear to the Ralph Committee was that the existing description of the tax base was now outdated.

2.18 They determined to come up with a new description. However, they didn't propose to change what was taxed (except by specific recommendation), only to redescribe what was taxed in simpler, more coherent, terms.¹³

2.19 That redescription is called the 'Tax Value Method'.

How is the Tax Value Method similar to the current income tax system?

2.20 The general income and deduction provisions¹⁴ are a fundamental aspect of the current business income tax system. However, an equally fundamental, and more pervasive, feature of the current business income tax system is the multitude of provisions that operate by seeking to classify transactions, assets or liabilities and give them a cost or amount so that, on certain later events, tax consequences can arise.

2.21 An example of these is the trading stock provisions. They specify what is trading stock, give that trading stock a value and specify when it was first held (on hand) and when it ceases to be held (no longer on hand).

2.22 Equally, the depreciation provisions specify what is plant and articles and whether they are used in the required circumstances. Those plant or articles can then be written off, and for that purpose they are given a cost by the

¹³ See more on this at paragraphs 2.33 to 2.39.

¹⁴ Divisions 6 and 8 of the ITAA 1997.

depreciation provisions.¹⁵ Similarly, Section 25-25 of the ITAA 1997 specifies certain outgoings as borrowing expenses, sets an amount for those borrowing expenses and then allows the amortisation of that amount by reference to the effluxion of time.

2.23 Each of these provisions (or its forbear) was found in the ITAA 1936 when it was originally enacted. Each of them performs the same basic function:

- It establishes the existence of a particular asset, such as trading stock, or of a liability, such as borrowing expenses.
- It sets a value for that asset or liability (e.g. its cost or amount), and on occasions allows that value to change (e.g. through the effluxion of time).
- It specifies when the taxpayer commences to hold and ceases to hold the asset, so that, for example, trading stock is no longer held when it is not 'on hand'.

2.24 Indeed, it is useful to refer to Section 70-35 of the ITAA 1997, which states:

“70-35 You include the value of your trading stock in working out your assessable income and deductions

- (1) If you carry on a business, you compare:
 - (a) the value of all your trading stock on hand at the start of the income year; and
 - (b) the value of all your trading stock on hand at the end of the income year.
- (2) Your assessable income includes any excess of the value at the *end* of the income year over the value at the *start* of the income year.
- (3) On the other hand, you can deduct any excess of the value at the *start* of the income year over the value at the *end* of the income year.”

2.25 Although this provision applies the methodology described above, its operation is no different to the operation specified by the Tax Value Method proposals. In essence, it is a tax value method provision.¹⁶

2.26 It operates by the application of the Tax Value Method concept of seeking to assess the change in tax value of an asset. The depreciation

¹⁵ Other capital asset amortisation provisions operate in the same manner.

¹⁶ To demonstrate this conclusion refer to *ATSR*, page 159.

provisions and borrowing expenses provisions equally apply the Tax Value Method.

2.27 In the same manner, more sophisticated provisions in the ITAA 1936 and ITAA 1997 are tax value method provisions. For instance, the traditional security provisions identify certain debts and seek to specify a cost for those debts. Then, in certain circumstances where the debt is no longer held, taxation consequences arise. Division 16E of the ITAA 1936 applies to certain debts, specifies a present and future value for the debt and deems consequences to arise as a result of the effluxion of time. The debt forgiveness provisions apply to liabilities owed by taxpayers, specify a value for these liabilities and specify tax consequences in circumstances where the liability is reduced.

2.28 The Tax Value Method is applied in more fundamental areas found originally in the ITAA 1936. In *Whitford's Beach Pty Ltd v FCT*¹⁷, the Full High Court effectively stated that where an asset was ventured into a profit making undertaking or scheme, it received at that time a tax value equal to its then market value. The assessable gain arising was the difference between this tax value and the amount received by the taxpayer on disposal of the asset.

2.29 In *RACV Insurance Pty Ltd v FCT*¹⁸ Menhennitt J. stated that a liability incurred, but not reported, had a tax value equal to its estimated dollar value and that this tax value would be deductible in the year in which the liability commenced to be held by the taxpayer. If it was established in a later income year that the tax value of the liability was different to the amount originally estimated, the difference between the later amount and its original estimate would become assessable or deductible in the later income year.

2.30 Of course, the description above of each example is not presented in the language in which they were decided, but it is easily demonstrated that the concepts expressed were merely the application of a tax value method.

2.31 In many circumstances in the current law, the Tax Value Method is the basis of assessing income and allowing deductions. Under the accruals method, income is assessed when it is derived. In essence, this means that where a taxpayer holds a receivable at year end (that was not held at the beginning of the year), the value of that receivable should be included in the taxpayer's assessable income. Under the general deduction provision, a taxpayer is allowed a deduction for a loss or outgoing incurred, even if not yet paid. Restated, where a liability exists at year end, the amount of the liability, its tax value, should be an allowable deduction in the calculation of the taxpayer's assessable income.

2.32 As this discussion demonstrates, the Tax Value Method is one of the foundations of the current income tax system and has an extensive and long

¹⁷ 82 ATC 4,031.

¹⁸ 74 ATC 4,169.

standing application within that system. Moreover, the Tax Value Method (or its equivalent) is a necessary component of an income tax system. An income tax system does not simply seek to recognise cash flows that occur within a given time period. If the income tax system seeks to tax rights to receive amounts, or to allow deductions for the obligations to pay amounts, it requires processes based upon the Tax Value Method.

Will the Tax Value Method always produce the same tax outcomes as the current law?

2.33 As a general statement, the Tax Value Method isn't intended to change tax outcomes; either the amount that is taxed or the time at which it is taxed.

2.34 Inevitably though, there will be some differences.

2.35 One case is where the Government makes policy decisions for change. This would be the case, for example, if the Government decided to accept the Ralph policy recommendations dealing with the taxation of financial arrangements (Section 9 of *ATSR*).

2.36 Also, inherent in the Tax Value Method is a more consistent treatment of assets and liabilities. This consistent treatment will do these things:

- *Standardisation.* The disparate treatment that currently applies to different kinds of assets and liabilities (e.g. depreciating assets as compared to CGT assets) will be standardised. This standardisation in turn may alter tax outcomes in some cases (e.g. consistent timing of recognition regardless of asset type). The comprehensive recognition of liabilities under the Tax Value Method will also standardise the timing of recognition of gains and losses for the provision of services and the disposal of assets.
- *Complete description of the income tax base.* One consequence of having a completely described tax base, rather than a patchwork of separate regimes trying to cover the same ground, is that there will be no gaps (e.g. expenditure black holes will all be filled; tax relief for all non-private expenses will be given at some time). Similarly, overlaps in the present patchwork of regimes should not arise. To the extent that the present law doesn't deal adequately with those overlaps, current cases of double taxing (or double deductions) will disappear under the Tax Value Method.

2.37 What *will* change, and what is intended to change, is how the law *describes* the tax base.

2.38 This will lead to some changes in the structure and wording of the law, most noticeably in the core rules, which would be completely replaced.

2.39 In addition, there would necessarily be changes to many other areas because they would need to marry with the Tax Value Method rather than with the existing core rules.

Chapter 3

Why change to the Tax Value Method?

Outline of Chapter

3.1 This Chapter explains what it is hoped will be achieved by changing the structure of Australia's income tax law to the Tax Value Method.

Preliminary

3.2 This discussion sets out a series of criteria against which the Tax Value Method could be assessed as it is developed. Many of the statements made are *assertions*. An aim of the process to develop the Tax Value Method should be to test these assertions.

Broad objective of the Tax Value Method

3.3 The broad objective of the Tax Value Method is to build a more internally consistent framework for the income tax law, as a means of achieving improved simplicity, durability, transparency and certainty in the law. In doing this, the Tax Value Method should not add to the costs of compliance.

3.4 It is hoped that a subsidiary benefit of producing a sounder structure to the law will be to provide a platform from which other deficiencies in the income tax law can be identified and addressed.

Simplification

Conceptual simplification

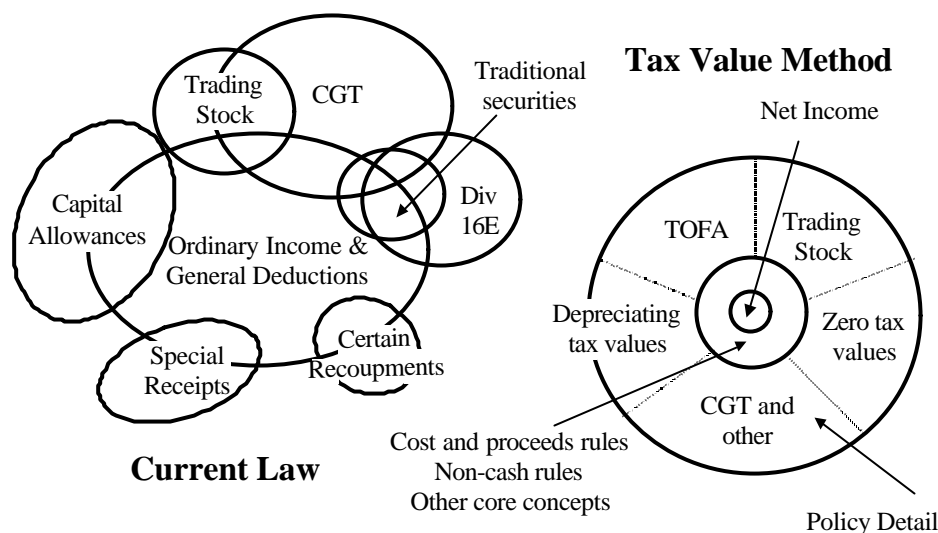
3.5 An aim of the Tax Value Method is to explicitly recognise a single conceptual base for the whole income tax law: the principle of changes in the tax value of net assets.¹⁹ It is hoped this will simplify the law by giving a common imprint for all transactions.

3.6 This aim is set in the context of the current law, which has 2 very different systems: ordinary income along with a general deduction for

¹⁹ That is, changes in the tax value of assets less changes in the tax value of liabilities.

expenditure incurred in gaining that income, and many overlapping specific asset and liability regimes (each with their own set of rules).

3.7 This diagram illustrates this difference between the current law and the Tax Value Method in so far as it treats assets and liabilities.



3.8 It is argued that adopting the Tax Value Method should be enough to streamline and simplify the law. That is, streamlining and simplification should not depend on removing provisions. An aim of the Tax Value Method is to help users of the law make more sense of what is already there.

Reducing the volume of law

3.9 Another aim of the Tax Value Method, in tandem with the business tax reform policy recommendations, is to reduce the volume of the current law by distilling the hidden commonality across regimes and elevating it to the high level core rules. These are examples of how it is anticipated this will be achieved:

- The current law contains many different rules for working out the cost of an asset. The Tax Value Method should reduce them to one primary rule.
- The Tax Value Method should integrate realised capital gains with other forms of economic income. This should allow for a reduction in the provisions required to tax capital gains. The main capital gains provisions required will be those to maintain concessional treatment (e.g. for discounted capital gains) and quarantine capital losses.
- The Tax Value Method should allow the removal of all the rules in the proposed Simplified Tax System for small business that deal with ensuring that all income and deductions are counted (but only once) when a taxpayer enters or leaves the system.

3.10 Legislation is only one part of our income tax law. There is also a great body of case law on what is ordinary income and when expenditure is on revenue or capital account. All of that case law should disappear under the Tax Value Method, reducing the material users need to consider to apply the law.

Durability

What does 'durable' mean?

3.11 Something is durable if it is able to endure long into the future while remaining efficient and effective. On this basis, durability has a temporal as well as qualitative aspect; for a thing to be durable, longevity is not enough, it must also be hard wearing.

Has the current law been durable?

3.12 It can be argued that the framework of the current law has not been durable because its foundation has been deficient.

3.13 The tax base of our current law has 2 systems: ordinary income and general deductions, and many asset and liability regimes. The inevitable result is contradiction and duplication.²⁰ Operating 2 different systems is inefficient, the cost being a tax system without a discernible principle. This makes it hard for the courts, administrators and taxpayers (and their advisers) to get to the purpose of the law in a particular situation.

3.14 Rules without context are very difficult to use, yet that is what we have. It is costly to legislatively smooth over that contradiction and duplication.

How is it anticipated the Tax Value Method will be more durable?

3.15 An aim of the Tax Value Method is to be more durable by getting the foundations of our income tax system to reflect the modern income tax base.

3.16 For some time, a key feature of our income tax law (and accounting concepts) has been changes in net assets.²¹ It can be argued that is the rationale that explains many of the amendments to the law. Even now, that rationale continues to account for the business tax reform policy recommendations in *ATSR*.

3.17 It can be argued that the tax system will be durable when the fundamental policy used to determine the law is itself reflected in the law's structure. If the outcomes that we are to provide for are based on changes in

²⁰ The diagram at paragraph 3.7 illustrates this.

²¹ See Chapter 2.

net assets, it can be said that the law should reflect that structure. It seems irrational to make policy decisions using one structure and then implement them using another.

3.18 For example, why should blackhole expenditures be taken into account in working out taxable income under the current law? Given the current structure of the law, it could be argued that they shouldn't. (Usually, this is because such expenditure is not incurred in the course of gaining assessable income, i.e. it is often incurred too soon in the commercial process.) The only reason they will become 'deductible' is because of a policy rationale that says decreases in net assets that result from non-private activities *should* be taken into account. That rationale is not yet reflected in the structure of our law, but would be under the Tax Value Method.

Transparency

3.19 A transparent law is one that allows its users to see through to the policy that guides it. In other words, it provides the context that binds many legislative rules.

3.20 Governments often use the income tax law to target concessions that in themselves have nothing to do with income tax policy. These concessions have helped to obscure any principle which explains the current law.

3.21 It can be argued that the Tax Value Method uses the same building blocks as commerce: changes in net assets. Even a government's policies cannot change these basic building blocks.

3.22 An aim of the Tax Value Method is to allow a government to influence the decision making of taxpayers without confusing the basic building blocks or impairing the scheme of the law. Instead, a government can modify taxable income using taxable income adjustments or tax value rules.

Certainty

3.23 Making the income tax law simpler and more durable and transparent should make the law more certain. It can be argued that much of the uncertainty in the current law is caused by the complexity, hidden intent and need for constant change that we now have.

3.24 An aim of the Tax Value Method is to give a structural solution to many problems, adding to certainty. An example is that the structure of the Tax Value Method should make all expenditure 'deductible' (at some time) unless the law provides otherwise (see paragraph 3.18.)

What should the benefits of the Tax Value Method mean in practice?

3.25 Lower compliance and administration costs should result from a law that is easier to learn, understand and apply. This should impact directly on the costs of those who use or administer the law. However, one of the main issues of concern is the transitional cost of learning and applying the law for the first time.

3.26 A significant issue is, if the Tax Value Method can realise the benefits discussed above, would those benefits outweigh the transitional cost of reform.

Chapter 4

The core components of the Tax Value Method

Outline of Chapter

4.1 This chapter broadly explains the legislative mechanics of the Tax Value Method by illustrating its core components.

Overview

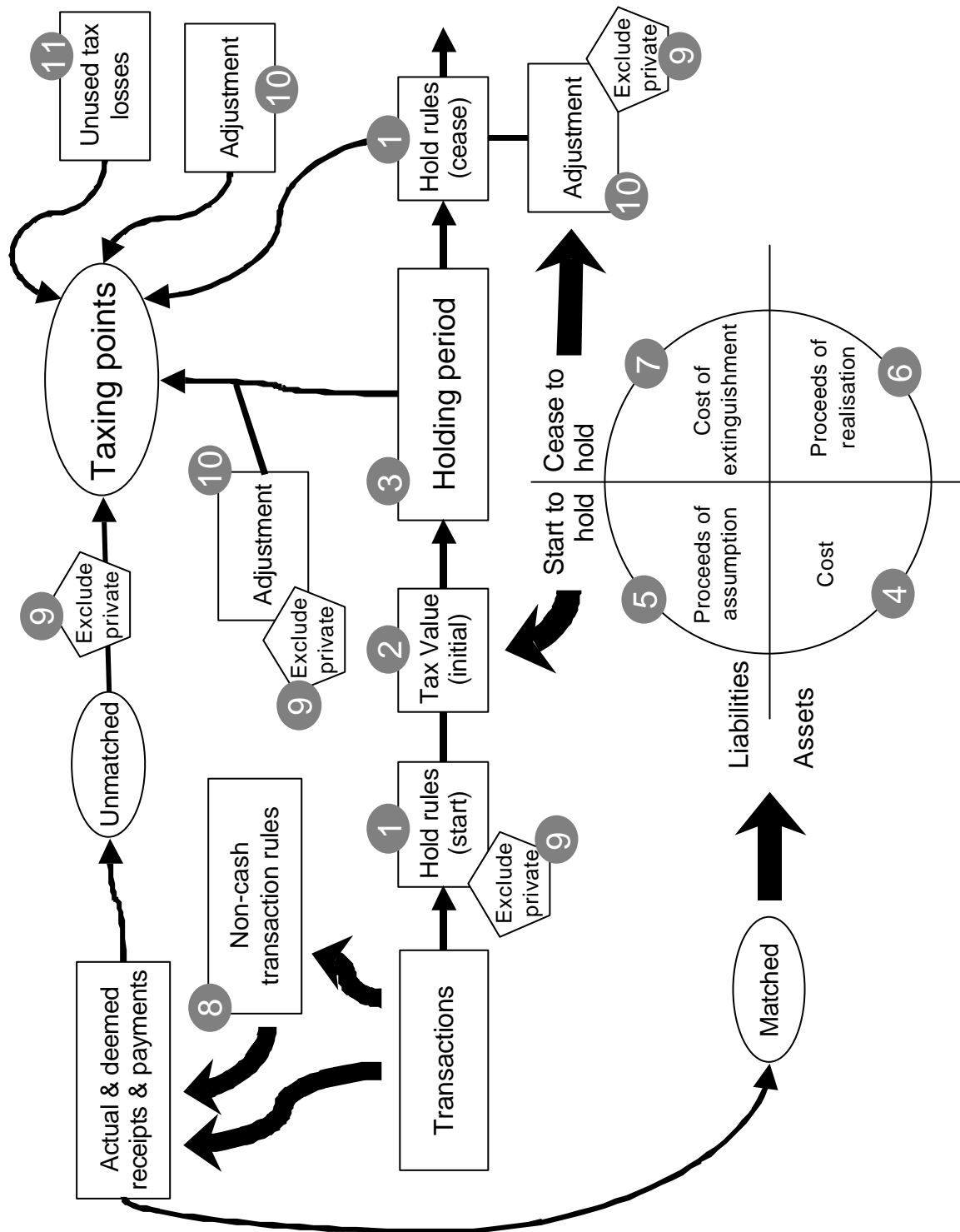
4.2 The Tax Value Method is comprised of a number of components which are described below. The system map on the next page illustrates the relationships between them, and the bracketed numbers (#) are references to that map. The discussion that follows the map provides more detail on several of these modules.

4.3 As discussed in Chapter 1, the Tax Value Method is based upon the following formula, which determines the net income of a taxpayer for an income year:

$$\left[\begin{array}{c} \text{Receipts} \\ \text{--} \\ \text{Payments} \end{array} \right] + \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of assets} & \text{of assets} \end{array} \right] - \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of liabilities} & \text{of liabilities} \end{array} \right]$$

4.4 As such, it recognises money flows but it also recognises the change in the tax value of net assets, by taking into account assets that a taxpayer *holds* and liabilities they *have*. There are rules to determine if you hold an asset or have a liability (1). Those same rules will also determine when you cease to hold an asset or have a liability.

Tax value method –system map



4.5 Naturally, the formula needs to produce a result expressed in dollars, so the components of the formula must also be expressed that way. It is evident, then, that money flows (receipts and payments) can be inserted straight into the formula, but that assets and liabilities must first be ascribed a dollar value – called their ‘tax value’. There are rules that specify the tax value of an asset or liability. Those rules specify the tax value when you start to hold an asset or have a liability (2) and whether (and to what extent) it changes over time (3). The nature of the tax value rules is such that decreases in tax value are more likely than increases.

4.6 Typically the initial tax value of an asset will be its cost, and the initial tax value of a liability will be the compensation the taxpayer gets for assuming the liability (e.g. the funds borrowed under a loan). Therefore there are ‘cost’ (4) and ‘proceeds of assumption’ (5) rules.

4.7 When you stop holding an asset or having a liability it is not normally necessary to isolate the gain or loss on that asset or liability. However, in some cases it may be necessary to determine a profit or loss to give effect to a taxable income adjustment (e.g. the discount on a capital gain). To do that, there are rules specifying the ‘proceeds of realisation’ of an asset (6) and the ‘cost of extinguishment’ of a liability (7) (e.g. the amount to pay back a loan).

4.8 No further step is needed to describe the cost/proceeds in dollars if the dealing that gave rise to the holding or disposal was in cash. However, many transactions are not transactions where someone just paid cash. Credit transactions, and unilateral transactions which have consideration on only one side, are common examples. To ensure that all transactions can be described in dollar terms, there are rules for non-cash transactions (8).

4.9 There are rules that disregard private or domestic dealings (9). They apply only to individuals.

4.10 There are also rules to make taxable income adjustments to the net income result, mainly for policy reasons (e.g. to give effect to research and development concessions) (10). Also, prior year tax losses would continue to be deductible in the same way as they are currently (11).

Assets and liabilities

4.11 An ‘asset’ is anything that embodies future economic benefits. The notion is clearly of wide embrace and would include, in addition to tangible items and legal or equitable rights, more nebulous kinds of *economic advantage*, such as information. [Section 6-15]

4.12 A ‘liability’ is an obligation to provide future economic benefits. While the notion is symmetrical to ‘asset’ in many respects, it is more limited. Notably

there are many kinds of economic disadvantage that aren't liabilities – there must be an *actual* obligation, even if eventual performance is subject to a contingency. [Section 7-20]

4.13 There will be rules for how to identify some assets and liabilities, and for merging and splitting them.²²

4.14 It is only the assets or liabilities 'held' by a taxpayer that are included in the tax calculation.

Who 'holds' an asset?

4.15 There are general rules and special rules about who 'holds' an asset (1).

4.16 The *general rules* set up this broad approach:

- *for an asset capable of ownership*, the owner (or legal owner if there is both a legal and an equitable owner) 'holds' it;
- *for an acquired commercial secret*, the acquirer 'holds' it for so long as the information is not generally available; and
- *for all other assets*, there is no holder. [Section 6-20]

4.17 The latter treatment means that nebulous advantages, such as good market recognition from an advertising campaign, are not brought to account in a taxpayer's tax calculation. As a result, tax relief is afforded immediately for expenditure on those advantages because the expenditure is not matched by a corresponding increase in assets that are held.

4.18 The *special rules* are mostly concerned with replacing the entity who would otherwise 'hold' the asset with someone else. Commonly, they replace the legal owner with the economic owner (e.g. in cases like hire purchase agreements, bare trusts and tenants' fixtures). [Sections 6-21 and 6-22]

Who 'has' a liability?

4.19 There are also general rules and special rules about who 'has' a liability (1).

4.20 Under the *general rules*, an entity 'has' a liability if it owes a *present* legal or equitable obligation to provide the future economic benefits (1). [Section 7-23]

4.21 The *special rules* deal with exceptions to the general rule. [Sections 7-24 and 7-25]

²² These rules are not yet in the working draft.

Tax value rules

4.22 The tax value rules ascribe dollar values to assets and liabilities to allow them to take their central place in a taxpayers' net income calculations.

4.23 Every asset and liability gets an initial tax value when it starts being held (2). In the vast majority of cases, an asset's initial tax value is its cost (4) and a liability's initial tax value is the proceeds the taxpayer gets for assuming the liability (5).

4.24 It follows that, in the vast majority of cases, purchasing an asset or assuming a liability will not, of itself, produce a taxing point because the tax value matches that cost or those proceeds.

Example 4.1

You are paid \$100,000 in advance to provide horticultural services for the next year. Your \$100,000 receipt is matched by a liability (your obligation to provide the services) with an initial tax value of \$100,000, so there is initially no tax effect.

Assets and liabilities with a tax value of zero

4.25 There are 4 main types of asset and liability that are given an initial tax value (2) of *zero*, as set out in this table. [Item 1 of the table in subsection 6-40(1); subsection 6-40(2); item 1 of the table in section 7-75; subsection 7-75(2)]

Table 4.1 Main types of assets and liabilities given a zero tax value

<i>Type of asset</i>	<i>Explanation</i>	<i>Examples</i>
Assets and liabilities ignored for policy reasons [Paragraphs 6-40(2)(b) to (g)]	Giving those things a zero tax value means that expenditure on them is not matched by an asset, so becomes effectively 'deductible' at the time it is made	Office supplies and unbillable work in progress
Some assets and liabilities pertaining to the relationship between an entity and its members [Paragraphs 6-40(2)(h) and (i); paragraph 7-75(2)(b)]	Giving these assets and liabilities a zero tax value reflects the current law	A shareholder's right to a dividend

<i>Type of asset</i>	<i>Explanation</i>	<i>Examples</i>
Matching (or 'routine') rights and liabilities [Paragraph 6-40(2)(a); paragraph 7-75(2)(a); section 6-45]	Where a taxpayer has both a right and a matching obligation, and over time any changes in the value of the right are reflected in equivalent changes in the value of the liability, the asset and the liability are called 'routine' and given a zero tax value. This recognises that, whatever their real tax values would be, they would be equal and opposite, cancelling each other in the taxpayer's net income. Therefore, there is no need to work out the real tax values	A lease under which a landlord is entitled to a stream of rental payments but has a symmetrical obligation to provide the premises to the tenant
Assets that are not acquired and liabilities for which compensation is not received, where the extent of the associated future economic benefits is uncertain ²³	Giving those things a zero tax value means that there is no taxation effect where the fact of the incoming or outgoing is uncertain. This reflects the current law	A cause of action - the asset and corresponding liability exist, but the extent of benefits is not known until the matter is fully litigated and judgement delivered

Short-term debt

4.26 Short-term debt (that is due and payable or to be paid within 12 months) takes a tax value (2) equal to its face value and, as such, is treated in much the same way as money. [Items 5 and 6 of the table in subsection 6-40(1); items 4 and 5 of the table in subsection 7-75(1)]

Changes in tax value over time

4.27 As a general proposition (though not an expression of the most common situation), assets and liabilities don't change their tax value over time (3). That conforms to a general principle of the current income tax system – only *realised* gains are recognised. Land and shares provide classic examples of that general proposition in action.²⁴

²³ These rules are not yet in the working draft.

²⁴ This refers to *unmatched* changes in tax value. The tax value of such an asset could increase (because its cost would increase) if payments are made to improve it. However, this increase is *matched* by the payments, so there is no effect on taxable income.

4.28 However, there are some exceptions. The main ones are set out in this table:

Table 4.2 Main types of assets and liabilities whose tax value changes

<i>Type of asset</i>	<i>Explanation</i>	<i>Examples</i>
Depreciating assets and liabilities ²⁵	This is a very significant category. The tax values of these things will decline as they are used up (or satisfied in the case of liabilities). The present capital allowances regime is but a subset (albeit an important one) of this approach. It is a complete departure from the ‘all or nothing’ (revenue versus capital) approach that is the general position under the current income tax law	It includes things like <i>profits à prendre</i> , the corresponding liabilities, rights to use assets or get services, the liabilities to provide those assets or services, and the assets themselves
Trading stock ²⁶	At the end of each year there will be a choice of methods to value trading stock just like the current law. In fact, the current trading stock regime is a micro version of the Tax Value Method	Goods available for sale in a retail store
Financial assets and liabilities ²⁷	These will have a tax value designed to implement the recommendation on the taxation of financial arrangements. ²⁸ When the return on such assets and liabilities is certain, they will have a rising or falling tax value, computed on the basis of internal rates of return, because of their relatively high liquidity. Even in the case of these ‘near money’ items, any taxation before realisation is based on accrued returns rather than on changes in the market value. In certain circumstances, a tax value can be set by reference to the market, <i>but only at the option of the taxpayer</i>	It includes things like bonds and deferred interest securities

Cost and proceeds

4.29 The notion of the cost (4) of something is commonly understood. The other 3 notions in the quartered circle on the system map (5) to (7) are not such

²⁵ These rules will be contained in Division 40, which is not yet included in the working draft.

²⁶ These rules will be contained in Division 38, which is not yet included in the working draft.

²⁷ These rules will be contained in Division 45, which is not yet included in the working draft.

²⁸ See Section 9 of *ATSR*. The Tax Value Method could, of course, be implemented independently of those recommendations.

everyday concepts, but that circle illustrates how the 4 notions interrelate to comprise a suite of symmetrical concepts.

4.30 The cost of an asset (4) and the proceeds of assuming a liability (5) are key concepts for the Tax Value Method because they typically set the initial tax values of assets and liabilities. This approach is provided for within the tax value rules.

Example 4.2

If you are paid \$10,000 to provide security services for a year, the initial tax value of your liability to provide those services will be the \$10,000 that were your proceeds of assuming that liability.

4.31 The proceeds of realising an asset (6) and the cost of extinguishing a liability (7) are also key concepts for the Tax Value Method. They allow the profits and losses that are often subject to taxable income adjustments (such as the adjustment for discounted capital gains and part private use) to be worked out. This approach is provided for within the provisions dealing with the taxable income adjustment.

Example 4.3

Suppose you have a truck with a tax value of \$30,000 that you use 50% of the time for private purposes. If you sell it for less than the tax value, the Tax Value Method will automatically bring the full loss to account but you will have to work the loss out so that you can add back the 50% private portion. To work out that adjustment, you need to know what the proceeds of realisation were.

4.32 Because the non-cash transaction rules cause every kind of transaction to be seen in terms of dollar cash flows, it is possible to ascertain the dollar amounts attaching to items that are included in any of the 4 calculations. Doing that does not, of itself, have taxation consequences. They are merely inputs into the rules about cost and proceeds of assumption and realisation. Those rules determine which transactions have taxation effects.

4.33 Generally speaking, those rules are as follows (but there are exceptions in special cases).

Cost of an asset

4.34 The 'cost' of an asset (4) is made up of:

- all the amounts paid to hold the asset. The purchase price is the most obvious example but it would also include things like stamp duty, registration fees, and so on.

- any amounts paid to bring the asset to its present condition and location. This would include, for example, the cost of improving the asset but not the cost of repairs or maintenance, which are expenses to preserve its existing condition rather than to bring the asset to a new condition. [Subdivision 7A-B]

Proceeds of assumption

4.35 The proceeds of assuming a liability (5) are made up of:

- the amounts received for assuming the liability; and
- any amounts received for accepting an increase in the liability. [Subdivision 7A-D]

Proceeds of realisation

4.36 The proceeds of realising an asset (6) are the amounts received because you stopped holding it. [Subdivision 7A-C]

Cost of extinguishment

4.37 The cost of extinguishing a liability (7) is the amount paid to stop holding it. [Subdivision 7A-E]

Non-cash transaction rules

4.38 The Tax Value Method differs from the current law in that it *explicitly* deals with both sides of any commercial dealing. Typically the present system doesn't.

Example 4.4

In the *Arthur Murray* case,²⁹ a dancing school was paid in advance for some dancing lessons. The question was whether the school's receipt was income (according to ordinary concepts) *before* the lessons were given. It was held that the receipts were income only as the lessons were given. To decide whether there was income or not, it was *implicitly* necessary to weigh up the natures and values of both the receipt and the obligations comprising the transaction.

Under the Tax Value Method, the amount paid would be taken into account as a receipt, and the liability to provide the lessons would be taken into account separately as a liability.

²⁹ *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314.

4.39 The approach of the Tax Value Method in *overtly* splitting transactions into their (typically) two constituent parts implies that dollar amounts must be ascribed to both sides.

Example 4.5

If you exchange your truck for a bulldozer, the Tax Value Method requires 2 amounts to be worked out – what you *got* for the truck and what you *paid* for the bulldozer.

4.40 Therefore, non-cash transaction rules **(8)** are *essential*.

Deemed receipts and payments

4.41 To the extent that you give non-cash benefits (e.g. goods or services) in a non-cash transaction, you are taken to have receipts and payments equal to the market value of what you *received*. [Division 8]

4.42 However, to the extent that you give money, or something close to money (such as a promise to pay money in the future), in a non-cash transaction, you are taken to have receipts and payments equal to the value of what you *provided*. This is because it is both easier and more intuitive to count the money, or near money, you gave rather than value what you receive. [Division 8]

Example 4.6

You promise to pay \$1m in six months' time for a factory site. It makes much more sense to set a value on your liability to pay (and on the site asset) by reference to the liability itself (what you gave) rather than by reference to a market valuation of the site (what you got). You are not selling your promise to pay money; rather you are buying the site.

4.43 These rules apply universally. Every non-cash transaction is notionally split into 2 cash transactions. The rules allow every acquisition of an asset, and every assumption of a liability, to be treated as paid for, or compensated by, cash. That is, *in every case* there either is, or is taken to be, a cost or proceeds of assumption. The same approach applies to disposals/extinguishments. This 'conversion' provides an essential building block for the Tax Value Method.

