FOR DISCUSSION PURPOSES

TAX VALUE METHOD WORKING DRAFT (Version 2, 6 July 2001)

EXPLANATORY MATERIAL

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Glossary

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

Abbreviation	***Definition***
ATSR	*A Tax System Redesigned: Overview, Recommendations, Estimated Impacts*
CGT	Capital gains tax
ITAA 1922	*Income Tax Assessment Act 1922*
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
SAC 4	Statement of Accounting Concepts 4
STS	Simplified tax system for small business
TOFA	Taxation of financial arrangements
TVM	Tax Value Method

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
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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.

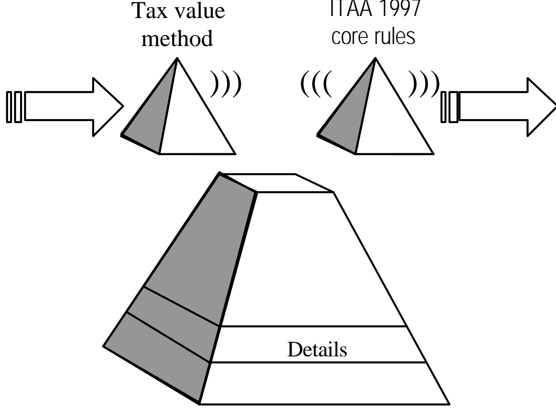
The Tax Value Method provides a new structure for the income tax law

In short

1.2 The Tax Value Method is a way of *structuring* the income tax law. In particular, it is a framework for expressing in legislation how to determine a taxpayer's *taxable income.*

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 Tax Value Method core rules consist mostly of:

- rules to work out 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, together with rules for holding assets and liabilities, basic tax value, uniform cost and proceeds, splitting and merging of assets and liabilities, and non-cash transactions.

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 be different to current rules. For example, it is anticipated that their quantity would be significantly reduced because:

- the Tax Value Method core rules would get directly to the result that some existing detailed rules are needed to get to; 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 on which income tax is levied. 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

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

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

1.9 The real work of the Tax Value Method, however, is done in the 'net income' part of taxable income. This is the net income formula:[1]

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

('Tax value' is a value assigned to assets and liabilities, as discussed in paragraphs 1.15 and following).

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 taxpayers, including individuals and STS taxpayers. Nevertheless, individual and STS taxpayers would likely experience little practical impact if their income were 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 The Tax Value Method is a system in which income tax payable is determined by reference to a taxpayer's cash flows and assets and liabilities, subject to 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 under the Tax Value Method is net annual cash flows of taxpayers. Putting aside private or domestic transactions, this is essentially the difference between a taxpayer's opening and closing cash (i.e. the change in their cash assets).

Matched receipts and payments

1.13 Under the Tax Value Method, many receipts and payments do not create immediate consequences for taxable income because they 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.

[1] Most private or domestic amounts are excluded. Assets included in the second element of the formula exclude money (this is further discussed at paragraph 6.23 and following of Chapter 6).

Unmatched receipts and payments

1.14 Alternatively, receipts and payments that are not matched by an offsetting change in the tax value of assets or liabilities are called 'unmatched' receipts and payments. Examples include receipt of money for services performed by a business and payment of salaries to staff. Unmatched receipts and payments, unlike matched ones, normally create immediate consequences for taxable income. Unmatched receipts increase taxable income while unmatched payments reduce taxable income.

Tax values of assets and liabilities

1.15 The other component of the Tax Value Method recognises a taxpayer's assets and liabilities, other than private assets and liabilities. 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.[2]

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 tax 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.[3]

How common situations are treated under the Tax Value Method

1.18 It is 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 with the proposed Tax Value Method law in producing tax outcomes, and illustrates the earlier discussion at paragraphs 1.11 to 1.17. How taxpayers prepare their tax returns in practice need not change (this is further discussed 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

[2] 'Taxing points' are the times at which gains are taxed and tax relief is given for losses.

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

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.

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:

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

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

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. Assuming that a revenue expense remains a revenue expense even if it is prepaid, the current 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 rules[4] 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 income year for cleaning to be done in later income 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 the same outcome more directly as part of its generic rules dealing with depreciating assets and liabilities. In the year of the transaction, the pre-payment has this effect on net income:

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

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

[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 the current law's special prepayment rules are not needed to get the same policy outcome under the Tax Value Method.

1.23 However, under the Tax Value Method a special rule is needed to get to the result achieved by the current law's limited exceptions to the prepayment rules (e.g. for people who elect into the STS). That special rule is to give a zero tax value to the right to future benefits for taxpayers in those limited circumstances. Effectively, this puts them on a cash receipts basis.

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 decision in *Arthur Murray (NSW) Pty Ltd v FCT*[5] would support the cleaner deferring assessment of the prepayment until the cleaning was done. 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 income year of the prepayment, the net income result would be:

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

[500 – 0] + [0 – 0] – [500 – 0] = 0

5 (1965) 114 CLR 314

The receipt would be matched by the liability to provide the future cleaning services. In the income 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 under the Tax Value Method.

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 does not much matter here whether there is a direct promise to pay, or an indirect promise via a credit card.

1.26 The current law would probably treat you as having 'incurred' the outgoing and give you a deduction immediately (subject to the prepayment rules). 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 is no 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 on net income in the first income year is:

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

[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 income year, when you make the payment, there would be no tax effect, just as under the current law:

[0 – 500] + [0 – 0] – [0 – 500] = 0

The $500 payment you make in the second income 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 tax value until you stopped holding the land because the tax value of CGT assets under the Tax Value Method is their cost.[6] So, applying the net income formula to the transaction in the income year you bought the land would look like this:

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

[0 – 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.

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6 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 net income.

Now see what happens when the land is sold in the tenth year:[7]

[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 2 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 under the Tax Value Method by 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 that 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 will have variable tax values. Depreciating assets are a key 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. Applying the net income formula, the decline in the press's tax value produces a net 'deduction' in the year you acquired it:[8]

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

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

8 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, or had it installed ready for use, on the first day of the year.

[0 – 15,000] + [13,500 – 0] – [0 – 0] = –1,500

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:[9]

[12,500 – 0] + [0 – 12,000] – [0 – 0] = 500

The $500 gain is 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 requires relatively little explanation, because the current law already uses similar rules (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. Little will change in the treatment of 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 you get the stock.[10]

1.35 The Tax Value Method achieves the same result without the need for a special rule.

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

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

Example 1.7

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

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

[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.[11]

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 *framework* in the law for explaining that result.

1.38 As a framework, 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 framework of the current law is assessable income less deductions. However, a business taxpayer might work out their taxable income by starting with their accounting profit and reconciling 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, and the same sort of results

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

obtained. However, those results would be explained using different conceptual building blocks, with some consequent changes in language.[12]

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

12 This is discussed in the paper 'Preparing income tax returns under the TVM' available on the Board of Taxation's website [www.taxboard.gov.au].

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 using the same ideas found in trust law that distinguished between income (which belonged to the life tenant) and capital (which belonged to the remainderman).[13]

2.6 That distinction caused the law to focus on the *form* of a gain, leading to many disputes over whether a gain was 'income' or not. It also focused on a need for a link between losses and a purpose of gaining 'income', leaving many taxpayers without appropriate tax relief for legitimate business expenditure.

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[13] There is some debate about whether or not the interpretation of 'income' for tax purposes directly evolved from trust law (see Prebble, Professor J, "Income Taxation: a Structure Built on Sand", *Parsons Lecture*, 14 June 2001, pages 3 to 6). While this point is of historical interest, it does not alter the fact that the ideas used in the 2 areas of law are conceptually the same.

2.7 The American courts, by way of contrast, recognised early on that a broader notion of gain should be recognised and not just gains that conformed to the narrower 'income' form.[14]

The reaction to early problems

2.8 The emphasis on form over substance led to an ongoing series of changes to the law all moving towards ensuring that what was taxed was gains, not just the narrower legal concept of '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.[15] But before tax reform in 1985, these changes were generally made within the narrower 'income' paradigm.

2.10 The introduction 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 nominal 'income' gains were still taxed.

2.11 But the changes weren'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 required a link to the production of 'income'.

2.12 The clearest examples of these were the capital allowance regimes that, before the introduction of the new capital allowances regime in Division 40 of the ITAA 1997, approached 40 different regimes.

2.13 The Courts too have recognised the deficiencies of the narrower 'income' model. In *Whitford's Beach Pty Ltd v FCT*[16] 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.

[14] 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).

[15] Paragraph (ba) of the definition of 'income' in section 4 of the ITAA 1922; paragraph 26(a) of the ITAA 1936.

[16] 82 ATC 4,031.

Where are we now?

2.14 So, the income tax law has been frequently amended since 1915 because it didn't recognise what the Parliament had come to think it should be recognising. 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 Australia's 'income' tax is not really a tax on what lawyers would have called 'income' in 1915. In truth, it is now more a tax on an economic concept of income.

2.16 The Ralph Committee's proposals in *ATSR* for a consistent treatment of assets and liabilities would, if adopted, move the tax law even further away from the narrower 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 had become outdated.[17]

2.18 The Committee determined to come up with a new description. However, it did not propose to change what was taxed (except by specific recommendation), only to redescribe it in simpler, more coherent, terms.[18]

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 provisions[19] are a fundamental aspect of the current business income tax system. However, equally fundamental, and more pervasive, are 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). This is further discussed at paragraph 2.24 and following.

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

17 *ATSR*, page 156.

18 See more on this at paragraphs 2.33 to 2.37.

19 Divisions 6 and 8 of the ITAA 1997.

can then be written off, and for that purpose they are given a cost by the depreciation provisions.[20] Similarly, the law 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 passage of time.[21]

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

- establishing the existence of a particular asset, such as trading stock, or of a liability, such as borrowing expenses;
- setting a value for that asset or liability (e.g. its cost or amount), and on occasions allowing that value to change (e.g. through the passing of time); and
- specifying 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.[22]

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[20] Other capital asset amortisation provisions operate in the same manner.

[21] Section 25-25 of the ITAA 1997.

[22] To demonstrate this conclusion refer to *ATSR*, page 159.

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 provisions and borrowing expenses provisions equally apply the principles of 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 passage of time. The debt forgiveness provisions apply to liabilities owed by taxpayers, specify a value for these liabilities and, where the liability is reduced, specify the tax consequences.

2.28 Tax Value Method principles are also relevant to more fundamental areas found originally in the ITAA 1936. In *Whitford's Beach Pty Ltd v FCT*[23], the Full High Court effectively stated that when 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*[24] 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 examples above are 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 areas of the current law, the basis of assessing income and allowing deductions is identical with that of the Tax Value Method. 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

[23] 82 ATC 4,031.

[24] 74 ATC 4,169.

tax value, should be an allowable deduction in the calculation of the taxpayer's assessable income.

2.32 As this discussion demonstrates, the principles of the Tax Value Method are one of the foundations of the current income tax system and have an extensive and long-standing application within that system. Moreover, these principles are 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 those in 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.[25]

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.* A completely described tax base, rather than a number of separate regimes trying to cover the same ground, will prevent gaps. For example, under the Tax Value Method expenditure black holes will be avoided so that tax relief for all non-private expenses will be given at some time. Similarly, overlaps between regimes that are present in the

25 Section 9 of *ATSR*.

current law should not arise. To the extent that the current law does not address those overlaps, current cases of double taxing (or double deductions) will disappear under the Tax Value Method.

2.37 It will be necessary, in due course, to identify and obtain an estimate of the revenue impact of these changes. This will enable their impact to be fully considered in developing the legislation, by the Tax Board and, ultimately, by the Government.

Chapter 3
Why change to the Tax Value Method?

Outline of Chapter

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

Preliminary

3.2 This Chapter 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, it is important that the Tax Value Method does not add to the costs of compliance.

3.4 An intended subsidiary benefit of producing a sounder structure to the law would be a platform from which other deficiencies in the income tax law could be identified and addressed.

Simplification

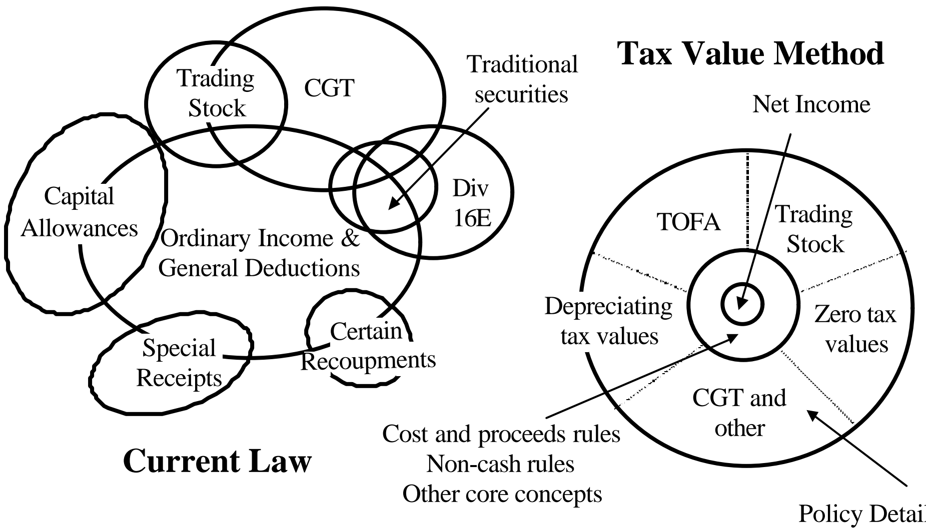
Conceptual simplification

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.[26] It is thought this will simplify the law by giving a common imprint for the income tax treatment of all transactions.

[26] That is, changes in the tax value of assets less changes in the tax value of liabilities.

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

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



3.8 Adopting the Tax Value Method should in itself 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 Ralph Committee policy recommendations in *ATSR*, 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. For example:

- 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 number of provisions required to tax capital gains. The main capital gains provisions required would 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 STS 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. The need to consider that pre-existing case law should disappear, 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 qualitative as well as a temporal 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.[27] 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 measuring changes in net assets. It is suggested in Chapter 2 that this object explains many of the amendments to the law. Even now, that object continues to account for the Ralph Committee's policy recommendations in *ATSR*.

[27] The diagram at paragraph 3.7 illustrates this.

3.17 The tax system should be durable if the fundamental policy used to determine the law is itself reflected in the law's structure. Because the outcomes that the law is to provide for are based on measuring changes in net assets, it can be said that the law's structure should reflect that basis. It seems inefficient to make policy decisions using one structure and then implement them using another.

3.18 For example, where the current law recognises blackhole expenditures, it does so *not* on the basis of its underlying principles, but by virtue of specific legislative amendments. Without these, it would not recognise such expenditures as deductible, because they are not incurred in the course of gaining assessable income (e.g. they are often incurred too soon in the commercial process). Any amendments to this general situation are based on a policy rationale that decreases in net assets resulting from non-private activities should be taken into account. That rationale would be reflected in the structure of the law under the Tax Value Method, without need for specific rules.

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 structure of the law. Instead, a government can modify taxable income using taxable income adjustments or tax value rules.[28]

Certainty

3.23 Making the income tax law simpler and more durable and transparent should make it 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.

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[28] See Chapter 1.

3.24 An aim of the Tax Value Method is to give a structural solution to many problems, adding to certainty. For example, the Tax Value Method should make all expenditure ‘deductible’ (at some time) unless specific provisions provide 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 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

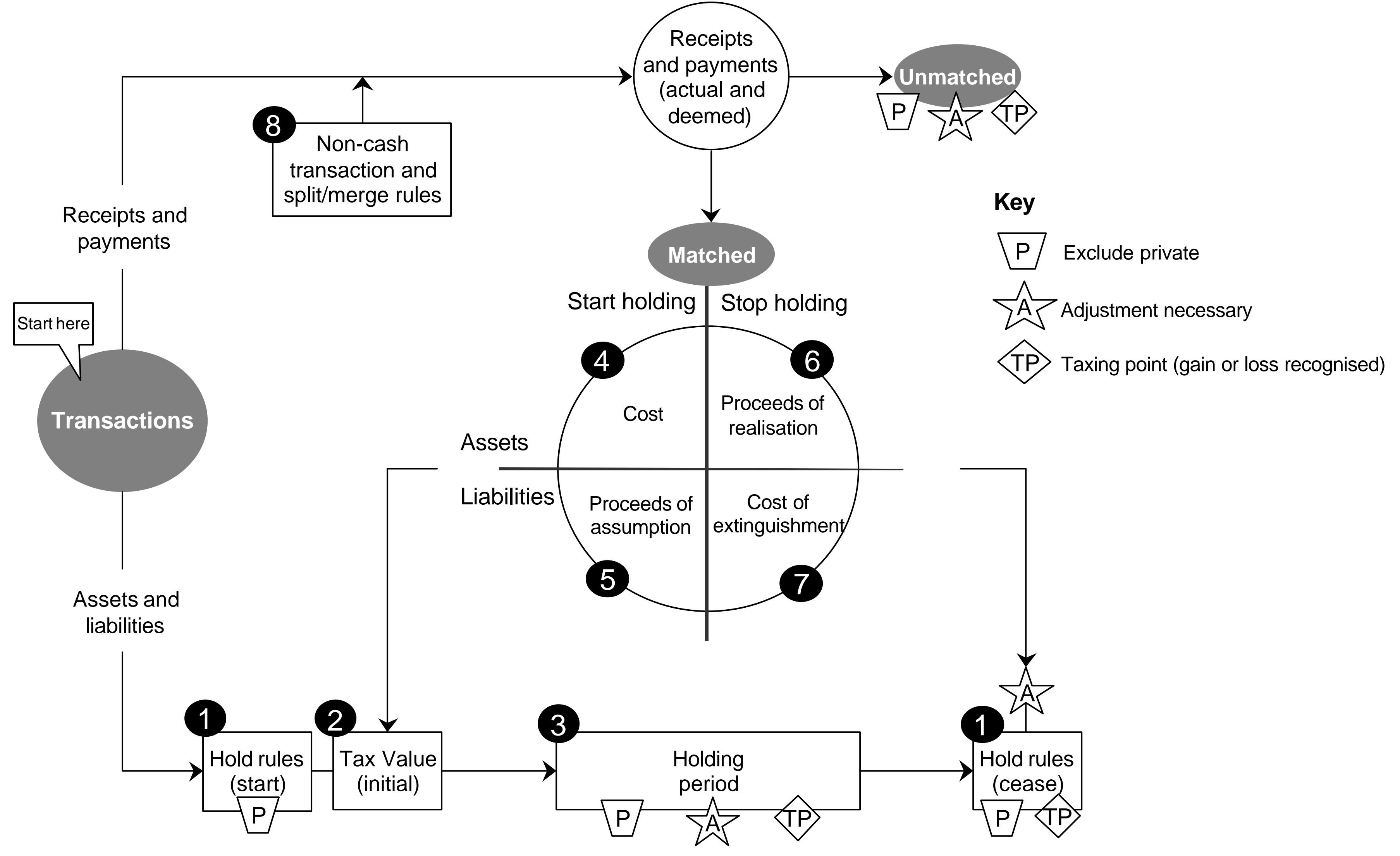
4.2 The Tax Value Method is comprised of a number of components which are described below. The system map on the next page illustrates the relationships between them, and the bracketed numbers **(#)** or symbols are references to that map. The discussion that follows the map provides more detail on several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

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:

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

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 As the formula needs to produce a result expressed in dollars all components put into the formula must also be expressed that way. While money flows (receipts and payments) can be put straight into the formula, 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.[29]

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)**. Splitting, merging and transforming assets and liabilities can also affect tax values and so must also be described in dollar terms **(8)**.

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

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

Assets and liabilities

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

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[29] Paragraphs 4.27 and 4.28 demonstrate this.

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 certain assets and liabilities ***[sections 6-18 and 7-22]***, and for merging, splitting and transforming them ***[Division 7B]***.

4.14 It is only the assets or liabilities 'held' by a taxpayer that are included in the tax calculation. ***[Section 5-55]***

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 third point above means that less obvious advantages, such as 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)**. ***[Section7-23]***

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

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(3); item 1 of the table in subsection 7-75(1); subsection 7-75(3)]***

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

Type of asset	*Explanation*	*Examples*
Assets and liabilities ignored for policy reasons ***[Paragraphs 6-40(3)(b) to (g)]***	Giving those things a zero tax value means that expenditure on them is not matched by an asset, so it 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(3)(h) and (i); paragraph 7-75(3)(b)]***	Giving these assets and liabilities a zero tax value reflects the current law	A shareholder's right to a dividend

Type of asset	*Explanation*	*Examples*
Matching (or 'routine') rights and liabilities ***[Paragraph 6-40(3)(a); paragraph 7-75(3)(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[30]	Giving those things a zero tax value means that there is no tax 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) associated with the supply of non-cash benefits (other than a financial asset) has 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 do not 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.[31]

[30] These rules are not yet in the working draft.

[31] 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

Type of asset	***Explanation***	***Examples***
Depreciating assets and liabilities ***[Division 40]***	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. This is a complete departure from the 'all or nothing' (revenue versus capital) approach that is the general position under the current income tax law	P*rofits á prendre* and the corresponding liabilities, rights to use assets or get services, the liabilities to provide those assets or services, and the assets themselves
Trading stock[32]	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 ***[Division 45]***	These will have a tax value designed to implement the recommendation on the taxation of financial arrangements.[33] 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, *but only at the option of the taxpayer*	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 everyday concepts, but that circle illustrates how those 4 notions interrelate to comprise a suite of symmetrical concepts.

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

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

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 the proceeds of your 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 adjustments for discounted capital gains and part private use) to be worked out. This approach is provided for in 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 need to work the loss out so that you can add back the 50% private portion. To work out that loss, 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 concepts at **(4)** to **(7)**. This does not, of itself, have tax consequences. They are merely inputs into the rules about cost and proceeds of assumption and realisation. Those rules then determine which transactions have taxation effects.[34]

4.33 Generally speaking, those rules are as follows (although exceptions apply 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 and registration fees.
- any amounts paid to bring the asset to its present condition and location. This would include, for example, the cost of improving the

[34] The rules on private or domestic transactions may also be relevant in determining tax effects.

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 does not.

4.39 In the *Arthur Murray* case,[35] 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.

4.40 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.

[35] *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314.

Example 4.4

> 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.

4.41 Therefore, non-cash transaction rules **(8)** are an *essential* feature of the Tax Value Method, just as they are under the current law.

Deemed receipts and payments

4.42 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*. ***[Division 8]***

Example 4.6

> You promise to pay $1m in six months' time for a factory site. The value of your liability to pay (and of the site asset) is determined by reference to the liability itself (what you gave) rather than by reference to a market valuation of the site (what you got). This reflects the essential nature of the transaction, which is your purchase of the site rather than sale of the promise to pay money.

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.

Chapter 5
How to work out income tax liability

Outline of Chapter

5.1 This Chapter outlines the way in which income tax for an income year is worked out under the Tax Value Method. The relevant provisions are in Part 1-3, Division 4 and section 5-10.

Context of Reform

5.2 The core rules dealing with how to work out income tax liability using the Tax Value Method largely replicate those presently found in the current law[36]. Some minor changes have been made, most of which do not affect the substance of the law.

5.3 Under the working draft, income tax liability is still based on the concept of taxable income. The major changes proposed by the working draft deal with the way in which taxable income is calculated. These changes are explained in later chapters.

Summary of working draft

5.4 Individuals, companies and certain other entities are liable to income tax on their taxable income. This is true for both Australian residents and non-residents, though different rules will apply.

5.5 As under the current law, income tax is worked out for each income year. An income year is generally a period of 12 months ending on 30 June. However, with the Commissioner's approval, taxpayers can adopt another period of 12 months that does not end on 30 June.

5.6 As under the current law, income tax is worked out by undertaking the following steps:

- *working out* taxable income for the income year;
- *multiplying* that taxable income by the relevant income tax rate or rates to give the taxpayer's 'basic income tax liability'; and

[36] Division 4 of the ITAA 1997.

- *subtracting* tax offsets from the basic income tax liability.

5.7 These steps can be represented in the following formula:

Income tax liability = Taxable income × Tax rate(s) − Tax offsets

Comparison of key features of working draft and current law

5.8 A comparison of the working draft and the corresponding provisions in the current law is set out in the following table:

Table 5.1 Comparison of key features of working draft and current law

Working Draft	*Current Law*
Income tax is payable by individuals, companies and some other entities.	Same as working draft.
'You' covers any entity, unless the term is used in an expressly limited way.	Same as working draft.
An 'income year' is the year whose events determine income tax payable for a 'financial year'. A company's income year is generally the financial year prior to that in which income tax is being paid. For other taxpayers, the income year is generally the financial year in which income tax is being paid.	Same as working draft.
A different period of 12 months can be adopted as an 'income year', with the Commissioner's approval.	Same as working draft.
A taxpayer that is not an Australian resident may still be liable to income tax. Specific provisions will deal with different residency circumstances. The core provisions only deal with a taxpayer that is an Australian resident throughout the year.	An individual or an entity that is not an Australian resident may still be liable to income tax.
Tax liability depends upon taxable income, prevailing tax rates and entitlement to tax offsets.	Same as working draft.

Detailed explanation of working draft

Meaning of 'you'

5.9 ***'You'*** refers to any entity unless a specific exclusion is made ***[section 4-5]***. This replicates the meaning in the current law.

5.10 Most of the working draft is drafted in the second person, using the term 'you'. For example, the working draft would generally say 'you are liable to income tax' rather than 'an entity is liable to income tax'.

5.11 The use of 'you' simplifies the drafting and makes the law more accessible.

Who must pay income tax?

Who is an 'entity'?

5.12 As in the current law, every individual and company is liable to pay income tax, as well as some other entities. ***[Section 4-1]***

5.13 The term, ***entity***, is used in a number of different but related senses. It covers all kinds of legal person. It also covers groups of legal persons, and other things, which in practice are treated as having a separate legal identity for tax purposes. ***[Subsection 960-100(1) of the ITAA 1997]***

When will income tax be payable?

5.14 The fact a taxpayer may be liable to pay income tax does not mean that tax will necessarily be paid. For instance, a taxpayer may have no taxable income, and will therefore not pay income tax.

5.15 Income tax may be payable even if a taxpayer is a foreign resident, either permanently or for just a period of time. The working draft contains a table that indicates the different rules for working out a taxpayer's income tax, depending on the taxpayer's residence. ***[Section 4-15]***

The period over which income tax is worked out and paid

5.16 Liability to income tax is still calculated by reference to years.

5.17 Like the current law, the working draft recognises 2 distinct years:

- the year, ending on 30 June, for which income tax is paid (called the ***financial year***); and
- the year whose events determine the income tax to be paid for that financial year (called the ***income year***).

[Section 4-10]

5.18 A company's income year is generally the financial year prior to that in which income tax is being paid. For other taxpayers, the income year is generally the financial year in which income tax is being paid.

5.19 With the Commissioner's approval, a taxpayer can adopt another accounting period of 12 months ending on another date as their ***income year***. ***[Paragraph 4-10(2)(b)]***

What is a taxpayer's income tax liability?

5.20 As under the current law, a taxpayer's income tax liability for an income year is the amount of tax that a taxpayer is liable to pay on their taxable income. It is generally calculated using this formula:

$$\text{Income tax liability} = \text{Taxable income} \times \text{Tax rate(s)} - \text{Tax offsets}$$

5.21 The working draft adopts the method statement in the current law for working out a taxpayer's income tax liability for the income year. This method statement is outlined below:

> *Method statement*
>
> *Step 1.* Calculate taxable income.
>
> *Step 2.* Calculate basic income tax liability by applying the relevant income tax rates and any special provisions.
>
> *Step 3.* Calculate any tax offsets.
>
> *Step 4.* Subtract tax offsets from the basic income tax liability.
>
> The result is the amount of income tax a taxpayer is liable to pay.

[Subsection 5-10(1)]

What is taxable income?

5.22 Chapter 6 explains the principles involved in working out taxable income.

5.23 Broadly, ***taxable income*** is worked out according to the formula:

$$\text{Taxable income} = \text{Net income} + \text{Taxable income adjustment} - \text{Unused tax losses}$$

[Subsection 5-15(1)]

What rates apply?

5.24 As in the current law, the rates that are to be applied to work out a taxpayer's basic income tax liability are set out in the *Income Tax Rates Act 1986*. More than one rate may have to be applied.

5.25 For individuals who are Australian residents, a progressive rate system is used to determine income tax liability. That is:

- for taxable income up to a certain limit there is no rate of tax applied; and
- for taxable income above that limit, progressive rates apply across particular taxable income bands.

5.26 For most other entities, income tax is imposed at a flat rate.

What are tax offsets?

5.27 A ***tax offset*** reduces the basic income tax liability directly ***[subsection 5-10(1), step 3 of the method statement].*** A tax offset encompasses what were previously referred to as rebates and credits.

5.28 Under the current law, if tax offsets exceed a taxpayer's basic income tax liability, there is no general entitlement to a refund. This is also generally the case under the working draft. ***[Subsection 5-10(3)]***

5.29 However, some tax offsets, such as the private health insurance offset and excess imputation tax offsets for franked distributions made by a company to certain members, are refundable ***[subsection 5-10(2)].*** This means that where a taxpayer's income tax liability is reduced to zero, any remaining balance of these tax offsets will be refunded to the taxpayer.

5.30 Some other tax offsets can be carried over to later years to reduce a tax liability of those years, even though they can not be refunded in the current year. An example of such a tax offset is a foreign tax credit.

Chapter 6
How to work out taxable income or tax loss

Outline of Chapter

6.1 In calculating a taxpayer's taxable income or tax loss the Tax Value Method takes into account changing *tax values* of assets and liabilities as well as receipts and payments. The 'tax value' concept ensures that gains and losses on most assets and liabilities are not recognised until they are realised.

6.2 This Chapter discusses the provisions set out in Division 5 of the working draft. It also outlines other provisions that are dealt with in more detail in later chapters.

Context of Reform

6.3 The Tax Value Method links the calculation of taxable income and tax loss more closely to accounting concepts. The working draft, however, is necessarily formulated in its own terms to recognise tax policy and administrative considerations, such as those underlying the treatment of net exempt income.

6.4 The Tax Value Method also refocusses key questions about how amounts are to be included in, or excluded from, taxable income. In particular, the expenditure that is to reduce taxable income is identified by reference to whether it is private or domestic, and if it is not, whether it is made to acquire or improve an asset. This is in contrast to the current law where questions of deductibility depend on whether the expenditure is to derive assessable income and whether it is of a capital or a private or domestic nature.

What is the existing method for working out taxable income or tax loss?

6.5 The existing method for working out a taxpayer's taxable income or tax loss basically involves determining assessable income and subtracting allowable deductions. Diagram 6.1 summarises the existing method.

Diagram 6.1 Current approach for working out taxable income or tax loss

Taxable income (loss)	=	Assessable income	-	Allowable deductions
		Ordinary income e.g. salary, dividends, trading receipts		Expenses linked to production of income but not capital or private or domestic expenses
		plus		*plus*
		Statutory income e.g. some accrued gains, capital gains		Capital allowances, incentives and concessions e.g. deductions for depreciation, research and development

6.6 The allowable deductions under the current approach include unused tax losses of earlier income years. These are normally deductible to the extent that assessable income exceeds other deductions.

Summary of working draft

6.7 Diagram 6.2 summarises the Tax Value Method for working out a taxpayer's taxable income or tax loss.

Diagram 6.2 Tax Value Method for working out taxable income or tax loss

Taxable income (loss)	=	Net income[37]	+	Taxable income adjustment
		Net receipts i.e. receipts less payments (both revenue and capital)		Upward adjustments e.g. an adjustment for a partly private asset
		plus		*less*
		Net change in the tax value of assets		Downward adjustments e.g. reduction in the taxable part of some capital gains
		less		
		Net change in tax value of liabilities		

37 Most private or domestic amounts are excluded.

6.8 Unused tax losses of previous years are normally subtracted from the above result to the extent that it is positive. This gives the taxpayer's final taxable income.

6.9 In considering the Tax Value Method, the following should be noted:

- If the result of the above formula is positive, it is the taxpayer's taxable income. If the result is negative, it is the taxpayer's tax loss.
- The Tax Value Method will apply to Australian resident taxpayers, and to non-residents for much of their Australian sourced income. It will not apply to bodies that are entirely exempt from income tax (e.g. religious and charitable institutions).
- Receipts and payments will include constructive receipts and payments and deemed receipts and payments under non-cash transactions.
- The tax value of assets and liabilities will not, in most cases, equate to economic value. For example, the tax value of real property will be the cost of the asset to the taxpayer, meaning that any unrealised gains and losses arising from changes in market value will not be taxed. The tax value of a depreciating asset or liability will be the written-down value.
- Capital gains and losses are brought into taxable income (loss) as part of net income. However, capital gains treatment will apply to certain capital gains (e.g. the CGT discount).
- Modifications will be made to the way taxable income is worked out for those taxpayers who are to be taxed on a cash basis (i.e. individuals and STS taxpayers).

Comparison of key features of working draft and current law

6.10 The following table compares the key features of the Tax Value Method for working out taxable income or tax loss with the method under the current law.

Table 6.1 Comparison of key features of the working draft and the current law

Working Draft	*Current Law*
Taxable income or a tax loss is worked out on the basis of net income, a taxable income adjustment and unused tax losses.	Taxable income or a tax loss is worked out on the basis of assessable income and deductions. Assessable income is made up of ordinary income and a range of statutory income additions. Deductions are made up of general deductions, a range of statutory deductions and unused tax losses.

Detailed explanation of working draft

How is 'taxable income' worked out?

6.11 A taxpayer's taxable income will be calculated using this formula:

Net income + Taxable income adjustment – Unused tax losses

[Subsection 5-15(1)]

6.12 If the result is a positive amount, there is taxable income equal to that amount ***[subsection 5-15(2)]***. If the result is zero or negative, the taxpayer does not have a taxable income, but may have a tax loss that reduces taxable income in a later income year ***[subsection 5-15(3)]***.

When is there a 'tax loss'?

6.13 A taxpayer will have a tax loss for an income year if the result of the formula set out below is negative (the amount of the tax loss will be the amount worked out under this formula expressed as a positive amount):

Net income + Taxable income adjustment

[Subsections 36-10(1) and (3)]

6.14 The amount of the tax loss will be reduced if the taxpayer has a net exempt income for the income year that is greater than zero. In this case the taxpayer will have a tax loss for the income year if the result of the following formula is negative (the amount of the tax loss is the result of the formula, expressed as a positive amount):

Net income + Taxable income adjustment + Net exempt income

[Subsections 36-10(2) and (3)]

6.15 The tax loss for an income year is added to any unused tax losses from previous income years. This amount may be used to reduce taxable income in future income years[38].

Who will use the Tax Value Method for working out taxable income (loss)?

6.16 As noted in Chapter 5, the Tax Value Method will apply to Australian residents, and to non-residents for their Australian sourced income and gains that are not subject to a final withholding tax. It will not otherwise apply to non-residents and it will not apply to entities that are entirely exempt from income tax. Specific rules for non-residents are anticipated but are not included in the working draft. A cash basis treatment will apply to individuals, and to small businesses choosing the STS.

How is 'net income' worked out?

6.17 'Net income' has 3 components, as follows:

- Net receipts (i.e. receipts less payments).
- Net change in the *tax value* of assets (other than money).
  - Net increases in tax value will add to net income.
  - Net decreases will reduce net income.
- Net change in the *tax value* of liabilities (other than a debit balance in a money account).
  - Net increases in tax value will reduce net income.
  - Net decreases will add to net income.

[Section 5-55]

Net change in the tax value of assets and liabilities

6.18 The net change in the tax value of assets is worked out by subtracting the opening tax value of all assets held at the start of the income year from the closing tax value of all assets held at the end of the income year. The same process would be used to determine the net change in the tax value of liabilities. This is illustrated in the formula and method statement below.

---

[38] Certain kinds of losses (like capital losses) are quarantined so that they can be offset only against income of the same kind.

Net income formula

6.19 Net income can be worked out using the following formula:

Receipts - Payments +/- Net change in tax value of assets and liabilities

6.20 More fully expressed, the net income formula is:

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

Net income method statement

6.21 The working draft includes a 6-step method statement that represents how to work out net income under the formula ***[section 5-55]***. That method statement is summarised below:

Method statement

Step 1. *Add* all the amounts received during the income year.

Step 2. *Subtract* all amounts paid during the income year.

Step 3. *Add* the closing tax value of each asset (other than money) held at the *end* of the income year.

Step 4. *Subtract* the opening tax value of each asset (other than money) held at the *start* of the income year.

Step 5. *Subtract* the closing tax value of each liability had at the *end* of the income year.

Step 6. *Add* the opening tax value of each liability had at the *start* of the income year.

The result is the net income of a taxpayer.

Most private or domestic amounts ignored for net income of individuals

6.22 For individuals, most private or domestic amounts are excluded from the calculation of net income. Payments that are private or domestic in nature would include, as under the current law, those for most clothing, childcare and travel between home and work. Some land and collectables that have a private or domestic character will be included in the calculation so that capital gains in respect of them can be included in taxable income. Division 12 will contain provisions dealing with the private or domestic amounts that are not included in working out net income.

Money and money accounts are excluded from assets and liabilities used to work out net income

This section explains the rules developed under the Review of Business Taxation. It should be noted that these provisions will be subject to further consideration and development.

6.23 Money is excluded from the assets that are taken into account in working out net income (see steps 3 and 4 of the net income method statement). Also, a debit balance in a money account is excluded from the liabilities that are taken into account in working out net income ***[subsection 5-60(3)]***.

What is money?

6.24 Money is defined to include the things set out in the following table.

Table 6.2 Meaning of money

Things that are money	*Comments*
Money in hand	This covers money over which a taxpayer has immediate legal control. For example, cash physically held by the taxpayer.
Any credit balance in any money account	For example, a current account at a bank that the taxpayer uses in their day-to-day business activities.

[Dictionary items, definition of 'money']

What is a money account?

6.25 An account is a 'money account' for an income year if it has all the characteristics set out in the following table:

Table 6.3 Requirements for an account to be a money account

Requirement	*Comments*
The account must be held at an authorised deposit taking institution (as defined in the *Banking Act 1959*), or a similar institution in a foreign country.	This includes banks, credit unions and building societies. The foreign institutions covered would be those that are similar in nature to these.

Requirement	*Comments*
The taxpayer must choose for the account to be treated as a money account for the income year. For the convenience of the taxpayer, the choice can be made after the end of the income year, such as when the taxpayer's income tax return is being prepared.	Money accounts are intended to cover transaction accounts that a taxpayer uses in their day-to-day business or investment activities. The money account rules are designed to give taxpayer's a choice, as far as is reasonable, about whether they want the account treated as an asset or liability, or as part of their 'cash book'.
The balance in the account must not be a financial asset or financial liability subject to accruals or market value tax value rules (see Table 6.4 at paragraph 6.45).	Gains or losses on these assets and liabilities are intended to be taxed on an accruals or market value basis. Treating them as money accounts would defeat this intention.

[Subsections 5-60(4) and (5)]

6.26 Examples of money accounts are a savings account or an overdraft account. Some taxpayers may carry out their business transactions using credit cards. This may be their equivalent to a record of receipts and payments. In these circumstances, their credit card account could also be a money account, if that is how they want to treat it. A debit balance in any money account is excluded from the liabilities taken into account in working out net income.

Receipts and payments to or from money accounts are receipts and payments of the taxpayer

6.27 To simplify the treatment of accounts that are money accounts, the working draft provides that amounts received into, or paid from, a money account are taken to be receipts and payments of the account holder ***[subsections 5-60(1) and (2)]***. This implies that any money transfer between the taxpayer (cash in hand) and their accounts, or between their accounts, will always involve both a receipt by, and a payment to, the taxpayer, and so can be ignored.

Why is money excluded from the assets and liabilities used to work out net income?

6.28 Assets and liabilities that are money, or in money accounts, do not need to be considered under steps 3 to 6 of the method statement because steps 1 and 2 take account of the net change in a taxpayer's money assets and liabilities. It is necessary to refer to all receipts and payments in the working draft because it may be necessary to examine each of them to determine their effect on taxable income. For example, it is necessary to determine which receipts and payments are of a private or domestic nature, because they do not

come into the calculation of taxable income except to the extent they relate to a non-private asset (see paragraph 6.22).

What receipts and payments are included in net income?

6.29 The net receipts component of the net income formula (steps 1 and 2 of the method statement) will include all money received, and all payments made, by a taxpayer in the income year. The words 'receipts' and 'payments' (and their derivatives) will have their ordinary meaning. The legal principles that currently apply in determining whether a person has received or paid something will remain relevant to net income under the working draft.

Constructive receipts are explicitly included in net income under step 1

6.30 The Tax Value Method explicitly includes constructive receipts as amounts that are received for the purposes of working out net income. This constructive receipts rule is intended to supplement, and not displace, general legal principles regarding when a person has received something.

6.31 A generally accepted principle of tax accounting is that an amount accountable on a receipts basis can be income, even if it has not actually been received, as soon as it is applied or dealt with in any way on the taxpayer's behalf or as they direct. In other words, an amount is treated as received as soon as the taxpayer gets benefit from it (this is referred to as a constructive receipt). However, this rule will not apply to amounts credited to a money account (paragraph 6.27 explains how amounts credited to a money account are treated as receipts). ***[Section 5-65]***

6.32 Although the concept of ordinary income is not relevant under the Tax Value Method for working out net income, the principle of constructive receipt is to be applied in working out whether an amount has been received. The working draft explicitly states this principle, confirming what is generally accepted as one of the principles of tax accounting.

6.33 This constructive receipt rule is based on the rule under the current law[39].

Certain constructive payments are explicitly included in net income under step 2

6.34 The Tax Value Method also explicitly treats certain constructive payments as amounts that are paid for the purposes of working out net income ***[subsection 5-65(2)]***. This constructive payments rule will apply where a taxpayer has a constructive receipt. The taxpayer will be taken to have paid, to the person who actually receives the amount, an amount equal to the constructive receipt.

[39] See subsections 6-5(4) and 6-10(3) of the ITAA 1997.

6.35 This constructive payments rule is intended to supplement, and not displace, general legal principles on when a person has paid something.

Examples of constructive receipts and constructive payments

6.36 The following are examples of constructive receipts and constructive payments included under the net income formula.

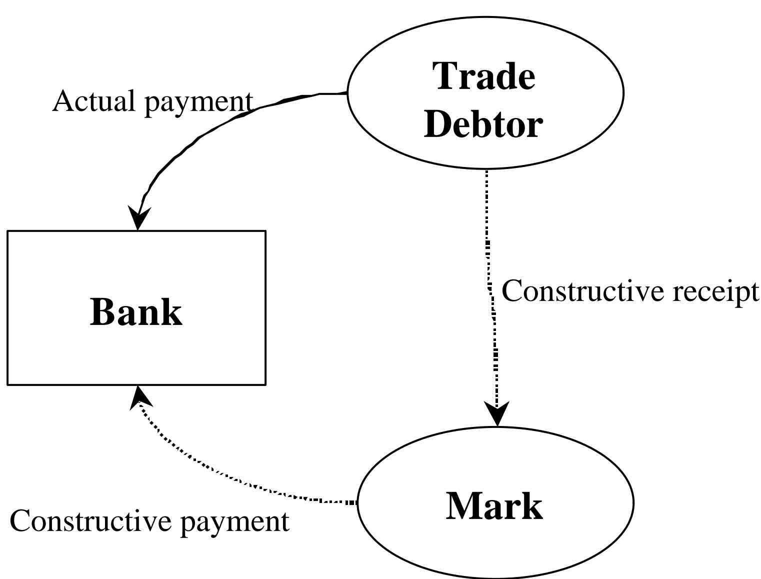
Example 6.1 Money credited to a loan account

In carrying on his business, Mark has an outstanding loan account with his bank (this account is not a money account). One of Mark's trade debtors pays amounts it owes to Mark by crediting amounts to his loan account. These amounts reduce the amount he owes to the bank and are, therefore, amounts he is taken to have received.

In this case Mark is also taken to have paid to the bank the amount credited to his loan account.

Diagram 6.3 illustrates this example.

Diagram 6.3 Illustration of Example 6.1



Example 6.2 Wages directed to a private health fund

On Homer's instructions, his employer sends part of his after-tax wages to a health fund to meet his liability to pay health insurance contributions for the benefit of him and his family. He is taken to receive the amount when his employer pays it to the fund.

In addition to the receipt, Homer is taken to have paid the amount to the private health fund. However, because the payment is private or domestic in nature, it is not actually included as a payment under the net income formula.

Example 6.3 Dividends credited to an account in a taxpayer's name

A company, of which Margarita is a shareholder, credits a dividend to an account held in her name with the company. The amount of the dividend is a constructive receipt to her. Margarita is also taken to have paid the amount of the dividend to the company (the person with whom the account is held). This payment will be matched by the increase in her asset, ie. the balance of her account.

The character of a receipt as revenue or capital is not relevant

6.37 Whether a particular receipt or payment is revenue or capital is irrelevant to the calculation of net income. This means that all receipts and payments (except those of a private or domestic nature) are included in working out net receipts.

What is the effect of including receipts and payments?

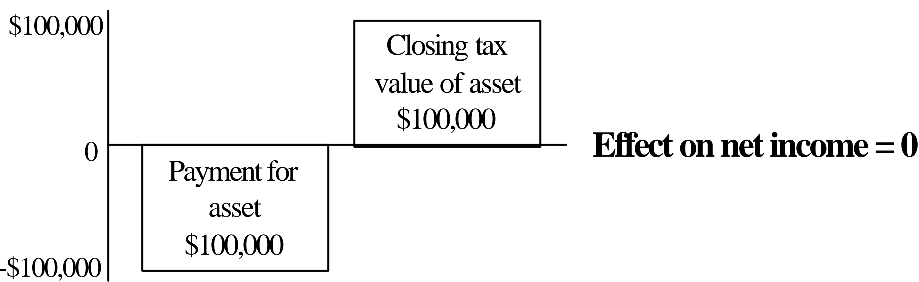
6.38 The interaction between steps 1 and 2 (net receipts) and steps 3 to 6 (net assets and liabilities) of the net income method statement ensures that receipts and payments that relate to the tax value of assets and liabilities do not affect a taxpayer's net income. Rather, they will be taken into account in determining the tax value of an asset or liability. The following examples illustrate this.

Example 6.4 The purchase of an asset

Hassan buys an asset at a cost of $100,000 (the asset's tax value is equal to its cost). The effect on net income is zero because the payment is matched by the closing tax value of the asset. This is illustrated as follows (see Diagram 6.4):

- net receipts are –$100,000 under steps 1 and 2 (i.e. zero (receipts) minus $100,000 (payments));
- the net change in the tax value of assets is $100,000 under steps 3 and 4 (i.e. $100,000 (closing tax value of assets) minus zero (opening tax value of assets)).

Diagram 6.4 Effect on net income of purchase of an asset



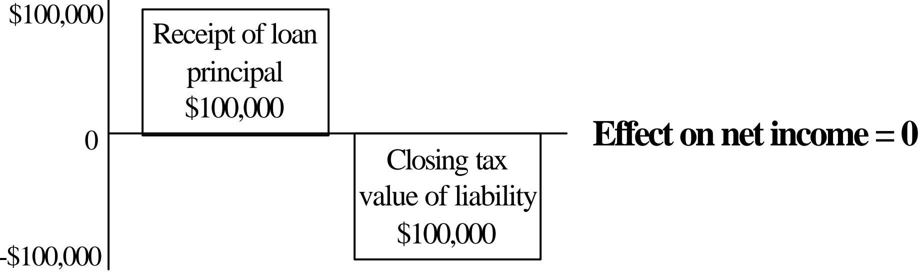
Example 6.5 A loan is taken out

Fishton borrows $100,000. The effect on net income is zero because the receipt is matched by a liability to repay the $100,000. This is illustrated as follows (see Diagram 6.5):

- net receipts are $100,000 under steps 1 and 2 (i.e. $100,000 (receipts) minus zero (payments));
- the change in the net income is –$100,000 under steps 5 and 6 (i.e. $100,000 (closing tax value of liabilities) minus zero (opening tax value of liabilities)).

The loan repayments made by Fishton will be matched by the decline in tax value of the liability to repay the loan.

Diagram 6.5 Effect on net income if loan is taken out



Deemed receipts and payments

6.39 Receipts and payments are taken to have occurred under non-cash transactions. Chapter 11 explains the rules that deem the receipts and payments that arise in these circumstances.

What is an asset?

6.40 An asset is a thing (such as land, chattels or a right) that embodies future economic benefits ***[section 6-15].*** An asset usually has economic benefits because it can be used or sold. Money is an asset but is excluded in working out the net change in the tax value of a taxpayer's assets (see steps 3 and 4 of the method statement).

6.41 Normally, a taxpayer holds an asset if they are recognised by the legal system as the owner of it. However, similar to the current law, under the Tax Value Method other rules will apply to determine who holds certain kinds of assets ***[sections 6-20, 6-21 and 6-22].*** Intangible advantages not capable of ownership (such as the market penetration that may arise from a successful advertising campaign) are taken not to be held by any entity.

6.42 Chapter 7 contains a detailed explanation of what an asset is and who holds an asset.

What is a liability?

6.43 A liability is normally an obligation to provide future economic benefits ***[section 7-20]***. So, it would include an obligation to pay money, or to provide another kind of asset or a service. Only liabilities that a taxpayer *has* are taken into account in working out net income. For the most part these are liabilities that are present legal or equitable obligations. Chapter 8 contains a detailed explanation of what a liability is and who has a liability.

What is the tax value of an asset or liability?

6.44 The working draft contains rules to determine the tax value of assets and liabilities ***[sections 6-40 and 7-75]***. The tax value will, in most cases, differ from market or economic value. For example, the tax value of most assets will be their cost, so that gains will only be taxed when the asset is disposed of.

6.45 Later chapters[40] contain a detailed explanation of how the tax value is determined for particular types of assets and liabilities. However, Table 6.4 briefly outlines the tax value of the main kinds of assets.

Table 6.4 Tax value of assets

Kind of asset	*Tax value*
An asset whose increase in value is to be taxed only upon realisation. This covers many assets capable of ownership (such as real property and some legally enforceable rights). It also covers some other assets not capable of ownership, such as some knowledge acquired from someone else.	The asset's cost. The main components of an asset's cost are its original cost plus the cost of any improvements (see Chapter 9).
Rights to receive an amount that is due and payable or must be paid within 12 months (e.g. trade debtors).	The amount to be received.
Depreciating assets (e.g. items of plant, equipment, fixtures and rights to have things done).	Written-down value based on effective life or relevant depreciation schedules (to be discussed in Chapter 16).
Trading stock	There would be the same choice of methods as under the current law.
Goodwill	If the goodwill is acquired from someone else (i.e. when a business or franchise is bought), its tax value is its cost at that time. Otherwise the tax value is zero (see Chapter 7).

40 Chapters 7, 8, 9, 10, 16 and 17.

Kind of asset	*Tax value*
Assets whose annual increase in value is to be taxed using an accruals system (some financial assets).	The value worked out using the appropriate accruals methodology (to be discussed in Chapter 17).
Assets for which an election has been made to value the asset at market value. (This election can only be made for a limited range of assets, mainly financial assets.)	The market value of the asset (to be discussed in Chapter 17).
Assets that are not, for policy or pragmatic reasons, to be recognised by the income tax system. Examples are certain rights (such as some of those arising under routine leases)	Zero (see Chapter 7).

What is the closing tax value of an asset or a liability?

6.46 The ***closing tax value*** of an asset or a liability will be its tax value at the end of the income year. ***[Subsection 5-70(1)]***

What is the opening tax value of an asset or liability?

6.47 The opening tax value of an asset or liability will always be the same as its closing tax value brought to account in working out net income in the preceding income year. Where there was no closing tax value brought to account at the end of the preceding year, the opening tax value of the asset is zero. ***[Subsection 5-70(2)]***

6.48 This opening tax value rule does not, however, apply to a balance in a money account that ceases to be a money account for the next income year and, therefore, becomes an asset or liability. In this case, the opening tax value of the relevant asset or liability is the balance in the account at the end of the income year when the account stopped being a money account ***[subsection 5-70(3)]***. This is illustrated in the following example.

Example 6.6 Changing treatment of accounts

> Henry operates an overdraft account, which is invariably in debit, in the course of carrying on his business. In Year 1 he chose to treat the account as a money account, and at the end of that year it had a debit balance of $5,000. However, at the start of Year 2 he decides to rearrange his finances and, in so doing, decides not to treat the account as a money account in that year.
>
> The opening tax value for Year 2 of the liability that is in the account is $5,000. If the opening tax value of the liability was instead zero (as it

would be in the absence of subsection 5-70(3)), Henry would effectively get a 'double deduction' for his expenditure.

What is the 'taxable income adjustment'?

6.49 The 'taxable income adjustment' is intended to adjust the net income to arrive at a taxable income for certain taxpayers. These adjustments will mainly be necessary for policy or anti-avoidance reasons.

Working out the taxable income adjustment

6.50 A taxpayer's taxable income adjustment is worked out as:

Upward adjustments – Downward adjustments

[Subsection 5-90(1)]

6.51 An upward adjustment will add to taxable income while a downward adjustment will reduce taxable income.

6.52 The taxable income adjustment can, as a result of the application of the above formula, be a positive or negative amount ***[subsection 5-90(2)]***. If the result of the formula is zero, there is no taxable income adjustment.

What are the upward and downward adjustments?

6.53 Various provisions throughout the working draft specify when an upward adjustment or downward adjustment arises. The rules dealing with the calculation of taxable income or tax loss provide tables that:

- set out some of the key adjustments ***[section 5-95]***; and
- direct the reader to where in the proposed law these various provisions can be found ***[section 5-100].***

6.54 Table 6.5 sets out some of the key upward adjustments while Table 6.6 sets out some of the key downward adjustments.

Table 6.5 Key upward adjustments

Upward adjustment	***Reason for the adjustment***
Apportioning private or domestic reductions	
An upward adjustment to reflect an apportionment for the private or domestic part of amounts that have *reduced* net income. An example is the decline in tax value of a depreciating asset that is used partly for private or domestic purposes. ***[Section 5-100, items 1, 2, 4 and 5 of the table]***	Losses or outgoings that are private or domestic should not reduce taxable income. Therefore, it is necessary to add back the portion of any loss or outgoing that is private or domestic. This is required because sometimes only wholly private or domestic amounts are excluded from net income. Chapters 12 and 13 will explain these issues in detail.
Negative net exempt income	
If the taxpayer has a negative amount of net exempt income, there is an upward adjustment for that amount. For example, a taxpayer with a net exempt income of –$100 has an upward adjustment of $100. The meaning of the term ‘net exempt income’ is set out at paragraphs 6.61 to 6.63. ***[Section 5-95, item 5 of the table]***	Because exempt amounts are not taxable (see Table 6.6), any expenses that arise in respect of them should not usually reduce taxable income. This is the position under the current law. A taxpayer will have a negative net exempt income if any such expenses exceed the exempt amounts. These expenses will have reduced net income (as either payments or liabilities) and, therefore, must be added back to ensure the correct outcome.
Gifts included in net income	
An upward adjustment equal to the amount of any gift or contribution (except to the extent that it is covered by Division 30 of the ITAA 1997) from which the taxpayer did *not* intend to gain an economic benefit. This adjustment will not cover a gift or contribution that is not taken into account in working out net income (i.e. as a payment or change in the tax value of an asset or liability). An example is a gift that is private or domestic in nature. ***[Section 5-95, item 10 of the table]***	Under the Tax Value Method, all non-private, non-domestic gifts will reduce net income (as either payments or liabilities). However, as under the current law, the only gifts intended to reduce net income are: • gifts that are made to obtain a benefit; or • gifts to bodies that qualify for a deduction under the tax law (these are set out in Division 30). Accordingly, it is necessary to add back gifts not meeting these criteria.

Table 6.6 Key downward adjustments

Downward adjustment	***Reason for the adjustment***
Apportioning private or domestic increases	
A downward adjustment to reflect apportionment for the private or domestic part of amounts included in working out net income that have *increased* that net income. An example is a gain on disposal of a depreciating asset that has been used partly for private purposes. ***[Section 5-100, items 1,2, 4 and 5 of the table]***	It is intended that amounts that are private or domestic should not be taxable. This adjustment will ensure that outcome. Chapters 12 and 13 will explain these issues in detail.
Positive net exempt income	
If the taxpayer has a positive net exempt income, a downward adjustment for the amount by which it is positive. For example, a taxpayer with a net exempt income of $100 has a downward adjustment of $100. The meaning of the term 'net exempt income' is set out at paragraphs 6.61 to 6.63. ***[Section 5-95, item 5 of the table]***	Exempt amounts are not intended to be taxable. Such amounts will be included in net income as either a receipt, increase in the tax value of assets or a decrease in the tax value of liabilities. Consequently, there needs to be a downward adjustment to ensure that the exempt amounts are not taxable.
Gifts not included in net income	
A downward adjustment equal to the amount of any gift or contribution that: • is not taken into account in working out net income (e.g. a gift that is private or domestic in nature); and • is covered by Division 30 of the ITAA 1997. ***[Section 5-95, item 15 of the table]***	A gift not included in working out net income (e.g. a private or domestic gift) will not reduce net income. This is appropriate unless the gift is made to a body listed in the gift provisions of Division 30. In these cases it is intended that a taxpayer be able to reduce their taxable income by the amount of the gift. This adjustment achieves that outcome.
Policy concessions	
A downward adjustment for expenditure concessions.	For policy reasons, the Parliament may provide for a taxpayer's expenditure on an asset, or an inflated proportion of a taxpayer's expenditure, to immediately reduce taxable income. Downward adjustments will achieve this outcome. For example, under the Tax Value

Downward adjustment	*Reason for the adjustment*
	Method a downward adjustment will be needed to fully incorporate the current law's tax incentives for research and development expenditure. ***[Section 5-100, item 3 of the table]***

Unused tax losses reduce taxable income

6.55 All or part of a taxpayer's tax losses from earlier years may be used in an income year if the taxpayer's 'net income' plus their 'taxable income adjustment' is positive. The working draft is not yet complete in its treatment of losses. Accordingly, the paragraphs that follow discuss the anticipated treatment of prior year losses.

6.56 Under the Tax Value Method, only a taxpayer's prior year losses that meet the relevant tests[41] can be carried forward to reduce taxable income in future years. Also, a tax loss will first reduce the amount of a taxpayer's net exempt income[42] (if positive) before it is used to reduce taxable income. If a taxpayer's net exempt income is negative or zero, it is not relevant to working out how much of a tax loss is used-up.

What are 'unused tax losses'?

6.57 Under the Tax Value Method, 'unused tax losses' for a given income year will be:

- the sum of all the taxpayer's allowable tax losses from earlier income years that have not previously been used;

less

- the amount of a taxpayer's net exempt income (if positive).

How much of a tax loss will be used in an income year?

6.58 Some of a taxpayer's unused tax losses may be left over for use in future years. The amount of the unused tax losses used up in an income year is set out in Table 6.7.

Table 6.7 Amount of unused tax losses used up in an income year

If net income plus the taxable income adjustment is:	*The amount of the tax loss used up is:*
Equal to, or greater than, the tax loss	The whole amount of the tax loss

41 Such as the continuity of majority beneficial ownership tests applying to companies and trusts.

42 The meaning of the term 'net exempt income' is set out at paragraphs 6.61 to 6.63.

If net income plus the taxable income adjustment is:	*The amount of the tax loss used up is:*
Less than the tax loss	An amount of the tax loss equal to [net income + taxable income adjustment]

In what order will tax losses be used if there is more than one?

6.59 A taxpayer may have a tax loss from each of 2 or more earlier income years. In this case, the tax losses are used up in the order in which they arise. This is also the position under the current law. This means that:

- net exempt income (if positive) first reduces tax losses in the order in which they arose;

then

- the amount of [net income + taxable income adjustment] reduces the remaining tax losses in the same order.

6.60 Example 6.7 illustrates how unused tax losses are used.

Example 6.7 A taxpayer has a tax loss from each of the previous two income years

Jacob is preparing his tax return for the 2004-2005 income year. For that income year he has:

- net income of $50,000;
- a taxable income adjustment of –$10,000; and
- net exempt income of $30,000.

Jacob also had a tax loss of $40,000 in each of the 2002-2003 and 2003-2004 income years.

For the 2004-2005 income year, Jacob does not have a taxable income. This outcome is worked out in the manner set out below:

- [Net income + taxable income adjustment] is $40,000 (i.e. $50,000 + (–10,000));
- Unused tax losses are $50,000 (i.e. $80,000 (tax losses) –$30,000 (net exempt income));
- The $40,000 [net income + taxable income adjustment] is reduced by the $50,000 unused tax losses, resulting in –$10,000;

- Jacob does not have a taxable income because the result of this process is not positive.

All of Jacob's 2002-2003 tax loss has been used up. He has $10,000 of his tax loss from 2003-2004 left over to be carried forward to future income years.

'Net exempt income' is relevant to calculating taxable income

6.61 A taxpayer will need to work out whether they have a 'net exempt income'. This is relevant to whether they have an upward adjustment or downward adjustment (see Tables 6.5 and 6.6) and to the amount of their unused tax losses that may be applied to reduce their taxable income (see paragraph 6.57). The working draft does not set out the provisions for working out net exempt income. Accordingly, the paragraphs that follow discuss the anticipated framework for doing that.

6.62 There are a variety of provisions in the income tax law that make various amounts exempt. Examples are the exemption of some social security benefits and the exemption of distributions that have been subject to family trust distribution tax.

How will net exempt income be worked out?

6.63 Net exempt income will be worked out using the same method used to work out net income (see the method statement at paragraph 6.21), but only including:

- receipts that the income tax law defines to be exempt, such as exempt social security benefits and distributions subject to family trust distribution tax;
- payments made, and liabilities taken on, in order to get an exempt receipt or exempt asset; and
- assets and other liabilities that the income tax law includes in working out net exempt income for an income year. For example, if a gain on the disposal of an asset is intended to be exempt from taxation, the receipt for the disposal would be included in working out net exempt income, as would the opening tax value of the asset.

How are cash basis taxpayers affected?

6.64 The method for calculating taxable income will need to be modified to accommodate those taxpayers who, for policy reasons, will be taxed on a cash basis. These would be individuals and STS taxpayers.

Chapter 7
Core rules for assets

Outline of Chapter

7.1 This Chapter explains:

- what an *asset* is;
- who *holds* an asset; and
- the rules for working out an asset's *tax value*.

7.2 Most of the provisions discussed in this Chapter are in Division 6 of the working draft.

Context of reform

7.3 What is assessable income in the current law is, in many instances, no more than an attempt to assess a change in the value of assets.[43] However, although that is true of much of the current law, it is not clearly expressed in those terms.

7.4 In particular, the current law does not have a concept of asset that is used consistently throughout the law. For example:

- the general deduction provision in the current law (i.e. section 8-1 of the ITAA 1997) applies an asset concept by referring to outgoings of a 'capital' nature – expenditures that provide an *enduring* benefit – whereas, the capital gains and losses provisions (i.e. Parts 3-1 and 3-3) apply an asset concept using, in part, the notion of legal property.

7.5 As a result, assets are *treated* in different and, often, inconsistent ways. For example:

- some expenditures that give rise to items of a capital nature may be deducted over time (e.g. plant and equipment), whereas others cannot be deducted at all (e.g. long-term rights that are only covered by the CGT regime).

[43] Chapter 2 discusses this in some detail.

7.6 Contributing to the inconsistent treatment of assets is the current law's *ad hoc approach*. That approach requires a regime to provide rules for recognising the capital expenditure that gives rise to an asset. Those regimes do not have consistent rules for when the asset starts being held, for when it stops being held, for when gains and losses are recognised, or for who brings those gains or losses to account.

7.7 For example, CGT assets usually start being held when the contract to buy them is entered into and stop being held when the contract of sale is made but depreciating assets start and stop being held when ownership changes. The CGT regime has very specific rules about what is included in the asset's 'cost base'; it differs from what is included in the 'cost' of a depreciating asset (which also has a specific definition) or the 'cost' of trading stock (which has no general definition).

7.8 The working draft defines *asset* for the whole law. That definition, which draws on the accounting meaning, will help make clear the scheme of the income tax law, making it easier to understand and, ultimately, to comply with. The draft also has just one set of rules for who holds the asset and when they hold it and one set of rules for what is the asset's cost and for working out the gain or loss on its disposal.

Summary of working draft

7.9 Division 6 deals with assets:

- what they are;
- whose they are; and
- what their value is for tax purposes.

7.10 An ***asset*** is anything that embodies future economic benefits.

7.11 Assets are only ***held*** by anyone if they are property, other legal or equitable rights or acquired commercial secrets. In those cases, they are generally held by their owner. There are a few special rules that change who holds the asset where the legal owner is not the real economic owner.

7.12 The value at which the working draft recognises an asset (its ***tax value***) at any particular time will usually be one of these:

- its *cost*; or
- its *estimated value* (i.e. its cost +/– the amount it is estimated to have changed by that time, typically downwards); or

- its *market value* (although this will be only rarely used and only if the taxpayer chooses to use it); or
- *nil* (this will mostly be used to reduce compliance costs or for policy reasons).

7.13 In some cases there will be a choice of the valuation method available but, usually, particular types of asset will be assigned just one of those valuation methods.

Comparison of key features of working draft and current law

7.14 Chapter 2 compares the treatment of assets under the current law to the treatment proposed under the Tax Value Method.

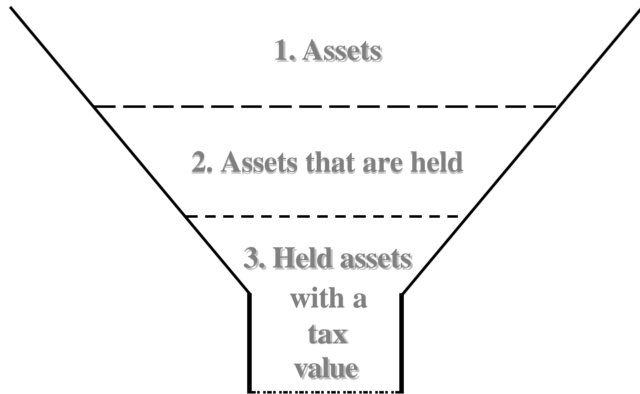
Detailed explanation of working draft

7.15 Taxpayers' net income for an income year will include any change in the *tax value* of *assets* that they *hold* ***[section 5-55]***. So, an increase in the tax value of an asset will increase taxable income and a decrease in its tax value will decrease taxable income.

7.16 We should focus briefly on the need for all 3 of those elements (i.e. existence, holding and tax value) to be present before there can be those effects on someone's net income. Although *asset* is given a wide meaning, the only assets that can affect *your* net income are those that *you hold*. Even then, they only affect net income if their *tax value* changes. A change in market value is not enough; the change must be in their *tax* value.

7.17 We can think of this system as a series of filters. Assets affect net income only when they pass through the final filter. At the coarsest filter, there are many assets; fewer of them are held as the filters become finer and fewer again can pass through the final filter because some have no tax value.

Diagram 7.1 The asset filter



7.18 An *asset* is, broadly, anything that embodies future economic benefits ***[section 6-15]***. So, a physical thing is an asset because you can get economic benefits from selling it or using it. Rights will also be assets (including debts, which are rights to get money), and so will information.

7.19 Taxpayers will *hold* an asset if they are its economic owner; that is, if they can access the future economic benefits it embodies while stopping others from accessing those benefits. In most cases, the legal owner of an asset will be its economic owner. ***[Sections 6-20, 6-21 and 6-22]***

7.20 The working draft sets out rules for working out the *tax value* of assets ***[section 6-40]***. Those rules will usually work to prevent a gain on an asset being taxed until the asset is disposed of. They do that by giving most assets a tax value equal to their cost, which usually does not change regardless of what happens to the asset's real value.

Importance of the asset concept

7.21 It is important to realise the significant role the asset concept will play under the Tax Value Method (when taken together with the rules about holding and valuing assets). Rather than being just another part of the net income calculation, together they are *the* part that (along with liabilities) determines the general timing of taxable gains.

7.22 The current law does that job by:

- distinguishing between items of revenue and capital and providing special rules for each (e.g. 'derived' 'received', or 'earned'); and
- establishing specific regimes to deal with specific types of gains and losses (e.g. trading stock, depreciation, CGT, Division 16E of the ITAA 1936, etc.).

7.23 The Tax Value Method will bring all amounts to account but will sometimes match them with an asset or a liability. So, a payment that is

matched by an asset will only become 'deductible' as the asset disappears. The rules about when assets are held, and the tax values given to them while they are, therefore play the vital, but not necessarily obvious, role of determining the timing of 'deductions' (to use the terminology of the current law).

7.24 Similarly, a receipt that is matched by a liability will only be taxable as the liability disappears. The rules about when liabilities are owed, and the tax values given to them, therefore play the equally vital role of determining the time that receipts are taxed.

Immediate deductibility

7.25 Under the current law, revenue expenditure is usually deductible straight away. Even though, under the Tax Value Method, revenue-type expenditure can give rise to an asset (theoretically deferring deduction), features of the Method ensure that revenue-type expenditure will continue to be immediately deductible. This table lists the ways that that outcome is reached.

Table 7.1 Continued deductibility of 'revenue type' expenditure

Case	***Comment***
No asset arises from the expenditure (i.e. it does not lead to an asset that provides future economic benefits).	***Example:*** Some gifts.
The asset is created during the income year, but its future economic benefits are wholly consumed during that year.	***Example:*** Typically consumable stores (like stationery or fuel).
The asset is created during the income year but it is not 'held' at the end of the year.	***Examples:*** Self-generated knowledge and market penetration from an advertising campaign.
The asset is given a tax value of nil.	There may be policy or practical reasons for not recognising an asset even though it is held. ***Example:*** Internally generated goodwill.
The asset has a tax value but the expenditure does not form part of its cost.	Expenditure may be connected to an asset, but be too remote to form part of its cost. ***Example:*** Payments for legal advice about the implications of acquiring an asset do not form part of the asset's cost.

What is an asset?

7.26 An ***asset*** is a thing that embodies (i.e. is the source of) economic benefits in the future ***[section 6-15]***. Put another way, assets are things of *positive* economic value.

7.27 The *relationship* between the thing and a taxpayer does not affect whether the thing is an asset.[44] So, it does not matter whether any particular taxpayer thinks that the thing embodies future economic benefits, or even whether it has future economic benefits *for that taxpayer*. Whether something embodies future economic benefits is a question to be answered objectively and independently of any particular taxpayer.

7.28 The asset concept is very broad and is intended to be read broadly. Assets can take many forms. They can be tangible things, like land or motor vehicles. They can be intangible things, like rights or knowledge.[45] They can be things you buy, things that are given to you, things that just spring into existence (e.g. the cause of action you have if someone wrongs you), or things that you create. They can be things that you can trade (e.g. shares) or things that cannot be traded (e.g. a personal right).

7.29 However, although 'asset' is a very wide concept, many things that are assets do not affect net income because:

- no one 'holds' them; or
- they are given a tax value of nil.

7.30 These things are discussed in some detail later.

What is an economic benefit?

7.31 Economic benefits can be contrasted with social benefits, such as the love of one's family or the respect of one's peers. Unlike social benefits, an *economic* benefit is a favourable circumstance or advantage that can be measured in money terms. However, that *does not* mean that it must be convertible into money (see paragraph 7.36).

7.32 Nor does it mean that you have to measure the asset's economic value. To satisfy the definition, it is enough that the asset has *some* positive economic value even if it is not ascertained. The quantum of that positive value is irrelevant.

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44 Although it can be critical in determining whose asset it is and is often relevant in working out what is its tax value.

45 The use of the term 'embodies' should be seen as a metaphor in the case of incorporeal assets that, of course, can't really have a body.

7.33 Economic value is a different way of looking at future economic benefits: a thing will have an economic value *now* if it is able to provide economic benefits in the *future*. Thus, assets may be considered from 2 perspectives:

- as a stock of future economic benefits; or
- as a store of economic value.

7.34 Assets can provide economic benefits of 2 types:

- inflows (e.g. a debt will give rise to cash receipts, as will selling trading stock) or reduced outflows (e.g. a right might give relief from a liability); and
- service or use (e.g. plant and equipment can be used to produce goods or services).

7.35 Most assets provide both types of economic benefit. For example, a computer can be used to run a program (providing a service benefit) *and* it can be sold for cash (providing a cash inflow benefit). Therefore, the computer has economic value because of what it can do (i.e. value-in-use) and what it can be sold for (i.e. value-in-exchange).

7.36 A thing may still be an asset even if it cannot be sold. This will be the case where the asset has value-in-use but does *not* have value-in-exchange. The most common example of these assets would be a personal right (such as a beneficiary's right to enforce the terms of a trust). Another example would be an item of specialised equipment, which may not have a disposal value if nobody other than its current owner can operate it. Nevertheless, such equipment would still constitute an asset if its owner could use it to provide economic benefits.

Identifying the asset

7.37 The identity of an asset is generally taken from the *thing* that constitutes the asset. As a result, a tangible asset is often identified by an object. The identity and existence of a tangible asset may be confirmed by viewing it (e.g. stock-take of trading stock).

7.38 An intangible asset is usually identified by a right. The identity and existence of rights cannot be confirmed by viewing them. However, their identity and existence can be confirmed by considering the transactions that gave rise to them. For example, the right to use business premises into the future, which arises out of a payment, may be identified on the basis of a tenancy agreement and expenditures made (as ascertained from business and accounting records).

7.39 Intangible assets that are *not* rights can be more difficult to identify. They are things like knowledge and other advantages. Like rights, they cannot be physically identified. However, unlike most rights, they do not usually result from agreements with others, and so may be more difficult to identify. Fortunately, the only one of these intangible assets that can affect net income (because it is the only one that can be 'held') is the acquired commercial secret and it, of course, *does* arise from an agreement.

One asset or many?

7.40 Most assets have constituent parts. In some cases, the question will arise whether *the* asset is:

- each of the things in a set; or
- the set of things itself.

7.41 That question is one of fact and degree. It will have to be determined in the light of all the circumstances of the particular case, including perhaps whether the things are normally seen as a set or as separate things, whether they are kept together or separately, whether they are tangible or intangible and whether provisions in the law imply that they are treated as one asset or as separate assets.

7.42 A further general principle that may be helpful is whether the set of things is functionally or structurally complete. If so, the set will usually constitute a single asset. For example:

- A working car is made up of a number of parts, but *the* asset will usually be the motor vehicle.
- However, if a wrecker purchases the car for spare parts, the assets may well be each of the vehicle's various parts.
- A share in a company is made up of a number of rights (e.g. the right to vote, the right to share in dividends and the right to share in returns of capital), but the share itself is *the* asset.

Fixtures separate from the land

7.43 The working draft contains some special rules that affect the identity of an asset ***[section 6-18].*** The first (and perhaps most important) of these is that land is an asset *separate from* any fixtures or improvements on it (whether or not the fixture or improvement can be removed) ***[subsection 6-18(2)].***

7.44 A fixture is a chattel that is fixed to land (e.g. a windmill) or fixed to something that is itself fixed to land (e.g. a light fitting fixed to a building). An

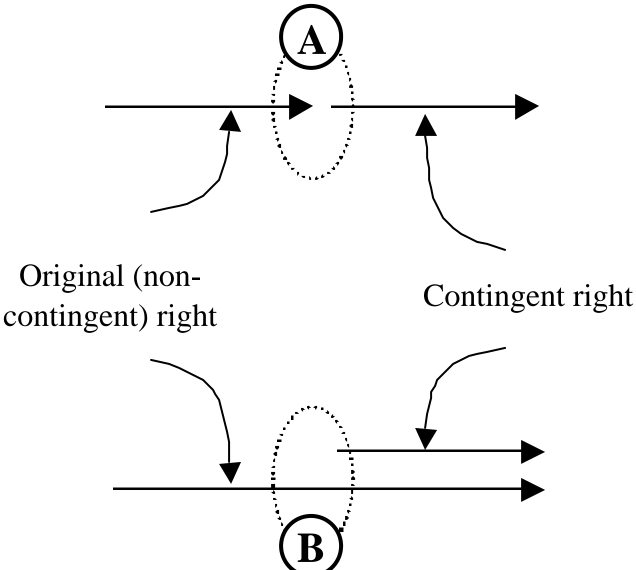
improvement is something that is just a change to the land itself (e.g. a road or an earthen dam).

7.45 The reason for that rule separating these things from the land is that the law often needs to treat the fixtures and improvements as depreciating assets so that their decline in value over time is properly accounted for. However, in law, fixtures and improvements are part of the land and land is not a depreciating asset. Therefore, to get the intended result, the fixtures and improvements must be treated as separate from the land.

Contingent rights

7.46 The second special rule is that contingent rights under an arrangement are treated as assets separate from the non-contingent rights under that arrangement ***[subsection 6-18(3)]***. We can think of those cases as looking like one of these diagrams:

Diagram 7.2 Contingent rights



7.47 This diagram covers the two main cases covered by this special rule. The top ('A') case is similar to an option agreement. The party with the option has a right as soon as the contract is entered into. When the contingent event occurs, the original right disappears but is replaced by a new right.

Example 7.1 Rights under contingencies - usual option case

> Irene is appointed as managing director of Big Bob's Bagels Pty Ltd, (well known for its patented crusty cheese bagel). As part of her employment agreement, she gets an option to acquire a thousand ordinary shares in Big Bob's Bagels for $1 each. Irene exercises the option 2 years later when the shares are trading at $1.25. When she entered the employment agreement, she got the non-contingent right to have Big Bob's Bagels meet her call for the shares to be issued. When

she exercised her option 2 years later, that right was replaced by a right to get the shares (which had been contingent until that point).

7.48 The bottom ('B') case is the usual insurance agreement. The original right continues even if the contingent event happens. If the contingent event happens, a new right also comes into existence.

Example 7.2 Rights under contingencies - usual insurance case

Big Bob's Bagels takes out a 3 year insurance policy against the risk of fire damage to its bagel factory. In the second of those years, the dough plant causes a fire in the west wing. The damage is assessed at $250,000. When it entered the insurance contract, Big Bob's Bagels acquired a non-contingent right to be insured against a risk of fire damage. It also had a right to be compensated for damage but that right was contingent on fire damage occurring. When the fire damage happened, the contingent right crystallised but the non-contingent right to insurance against the on-going risk of fire damage continued.

7.49 Of course, some option contracts will look like the B case (e.g. if there were a right to call for shares more than once) and some insurance contracts will look like the A case (e.g. insurance against the risk of death).

7.50 That special rule does not apply if the contingent event is artificial or will probably be met ***[subsection 6-18(5)]***. That exception is designed to prevent what are really non-contingent cases being turned into contingent ones for a taxation advantage. For instance, a contract that only applies if the sun comes up on Christmas day would have a contingency that was both highly likely to happen and artificial (in the sense that it had nothing to do with either the substance or the circumstances of the contract). Such a contingency would be ignored.

7.51 When the rule does apply, the contingent right is treated as beginning to be held only when the contingency happens ***[paragraph 6-18(4)(a)]***. It is also treated as obtained for no consideration and outside of the agreement ***[paragraphs 6-18(4)(b) and (c)]***. Those rules have the effect of:

- attributing the consideration given under the agreement entirely to the non-contingent right; and
- attracting the one-sided non-cash rules to value the contingent right when the contingency is satisfied (see Chapter 11).

Example 7.3 Contingent rights - when held and what tax value

Big Bob's Bagels takes out $1m insurance against the risk of weevil infestations in its wheat stocks for a year. It agrees to pay a single premium of $10,000 at the start of the year. It has the non-contingent right of insurance against the risk of infestation. Because all the

consideration is attributed to that right, it has a cost of $10,000. Big Bob's will hold that right for the whole year, regardless of how many infestations occur, so is an example of the 'B' case described in the diagram.

Big Bob's also has a contingent right that is treated as a separate asset but is only treated as being held by Big Bob's if an infestation occurs. In that event, Big Bob's will start to hold a right to compensation for the infestation that will have a cost of $1m. That right will last until the compensation is paid.

7.52 It is important to note that the working draft is not complete in this area. In particular, the cost of an option that is exercised will need to form part of the cost of the asset acquired upon that exercise.

Renewal or extension of a right

7.53 When a right is renewed or extended, the renewal or extension is treated as a continuation of the original right rather than as a separate asset. ***[Subsection 6-18(6)]***

Splitting and merging

7.54 The function and structure of assets can change over time. An asset can be split into a number of assets. For example, a developer might split a block of land into several assets by subdividing the block. Also, assets can merge into a single asset. For example, components such as a keyboard, hard-disk drive and motherboard can be assembled to form a computer. Equally, assets can be transformed into different assets. For example, an ingot of metal could be cast into an engine block.

7.55 In all these cases, the tax value of all the new assets will equal the tax value of all the original assets (plus any costs of splitting, merging or transformation). These matters are covered by Division 7B and will be discussed in more detail in Chapter 10. A cross-reference to the splitting rules is contained in the section dealing with identification of assets ***[Subsection 6-18(7)]***.

Who holds an asset?

7.56 The change in the tax value of an asset is included in the net income of the taxpayer who *holds* the asset. ***[Section 5-55, steps 3 and 4 of the method statement]***

7.57 The working draft sets out 3 tables identifying the holder of different kinds of asset. Broadly, they result in the economic owner holding the asset; that is, the taxpayer who is able to access the asset's economic benefits *while* stopping other taxpayers from doing the same. ***[Sections 6-20, 6-21 and 6-22]***

The general rules

7.58 The first table deals with the *general* rules. ***[Section 6-20]***

No one holds some assets

7.59 The general rules explain that, unless a special rule applies, *no one holds* the asset, unless it is:

- property; or
- any other legal or equitable right; or
- a purchased commercial secret.

[Section 6-20; item 4 in the table]

7.60 So, even if something is an asset, it need not be *held* by anyone. The first significant thing about that is that, even though it is usually possible to characterise a wide range of generally advantageous things (such as, say, a favourable exchange rate) as assets because they embody future economic benefits, it is quite clear that they are not assets that anyone holds. Therefore, they do not appear in anyone's calculation of net income.

7.61 The second significant thing is that expenditure that gives rise to an asset that is not held will get immediate tax relief. For example, you might buy generally available information. Although such information is an asset, we will see that that information[46] is not *held* by anyone, so your payments towards acquiring it will be 'deductible' straight away.

7.62 Let's look at the main types of asset covered by the general rules that *are* held.

Property

7.63 The first general rule is that an asset that is *property* is held by its *owner* ***[section 6-20, item 1 in the table].*** In broad terms, *property* is anything that can be owned. Sometimes, it is also the ownership interests in things that can be owned. Both senses of the term are relevant to the working draft. For example, a block of land might appropriately be called property and the owner of that land correctly identified as its holder. However, if it were jointly owned by 2 parties, each of them would correctly identify their *proprietary interest* in the land as the asset they held. The land would still be an asset, of course, but it would not be held by either of them.

7.64 Treating the owner of proprietary assets as holding them continues the general position under the current law. It is also consistent with policy because

[46] As opposed to any tangible thing on which the information is recorded.

an owner's ability to use or exchange the asset, and deny others from doing so, is protected by the courts, so that an asset's owner in law is usually also its economic owner. If there is *both* a legal and an equitable owner of an asset, the legal owner holds it. That clarifies what is sometimes ambiguous in the current law but is the most widely accepted view.

Non-proprietary rights

7.65 Some rights recognised by law or equity are not property. The scope of such rights is not clear but some have suggested that rights that are not capable of assignment are personal rights, rather than proprietary rights.[47] An example of such a right is a beneficiary's right to enforce the terms of the trust.

7.66 To the extent that such personal rights are legal or equitable, they would be held by whoever has that right ***[section 6-20, item 2 in the table].*** That preserves the outcome under the capital gains rules in the current law.[48]

Information

7.67 Information can certainly be an asset because it can embody future economic benefits. However, information that is generally available cannot really be said to be *held* by any particular taxpayer.

7.68 The third general rule, then, says that a taxpayer only holds information if:

- it is *not* generally available; and
- the taxpayer acquired it from another entity; and
- its cost was mainly attributable to it not being generally available.

[Section 6-20, item 3 in the table]

7.69 The requirement that information can only be held if it is *not generally available* means that it is really limited to secrets. Indeed, 'commercial secrets' is quite a reasonable way of describing such assets.

7.70 It's important not to confuse information that is generally *available* with information that is commonly *known*. For instance, very few people know how to build a nuclear reactor but that information is generally *available* and, so, would not be an asset that could be held.

7.71 What's also worth noting is that a secret that does become generally available (i.e. available to the public at large) would stop being held, without any action being taken by the taxpayer(s) who formerly held it. Taxpayers

47 For example, see the judgment of Gummow J. in *Hepples v FCT* (1990) 22 FCR 1.
48 See the definition of *CGT asset* in section 108-5 of the ITAA 1997.

holding a secret could, of course, accelerate that outcome by making it generally available.

7.72 The requirement that it be *acquired from someone else* means that taxpayers do not hold information they generate themselves (e.g. by industrial research). This reflects a policy decision to allow immediate tax relief for expenditure on such activities and preserves the general treatment given by the current law.

7.73 The same policy extends to information a taxpayer acquires from another entity if the taxpayer engaged that entity (e.g. a consultant designer) to generate the information for them. For practical purposes, the law treats that information as if it had been generated directly by the taxpayer.

7.74 In principle, the treatment accorded to information mirrors that given to goodwill. Both information and goodwill that you *did not* generate yourself is treated as an asset you hold with a tax value equal to its cost. Information and goodwill that you *did* generate yourself is not recognised in net income, either because it's not held (in the case of information) or because it has a zero tax value (in the case of goodwill).

7.75 The final requirement is that the cost of the information must be mostly attributable to it not being generally available. This is designed to ensure that it was the secret that was being paid for, rather than, say, an educative service.

The special rules

7.76 The special rules override the general rules in some particular cases ***[subsection 6-21(1)]***. They deal with cases where the holder of the asset under the general rules would not be the right taxpayer as a matter of policy. In most of those cases, the legal owner is *not* the asset's economic owner and the special rules aim to ensure that the economic owner of the asset *holds* it.

7.77 In some instances, the special rules make it clear not only who holds the asset but also who does not (e.g. see item 1). In those cases, the entity identified as not holding the asset is not the holder for any purposes of the Act ***[subsection 6-21(2)]***.

Leased luxury cars

7.78 There is a special rule about leased luxury cars. The current law provides that the lessee, rather than the lessor, 'owns' a leased luxury car for tax purposes. The working draft maintains that result ***[subsection 6-21(1), item 1 of the table]***.[49]

[49] However, we are considering whether the same net outcome can be achieved in a more intuitive way.

Fixtures and improvements on land

7.79 In law, assets fixed to land (e.g. a building) become part of the land and, therefore, become owned by the landowner. Improvements to the land (e.g. roads, earthworks, and landscaping) are more intuitively part of the land itself but are still owned by the landowner.

7.80 In both of those cases, though, the economic owner may not be the land owner. Typically, for instance, tenants will affix an asset, or make an improvement, to a landlord's land for their own purposes. The tenant, rather than the landlord, is the economic owner in such cases and should be recognised as holding the fixture or improvement for tax purposes, at least while the asset is in their control.

7.81 The first part of that work is done by the asset identification rules, which treat the fixture or improvement as an asset separate from the land ***[subsection 6-18(2)]***. The general rules then apply to work out who holds the land and they, or the special rules, apply to work out who holds the assets separated from the land.

7.82 A fixture on land subject to a quasi-ownership right (leases, easements, etc.) is held by the owner of that quasi-ownership right for so long as they can remove the fixture ***[subsection 6-21(1), item 2 of the table]***. This recognises the effect of the tenants' fixture laws but also extends to similar (non-lease) cases. It is not necessary for the lease (or other quasi-ownership right) to still exist; it is only necessary that the right to remove the fixture still exists. If the right to remove expires without any removal, the fixture would then start to be held by the landowner.

7.83 A fixture that cannot be removed (or an improvement) on land subject to a quasi-ownership right is held by the owner of that right ***[subsection 6-21(1), item 3 of the table]***. However, that is only the case if the fixture or improvement was made by the owner of the quasi-ownership right, or by a previous owner, *for their own use*.

Example 7.4 Holding tenants' non-removable assets

> If Simon leases a shop and permanently installs a pizza oven, *he* would hold the pizza oven, not his landlord, while the lease lasted. If the shop is later leased to Renee, she would become the oven's holder and could depreciate it based on its cost to her.

7.84 In law, an asset that is leased and then fixed to land becomes owned by the landowner. However, the lessor of the asset usually retains a right to recover the asset. In such cases, the asset lessor will *hold* the asset ***[subsection 6-21(1), item 4 of the table]***.

Bare trusts

7.85 Assets that are trust property are normally *held* by the trustee because the trustee will be their legal owner. However, there is a special exception in the case of an asset subject to a bare trust (i.e. a trust where the trustee's only obligation is to convey the property to the beneficiary). In such cases, the *beneficiary* holds the asset but does not hold their actual beneficial interest ***[subsection 6-21(1), item 5 of the table].*** This reflects the true nature of the relationship between the beneficiary and the property - the beneficiary is the economic owner of the property because the trustee has no power to control its use and disposition.

Hire purchase, retention of title clauses and chattel mortgages

7.86 Another category where the economic owner is not the legal owner covers the cases like hire purchase, retention of title clauses and chattel mortgages. In all of them, the party with the use and enjoyment of the asset is not the legal owner. When that party is also probably going to become the legal owner before the arrangement ends, the special rules treat them as *holding* the asset and the legal owner as *not* holding it.

7.87 A taxpayer *holds* an asset if they have the use and enjoyment of it under an arrangement and, under the same arrangement, title in it will, or may, pass to them by the time the arrangement ends. ***[Subsection 6-21(1), item 6 of the table]***

7.88 'Will or may pass' does not mean just a possibility at large, in the sense that anything *may* happen. Rather, there must be a nexus between the possibility of title passing and the totality of the arrangements (*Case 2/93*, 93 ATC 107 at p. 111).

7.89 This rule will apply typically in hire purchase cases. Another case where it will often apply is where one taxpayer has possession and use of an asset but the vendor has retained title in it (perhaps until it is paid for). If title will, or may, pass, the purchaser, and not the vendor, will *hold* the asset.

Example 7.5 Holding hire purchased assets

> Amanda needs a car for use in her home delivery business and decides to acquire it on hire purchase terms from a finance company. She will pay a monthly hire charge and have the option to buy the car outright after 2 years. Amanda has the use and enjoyment of the car and, because the buy out price will probably be well below market value, it is likely that she will eventually take full title in the car. Therefore, Amanda, rather than the finance company, will hold the car.

7.90 A taxpayer who used to be the legal owner of an asset still *holds* it if they have retained use and enjoyment of it and title to it is likely to pass back to them. ***[Subsection 6-21(1), item 7 of the table]***

7.91 The typical case where this rule will apply is where assets become subject to a chattel mortgage. The legal title in the asset passes to the mortgagee but the mortgagor retains what is known as the 'equity of redemption', which is their right to redeem the asset by repaying the mortgage money. In these cases, they will stay its holder.

7.92 In theory, this rule could affect mortgages over land but most land in Australia is now subject to the Torrens Title system, under which legal title *does not* pass when a mortgage is granted. So, with land, a mortgagor will usually remain the legal owner and hold the land under the general rules. However, land that is still held under deed, rather than Torrens title, and is subject to a mortgage, will be covered by the special rule so that the mortgagor holds the land for tax purposes for as long as they remain in possession.

Partnership assets

7.93 Assets that are partnership assets are *held* by the partnership and not by any of the partners ***[subsection 6-21(1), item 8 of the table].*** This does not reflect the true economic owner's position but the income tax law is based on the premise that a partnership is an entity and, on that premise, the partnership would be the economic owner.

7.94 A partner's actual interest in each asset of the partnership is recognised under this system indirectly as an entitlement to an appropriate share of the partnership's net income. That entitlement is part of the partner's interest in the partnership as a whole, which *is* recognised as an asset the partner holds.

Other jointly held assets

7.95 Assets that would otherwise be held by 2 or more taxpayers are held by neither of them so long as each of them also holds an ownership interest in the jointly held asset ***[subsection 6-21(1), item 9 of the table].*** This is simply a rule to avoid double counting assets. It means that there will almost never be more than one holder of each asset. Such cases are treated as if each joint holder only held their interest instead.

Example 7.6 Jointly holding assets

> As a cost saving measure, Ripsnorter Productions and Krazy Kelly's Discount Advertisements go halves in the purchase of the latest video editing equipment. They are not in partnership but do jointly own the equipment. Therefore, each is treated as *not* holding the equipment. However, each has an asset that is its legal interest in the equipment, and each holds that interest under the general rules.

7.96 Cases where there *would* be more than one holder of an asset would involve joint holding without joint ownership interests. For instance, tenants who build a road on their landlord's property would hold the road under the special

rules and the landlord would hold it under the general rules. Since the tenants would not have an ownership interest, all these parties would jointly hold the road.

Dealing with inconsistent rights

7.97 One consequence of having special rules making someone the holder of an asset even though not its legal owner, is that there will be a number of actual legal rights that are inconsistent with the fiction created by the special rule. For example, making the lessee of a luxury car its holder is inconsistent with the lessee's actual legal rights under the lease agreement.

7.98 The final special rules deal with those inconsistencies by treating the inconsistent actual rights as being held for taxation purposes by no one.

7.99 No one holds interests or rights in an asset if someone else holds the asset itself because of one of the special rules. ***[Subsection 6-21(1), item 10 of the table]***

Example 7.7 Excluding inconsistent assets

> Clare leases a luxury car from the Adequate Finance Corporation. The special rules tell us that Clare holds the car and Adequate Finance does *not*. But Adequate does have a right to get the car back at the end of the lease. That right is inconsistent with the fiction that Clare holds the car. That inconsistency is cured because, for tax purposes, no one holds that interest.

7.100 Similarly, no one holds interests or rights in an asset if, because of those interests or rights, a special rule makes them the holder of the asset itself. ***[Subsection 6-21(1), item 11 of the table]***

Example 7.8 Excluding inconsistent assets

> Clare's legal right to use the luxury car is also inconsistent with the fiction that she holds the car. Again, that inconsistency is cured because, for tax purposes, no one holds the right to use the car.

The additional special rules

7.101 There will inevitably be some other rules about who holds an asset that are more appropriately included in a particular place because they relate to the other provisions there (e.g. the rules in subsection 6-18(4) about who holds contingent rights). All of those cases will be listed in a table. The rules in those provisions override the rules in sections 6-20 and 6-21. ***[Section 6-22]***

What is an asset's tax value?

7.102 While *economic value* is important in applying the asset definition, the working draft generally does not use the concept in working out taxable income. Instead, it contains special rules for valuing assets. Those values are called ***tax values*** ***[Subdivision 6-C].*** The working draft explains how to work out an asset's tax value ***[section 6-40].***

No negative tax values

7.103 The tax value of an asset can never be less than nil. If a provision would otherwise reduce it to less than nil, it is instead reduced to nil ***[subsection 6-40(2)].*** This will be particularly relevant to depreciating and financial assets.

Effects of particular tax values

7.104 In very broad terms, each of the *rules* about the tax values of assets can be categorised into one of 3 general *approaches*:

- cost;
- face value (see paragraph 7.122);
- estimated value; or
- market value.

Cost

7.105 If an asset's tax value is set at its cost, gains or losses will only be included in a taxpayer's taxable income when the asset is disposed of.

Example 7.9 Effect of tax value equal to cost

At the start of year 1, Kathy pays $150,000 for a vacant block of land that she holds as an investment.

The local council announces plans later in the year to redevelop the local shopping centre. As a result, local property values improve. By the end of the year, the land is worth $180,000.

Kathy's taxable income for the year does *not* include her $30,000 unrealised gain because the land's tax value is its cost, *not* its market value. As a result, Kathy's $150,000 payment for the land is matched by the land's tax value of $150,000.

In the next year, the local council announces that it is abandoning its plans to redevelop the local shopping centre and local property values

fall. Kathy sells the land for only $130,000. She makes a loss of $20,000 because she has disposed of the asset.[50]

7.106 There is a more detailed discussion about the cost of assets in Chapter 9.

Estimated value

7.107 Under this approach, an asset's expected gains or losses are spread over time. This approach is appropriate if the amount and timing of the gains or losses are relatively certain or can be reliably estimated. Almost all of these cases will be assets where a loss is expected (e.g. depreciating assets). Expected gains will only be recognised for a limited range of financial assets.

7.108 However, different techniques will be used in spreading an asset's gains or losses depending on the kind of asset.

Example 7.10 Tax value of depreciating assets

Tartan Designs Pty Ltd buys a computer for use in graphic design work. It was purchased for $12,000 at the start of year 1 and was ready for use immediately. It has a 2 year effective life.

Using the straight-line method of depreciation, the tax value of the computer would decrease to $6,000 at the end of year 1 and to nil at the end of year 2. As a result, Tartan's taxable income would be reduced by $6,000 in each year.

Example 7.11 Tax value of appreciating financial assets

At the start of year 1, Finco Pty Ltd issued Simone with a promissory note for $10,000. The face value of the note was $12,100 and was due to be paid at the end of year 2.

Subject to the risk of default, Simone is certain to make a $2,100 gain from the promissory note when it is paid. As the amount and timing of the gain are certain, it can be spread over the life of the note.

Using the formula proposed for financial assets,[51] the tax value of the note would increase from its cost of $10,000 to $11,000 at the end of year 1 and to $12,100 at the end of year 2. As a result, Simone would be taxed on a $1,000 gain in year 1 and an $1,100 gain in year 2.

7.109 Under the estimated value approach, the tax value of an asset at any time would have 2 components:

- its cost; and

[50] This loss would be a quarantined capital loss.

[51] See section 45-75 (to be discussed in Chapter 17).

- the amount of the expected gain or loss that has accrued to that time.

Market value

7.110 Taxpayers can choose to take the market value of some assets as their tax value. Using that method, gains and losses from market fluctuations between the start and end of the year would be brought to account.

7.111 However, that method will not apply automatically to any asset. It will only apply when a taxpayer meeting the necessary requirements chooses to apply it to the asset and only for specified assets whose market value is readily ascertainable (e.g. trading stock and some financial assets).

The particular tax value cases

Opening tax value

7.112 The tax value of an asset at the start of an income year (its 'opening tax value') is the same as the tax value it had at the end of the previous year ***[subsection 5-70(2)]***. That has already been discussed (see Chapter 6). The rest of this discussion explains the tax value an asset has at other times.

Nil tax values

7.113 Some assets will specifically be given a nil tax value ***[subsection 6-40(1), item 1 of the table]***. They are called ***listed zero tax value assets***. Expenditure on those assets will get immediate tax relief, because no tax value will be brought to account for the asset to match the expenditure. The converse is true for receipts.

7.114 A nil tax value may be given to an asset for the policy reason that particular expenditures should get immediate tax relief (e.g. to encourage investment in those assets). A nil tax value may also be given for pragmatic reasons (e.g. to remove uncertainty or to reduce compliance costs).

7.115 These are the ***listed zero tax value assets***:

- Routine rights ***[paragraph 6-40(3)(a)]***. Typically, these are rights under equally and proportionately unperformed contracts. They are explained in more detail later but, essentially, this is a compliance cost saving measure made possible because the right's tax value would otherwise be matched by an equal and opposite liability.

- Consumable stores and spare parts that are not trading stock ***[paragraph 6-40(3)(b)].*** This is a compliance cost saving measure.[52]

- Office supplies that are *not* trading stock ***[paragraph 6-40(3)(c)].*** This measure was recommended by the Ralph Committee.

- Crops (including timber) planted for sale or for environmental works ***[paragraph 6-40(3)(d)].*** This measure maintains the treatment of crops under the current law, which only become trading stock when severed. It is made necessary by the provision (subsection 6-18(2)) that treats fixtures and improvements as separate from the land. The reference to environmental works also preserves an existing policy decision to encourage such activities.

- Work-in-progress that cannot yet be billed ***[paragraph 6-40(3)(e)].*** It recognises the compliance difficulties that would be imposed in valuing such things.[53]

- The results of exploration and prospecting activities ***[paragraph 6-40(3)(f)].*** This preserves the existing treatment, which reflects a policy of encouraging such activities.

- Intellectual property in advertising material unless that property was acquired from someone else ***[paragraph 6-40(3)(g)].*** Again, this was a Ralph Committee recommendation. It is based on the view that advertising expenditure is on revenue account, and therefore deductible, under the current law. That treatment is preserved. There is no effect on other assets created as part of an advertising campaign. For instance, a prepaid right to future advertising will still be written off over the life of that right. Intellectual property in advertising material is not counted as being acquired from someone else if you engaged them to generate it for you.

- Rights to receive company dividends ***[paragraph 6-40(3)(h)].*** This preserves the present treatment of dividends.

- Rights of companies and trusts to receive capital contributions from members and beneficiaries ***[paragraph 6-40(3)(i)].***

[52] The Ralph Committee recommended a ceiling of $25,000 on the total of consumable stores if they were to get a zero tax value (see *ATSR*, recommendation 4.3(i)). That recommendation is not reflected in the working draft.

[53] The Ralph Committee recommended that zero valuing work in progress be limited to work that was likely to be billed within 12 months of the year the work was done (see *ATSR*, recommendation 4.3(iv)). That recommendation is not reflected in the working draft.

Trading stock

7.116 Trading stock will have a tax value that replicates the choice of closing values for trading stock under Division 70 of the ITAA 1997. ***[Subsection 6-40(1), item 2 of the table]***

7.117 The working draft refers to the tax value being found in Division 38, which is not yet completed, but will reproduce the taxpayer's existing choice of values.[54]

Depreciating assets

7.118 Depreciating assets will have a tax value that declines as the economic benefits the asset provides are consumed ***[subsection 6-40(1), item 3 of the table].*** In essence, that will replicate the present depreciation system[55] and prepayment rules.[56] However, instead of the amount of depreciation or use being taken into account as a deduction, it will be taken into account as a decline in the tax value of the asset. The effect on net income will be identical.

7.119 It is likely that some things will be deemed to be depreciating assets so that they can get the same treatment as depreciating assets. The sorts of things in mind here are the 'pools' of assets and payments (e.g. project pools) created for regimes, like the Simplified Tax System[57] and the capital allowances regime,[58] either to reduce compliance costs associated with separately tracking many small assets or to spread out the deduction for a payment that would otherwise be deductible immediately.

7.120 The working draft refers to the tax value of depreciating assets being worked out under Division 40. These rules are included in the working draft and will be discussed in Chapter 16.

Financial assets

7.121 A ***financial asset*** is a right to be paid money. It is also a right to get another financial asset (e.g. a right to get a bill of exchange). The extent of what is a financial asset is not yet fully worked out. Consideration is being given to whether any other things (e.g. some shares, gold) properly belong within the definition. ***[Subsection 6-40(4)]***

7.122 Some financial assets will be rights to get money within 12 months of their creation. We can think of them as short-term debts. These assets will have a tax value equal to the amount that is owed (their face value) if the right to get

54 Note that the Ralph Committee recommended some changes to the valuation of trading stock (*ATSR*, rec. 4.17). That recommendation is not reflected in the working draft.

55 Division 40 of the ITAA 1997.

56 Sections 82KZM et al of the ITAA 1936.

57 Division 328 of the ITAA 1997.

58 Division 40 of the ITAA 1997.

an amount is for providing a non-cash benefit that was not a financial asset ***[subsection 6-40(1), item 6 of the table].*** Rights to get paid within 12 months for providing financial assets will not be eligible for this tax value and will have to apply the normal TOFA rules. The rules for short-term debts is a compliance saving measure, designed to avoid applying the full TOFA rules to simple credit and trade debtor cases.

7.123 Similarly, any financial asset that becomes due and payable will have a tax value equal to the amount owed ***[subsection 6-40(1), item 5 of the table].*** If an amount is not paid when it becomes due and payable, it is likely that interest will accrue on the debt. The right to get that interest will typically be part of the financial asset that is due and payable, so its tax value at any particular time will include the amount of interest that is then due and payable.

7.124 All other financial assets, except those for which a market value election is made (see paragraph 7.125), will have a tax value worked out under the TOFA rules ***[subsection 6-40(1), item 7 of the table].*** The working draft refers to the tax value of these assets being worked out under Division 45. That is where the TOFA rules are intended to be located. In very broad terms, they aim to bring to account on an accruals basis gains and losses that are sufficiently certain.

7.125 Some financial assets will be able to have a tax value equal to their market value ***[subsection 6-40(1), item 4 of the table].*** This tax value will be available for these assets at the *election* of the taxpayer.

7.126 In general, the types of assets that can have a tax value equal to their market value will be those whose market value is readily ascertainable. So, as well as financial assets, it may extend to things like shares and options and trading stock. The rules for how and when this method would be available have not yet been considered.

Goodwill

7.127 The tax value of goodwill is the cost to acquire it from someone else ***[subsection 6-40(1), item 8 of the table].*** To the extent that you build up the goodwill yourself, it has a nil tax value. That means that, when a taxpayer buys into a business, the tax value of the goodwill acquired will be set to its cost at that time but any subsequent increases in its cost will not be recognised in the goodwill's tax value.

7.128 Therefore, immediate tax relief is given to payments to the extent that they only increase goodwill. This generally preserves the treatment in the current law.

Other assets

7.129 Any other asset that is held has a tax value equal to its cost ***[subsection 6-40(1), item 9 of the table].*** These assets will be:

- tangible assets that are not depreciating assets (e.g. land);
- rights that are neither depreciating assets nor financial assets (e.g a perpetual easement over another's land); and
- information acquired from someone else.

7.130 Those assets will mostly have a stable tax value regardless of what happens to their market value. Therefore, gains and losses that accrue because of market fluctuations will be ignored until the asset is realised (in whole or part). Any gain or loss will only be brought to account at that time because there will be a difference between the sale price and the asset's cost.

7.131 This does not mean that the tax value of these assets cannot change. The cost of an asset will increase every time an amount is spent to improve it. However, there is no effect on net income when that happens because the payment is matched by the increase in the asset's tax value.

7.132 In the case of information, the only part of the asset that is *held* is the information acquired from someone else ***[section 6-20, item 3 of the table].*** Therefore, expenditure improving the information would only be recognised in its tax value if the improvement was from acquiring further information from someone else. Expenditure on self-generated information will not be reflected in the tax value of any asset that is brought to account.

Routine rights and liabilities

7.133 Routine rights are given a nil tax value for compliance cost reasons. That treatment is possible without affecting the net income figure because, if a taxpayer went to the trouble to work out the 'real' tax value of the right, they would find that it more or less matched the 'real' tax value of the accompanying liability. Since the 'real' tax values of the right and liability therefore more or less cancel each other out, it is not necessary to go to the trouble of working them out because giving them both a nil tax value produces the same outcome. That was discussed earlier (see paragraph 7.115).

7.134 The only thing remaining then is to describe the circumstances in which you can say that the tax values of a right and its accompanying liability are likely to be equal without knowing what those tax values are. The working draft proposes 2 broad cases. Under both, a right and a liability can only be ***routine*** if:

- the same entity holds both of them; and

- they arise under the same contract.

[Subsection 6-45(1)]

7.135 The first case also requires that:

- neither party has yet provided or received any economic benefits under the contract; and
- that both the right and the liability are subject to exactly the same contingencies (or that neither is subject to any contingency).

[Subsection 6-45(2)]

7.136 In effect, this means that the rights and liabilities under a contract that has been entered into *and nothing more* by the end of a year will be routine in that year. This could continue for as long as nothing is done. Once something is done under the contract, the rights and liabilities would cease to be routine, unless they were covered by the second case.

7.137 The second case requires that economic benefits were both received and provided under the contract during the year and that those benefits received *only* related to those provided and vice versa. Further, the value of the benefits received must be in reasonable proportion to the value of those provided when the contract was looked at as a whole. ***[Subsection 6-45(3)]***

7.138 That sounds more complex than it really is. It simply means that benefits cannot be provided in one year that relate to benefits received in an earlier year or that will be received in a later year. Nor can the contract be structured so that the benefits provided are front-weighted or end-weighted unless the benefits received are similarly weighted. In short, there must be a reasonably proportional relationship between the benefits provided and those received on a year by year basis.

7.139 This idea of reasonable proportionality is carefully chosen. It does not mean that the values of the benefits provided and those received must be equal. Such a restriction would deny a routine treatment to taxpayers who get a bargain or pay an above market premium. Instead, all that is necessary is that the *same proportion* of the total benefits under the contract is both provided and received in each year.

7.140 In working out the *values* to see if they are reasonably proportional, the only time that matters is when the contract was entered into ***[paragraph 6-45(3)(d)]***. It does not matter if the values have changed so that they no longer look reasonable in a later year, so long as they would have looked reasonable if they had not changed.

Example 7.12 Routine rights and liabilities

Lagoc enters into a lease of business premises from Senotni Pty Ltd in year 1. The agreement provides that Lagoc will take possession in the last 3 months of year 2 and will relinquish it at the end of year 3. The rent for year 2 will be $8,000 and for year 3 will be $32,000.

At the end of year 1, Lagoc's rights and liabilities under the contract are routine because the contract is, as yet, completely unperformed.

In year 2, the rights and liabilities Lagoc has will be routine so long as he has paid the $8,000 (and only that much) and the premises were made available to him for the 3 months. The $8,000 is a reasonable proportion (a fifth) of the $40,000 total rent that he will pay under the contract because a fifth of the rental period fell into year 2.

Therefore, Lagoc can bring to account both his right to future occupation of the premises, and his liability to make future rental payments, at a nil tax value.

In year 3, the market value of the annual use of the premises has increased to $50,000. Even so, Lagoc's rights and liabilities remain routine because the $32,000 he pays is a reasonable proportion of the total he has agreed to pay under the contract, looked at when the contract was entered into.

7.141 It is worth noting that, if rights and liabilities are routine for one party to a contract, they must also be routine for the other party as a matter of mathematical necessity. It is also worth noting that, although the benefits provided in a year must be proportional to those received in the year, it does not matter if they are not proportionally aligned *within the yea*r. For example, all the payments could be made on the first day of the year and all the benefits provided on the last without affecting the 'routineness' of the rights and liabilities.

Ceasing to be routine

7.142 Sometimes a right and its accompanying liability that were routine in one year may cease to be routine in a later year. That will commonly be the case when a contract, unperformed in one year, begins to be performed in a later year but not in a reasonably proportional way.

7.143 In those cases, the right and liability take the tax value they would have had if they had never been routine ***[subsections 6-45(4) and (5)].*** For instance, if the right is a depreciating asset, it would be necessary to work out its tax value using the depreciation rules. However, that a right or liability stops being routine in one year *does not* affect the tax value it had in an earlier year when it was routine ***[subsection 6-45(6)].***

Chapter 8
Core rules for liabilities

Outline of Chapter

8.1 This Chapter explains:

- what a *liability* is;
- who *has* a liability; and
- the rules for working out a liability's *tax value*.

8.2 Most of the provisions discussed in this Chapter are in Division 7 of the working draft.

Context of reform

8.3 The current law does not have a well defined liability concept. Indeed, the non-existence of a consistent or comprehensive liability regime is a prominent feature of the current law. Sometimes liabilities are recognised from the moment the taxpayer becomes subject to them, sometimes from that moment but only if they are eventually satisfied, and sometimes not at all. This means the current law has no consistent timing rule for recognising gains and losses.

8.4 The liability idea appears clearly in the 'incurred' concept in section 8-1 of the ITAA 1997. An amount is incurred when it has come home, in the sense that there is a *presently existing* liability rather than a liability that is no more than impending, threatened or expected.[59] The idea of a presently existing liability lying behind the incurred concept permits a deduction in advance of payment.

8.5 Other provisions in the law use the word 'incurred' to tap into the same idea.[60]

8.6 In some cases, the timing rule that 'incurred' suggests is affected by a rule that deliberately changes the outcome. A good example is section 70-15 of

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[59] *New Zealand Flax Investments Ltd* (1938) CLR 179 at p. 207; *Nilsen Development Laboratories Pty Ltd v FCT* (1981) 144 CLR 616 at pp. 623-4, 627.

[60] See, for example paragraph 20-125(2)(c), subsection 25-35(2), subsection 36-15(5), and subsection 43-70(1) of the ITAA 1997.

the ITAA 1997. It defers recognising an outgoing incurred to acquire trading stock until the stock is on hand.

8.7 Liabilities are also recognised in other provisions but not necessarily in the same way. One such example can be found in the capital gains provisions. The main CGT event (A1 - disposal) happens when the contract of disposal was entered into *but only if* the disposal actually occurs.[61] In other words, that CGT event treats taxpayers as having been under a liability to dispose of the asset from the time the contract was entered into, if that liability is eventually satisfied. That brings a gain or loss on disposal forward to the time of the contract. However, liabilities are not consistently recognised across the CGT events, leading to inconsistencies in the timing of gain and loss recognition.

8.8 The current law also does not recognise the value of a liability in a consistent way. The general deduction provision normally recognises a deduction for the amount incurred in the income year. The effect of this position has, in recent years, been affected by two developments:

- court decisions to the effect that a present liability can be an outgoing 'incurred' over time (e.g. see *Coles Myer Finance Ltd v FCT* 93 ATC 4214); and

- special rules that spread deductions, for amounts incurred for future benefits, over the period that those benefits are to be received (e.g. see the prepayment rules in Subdivision H of Division 3 of Part III of the ITAA 1936).

8.9 The working draft defines *liability* for the whole law. That definition, which draws on the accounting meaning, will help make clear the scheme of the income tax law, making it easier to comply with.

Summary of working draft

8.10 Division 7 deals with liabilities:

- what they are;

- whose they are; and

- what their value is for tax purposes.

8.11 A ***liability*** is an obligation to provide future economic benefits.

8.12 Apart from a few special cases, the working draft only recognises a liability if it is a *present* legal or equitable obligation. The terminology it uses to

[61] Section 104-10, ITAA 1997.

describe this is ***having*** a liability. When it is a present legal or equitable obligation, it will be the liability of the entity who owes that obligation.

8.13 The value at which the working draft recognises a liability (its ***tax value***) at any particular time will be:

- the *proceeds* received for assuming the liability; or
- its *face value* (used only for some short term debts); or
- its *estimated value* (i.e. the proceeds for assuming it +/– the amount it is estimated to have changed by that time); or
- its *market value* (mostly applying to financial liabilities and only if the taxpayer chooses to apply it); or
- *nil* (this will be rare and mostly used to reduce compliance costs or for policy reasons).

Comparison of key features of working draft and current law

8.14 Chapter 2 compares the treatment of liabilities under the current law to the treatment proposed under the Tax Value Method.

Detailed explanation of working draft

8.15 A taxpayer's taxable income for an income year will reflect any changes in the *tax values* of that taxpayer's *liabilities* in the year. ***[Section 5-55]***

8.16 So, an increase in the tax value of a liability will decrease taxable income and a decrease in a liability's tax value will increase taxable income. So, changes in the tax value of liabilities work in the opposite way to changes in the tax value of assets.

What is a liability?

8.17 A ***liability*** is an obligation to provide future economic benefits ***[subsection 7-20(1)]***. This definition draws on the accounting world's understanding of a liability. A company's paid up share capital is also a ***liability*** ***[subsection 7-20(2)]***.[62]

[62] This treatment of paid up share capital will be considered further when other entity tax issues are considered.

What is an obligation?

8.18 An obligation is a requirement to do something (or to *not* do something). It must involve at least 2 entities: one entity owing the obligation and another entity to whom the obligation is owed. Therefore, a unilateral decision, or a mere intention, to do something is not an obligation. For example, deciding to spend money does not give rise to an obligation, even if provision is made for the planned expenditure in the accounts, because nothing is owed to another entity.

8.19 The obligation must be an obligation to provide *economic* benefits; so an obligation to provide mere social benefits (e.g an obligation not to wear a T-shirt to the debutantes' ball) would not qualify. The assets chapter discusses what an economic benefit is (see Chapter 7).

8.20 Ordinarily, the obligation will be owed to the taxpayer to whom the future economic benefits will be provided. However, that does not have to be the case. You can have a liability to one person to provide benefits to another. ***[Subsection 7-20(1)]***

Example 8.1 Benefits not going to entity obligation owed to

> Haydn enters into an in-substance debt defeasance arrangement with Paul under which he agrees to pay Cassandra a fixed amount in 2 years' time. Haydn has a liability even though his obligation, owed to Paul, will provide benefits to Cassandra.

8.21 The obligation need not be legally binding. However, as we will see, the only liabilities that are counted in the net income calculation are legal or equitable[63] obligations (see paragraph 8.31).

8.22 Obligations can arise voluntarily (e.g. by contract or deed), or they may be imposed on the taxpayer (e.g. by legislation or judicial order).

Identifying the liability

8.23 As with assets, there can be questions about whether you are looking at a single liability or a collection of related liabilities. This question is more important in the case of assets because the taxation treatment of assets is more varied, so there is more pressure on the issue. The treatment of liabilities tends to be more uniform, so the differences in outcome between treating several related obligations as one liability or many are less pronounced.

8.24 Where it does matter the conclusion would be reached after examining all the relevant facts and circumstances of the case.

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[63] Note, 'equitable' here is used in the legal sense, not the sense that it is sometimes used by accountants (e.g. in paragraph 55 of SAC4).

Contingent liabilities

8.25 The working draft contains a special rule to cover contingent liabilities. It mirrors the similar rule about contingent rights and the discussion about the issue in Chapter 7 is equally relevant here.

8.26 In broad terms though, the obligation that exists under a contingent arrangement whether or not the contingency happens is a separate obligation from the one that only exists if the contingency does happen. ***[Subsection 7-22(2)]***

Example 8.2 Identifying separate liabilities under contingent arrangements

> Henry runs a car yard. He sells a 3 year warranty with each car he sells. He has a general obligation under the arrangement to warrant the quality of the car. That is separate from the obligation to fix the car, which arises if a defect appears.

8.27 The contingent obligation is only owed once the contingency happens and the one-sided non-cash transaction rules apply to work out the proceeds of assuming it when it begins to be owed. ***[Subsection 7-22(3)]***

8.28 As with assets, contingencies that are either artificial or are highly likely to happen are ignored ***[subsection 7-22(4)]***. In such a case, the contingent obligation would therefore be held as soon as the agreement was entered and the cost of each liability would be worked out at that time using the normal rules.

Example 8.3 When do you have a contingent liability and what is its tax value?

> Continuing the previous example, Henry recognises a $2,200 provision for warranty claims in his commercial accounts for a particular year. The accounts are based on his records that show that 3 warranty claims have been made in the current year and that, on average, he will receive 8 claims in the future (the 5 he expects in the following year and the 3 he expects in the year after that) at an average cost of $200.
>
> Henry's obligations can be separated into 3 categories:
>
> - his general obligation to warrant the quality of his cars for 3 years;
> - the contingent obligation for cars that are defective in the current year; and
> - the contingent obligation for cars that are likely to be defective in the next 2 years.

The full purchase price of the warranty will be allocated to the first of those because the other 2 categories are contingent obligations.

The contingency for the second category has been satisfied because Henry can show that he is under a present obligation to repair 3 cars, so that obligation is treated as a separate liability. It will be given a tax value by the one-sided non-cash transaction rules (which will probably be the same as the $600 accounting calculation).

The contingency for the third category has not yet been satisfied, so it will not be an obligation Henry owes in the current year.

Renewal or extension of a liability

8.29 When a liability is renewed or extended, the renewal or extension is treated as a continuation of the original liability rather than as a separate liability. ***[Subsection 7-22(5)]***

Who has a liability?

8.30 The change in the tax value of a liability affects the taxable income of the taxpayer who *has* the liability ***[section 5-55, steps 5 and 6 of the method statement]***. The working draft sets out 3 tables identifying who has different kinds of liability. They are divided into general rules and special rules ***[sections 7-23, 7-24 and 7-25]***.

General rules

8.31 An entity ***has*** a liability if they owe a present legal or equitable obligation ***[section 7-23, item 1 of the table]***. Subject to the special rules, no one ***has*** any other liability ***[section 7-23, item 2 of the table]***.

What is a legal or equitable obligation?

8.32 In broad terms, legal or equitable obligations are obligations that can be enforced by a Court. 'Enforced' does not mean that a remedy of specific performance must be available. An entity still has an obligation where damages is the only remedy for breach of the obligation (most personal obligations will fit into this category).

What is a present obligation?

8.33 The obligation must be a *present* one. It will not be enough that it will arise in the future; a taxpayer can only count it at the end of a year if it exists

then. Therefore, a future obligation is not a liability anyone has for tax purposes, no matter how certain it is to arise.[64]

8.34 Of course, you can have an obligation now to provide economic benefits later – such an obligation would be a present obligation even though the benefits do not have to be provided until a later year.

8.35 It is important to understand the distinction between an obligation now to do something in the future and an obligation that you do not have yet but will have in the future. That distinction is how the working draft reproduces the effect of the current law's 'incurred' test for deductibility.

Example 8.4 What is a *present* obligation?

Ethel's Café buys bread and milk on terms that require payment within 30 days of them being supplied. At the end of year 1, it has a liability to pay for the last 30 days' bread and milk because it owes a present obligation to pay for the bread and milk it has received. Ethel's would get a 'deduction' in year 1, even though the money will not be paid until year 2.

The obligation to pay for year 2's undelivered bread and milk is a future obligation, not a present one (because it has not yet received that bread and milk), even though it will certainly become a present obligation in the future if the business continues. Therefore, that future obligation is not a liability Ethel's has in year 1.

8.36 This issue is often relevant to contingent obligations. Consider, for example, issuing an option. That typically separates into 2 liabilities; the contingent obligation and the general obligation to meet the contingent obligation when the contingency is met. The contingent obligation is not a present obligation until the contingency is met. The general obligation is a present obligation as soon as the option agreement is entered into.

Example 8.5 Option agreement

Famous author, Simon South, grants Ian Haines Publications Ltd an option over his next best seller, a racy spy thriller. On one view of the law, an option is an offer to sell the rights at a given price, coupled with a contract that the offer will not be withdrawn.[65] Alternatively it could be viewed as a conditional contract to sell the rights, which becomes binding only when Haines takes up the option.[66]

On either view, South has one liability at the time he entered into the option contract. That obligation could be appropriately described as a

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[64] *FCT v James Flood Pty Ltd* (1953) 88 CLR 492 at pp. 506-8; *Nilsen Development Laboratories Pty Ltd v FCT* (1981) 144 CLR 616 at pp. 623-4; *Coles Myer Finance Ltd v FCT* (1993) 176 CLR 640 at pp. 660-663.

[65] See *Goldsbrough Mort & Co Ltd v Quinn* (1910) 10 CLR 674 per Isaacs J at 691 and 696.

[66] See *Goldsbrough Mort* per Griffith CJ at 678.

present obligation to keep open his offer to sell the rights. He gets another liability when (and if) Haines accepts the offer. That second liability is contingent until acceptance and therefore, not a present obligation before that time.

Provisions

8.37 The working draft preserves the taxation law's approach to provisions for future outlays rather than adopting the accounting approach.

8.38 The accounting approach recognises a liability when it is *more likely than not* to reflect a future outlay.[67] By contrast, the taxation approach has traditionally been jurisprudential rather than commercial.[68] That is, it applies a legal analysis of the legislation rather than adopting the accounting approach. This is not to say that there has been no cross-over between the 2 approaches. Indeed, the courts' interpretation of taxation legislation has been heavily influenced by accounting approaches.[69]

8.39 The jurisprudential analysis asks whether there is a *present liability* to make a future outgoing rather than to whether the future outgoing is likely.

8.40 In general, a mere probability that a particular amount is owed would not be sufficient to constitute a present liability to pay that amount. However, there is some case law in the insurance area to the effect that an actuarial calculation of the amount of the liability can be sufficient even though it is not mathematically certain.[70]

8.41 In that, and other, areas the working draft preserves the outcomes under the existing law because it uses the same 'present liability' concept[71] that the courts have applied to explain the current law.

8.42 The accounting provisions that will be recognised as liabilities under the working draft will remain the same as those that are 'incurred' under the current law.

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67 See the *Statement of Accounting Concepts on the Definition and Recognition of the Elements of Financial Statements* (SAC 4) at paras. 65-67.

68 See, for example, *FCT v James Flood Pty Ltd* (1953) 88 CLR 492 at p. 506.

69 See a convenient summary of this relationship in the judgment of Hill J in *FCT v Citibank* 93 ATC 4691 at pp. 4698-4700.

70 See, for example, *RACV Insurance Pty Ltd v FCT* 74 ATC 4169; *Commercial Union Assurance Co of Australia Ltd v FCT* 77 ATC 4186. Also see the decision of the Privy Council in *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Ltd* 95 ATC 4711 in relation to warranties.

71 See 7-23, item 1 of the table.

Example 8.6 Provision for leave

Cogal Intones Ltd makes provision in its accounts for the future annual and long service leave of its employees. It wonders whether those provisions are liabilities recognised for taxation purposes.[72]

The provisions can clearly be described as obligations to provide future economic benefits (viz. the wages of its employees while on leave), so would be liabilities under the working draft. However, Cogal does not *have* those liabilities yet because they are not *present* obligations. They are not present obligations because the employees' right to leave payments, although certain to arise in the future, will not actually arise until they take the leave, or leave Cogal's employ.

An alternative argument might be that Cogal's liability is to provide its employees with leave (annually and for long service). However, this does not amount to a liability. Cogal has a right to the services of its employees for certain periods circumscribed by statute, award and contract. It has no right to their services outside those periods (including while the employee is on leave).[73] The mere absence of a right is not an obligation. Even if it could be so described, Cogal again would not *have* a liability until the leave was taken.

Example 8.7 Provision for unreported insurance claims

In accordance with normal insurance industry practice, Kwikpay Insurance provided $1.5m in its accounts for claims arising during the year that had not been reported by year's end. This was its statistical estimate of the amount that would be paid in relation to those claims. Kwikpay wonders whether the $1.5m is a liability it has at the end of the year.[74]

Kwikpay can have obligations to provide future economic benefits (viz. the compensation due under the insurance contract) even though it is not yet aware of them. The case law seems clear that they can be present obligations even before they are reported. Therefore, Kwikpay can 'have' liabilities in relation to events that have not yet been reported. Their tax value will be the amount that Kwikpay will pay (assuming that they will be paid within 12 months of the insured event happening). Since that amount can't yet be known with certainty, a reasonable estimate based on statistical data will be acceptable. Therefore, Kwikpay has a $1.5m liability at the end of the year.

The special rules

8.43 There are some special rules about who has a liability that override the general rules. ***[Subsection 7-24(1)]***

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72 Note: These are the facts in *Nilsen Development Laboratories Pty Ltd v FCT* (1981) 144 CLR 616.

73 Of course, the employer might have a right to decide *when* the employee can take their leave.

74 Note: These are the facts in *RACV Insurance Pty Ltd v FCT* 74 ATC 4169.

Share capital

8.44 A company has a liability for the amount of its paid up share capital.[75] ***[Subsection 7-24(1), item 1 of the table]***

Partnership liabilities

8.45 The partnership has the liabilities that are partnership liabilities. None of the partners has those liabilities ***[subsection 7-24(1), item 3 of the table].***

8.46 This is particularly important for real partnerships (as opposed to relationships that are deemed to be partnerships for tax purposes) because entities are severally liable for the partnership acts of their partners (i.e. each partner is fully liable themselves for each partnership act). Without this special rule, each partner would therefore bring the same liability to account. Under the special rule, only the partnership itself does so. The effect of that on the partnership's net income flows through to each partner in proportion to their interest in the partnership.

8.47 When this special rule says that the partnership, and not the partners, has the liability, the partners do not have that liability for *any* purposes of the Act. ***[Subsection 7-24(2)]***

Dealing with inconsistent liabilities

8.48 One consequence of having special rules making someone the holder of an asset even though not its legal owner, is that there will be a number of actual rights and obligations that are inconsistent with the fiction created by the special rule.

8.49 The final special rule deals with those inconsistent obligations. No one has a liability to provide the economic benefits embodied in any asset that, because of the equivalent special rules for assets, no one holds ***[subsection 7-25(1), item 4 of the table].***

Example 8.8 Excluding inconsistent 'real world' liabilities

Clare leases a luxury car from the Adequate Finance Corporation. The asset special rules tell us that Clare holds the car and Adequate Finance does not. In the real world, Adequate has an obligation to make the car available to Clare in accordance with the terms of the lease. That obligation matches a real world asset of Clare's that item 11 of the table in subsection 6-21(1) says is held by no one for tax purposes. Therefore, for tax purposes, no one has that real world obligation either.

[75] This treatment of paid up share capital will be considered further when other entity tax issues are considered.

Other special rules

8.50 There will inevitably be some other rules about who has a liability that are more appropriately located in another place because they relate to the other provisions there. All of those cases will be listed in a table. The only example the working draft identifies so far is the rule in subsection 7-22(3) about who owes a contingent obligation. ***[Section 7-25]***

What is the tax value of a liability?

8.51 The working draft contains special rules for valuing liabilities. Those values are called ***tax values*** ***[Subdivision 7-C]***. Initially, it may seem strange to think of a liability as having a 'value' because our natural assumption is that liabilities have a cost to us rather than a value. Because of that idea, it is very important to understand that the 'tax value' of something is simply the dollar figure at which the tax system recognises it. There is no necessary relationship between a thing's real world value and its tax value. This point stretches far enough for us to be able to say that something like a liability can have a tax value, even though we are inclined to think of it as being of no value to us at all.

8.52 In broad terms only, the tax value of a liability shadows the tax value of the corresponding asset held by the entity to whom the liability is owed ***[section 7-75]***.

No negative tax values

8.53 The tax value of a liability can never be less than nil. If a provision would otherwise reduce it to less than nil, it is instead reduced to nil ***[subsection 7-75(2)]***. This will be particularly relevant to depreciating and financial liabilities.

Effects of particular tax values

8.54 The tax value of a liability is worked out on one of 5 general bases:

- proceeds of assumption (the liability equivalent of cost);
- face value (see paragraph 8.68);
- market value;
- estimated value or
- nil.

Proceeds of assumption

8.55 If a liability's tax value is set at its proceeds of assumption, gains or losses on the liability will only be included in net income when the liability is discharged or extinguished. Any change in the liability's market value in the

interim will *not* be recognised for tax purposes. There is more detail about the proceeds of assumption in Chapter 9.

Market value

8.56 Taxpayers can choose to set the tax value of some liabilities to their market value. Using that method, gains and losses from market fluctuations between the start and end of the year *would* be brought to account on an annual basis. Paragraph 8.73 explains what the market value of a liability is.

8.57 However, that method will not apply automatically to any liability. It will only apply when a taxpayer *chooses* to apply it to the liability and only for some specified liabilities whose market value is readily ascertainable (e.g. some financial liabilities).

Estimated value

8.58 Under this approach, the expected gain or loss on a liability's value is spread over time. This approach is appropriate if the amount and timing of the gains or losses are relatively certain or can be reliably estimated.

Example 8.9 Tax value of depreciating liabilities

Terrific Promotions Pty Ltd wins the contract to handle the publicity for the Convent family reunion and is paid $20,000 in advance for the 12 months' work that is expected to be involved. That 12 months falls 40% into income year 1 and 60% into year 2.

Terrific has a liability to provide the services evenly over 12 months. At the end of year 1, the liability will have declined by 40%, so would have a tax value down to $12,000 at the end of that year. Its net income for that year would be affected like this:

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

[20,000 – 0] + [0 – 0] – [12,000 – 0] = 8,000

So, $8,000 of the receipt would be taxed in year 1. The remaining part would be assessed in year 2 through a decline in the tax value of the remaining liability to nil:

[0 – 0] + [0 – 0] – [0 – 12,000] = 12,000

The receipt is effectively taxed over the period that the services are provided through use of a depreciating liability.

The particular tax value rules

Opening tax value

8.59 As with assets, the tax value of a liability at the start of a year is the same tax value it had at the end of the previous year ***[subsection 5-70(2)].*** This is discussed in more detail in Chapter 6.

Nil tax values

8.60 For policy or practical reasons, a small number of liabilities will be given a tax value of nil ***[subsection 7-75(1), item 1 of the table].*** They are called ***listed zero tax value liabilities***. Giving a liability a tax value of nil means that it effectively will not be recognised in the net income calculation even if the taxpayer owes the obligation. The deductive effect of a liability will therefore be deferred until the liability is satisfied (e.g. by paying money or providing goods). Typically a liability is only given a zero tax value where there is a matching or corresponding asset that is also given a zero tax value.

8.61 The working draft makes 2 liabilities listed zero tax value liabilities:

- routine liabilities; and
- liabilities of companies to pay dividends.

[Subsection 7-75(3)]

8.62 You can only have a routine liability if you also have a routine asset (and vice versa). This issue was discussed earlier at the same time as routine assets (see paragraph 7.133 and following).

8.63 Zero-valuing liabilities of companies to pay dividends to their members or beneficiaries preserves the treatment under the current law.

Depreciating liabilities

8.64 Depreciating liabilities are the liability equivalent of depreciating assets. In broad terms, they are liabilities whose tax value will decline over time. There are 2 main types:

- a liability that lasts for a particular time and will decline in tax value evenly over that time; and
- a liability to do, or to provide, a certain number of things that will decline as those things are done or provided.

8.65 The working draft refers to the declining tax value of such a liability being worked out under Division 40 ***[subsection 7-75(1), item 2 of the table].*** These rules are contained in the working draft and will be discussed in Chapter 17.

Financial liabilities

8.66 The tax values of financial liabilities exactly mirrors the treatment of financial assets. The same range of values is available and in the same circumstances.

8.67 A ***financial liability*** is a liability to pay money. It is also a liability to provide a financial asset (e.g. a liability to provide a bill of exchange). ***[Subsection 7-75(4)]***

8.68 Some financial liabilities will be obligations to pay money within 12 months of their creation. We can think of those liabilities as short term debts. They will have a tax value equal to the amount that's owed if the obligation is to pay an amount for receiving a non-cash benefit that was not a financial asset ***[subsection 7-75(1), item 5 of the table].*** Liabilities to pay within 12 months for providing financial assets will not be eligible for this tax value and will have to apply the normal TOFA rules. This is a compliance saving measure, designed to avoid applying the full TOFA rules to simple credit cases.

Example 8.10 Tax value of short term debts

> Smith delivers an asset to Jones on terms that require payment in 6 months' time. The asset is worth $95 but, because payment is deferred, Jones undertakes to pay $100. Jones' income year ends 2 months after delivery, and the asset is consumed in Jones's business by that time.
>
> The difference between the $100 that will be paid for the asset and its $95 market value reflects the time value of money. Because the obligation is to pay within 12 months, the tax value of the liability simply equals the amount of money owed.
>
> Therefore, Jones' net income for the income year would be reduced by $100 because that is the increase in the tax value of her liabilities (there is no corresponding increase in the tax value of her assets because she does not hold the asset at the end of the income year).
>
> This outcome is equivalent to what occurs under the current law if the $100 is a revenue outgoing to which Jones is definitively committed or completely subjected.

8.69 The same 'face value' tax value will apply to all financial liabilities once they are due and payable ***[subsection 7-75(1), item 4 of the table].*** If an amount is not paid when it becomes due and payable, it is likely that interest will accrue on the debt. The liability to pay that interest will typically be part of the financial liability that is due and payable, so its tax value at any particular time will include the amount of interest that is then due and payable.

8.70 All other financial liabilities, except those for which a market value election is made (see paragraph 8.71), will have a tax value worked out under the TOFA rules ***[subsection 7-75(1), item 8 of the table].*** The working draft refers

to the tax value of these assets being explained in Division 45. That is where the TOFA rules are intended to be located. In very broad terms, they aim to bring to account some gains and losses on an accruals basis.

8.71 Some financial liabilities will be able to have a tax value equal to their market value ***[subsection 7-75(1), item 3 of the table].*** This tax value will be available for these liabilities at the *election* of the taxpayer.

8.72 In general, the types of liabilities that can have a tax value equal to their market value will be those whose market value is readily ascertainable (e.g. a liability to repay, at a given point, a given amount borrowed at a given interest rate).

8.73 There is arguably no market for liabilities, so describing their tax value as equal to their market value is perhaps a misdescription. What this means in the case of liabilities is the market value of the asset that someone else has because the liability is owed to them ***[Dictionary items, paragraph (a) of the definition of 'market value'].***[76]

Paid up share capital

8.74 The amount of a company's paid up share capital will be a liability to the company ***[subsection 7-75(1), item 6 of the table].*** That will match the amount the company receives by way of subscription for shares and any other amounts included in the share capital. Consequently, a company's net income would never increase just because it receives money subscribing for shares.[77]

8.75 As share capital is returned to shareholders, the amount of paid up share capital liability would reduce to match the amount returned. Again, that would mean that returns of share capital would not decrease the company's net income.

Other liabilities

8.76 Any other liability has a tax value equal to the proceeds of assuming it. ***[Subsection 7-75(1), item 9 of the table]***

Example 8.11 When tax value equals proceeds of assuming liability

> Black Stump City Council pays Classic Worm Farms Pty Ltd $200,000 to provide half a tonne of worms for a new waste disposal trial. Classic's obligation to supply the worms is a liability it owes to the Council. Therefore, until the liability is met, it has a tax value equal to the proceeds Classic got for assuming it; viz. $200,000.

[76] An alternative would be to make their market value equal the amount you would have to pay someone else to assume the liability.

[77] We will consider whether this mechanism is the best way to achieve this result.

Chapter 9
Cost and proceeds

Outline of Chapter

9.1 This Chapter explains what these things are:

- the *cost* of an asset;
- the *proceeds of realising* an asset;
- the *proceeds of assuming* a liability; and
- the *cost of extinguishing* a liability

9.2 The cost of an asset and the proceeds of assuming a liability are used in most cases to work out the initial tax values of assets and liabilities. The other 2 concepts are relevant to some taxable income adjustments.[78]

9.3 The rules for working these things out are contained in Division 7A of the working draft.

Context of Reform

9.4 Working out the initial tax values of assets and liabilities is essential to calculating an entity's taxable income or tax loss. This is because the taxable income or tax loss of an entity depends upon their net income, and the calculation of net income uses a formula that takes into account the tax value of their assets and liabilities (see Chapter 6).

9.5 In addition, where a gain or loss made upon disposal of an asset or extinguishment of a liability is subject to a taxable income adjustment it is necessary to measure the flows of economic benefits which arise at that time.

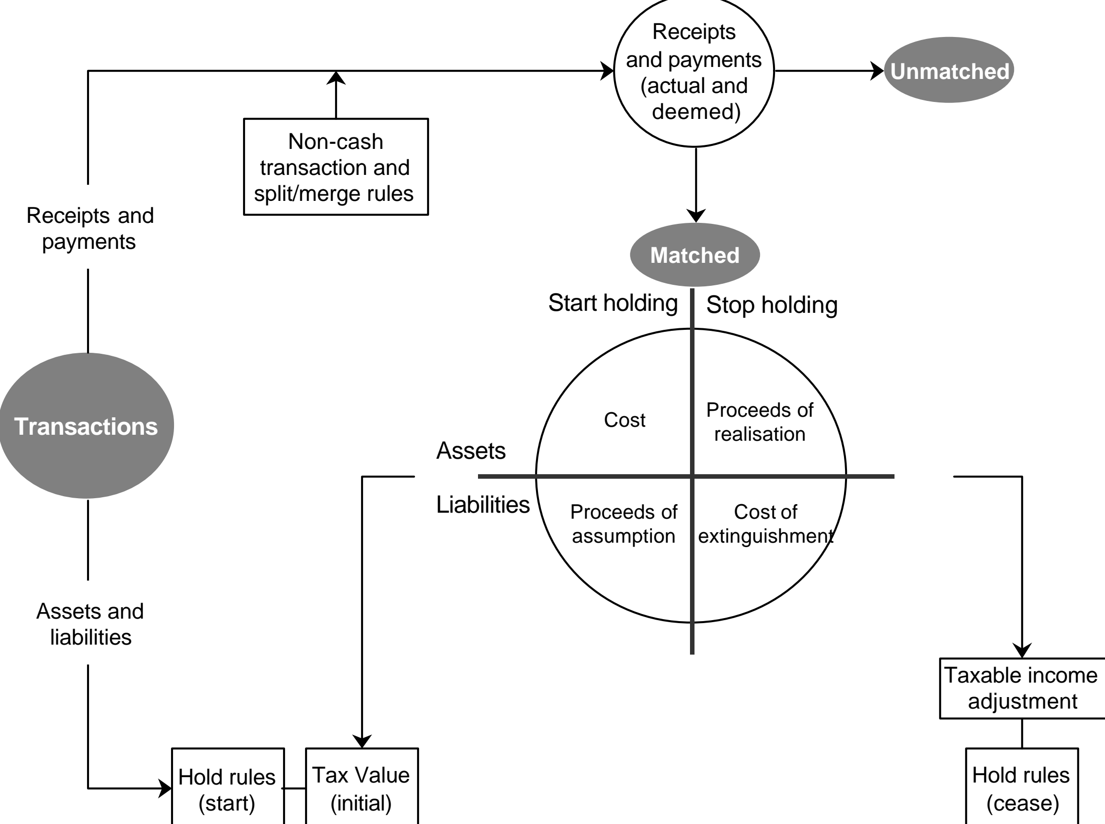
9.6 The cost and proceeds rules form one of the building blocks which make up the 'core valuation regime' used by the Tax Value Method. The other essential components of this regime are the non-cash transaction rules, which are explained in Chapter 11, and the rules dealing with splitting, merging and transformation of assets and liabilities.[79] We can describe these rules as a core

[78] As explained at paragraphs 9.62 and 9.87.
[79] Division 7B of the working draft.

valuation regime because the tax value of most assets starts at their cost, and the tax value of most liabilities starts at their proceeds of assumption.

9.7 The following diagram summarises where the cost and proceeds rules fit in within the tax system (in terms of the system map presented in Chapter 4):

Diagram 9.1 The core valuation regime



9.8 As the diagram shows, the core valuation regime is driven by actual and deemed receipts and payments arising under transactions (see the top of the diagram). If a receipt or payment is part of the cost of an asset or proceeds of assuming a liability, it is a receipt or payment *matched* by an asset or liability, and so, in itself, has no effect on net income. However, if a receipt or payment is *unmatched*, it has an immediate impact on the net income of the entity.

Summary of working draft

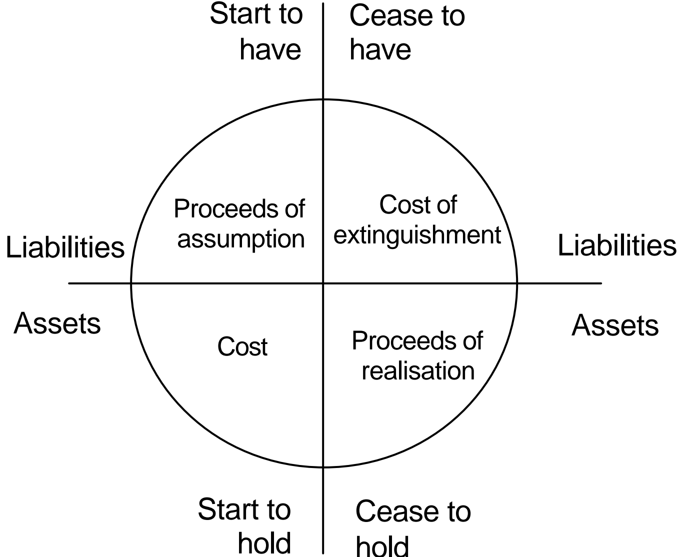
9.9 Costs become relevant for assets when they *begin* to be held, and for liabilities when they *cease* to be owed. Conversely, proceeds are relevant for assets when they *cease* to be held, but for liabilities when they *begin* to be owed.

9.10 One of the most important features of the costs and proceeds regime is *symmetry*. This can be seen in the way that:

- the rules about assets mirror the rules about liabilities; and
- the rules about *starting* to 'hold' or 'have' mirror the rules about *ceasing* to 'hold' or 'have'.

9.11 The relationships established by the cost and proceeds rules are illustrated in the following diagram:

Diagram 9.2 A quartet of symmetrical concepts



9.12 This 'mirroring' effect is not merely a legislative device; it is a reflection of the two-sided nature of commercial dealings. This is why:

- most assets are acquired by an entity as the result of a corresponding disposal by another entity. In addition, the amount a purchaser pays for an asset is both the cost of acquisition to the purchaser and the proceeds of disposal to the vendor; and
- every right an entity holds typically corresponds to a liability of another entity. The amount a creditor advances to a debtor is both a cost of acquisition of a financial asset for the creditor and the proceeds of assuming a liability to the debtor. Furthermore, the amount a debtor pays to discharge a liability is both a cost of extinguishment of a liability for the debtor and a proceeds of realisation of an asset for the creditor.

9.13 The working draft uses these observations about the nature of economic dealings to build initial tax values for assets and liabilities.

Receipts and payments

9.14 Costs and proceeds are determined by reference to actual and deemed receipts and payments. Actual receipts and payments are any real flows of money. Deemed receipts and payments arise when an entity enters into a non-cash transaction (these include credit transactions) or there is a split, merger or transformation of an asset or liability. Although realisation events do not always involve actual flows of money, the non-cash transaction rules deem receipts and payments to arise where a non-cash transaction occurs.

9.15 These real and notional cash flows establish costs and proceeds in the following way:

- the *cost* of an asset is the amounts *paid* in order to hold it, and bring it to its present condition and location;
- the *proceeds of realising* an asset are the amounts *received* because an asset ceases to be held;
- the *proceeds of assuming* a liability are the amounts *received* because the liability was assumed or augmented;
- the *cost of extinguishing* a liability is the amounts *paid* in order to cease owing the liability.

9.16 The cost and proceeds rules cannot be fully understood without appreciating the effect of the non-cash transaction rules. These rules, which are an essential input into the Tax Value Method's core valuation regime, are explained in Chapter 11. The rules for splitting, merging and transforming assets and liabilities may also be relevant.

Comparison of key features of working draft and current law

9.17 The working draft is designed to provide a coherent, certain and robust system for enabling the assets and liabilities of an entity to be recognised for tax purposes. It does this by defining concepts consistently and on the basis of their economic substance (in the sense discussed at paragraphs 9.10 to 9.13). In doing so, the law also explicitly recognises the economic relationships between assets and liabilities and between acquisitions and disposals of those things.

9.18 The key design features of the working draft as compared to the current law, in so far as they relate to costs and proceeds, are outlined in this table.

Table 9.1 Comparison of key features of working draft and current law

Working draft	*Current Law*
The economic correspondence between assets and liabilities is explicitly recognised.	There is no necessary correspondence between the concept of an asset and that of a liability (e.g. an entity may be entitled to deduct an amount for a liability 'incurred', even though the tax system does not recognise the entity to whom the liability is owed as having an asset).
The *cost* of an asset is defined on an economic basis, and that definition is used consistently throughout the law.	The cost of an asset is not consistently defined. For example, the CGT provisions use 'cost base' or 'reduced cost base', whilst the trading stock provisions use 'cost'. These terms include different elements.
The *proceeds of realising* an asset are defined on an economic basis, and that definition is used consistently throughout the law.	The proceeds of realising an asset are not consistently defined. For example, the CGT provisions use 'capital proceeds', whilst the capital allowances provisions use 'termination value'. These amounts are not always the same.
The *proceeds of assuming*, and the *cost of extinguishing*, a liability are defined on an economic basis, and that definition is used consistently throughout the law.	Liabilities are often not explicitly recognised, but are treated as a type of loss or outgoing.

Detailed explanation of working draft

9.19 The intention of the core rules for cost, proceeds of realisation, proceeds of assumption, and cost of extinguishment is to provide a principled valuation regime to support the cashflow, assets and liabilities framework upon which the Tax Value Method is built.

9.20 It should be noted that this regime does not provide all tax values. For example, an asset may have an initial tax value other than its cost (e.g. if it is a 'listed zero tax value asset' – see subsection 6-40(3)). But for most assets and liabilities that are held, these rules will supply the principles for arriving at initial tax values.

Cost of an asset

9.21 A crucial component of the net income calculation in section 5-55 is a comparison of the tax value of assets held at the beginning and end of a year of income. Accordingly, when an entity begins to hold an asset, it is necessary to assign an initial tax value to it. This value is generally a measure of the economic benefits provided by the entity to acquire the asset, and in most cases, will be the asset's cost.

Cost and tax value

9.22 It is important to distinguish between the cost of an asset and its tax value. The tax value of an asset is worked out under Subdivision 6-C. It may be set at its cost for the time it is held; for example, land maintains a tax value equal to cost. On the other hand, an asset's tax value may begin at cost but vary over time; a depreciating asset is the most common example.

General cost rule

9.23 The general definition of 'cost' adopts the unified concept of cost proposed in Recommendation 4.18 of *ATSR*.

9.24 The ***cost*** of an asset is simply the total amounts an entity has paid in order to hold an asset, and in order to bring the asset to its present condition and location from time to time. ***[Section 7A-20]***

Example 9.1 Cost of manufacture

> Philip manufactures cigarettes. This involves paying amounts for materials, wages of employees, sick pay, holiday pay, payroll tax, electricity, quality control processes, waste disposal, insect control, spare machine parts, and tools.
>
> Philip has paid or is deemed to have paid these amounts in order to have the cigarettes. In doing so, Philip is either adding amounts to the cost of his raw materials, or is merging together those raw materials into new assets.
>
> Although he does not make an individual payment for each cigarette, it is possible to relate the total payments to each cigarette he has upon completion of the manufacturing process. This would probably be done by dividing the total amount of payments by the number of cigarettes produced.

9.25 Because the cost of an asset can change, it is always defined by reference to the time at which it needs to be measured (referred to as the ***test time***). Where measurement occurs at the time that an entity begins to hold the asset, the asset's cost is equal to its ***first element*** at that time ***[paragraph 7A-20(1)(a)]***. Where measurement occurs later, the cost is the sum of the first element, and the ***second element.*** The second element comprises all of the amounts paid in order to bring the asset to its current condition and location ***[paragraph 7A-20(1)(b)]***.

Example 9.2 Second element of cost

> Telemachus adds a new tray and canopy to improve his ute. The materials and labour that go into the addition contribute to the ute's present condition. The payments he makes for those the materials and labour are included in the ute's cost.

9.26 If the entity has held the asset more than once (e.g. because it has been sold and later repurchased), the relevant time of measurement is when the taxpayer most recently began to hold it.

9.27 A payment is not included within the second element of cost merely because it relates to an asset that the entity holds. In every case, it is necessary to consider whether the payment is made in order to bring the asset to its present condition and location.

Example 9.3 Amounts paid to dispose of an asset

> Demodocus operates a farming business. He owns a harvester, which he plans to sell. He spends a total of $1,000 in order to advertise for a buyer in a number of newspapers. None of these amounts is paid in order to affect the present condition and location of the harvester; each is unmatched and therefore 'deductible' in the year of payment.

What amounts paid are part of bringing an asset to its present location?

9.28 Amounts paid to bring an asset to a transitory location rather than to the location at which, or from which, it will mostly be used would not be counted in the second element of its cost. So, for example, the cost of transporting a semi-trailer from the dealer to the taxpayer's premises would be counted in its cost, but the costs of moving it around in the course of its transport activities would *not* form part of its cost. If the taxpayer's premises change, the cost of moving it to the new premises would be counted in its cost.

Interaction with non-cash transaction and splitting and merging rules

9.29 The first and second elements of cost comprise amounts the entity 'paid'. It is important to note, however, that the concept of 'paid' includes both:

- actual (including constructive) payments, as contemplated in Division 5; and
- deemed payments arising under a non-cash transaction because of the operation of Division 8, and those arising under Division 7B from the splitting, merging or transformation of assets and liabilities.

9.30 The rules for non-cash transactions are explained in Chapter 11. Because of the system of deemed payments and receipts established by the non-cash transaction regime, there is no need to list all of the ways in which the provision of economic benefits can form the cost of an asset. *Every* transaction can be reduced to an actual or deemed payment (or series of these) for the purposes of the cost and proceeds rules.

9.31 To illustrate:

- if an entity pays an amount for an asset, the asset's cost is the amount of money paid;
- if an entity provides a non-cash benefit (including services) in return for the asset, it will be deemed to have paid an amount for the asset under the non-cash transaction rules;
- if an entity assumes a liability or provides a financial asset in order to hold the asset, a payment is deemed to arise since the liability or financial asset is a non-cash benefit given to the entity to whom the liability is owed.

Example 9.4 Interaction between cost and non-cash transaction rules

Odysseus buys a GPS unit with a market value of $5,000 from Athene, but instead of paying cash, he gives Athene a computer system. Even though Odysseus does not actually pay cash for the GPS, he is deemed to have paid $5,000 for it under the non-cash transaction rules. His cost for the GPS is therefore $5,000.

Nexus between payment and asset

9.32 Inherent in the requirement that payments be made 'in order to' hold or bring an asset to a particular condition or location is a nexus between each payment and a particular asset or assets. The question of whether a particular payment relates to an asset is a question of fact and can only be worked out on a case-by-case basis.

9.33 In particular, it will be important to consider the *purpose* for which the payment is made. In general terms, there is a distinction to be made between payments which directly relate to the holding of the asset by the entity, and those which are merely designed to put the entity into a position to hold that asset in the future.

9.34 Expenses relating to securing a contract raise these issues. This table lists some examples of this other expenditure, which could be described as expenses of securing a contract.

Table 9.2 Expenses of securing contracts that are not part of cost

Types of contracts	*Expenses commonly incurred*
Contract for purchase of equipment – e.g. a contract for purchase of a truck for use in business.	Fees for legal advice on the contract; expenses incurred in choosing type/brand of equipment to purchase.

Types of contracts	***Expenses commonly incurred***
Contract for short-term work – e.g. engagement of contractor or temporary staff.	Contractor – expenses incurred prior to engagement to 'size up the job'. Temps – expenses incurred in attending interview. Employer – advertising costs.
Contract for construction of factory	Fees for legal advice on the contract; costs of feasibility studies; expenses of meeting with prospective builders.
Contract for supply of materials needed to run business – e.g. supply of paper for a printing business.	Costs incurred in testing prospective products; costs of checking out potential suppliers; fees for legal advice.
Contract for supply of intellectual property – e.g. for a licence to use a formula to produce soft drink.	Fees for legal advice on the contract; expenses incurred conducting market research.
Contract for consultancy services – e.g. a university academic performing consultancy services for a company.	Consultant – cost of attending interviews and preparing applications. Employer – advertising expenses.
Contract for provision of advertising.	Advertising agency - costs of obtaining market information; cost of preparing presentation of proposed advertising campaigns and materials for tenders. Client – fees for legal advice on the contract; costs of meeting with prospective advertising agencies; expenses in determining the need for advertising.
Contract for a bank loan	Borrower – fees for legal advice on the contract; accountant's fees (e.g. charges for producing documents detailing the business's financial position). Bank – advertising expenses; salary of loans staff.

9.35 The current law would normally treat these expenses as revenue (and therefore deductible), although they would in some circumstances be treated as capital.[80] These expenses would not be part of the cost of the asset subsequently acquired because they are not expenditure made in order to come to hold it (i.e. they are not sufficiently proximate to acquiring the asset). Instead, they are merely expenses of putting a taxpayer in a position to acquire the asset.

80 See for instance Case J7, (1958) 9 TBRD.

9.36 For example, at present, such expenses are not included in the cost of depreciable plant. The cost of depreciable plant is determined as its purchase price or construction cost plus customs duty, delivery costs, in-transit insurance and installation costs. Expenses incurred to enter into the contract to purchase the asset are not included.[81] In cases where the expenditure is not made to hold the asset, but is nonetheless of a capital nature, the current law may give rise to a 'black hole', because the entity's expenditure will not be reflected in a cost or a deduction.

9.37 Under the Tax Value Method, these costs of securing a contract would also not be in the cost of the asset acquired under the contract. They would, therefore, be immediately deductible.[82] In some cases this would result in a more generous outcome than the current law, and is therefore an issue that would, with all similar issues, require further Government consideration.

9.38 Where it is necessary to allocate a particular payment to multiple assets, or assets and other things, the apportionment rules determine the cost of each asset (see further, paragraphs 9.96 to 9.102).

No adjustments to cost to reproduce the current CGT 'cost base'

9.39 The working draft does not seek to preserve the disparities between the current 'cost base' or 'reduced cost base' concept in the CGT provisions and the economic cost of an asset. This approach is consistent with recommendation 4.18 of *ATSR*.

Economic benefits no longer reflected

9.40 Under the current law, the cost base of a CGT asset does not include expenditure incurred to increase an asset's value unless that expenditure is reflected in the state or nature of the asset at the time a CGT event happens to the asset. In this respect, the working draft changes the cost rules applying to CGT assets because, providing a payment is reflected in the condition or location of the asset when it is made, it does not matter if the state or nature of the asset subsequently changes. This approach is appropriate as part of giving tax relief for business expenditure in a more consistent way (including removing black holes created by the current CGT rule).

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[81] Taxation Ruling *IT 2197*.

[82] Note, however, that expenditure on a feasibility study, and some other expenditure, associated with a project may form part of a 'project pool'. A project pool is treated as if it were a depreciating asset with the expenditure therefore being written-off over time (see recommendation 8.9 of *ATSR* and Subdivision 40-I of the ITAA 1997). The project pool rules will be included in the rules dealing with depreciating assets and liabilities. Also, some expenditure would be subject to a 5-year write-off in accordance with the policy reflected in section 40-880 of the ITAA 1997.

Professional advice by non-recognised adviser

9.41 The incidental costs currently included in the cost base of a CGT asset exclude remuneration for professional advice by an entity that is not a recognised tax adviser. In this respect also, the working draft changes the cost rules applying to CGT assets, as expenditure of this nature will be included in the cost of an asset. This provides consistent treatment and removes black holes.

Expenses incurred to dispose of an asset

9.42 Costs incurred which relate to a CGT event are included in the second element of cost base under the current law: paragraph 110-25(3)(b) and section 110-35 of the ITAA 1997. The working draft does not explicitly include these amounts in the cost of an asset. Payments made to prepare an asset for disposal are included in the second element of cost if they lead to a change in the condition or location of the asset. Otherwise, they are unmatched and so will be immediately written-off in the year of payment. This issue was discussed further at paragraph 9.27.

Payments that are private or domestic in nature which are directly attributable to land

9.43 Subsection (2) in the general cost rule (section 7A-20) reflects subsection 6-110(4) in the Ralph draft and recommendation 4.13(d)(i) in *ATSR*. This is done because the gain on the land will be taxed, so tax relief should be given for expenses directly attributable to the land.

9.44 The second element of the cost of land specifically includes expenses directly attributable to the land (e.g. payments of rates, land tax, and interest on money borrowed to pay for the land), but only to the extent that these payments are private or domestic in nature ***[subsection 7A-20(2)]***. This rule ensures that these payments, which would otherwise be disregarded because of their private nature, will reduce a taxable gain made when the land is realised. It does that by making them part of the cost of the land, so that they will be taken into account in working out net income.

What is not part of cost

9.45 In an entirely non-private situation, an asset's cost will never include:

- interest on money borrowed; or
- amounts paid to maintain, repair or insure the asset; or
- rates or land tax.

[Subsection 7A-25(1)]

9.46 This rule ensures that those expenses reduce an entity's net income *immediately* (unless prepaid) rather than only doing so when the asset is realised.

9.47 The list will be expanded to include other expenses that the current law allows an immediate deduction for even though the general rules would treat the expenses as part of the cost of an asset. This will be done as the working draft is further refined.

Private payments

9.48 However, the rule in subsection 7A-25(1) does not apply to payments discussed at paragraphs 9.43 and 9.44 that are private or domestic in nature. In the case of land, the second element of the land's cost includes each amount paid that relates to the land and is of a private or domestic nature. Section 7A-25 does not prevent these amounts from being added to the cost of the land. This ensures tax relief is given for this expenditure. ***[Subsection 7A-25(2)]***

Special cost rules

9.49 There are a number of exceptions to the general cost rule. The 5 items listed here are examples; other exceptions may be added later as work on the Tax Value Method progresses.

Starting to hold an asset you had a right to get

9.50 When an entity which has a right to an asset *actually gets* the asset, their right to the asset is extinguished and replaced by the asset it had the right to get. If the right to get the asset is itself a separate asset, the first element the new asset's cost is the tax value of that right. On the other hand, if the right is merely part of a broader asset (like a right to get a number of things), the new asset's cost is the amount by which the broader asset's tax value falls as a result of ceasing to have the right. (The broader asset's tax value is likely to fall under these circumstances, because of the operation of the splitting or depreciating asset rules.) ***[Section 7A-30, item 1 of the table]***

9.51 The effect of this item is to 'roll over' the tax value of the right into the cost of the new asset. This is necessary in order to ensure that entities that contract to acquire assets are not taxed on any increase (or able to claim tax relief for any decrease) in the new asset's market value between the date of contract and settlement.

Devolution under a deceased estate

9.52 When a legal personal representative begins to hold an asset because it devolves to them under a deceased estate, the first element of the asset's cost in the hands of the representative is the asset's tax value at the time of death. ***[Section 7A-30, item 2 of the table]***

9.53 This treatment also represents a 'roll over' of the cost of the asset. It replicates the cost base modifications which apply to CGT assets acquired after 19 September 1985, and to depreciating assets, that devolve to a legal personal representative under a deceased estate.

9.54 However, it represents a departure from the current treatment of trading stock, which treats the legal personal representative as having bought the devolved stock for its market value.

Live stock

9.55 Consistently with the current law, live stock that an entity acquires by way of natural increase can be valued at a cost prescribed by regulation. Where the entity elects to use the regulations, the cost specified in the regulations will apply to the exclusion of cost under the general rules. ***[Section 7A-30, item 3 of the table]***

9.56 Otherwise, the general cost rule is used to work out the cost of the live stock.

Minister's declaration – airports

9.57 The *Airports (Transitional) Act 1996* empowers the Minister for Finance to determine the cost of plant in specified circumstances. Essentially, this is where the plant is:

- attached to land formerly held by an entity, but subsequently vested in the Crown and subleased through an interposed company to the entity; or
- transferred from the Commonwealth or the Federal Airports Corporation to a company because of an airport lease.

9.58 Where the Minister makes a determination as to cost, this determination applies to the exclusion of the cost under the general rules. ***[Section 7A-30, item 4 of the table]***

Partner's asset becomes partnership asset

9.59 Where one or more partners in a partnership hold an asset which subsequently becomes a partnership asset, the first element of cost of the asset in the partnership's hands is the asset's market value when the partnership starts to hold it ***[section 7A-30, item 5 of the table]***. This reflects the current treatment for capital allowances under Division 40 of the ITAA 1997.

9.60 Whether a particular asset is a partnership asset is determined in accordance with partnership law. This is a question of fact and can only be determined from the terms of the partnership agreement and/or inferences drawn from the conduct of the partners towards the assets.

Proceeds of realising an asset

9.61 In some cases it is necessary to make a taxable income adjustment to the gain or loss upon disposal of a particular asset. To do this, it is necessary to assign a value to the economic benefits that an entity receives upon, and by reason of, ceasing to hold the asset. This is the role of the 'proceeds of realisation' concept.

9.62 The proceeds of realising an asset do not need to be separately calculated in most cases. Frequently, realisation proceeds will simply be added to the net income formula without any reference to a particular asset. Separate calculation is only necessary where a profit or loss realised upon disposal of the asset is subject to a taxable income adjustment (such as the adjustment for discounted capital gains and private or domestic use). For example, any gain or loss made upon the sale of a depreciating asset must be adjusted to take into account private or domestic use while the asset was held. To make this adjustment, you need to know the proceeds of realising the asset.

General proceeds of realisation rule

9.63 The ***proceeds of realising*** an asset are simply the total of the amounts an entity receives because they stop holding it ***[section 7A-55]***. It does not matter whether the amounts are received before, or at the time when, holding ceases.

9.64 It is important to note that the concept of 'receive' includes both:

- actual (and constructive) receipts, as contemplated in Division 5; and
- deemed receipts arising under a non-cash transaction because of the operation of Division 8, and those arising under Division 7B from the splitting, merging or transformation of assets and liabilities.

9.65 The rules for non-cash transactions are explained in Chapter 11. Because of the system of deemed receipts and payments established by the non-cash transaction regime, there is no need to list all of the ways in which the receipt of economic benefits can form the proceeds of realisation of an asset. For the purposes of the cost and proceeds rules, *every* transaction can be reduced to an actual or deemed receipt (or series of these) at the time of the realisation.

Example 9.5 Interaction between proceeds of realisation and non- cash transaction rules

Poseidon gives Calypso a car. In return Calypso performs professional services for him, with a market value of $5,000. Even though Poseidon is actually receiving services, he is deemed, under the non-cash

transaction rules, to have received $5,000. $5,000 is the proceeds of realising the car.

Nexus between receipt and cessation of holding

9.66 Inherent in the requirement that an entity receive amounts ‘because’ they stop holding an asset is a nexus between each receipt and the cessation of holding. The question of whether a particular receipt relates to the entity ceasing to hold a particular asset is a question of fact and can only be worked out on a case-by-case basis.

9.67 Where it is necessary to allocate a particular receipt to multiple assets, or assets and other things, the apportionment rules determine the proceeds of realising each asset (see further, paragraphs 9.96 to 9.102).

Special proceeds of realisation rules

9.68 There are exceptions to the general proceeds of realisation rule. The 2 items listed here are examples; other exceptions may be added later as work on the Tax Value Method progresses.

Devolution under a deceased estate

9.69 When a person ceases to hold an asset because of death, and it devolves to that person’s legal personal representative, the proceeds of realisation for the asset are equal to the asset’s tax value immediately prior to death. ***[Section 7A-60, item 1 of the table]***

9.70 This treatment serves to defer the recognition of any gain or loss on the asset. The deceased’s net income calculation will not include the tax value of the asset, but the effect of this is offset by an equal amount representing the proceeds of realisation.

Partner’s asset becomes partnership asset

9.71 This rule corresponds to the cost rule discussed at paragraphs 9.59 and 9.60. Where one or more partners in a partnership hold an asset which subsequently becomes a partnership asset, the proceeds of realising the asset are equal to its market value when the partnership begins to hold it. ***[Section 7A-60, item 2 of the table]***

Proceeds of assuming a liability

9.72 A crucial component of the net income calculation is a comparison of the tax value of liabilities owed at the beginning and end of a year of income. Accordingly, when an entity begins to owe a liability, it is necessary to assign an initial tax value to it. This value is generally a measure of the economic benefits received by the entity in return for assuming the liability.

9.73 The proceeds of assuming a liability mirror the cost of an asset, in that both concepts capture the initial tax value of an element of the net income formula. The Tax Value Method treats liabilities like assets, except what holds true for an asset holds true in *reverse* for a liability. So while the cost of an asset is what you *pay* to start holding it, the proceeds of assuming a liability are what you *receive* to start owing it.

9.74 However, proceeds of assuming a liability are also conceptually similar to the proceeds of realisation of an asset; the assumption of a liability is, notionally, the disposition of a financial asset to the creditor. The key difference between proceeds of assumption and proceeds of realisation is that the proceeds of assumption may vary over time (like the cost of an asset), whereas proceeds of realisation are measured only at the time when holding ceases.

Proceeds of assumption and tax value

9.75 It is important to distinguish between the proceeds of assuming a liability and its tax value. The tax value of a liability is worked out under Subdivision 7-C. Typically, the tax value of a liability begins at its proceeds of assumption, but falls over time as it is discharged or extinguished. But a liability does not necessarily begin at a tax value equal to its proceeds of assumption; for example, a liability to pay an amount within 12 months of the day the liability begins has an initial tax value equal to the amount the entity is liable to pay.

General proceeds of assumption rule

9.76 The ***proceeds of assuming*** a liability are simply the total amounts an entity has received to start having the liability, and from time to time because the amount of the liability increases. ***[Section 7A-75]***

9.77 Because the proceeds of assuming a liability can change, they are always defined by reference to the time at which they are measured (referred to as the ***test time***). Where measurement occurs at the time that an entity begins to have the liability, the liability's proceeds of assumption are equal to its ***first element*** ***[paragraph 7A-75(a)]***. Where measurement occurs later, the proceeds of assumption are the sum of the first element, and the ***second element.*** The second element comprises all of the amounts the entity receives because the amount of the liability is increased ***[paragraph 7A-75(b)]***.

9.78 The first and second elements of proceeds of assumption comprise amounts the entity 'received'. This includes both:

- actual (and constructive) receipts, as contemplated in Division 5; and

- deemed receipts arising under a non-cash transaction because of the operation of Division 8, and those arising under Division 7B from the splitting, merging or transformation of assets and liabilities.

9.79 The first and second elements of proceeds of assuming a liability are analogous to the cost of an asset.

Example 9.6 Assuming a liability

> Odysseus secures an overdraft facility for his business with his bank, Homer Ltd on 30 June 2005.[83] On the same day he overdraws the account by $1,000. $1,000 is Odysseus's initial proceeds of assuming this liability. On 1 July 2005 Odysseus enters into a bill facility with Homer, also for his business, under which he becomes liable to provide Homer with $10,000 for payment of the bill upon maturity within 180 days. This $10,000 does not go into the proceeds of assumption for Odysseus's overdraft; it is clearly a separate liability, because the legal nature of the obligation, and the terms of repayment are fundamentally different from those of the overdraft.

Example 9.7 Increasing a liability

> Odysseus secures an overdraft facility with his banker, Homer Ltd on 30 June 2005. On the same day he overdraws the account by $1,000. $1,000 is Odysseus' initial proceeds of assuming the liability. On 1 July 2005 Odysseus draws a cheque for $500 against the same account.
>
> The $500 goes into Odysseus' proceeds of assuming the liability he started to owe on 30 June 2005. This is because the account is a single current account consisting of blended funds or debts; each amount drawn upon the account from time to time is merely an extension of the same facility, and is therefore part of the same liability.
>
> Note, however, that the tax value of Odysseus' liability at any given time will probably not be its proceeds of assumption, but rather the amount Odysseus is liable to pay. This is because his account with the bank is likely to represent a financial liability to pay an amount within 12 months (subsection 7-75(1), item 4 or 5 of the table).

Nexus between receipt and liability

9.80 Inherent in the requirement that the entity started having a liability or the liability is increased 'because' they receive amounts is a nexus between each receipt and a particular liability or liabilities. The question of whether a particular receipt relates to a liability is a question of fact and can only be worked out on a case-by-case basis.

9.81 Where it is necessary to allocate a particular receipt to multiple liabilities, or liabilities and other things, the apportionment rules determine the proceeds of assuming each liability (see further, paragraphs 9.96 to 9.102).

[83] Assume this facility is *not* a 'money account' – see section 5-60.

Special proceeds of assumption rules

9.82 There are exceptions to the general proceeds of assumption rule ***[section 7A-80].*** The 2 items listed here are examples; other exceptions may be added later as work on the Tax Value Method progresses.

Devolution under a deceased estate

9.83 When a legal personal representative begins to have a liability because it devolves to them under a deceased estate, the first element of the proceeds of assuming the liability is equal to the tax value of the liability at the time of death. ***[Section 7A-80, item 1 of the table]***

9.84 In accepting the office of personal representative, a person becomes a trustee in the sense that he or she is personally liable in equity for the deceased's debts to the full extent of the assets of the estate that have come into their hands.[84]

Partner's liability becomes partnership liability

9.85 Where one or more partners in a partnership have a liability which subsequently becomes a partnership liability, the first element of the proceeds of assuming the liability for the partnership is the market value of the liability when the partnership starts to have it. ***[section 7A-80, item 2 of the table]***

Cost of extinguishing a liability

9.86 In some cases it is necessary to make a taxable income adjustment to the gain or loss upon extinguishment of a particular liability. To do this, it is necessary to assign a value to the economic benefits that an entity gives upon, and by reason of, ceasing to have the liability. This is the role of the 'cost of extinguishment' concept, which is the 'flip-side' of the proceeds of realising an asset.

9.87 The cost of extinguishing a liability does not need to be separately calculated in most cases. Frequently, extinguishment costs will simply be included in the net income formula without any reference to a particular liability. Separate calculation is only necessary where a profit or loss realised upon extinguishment is subject to a taxable income adjustment. For example, any gain or loss made upon the discharge of a loan must be adjusted to take into account any private or domestic use of the loaned sum. To make this adjustment, you need to know the cost of extinguishing the liability.

[84] *Halsbury's Laws of Australia* [395-4205] at 736,877; *Norman v Baldry* (1834) 58 ER 726.

General cost of extinguishing a liability rule

9.88 The ***cost of extinguishing*** a liability is the total of each amount an entity pays in order to stop having the liability. It does not matter whether the payment is made before or at the time when the liability ceases to be had. ***[Section 7A-100]***

9.89 It is important to note, however, that the concept of 'paid' includes both:

- actual (including constructive) payments, as contemplated in Division 5; and
- deemed payments arising under a non-cash transaction because of the operation of Division 8, and those arising under Division 7B from the splitting, merging or transformation of assets and liabilities.

Nexus between payment and liability

9.90 Inherent in the requirement that the entity pay amounts 'in order to' cease having a liability is a nexus between each payment and a particular liability or liabilities. The question of whether a particular payment relates to a liability is a question of fact and can only be worked out on a case-by-case basis.

9.91 Where it is necessary to allocate a particular payment to multiple liabilities, or liabilities and other things, the apportionment rules determine the cost of extinguishment for each liability (see further, paragraphs 9.96 to 9.102).

Special cost of extinguishing a liability rules

9.92 There are exceptions to the general cost of extinguishment rule ***[section 7A-105]***. The 2 items listed here are examples; other exceptions may be added later as work on the Tax Value Method progresses.

Devolution under a deceased estate

9.93 When a person ceases to have a liability by reason of death, and that liability devolves to the deceased's legal personal representative, the cost of extinguishment of the liability is the liability's tax value just before death. ***[Section 7A-105, item 1 of the table]***

Partner's liability becomes partnership liability

9.94 When one or more partners in a partnership have a liability which subsequently becomes a partnership liability, the cost of extinguishment for the partner or partners who previously had the liability is equal to the liability's market value when the partnership begins to have it. ***[Section 7A-105, item 2 of the table]***

Part extinguishments

9.95 Extinguishing part of a liability may involve a splitting of the liability, with one of the split liabilities then being extinguished. So the residue of the original liability remains in existence if it is not paid-off in full. Alternatively, a depreciating liability that is progressively extinguished by performance would have its tax value worked out under the depreciating asset and liability rules.

Apportionment rules

9.96 The actual or deemed receipts and payments that are used to determine costs and proceeds under these rules may relate to more than one asset or liability, or assets and liabilities and other things. Thus, apportionment rules are necessary for both assets and liabilities.

When an amount relates to an asset or liability

9.97 The general apportionment rule for assets provides that an amount ***relates to*** an asset or liability to the extent that it is reasonably attributable to that asset or liability ***[subsection 7A-120(1)]***. This is similar to apportionment tests that apply under the current law (see, for example, sections 112-30 and 116-40 of the ITAA 1997).

9.98 Implicit in the ‘reasonably attributable’ requirement is that there will be a reallocation costs and proceeds for tax purposes where the allocation determined by the parties is unreasonable.

9.99 Apportionment rules are of particular importance when a single amount is:

- received or paid for two or more different assets; or
- received or paid for one or more assets and one or more things which aren’t assets (e.g. services or a liability); or
- received as compensation for the assumption, or paid for the extinguishment, of two or more liabilities; or
- received as compensation for the assumption, or paid for the extinguishment, of one or more liabilities and one or more things which aren’t liabilities (e.g. services or an asset).

9.100 In cases such as this, the receipt or payment must be apportioned between the various items in order to establish the cost or proceeds of each (to the extent that each can have a cost or have a proceeds). In performing this apportionment, regard should be had to the relative market value of the asset or liability at the time of the receipt or payment, compared to the total market

value of everything else to which any of the amount is reasonable attributable. ***[Subsection 7A-120(2)]***

Apportionment and non-cash benefits

9.101 As previously mentioned, the non-cash transaction rules in Division 8 may deem an entity to have received and paid amounts in a non-cash transaction. Where this occurs, Division 7A connects each deemed payment and receipt with the particular asset or liability that it is taken to be for under Division 8. ***[Subsections 7A-120(3) and (4)]***

Apportionment and splitting, merging and transformation

9.102 The rules in Division 7B dealing with splitting, merging and transformation of assets and liabilities also may deem an entity to have received and paid amounts. The ordinary apportionment rules apply in these cases.

No double-counting

9.103 This rule is intended to make it abundantly clear that the costs and proceeds of realising assets, and proceeds of assuming and cost of extinguishing liabilities, are not to be counted more than once by attributed to multiple assets or liabilities. This means they are not counted more than once and also reinforces that assets can have a cost, and liabilities can have proceeds of assumption, even though their tax value is different from that cost or those proceeds (e.g. zero) or the asset or liability is not held. ***[Section 7A-130]***

Cost of assets

9.104 The cost of an asset an entity holds does not include an amount to the extent that the amount is included in the cost of another asset an entity holds. This is the case, even though the tax value of one or both of the assets may not be worked out by reference to cost. ***[Paragraph 7A-130(a)]***

The cost of intellectual property: an example of no double counting

9.105 An example of the operation of the rule that there is to be no double counting of costs can be found in the treatment of intellectual property. Information, unless purchased from someone else, is not held (c/f section 6-20, item 3 of the table) ***[section 6-20, item 4 of the table].***

9.106 The form in which information is presented can give rise to a copyright, which is a separate asset that can be held and have a positive tax value. Information can also lead to a patent, a registered design, a trademark, a circuit layout, etc. These, too, are separate assets that can be held and have positive tax values.

9.107 However, the fact that internally-generated information is not held does not mean that the costs associated with it would instead be imputed to the tax values of the separate intellectual property assets that arise as a result of that information.

9.108 It can be observed that:

- even though the information is not held, it still has a cost and the things that go into that cost *cannot* also be taken into the cost of any other assets;[85] and
- the only kinds of expenditure that are included in the cost of intellectual property assets are the costs of creating or acquiring those assets (e.g. registration fees, costs of preparing for registration, legal fees, etc) and not the costs of creating the information they are based on.

9.109 In some cases this would result in a more generous outcome than the current law, and is therefore an issue that would, with all similar issues, require further Government consideration.

Example 9.8 Advertising

Argus Ltd undertakes market research to determine whether it needs to advertise to improve the profile of its products. The research suggests that television advertising should be undertaken.

Argus engages Zeus Pty Ltd, an advertising agency, to prepare a campaign. Zeus produces the campaign and copyright in it passes to Argus.

The information acquired as a result of the research is an asset, but it was not acquired from another entity; Argus does not therefore hold it. Thus, the information does not affect Argus' net income. Accordingly, the expenditure on the research is immediately deductible.[86]

The expenditure on the advertising campaign (including the copyright in it) is also immediately deductible. Argus does not hold the information in the advertising campaign created by Zeus because Argus engaged Zeus to generate the information for it (section 6-20, item 4 of the table; c/f: item 3). Further, the intellectual property (copyright) acquired by Argus

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85 Of course an asset may be replaced by another asset. For example, if you pay $1,000 for a machine that will be delivered later, your asset is a right to that future delivery. The cost of the right is the $1,000 you paid. When the delivery happens, the right disappears and is replaced by the machine itself. The cost of that machine is also $1,000. In this case the cost of one asset becomes the cost of the second asset that replaces it. However, for the assets discussed here, the costs of information and any intellectual property assets that might flow from it must clearly be kept separate because they exist concurrently.

86 This may be affected by the project pool rules and those dealing with a 5-year statutory write-off for some expenditure (see footnote 82).

is a 'listed zero tax value asset', because its subject matter is advertising material: paragraph 6-40(3)(g). This means that neither the information nor the copyright have any impact upon Argus' net income.

Example 9.9 Staff procedures manual

Argus Ltd decides that its staff need more guidance about dealing with customers, and that a procedures manual is necessary for this purpose. Argus' staff conduct research on appropriate procedures and eventually develop a final version of a manual, which is placed on Argus' local area network.

Staff costs in researching and developing procedures give rise to information. Argus' employees were engaged to generate the information for it; therefore Argus does not 'hold' the information (section 6-20, item 4 of the table; c/f item 3). Nonetheless, the information has a cost equal to the amounts paid to create it.

The copyright in the manual is property that is separate from the information. The cost of the copyright is nil, because nothing was paid to obtain it in this case. The production costs associated with development of the manual were allocated to the information. For the purposes of allocating cost to each asset, it is irrelevant that the information is not held.

Thus, neither the information nor the copyright have any effect on Argus' net income; payments made to obtain these things can be immediately written off.[87]

Proceeds of realising assets

9.110 The proceeds of realising an asset does not include an amount to the extent that it is included in the proceeds of realising another asset. ***[Paragraph 7A-130(b)]***

Proceeds of assuming liabilities

9.111 The proceeds of assuming a liability do not include an amount to the extent that it is included in the proceeds of assuming another liability. This is the case even though the entity may not have the liability or that the tax value of one or both of the liabilities is not worked out by reference to proceeds of assumption. ***[Paragraph 7A-130(c)]***

Cost of extinguishing liabilities

9.112 The cost of extinguishing a liability does not include an amount to the extent that it is included in the entity's cost of extinguishing another liability. ***[Paragraph 7A-130(d)]***

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87 This may be affected by the project pool rules and those dealing with a 5-year statutory write-off for some expenditure (see footnote 82).

Splitting, merging, and transformation of assets and liabilities

9.113 Special rules address the splitting, merging, and transformation of assets and liabilities. These are in Division 7B of the working draft.

Chapter 11
Non-cash transactions (including credit transactions)

Outline of Chapter

11.1 This Chapter explains the rules under which receipts and payments are taken to have occurred under arrangements involving:

- the exchange of non-cash benefits – these are called ‘2-sided non-cash transactions’;
- the receipt of a non-cash benefit without consideration being given in return – these are called ‘one-sided non-cash transactions’.

2 important points about the non-cash transaction rules

11.2 There are 2 important points which need to be kept in mind in order to fully understand the scope and significance of the non-cash transaction rules in this working draft.

Integral part of the TVM’s core valuation regime

11.3 Firstly, the non-cash transaction rules can only be fully understood in the context of the broader scheme of the Tax Value Method. They are essentially a *mechanism* to allow taxpayers to work out the cost and proceeds of assets and liabilities. This regime operates by:

- using *deemed payments* (together with actual payments) to establish the cost of an asset (which in most cases sets its initial tax value) and the cost of extinguishing a liability (which is relevant to some taxable income adjustments); and
- using *deemed receipts* (together with actual receipts) to establish the proceeds of assuming a liability (which in most cases sets its initial tax value) and the proceeds of realising an asset (which is relevant to some taxable income adjustments).

Not just about barter

11.4 Secondly, the rules apply to any transaction other than one in which a non-cash benefit is exchanged for money only. This means that *rights to money* are classified as non-cash benefits under these rules.

11.5 Consequently, the non-cash transaction rules extend beyond barter arrangements, to include transactions involving purchases and sales on credit.

Context of Reform

11.6 The Tax Value Method explicitly deals with both sides of a commercial dealing. This approach means that it is necessary, as is often the case under the current law, to ascribe dollar amounts to what is given and received in a transaction in order to work out the income tax outcome. As such, rules relating to credit transactions and other non-cash transactions (all 'non-cash transactions') are essential.

Core valuation regime

11.7 The non-cash transaction rules are essential in order to ensure that entities are appropriately taxed on their income, and that they are given appropriate tax relief for their expenditure, regardless of form. The receipt of something of value other than money might need to be recognised as income by the tax system, just as the receipt of money may be so recognised. The same applies when something other than money is provided.

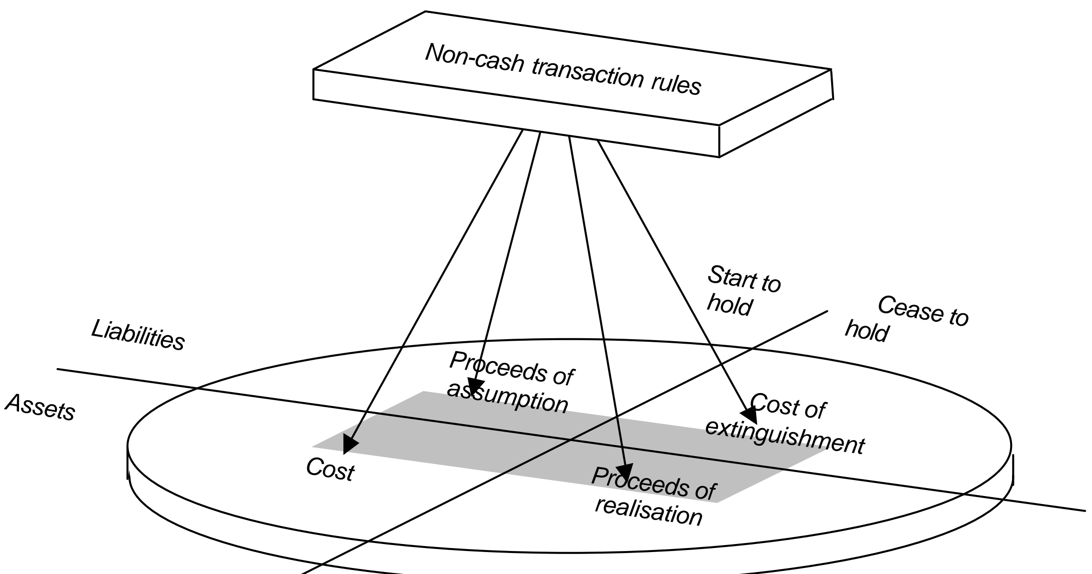
11.8 The non-cash transaction rules support the Tax Value Method's core valuation regime for assets and liabilities: the cost and proceeds rules in Division 7A, explained in Chapter 9.

11.9 The non-cash transaction rules interact with the cost and proceeds rules by generating a series of deemed receipts and payments. This approach allows the tax system to recognise the value of a non-cash benefit as forming all or part of:

- the cost of an asset an entity acquires;
- the proceeds of realising an asset an entity ceases to hold;
- the proceeds of assuming a liability an entity starts to have; or
- the cost of extinguishing a liability an entity ceases to have.

11.10 This relationship is shown in the following diagram.

Diagram 11.1 Relationship between non-cash transaction and cost and proceeds rules



11.11 As the diagram shows, the non-cash transaction rules generate 'inputs' into the cost and proceeds rules. This mechanism performs an important technical function. It simplifies the drafting of the working draft by treating most things that tend to increase net income as receipts, and most things that that tend to reduce net income as payments. This makes it easier to assign costs and proceeds of realisation to assets, and proceeds of assumption and costs of extinguishment to liabilities.

The link between receipts, payments, assets, and liabilities

11.12 The net income formula takes into account *all* receipts and payments, but has regard to assets and liabilities only at the beginning and end of the tax year. In theory, money too could have been brought to account merely on a year-end basis, as the difference between the year's payments and receipts will necessarily be equal to the difference between money holdings at the beginning of the year and money holdings at the end.

11.13 However, the formula instead deals with money on a receipts/payments basis so as to focus the legislative mechanics on each transaction occurring during the year. In the case of individuals, this is necessary in order to make decisions about private transactions; more generally it is necessary in order to match particular payments and receipts with particular assets and liabilities (i.e. to give them a cost or proceeds).

Summary of working draft

When do the non-cash transaction rules apply?

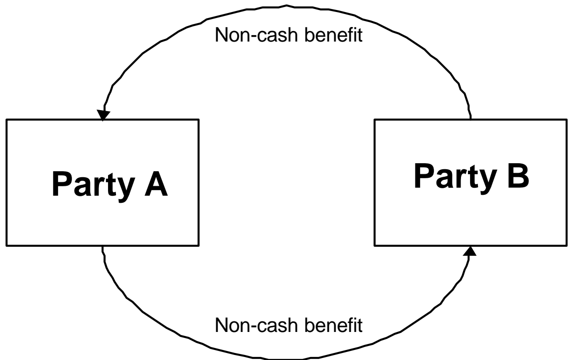
11.14 The non-cash transaction rules apply to any arrangement under which at least one entity gives one or more non-cash benefits for something other than just money. A non-cash benefit is essentially a service or any asset other than money.

11.15 There are 2 basic forms of non-cash transaction; 2-sided non-cash transactions and one-sided non-cash transactions.

2-sided non-cash transactions

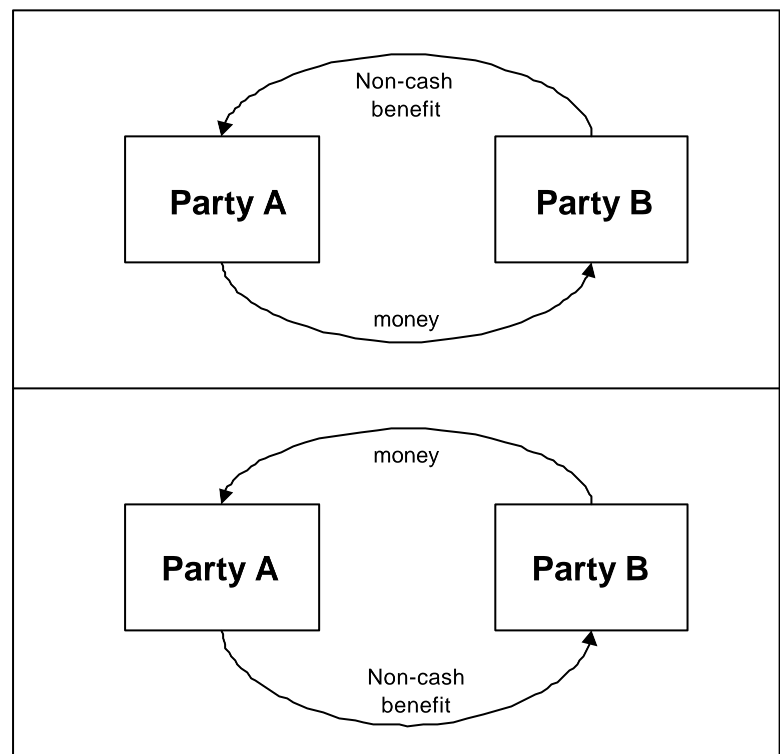
11.16 A 2-sided non-cash transaction involves an exchange of non-cash benefits between parties. This is illustrated in the following diagram.

Diagram 11.2 A 2-sided non-cash transaction



11.17 The 2-sided non-cash transaction rule applies in these kinds of cases. In effect, the rule treats the single transaction as if it comprised 2 separate transactions, each involving the exchange of one of the non-cash benefits for a matching money payment. The effect of the 2-sided non-cash transaction rule is set out in the following diagram.

Diagram 11.3 Effect of the 2-sided non-cash transaction rule



11.18 The amount of the deemed receipt and payment under a 2 sided non-cash transaction is worked out like this:

Table 11.1 Amount of deemed receipts and payments

If you:	*The amount of the deemed receipt and payment is:*
Assume a liability to pay money in the future (called a 'cash like benefit')	The amount you have a liability pay if the promise is to pay, within 12 months, for a non-cash benefit (other than a financial asset) In other cases, the market value of the liability[88]
Give any other kind of non-cash benefit	The market value of what you *get*

11.19 These deemed receipts and payments are taken to arise *in addition to* any actual receipts and payments that may flow between the parties.

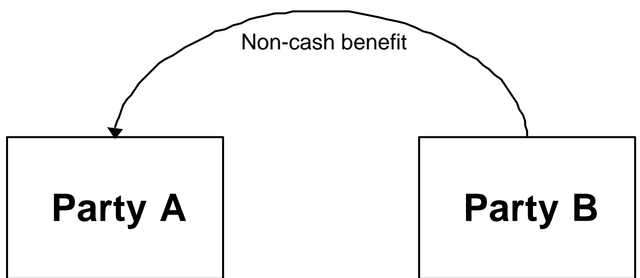
11.20 Because the deemed receipt and payment are always equal, they offset each other exactly; this means that they have no direct effect on the entity's net income.[89] Their effect, however, is to set the initial tax values and/or disposal proceeds of assets and/or liabilities of the entities involved in the arrangement.

[88] The dictionary items contain a definition for market value of a liability.
[89] Subject to private or domestic rules.

One-sided non-cash transactions

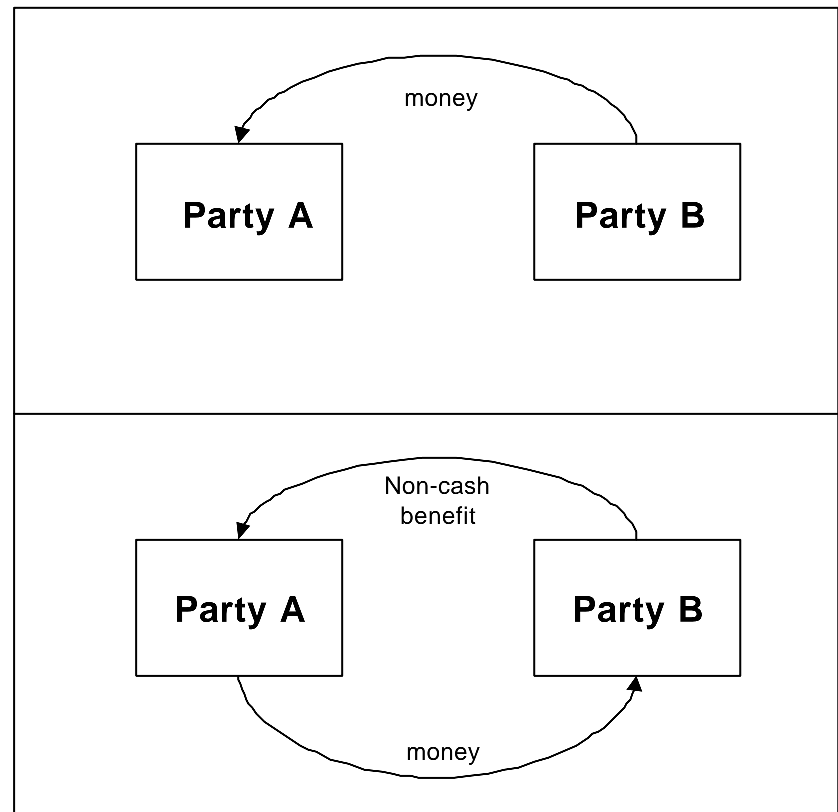
11.21 A one-sided non-cash transaction involves one party giving a non-cash benefit without consideration. This is illustrated in this diagram.

Diagram 11.4 A one-sided non-cash transaction



11.22 The one-sided non-cash transaction rule applies in these kinds of cases. The rule treats the passing of the benefit as if there were actually 2 transactions - the party providing the benefit pays an amount of money to the other party, and then the other party is taken to have paid the money back in return for the non-cash benefit. The effect of the one-sided non-cash transaction rule is set out in this diagram.

Diagram 11.5 Effect of the one-sided non-cash transaction rule



11.23 Again, these deemed receipts and payments are taken to arise *in addition to* any actual receipts and payments that may flow with the non-cash benefit.

11.24 Because the deemed receipts and payments are equal, they offset each other exactly; this means that they have no direct effect on the entity's net income.[90] Their effect, however, is to set the initial tax values and/or disposal proceeds of assets and/or liabilities of the entities involved in the arrangement.

Comparison of key features of working draft and current law

11.25 There are 2 important points of comparison between the non-cash transaction rules and those in the current law.

Common set of principles

11.26 Firstly, the non-cash transaction rules apply a common set of principles across the entire tax law. In contrast, the non-cash benefit rules in the current law contain 'gaps' in some areas, whilst in others involve significant replication of similar provisions and concepts.

Overcoming potential double counting

11.27 Secondly, the non-cash transaction rules seek to overcome an anomaly which could potentially arise under the various cost rules in the current law. This difficulty is discussed below in the examples in paragraphs 11.80 to 11.90. It does not often surface in practice, because there is a tendency to assume that parties dealing at arm's length will exchange benefits of equal market value.

11.28 The exchange of one asset for another is viewed as a simultaneous acquisition and disposal of assets; however, the purchase of an asset for cash is viewed only as the acquisition of an asset. When acquiring an asset for cash, any implicit gain or loss from the transaction is embedded in the asset value; it is not realised until the asset is disposed of. In contrast, the exchange of one asset for another constitutes both an acquisition and a disposal. A gain or loss is again embedded in the value of the asset acquired, but no allowance is made for the fact that the value of this asset was taken into account in calculating the gain or loss on the asset disposed of. The result is a duplication of taxing points.

11.29 This table compares the key features of the new treatment of non-cash benefits for income tax purposes with the treatment under the current law.

[90] Subject to private or domestic rules.

Table 11.2 Comparison of key features of working draft and current law

Working draft	*Current Law*
Receipt or provision of non-cash benefits may increase or decrease net income	Receipt or provision of non-cash benefits may give rise to assessable income or allowable deductions
Recognises the value of *all* non-cash benefits given and received, including services, under a single set of rules	Recognises the value of some non-cash benefits given and received, where they fall within a particular category of transaction; e.g. receipt of a non-cash business benefit, disposal of a CGT asset for property, disposal of a depreciating asset for property
All proceeds consisting of non-cash benefits other than financial assets are brought to account using a single valuation concept (market value)	Inconsistent terminology is used to value non-cash benefits – 'value', 'money value', 'arm's length value' and 'market value'
In establishing the cost of an asset, takes into account the fact that the asset may have been acquired in a transaction which itself triggered a taxing point	Determines the cost of an asset only by reference to what was paid or the value of what was given for it, creating the potential for double taxation or loss duplication
The first $300 of non-cash benefits received is exempt from income tax for a taxpayer carrying on a business	The first $300 of non-cash benefits received is exempt from income tax for a taxpayer carrying on a business

Detailed explanation of working draft

11.30 The non-cash transaction rules apply to arrangements under which at least one entity provides one or more non-cash benefits for something other than just money.

What is a non-cash benefit?

11.31 A non-cash benefit is a service or any asset other than money ***[section 8-27]***. Therefore, all financial assets are non-cash benefits. This means that the non-cash transaction rules have far-reaching implications in the tax system; they will apply whenever a transaction involves a purchase or sale on credit terms.

11.32 The rules in subsections 8-27(1) to (4) are all directed towards the same principle; giving an asset to another entity represents the giving of a non-cash benefit. Each case is dealt with separately in order to make it clear that, under the non-cash transaction rules, an entity need not hold an asset in order to give one. For example, assuming a liability constitutes giving a financial asset to the creditor, even though the debtor did not first hold the right to payment as an asset.

11.33 The following table summarises the things which are specified to be non-cash benefits under these rules.

Table 11.3 Things that are non-cash benefits

Non-cash benefit	*Comments*
An asset (but not money)	The term 'asset' is defined in section 6-15 of the working draft ***[subsection 8-27(1)]***
A service	This would include the use of facilities and other kinds of accommodation ***[subsection 8-27(1)]***
Assuming a liability, or increasing an existing liability	In this case the party that owes the liability is giving a non-cash benefit to the party to whom it is owed. ***[subsection 8-27(2)]***
The termination of all or part of a liability	This covers the extinguishment, forgiveness, release or waiver of the whole or part of the liability (but not through mere performance). The party to whom the liability was owed is giving a non-cash benefit to the party that owed it. ***[subsection 8-27(3)]***

11.34 The definition of non-cash benefit ensures that the giving of a promise to pay an amount of money is a non-cash benefit. Thus, for example, a 2-sided non-cash transaction will occur where A gives B goods in return for B promising to pay money in the future.

11.35 This means that any loss or outgoing in a transaction that may be reflected in an increase in the tax value of liabilities will be treated as a 'payment' under the working draft. Indeed these kinds of arrangements would be expected to constitute the most common form of 2-sided non-cash transaction. Likewise, a loss or outgoing in a transaction that may be reflected in a decrease in the tax value of assets will be treated as a 'payment'. This treatment of all these losses or outgoings as payments for the purposes of the working draft simplifies the drafting of the law significantly.

Constructive receipt of a non-cash benefit

11.36 The non-cash transaction rules include a 'constructive' receipt rule to assist in determining whether a non-cash benefit has been provided to a taxpayer. So, in addition to the usual circumstances when a taxpayer would be taken to get a non-cash benefit, they will also be taken to get it when it is dealt with on their behalf or as they direct ***[subsection 8-27(4)]***. This rule is to the same effect as the constructive receipt rule in subsection 4-20(2), which deals with the calculation of net income.[91]

[91] See Chapter 6.

2 kinds of non-cash transaction

11.37 There are 2 kinds of transaction covered by these rules:

- 2-sided transactions; and
- one-sided transactions.

11.38 Importantly, the rules do not apply to transactions involving the exchange of a non-cash benefit for money and nothing else ***[section 8-5]***. The rules will still apply, however, if any entity that pays money under the arrangement *also* provides one or more non-cash benefits under that arrangement.

2-sided non-cash transactions

11.39 The rules for 2-sided non-cash transactions are contained in Subdivision 8-A. These rules operate, in effect, by treating an entity as if it sold the non-cash benefits it gave, and bought the non-cash benefits it got, for the same amount of money. This approach ensures that all non-cash benefits received or provided are appropriately recognised by the income tax system. ***[Section 8-10]***

11.40 The discussion below explains the 2-sided non-cash transaction rule. The Appendix to this Chapter sets out a number of examples of how the rule would apply by way of further explanation.

When will the 2-sided non-cash transaction rule apply?

11.41 The 2-sided non-cash transaction rule will apply when the following 2 conditions exist (this is illustrated in Diagram 11.2):

- under an arrangement, an entity *gives* one or more non-cash benefits; and
- under the same arrangement, the entity *gets* one or more non-cash benefits.

[Sections 8-1 and 8-25]

11.42 Where both of these requirements are satisfied, the income tax consequences of the arrangement are worked out under Division 8, by applying sections 8-28, 8-29 and subsequent sections. ***[Subsection 8-25(2)]***

11.43 Applying the 2-sided non-cash transaction rule involves 2 steps.

First step: deemed receipt for the non-cash benefit you gave

11.44 The first step is to work out the amount you are taken to have *received* for each non-cash benefit you gave under the arrangement.

The role of the deemed receipt rule

11.45 The deemed receipt rule establishes a mechanism for assigning appropriate values to:

- the proceeds of realising assets given in a 2-sided non-cash transaction; and
- the first and second elements of the proceeds of assuming liabilities in a 2-sided non-cash transaction.

11.46 This is done by deeming amounts to have been received for the non-cash benefits given by the entity under an arrangement. These deemed receipts flow into the proceeds rules in Division 7A, because:

- the proceeds of realising an asset is defined to be the amount you receive (including deemed receipts) because you stop holding an asset (see section 7A-55); and
- the first and second elements of the proceeds of assuming a liability is defined to be the total of each amount you receive (including deemed receipts) because you started to have, or increased, a liability (see section 7A-75).

Giving single or multiple benefits

11.47 In working out this deemed receipt, the arrangement is first classified as falling into one of 2 possible categories:

- the *single benefit case* – where an entity gives one non-cash benefit, and nothing else; or
- *other cases* – any other arrangement.

Single benefit case

11.48 In the single benefit case, an entity gives one non-cash benefit, *and nothing else.* There are 2 possibilities here; the entity either gives:

- a cash-like benefit; or
- any other kind of non-cash benefit.

11.49 Where the entity gives a cash-like benefit, they are taken to receive, for that benefit, an amount equal to the market value of the benefit they *gave* ***[subsection 8-28(1)]***. The reason for this treatment of cash-like benefits is discussed at paragraphs 11.80 to 11.82 below.

11.50 A ***cash-like benefit*** is a non-cash benefit an entity gives because it starts to owe a financial liability, or because there is an increase in the financial liability it already owes. ***[Subsection 8-28(4)]***

11.51 Where the entity gives any other kind of non-cash benefit, they are taken to receive, for that benefit, an amount equal the total market value of the non-cash benefits *received* under the arrangement. ***[Subsection 8-28(3)]***

Any other arrangement

11.52 Other arrangements involve the entity giving:

- more than one non-cash benefit; or
- one or more non-cash benefits, and an amount of money.

11.53 For each *cash-like benefit* that the entity gives, they are simply taken to receive an amount equal to the market value of the benefit. ***[Subsection 8-28(1)]***

11.54 For each non-cash benefit that the entity gives *which is not a cash-like benefit*, the entity is taken to receive an amount worked out on the basis of a proportion of the market value of the non-cash benefits the entity *gets* under the arrangement. ***[Subsection 8-28(4)]***

11.55 This proportion is worked out by comparing the non-cash benefit given with *all* of the non-cash benefits given, and any actual payments made, under the arrangement. ***[Subsections 8-28(5) and (6)]***

11.56 This apportionment is based upon the relative market values of the assets being exchanged. This does not mean that a taxpayer has to work out the actual market values of all the things given in the transaction. It would be enough to do the apportionment having regard to a reasonable assumption of the relativities of those market values.

11.57 Under apportionment calculation, the deemed receipt for the non-cash benefit given could be worked out using the following formula:

$$\text{Total market value of } \textit{all} \text{ non-cash benefits entity gets} \times \frac{\text{Market value of non-cash benefit given}}{\text{Total market value of } \textit{all} \text{ non-cash benefits given} + \text{Amounts actually paid}}$$

Why is apportionment necessary?

11.58 In cases where more than one non-cash benefit is provided under a 2-sided non-cash transaction, it is necessary to allocate the deemed receipts to *each* of the non-cash benefits. Where liabilities are assumed under the arrangement, allocation is necessary in order to work out which part of the deemed receipt forms the proceeds of assuming the liability. Allocation might also be necessary because, for example, some part of the amounts taken to be received might need to be characterised as private or domestic in nature.

Example 11.1 Barter transaction

Odysseus sells his packing machine (market value, $4,000), generator (market value, $3,000), and trolley (market value, $2,000) to Athene. Instead of paying Odysseus cash, Athene gives him a forklift with a market value of $9,000.

Using the formula, Odysseus would be deemed to have received the following amounts of money for each item he gave:

$$\text{Receipt}_{\text{packing machine}} = 9{,}000 \text{ X } \left(\frac{4{,}000}{9{,}000}\right) = \$\ 4{,}000$$

$$\text{Receipt}_{\text{generator}} = 9{,}000 \text{ X } \left(\frac{3{,}000}{9{,}000}\right) = \$\ 3{,}000$$

$$\text{Receipt}_{\text{trolley}} = 9{,}000 \text{ X } \left(\frac{2{,}000}{9{,}000}\right) = \$\ 2{,}000$$

The 'proceeds of realisation' of an asset are the amounts you receive because of the realisation event, including deemed receipts. So, these deemed receipts form the proceeds of realisation for each asset Odysseus disposed of.

Second step: deemed payment for the non-cash benefits you got

11.59 The first step in working out the tax consequences of a 2-sided non-cash transaction was explained above at paragraphs 11.44 to 11.58. The second step is to work out the amount you are taken to have *paid* for each non-cash benefit you got under the arrangement.

Role of deemed payment rule

11.60 The deemed payment rule establishes a mechanism for assigning appropriate values to:

- the first element of cost of each asset acquired under the arrangement;
- the second element of cost for assets already held; and

- the cost of extinguishment of any liabilities that are extinguished as a result of the arrangement.

11.61 This is done by deeming payments to have been made for the non-cash benefits received or liabilities extinguished. These deemed payments flow into the cost rules in Division 7A, because:

- the first element of the cost of an asset is defined to be the amount you paid (including deemed payments) to hold the asset (see paragraph 7A-20(1)(a));
- the second element of the cost of an asset is defined to be the amount you paid (including deemed payments) to bring the asset to its present condition and location (see paragraph 7A-20(1)(b)); and
- the cost of extinguishing a liability is defined to be the amount you pay (including deemed payments) in order to stop owing a liability (see section 7A-100).

Getting single or multiple benefits

11.62 In working out this deemed payment, the arrangement can again be classified as falling into one of 2 possible categories:

- the *single benefit case* – where an entity gets one non-cash benefit, and nothing else; or
- *other cases* - any other arrangement.

Single benefit case

11.63 The single benefit case occurs where an entity gets one non-cash benefit, and nothing else. In that case, the entity is taken to have paid, for the benefit, an amount equal to the total of the amount they were taken to have received because of section 8-28 (which was worked out in step 1). ***[Subsection 8-29(1)]***

Other cases

11.64 Where the entity receives 2 or more non-cash benefits under the arrangement, they are taken to pay an amount which equals the total of all the amounts they were taken to receive because of section 8-28 (which, again, was the amount worked out in step 1). ***[Subsection 8-29(2)]***

11.65 Because the entity is getting more than one non-cash benefit, it is necessary to dissect the deemed payment and allocate a portion of it to each benefit, thereby allowing the cost of each benefit to be separately determined. This will involve allocating the payment to each benefit received on the basis of

the relative market values of the non-cash benefits and any amounts of money actually received. ***[Subsection 8-29(3)]***

11.66 Where the proportion is worked out on the basis of the market values of the non-cash benefits received under the arrangement, the calculation can be represented by the following formula:

$$\text{Total amounts taken to have been received under section 8-28} \times \frac{\text{Market value of non-cash benefit received}}{\text{Total market value of } \textit{all} \text{ non-cash benefits received}}$$

Why is apportionment necessary?

11.67 In cases where more than one non-cash benefit is received in a 2-sided non-cash transaction, it is sometimes necessary to allocate the deemed payment to each of the non-cash benefits received. This allocation will be necessary, for example, in order to work out what part of a deemed payment forms the cost particular assets acquired in the transaction. It may also be necessary in order to determine the cost of extinguishment of a particular liability resulting from the arrangement.

The matching of deemed receipts and payments

11.68 It is important to note that the non-cash transaction rules match deemed payments with deemed receipts. The sum of the amounts worked out under the first step *must* add up to the total deemed receipt worked out under the second step.

11.69 This means that total deemed receipts will always equal total deemed payments (although total receipts may not equal total payments, because *actual* receipts and payments must be counted).

11.70 This matching outcome is a very important feature of the non-cash transaction rules. The result is to 'cancel out' the effect of the deemed cash flows upon the receipts and payments element of the net income formula, but to allow these deemed cash flows to impact upon the cost of assets and proceeds of assuming liabilities. This outcome serves to avoid the 'double counting' problems explained above at paragraphs 11.27 and 11.28. The rationale for this matching approach is explained further below at paragraphs 11.83 to 11.90.

Example 11.2 Deemed payment in barter transaction

> Odysseus sells his packing machine (market value, $4,000), generator (market value, $3,000), and trolley (market value, $2,000) to Athene. Instead of paying Odysseus cash, Athene gives him a forklift with a market value of $9,000. Athene is taken to have received a total of

$9,000 for the forklift under the deemed receipt rule. Using the deemed payment rule, we'd work out Athene's deemed payments like this:

- $\text{Payment}_{\text{packing machine}} = 9{,}000 \text{ X} \left(\frac{4{,}000}{9{,}000}\right) = \$\,4{,}000$
- $\text{Payment}_{\text{generator}} = 9{,}000 \text{ X} \left(\frac{3{,}000}{9{,}000}\right) = \$\,3{,}000$
- $\text{Payment}_{\text{trolley}} = 9{,}000 \text{ X} \left(\frac{2{,}000}{9{,}000}\right) = \$\,2{,}000$

These amounts add up to $9,000. So, it's clear that deemed payments match deemed receipts.

Non-cash benefits an entity gives or gets in discharge of a right or liability

11.71 An important exception to the 2-sided non-cash transaction rules applies where an entity simply gets a non-cash benefit in satisfaction of a right it had to get it, or simply gives a non-cash benefit in discharge of a liability it had to give it.

11.72 If an entity gets a non-cash benefit pursuant to a right it had, and, as a result, the right decreases or ends, the non-cash transaction rules will not apply at that time. ***[Subsection 8-31A(1)]***

11.73 Equally, if an entity gives a non-cash benefit pursuant to a liability it had, and, as a result, the liability decreases or ends, the non-cash transaction rules will not apply at that time. ***[Subsection 8-31A(2)]***

Example 11.3 Non-cash benefit in satisfaction of right to get it

Wilbur pays $1 million to Orville in return for which Orville agrees to supply an aeroplane in 12 months. Wilbur has an asset consisting of a right to get the aeroplane. When Wilbur gets the aeroplane, his right disappears. The non-cash transaction rules would not apply at this time.

Rationale for the rule

11.74 The rule in section 8-31A is required to ensure that a gain or loss made upon a right to get a non-cash benefit, or a liability to provide a non-cash benefit is not recognised at the time of performance. Any such gain or loss is 'rolled-over' into the non-cash benefit acquired.

Example 11.4 Satisfaction of a right to get an asset which has increased in value

Agamemnon contracts to buy a block of land from Argus. Under the contract, the house will be conveyed in 6 months from the date of contract. At the date of contract, Agamemnon pays $100,000 in cash

and receives a non-cash benefit, being his right against Argus to get the house in 6 months. At the time of the contract, the market value of the house is $100,000. Six months later, the value of the house has increased to $150,000. Agamemnon exchanges his right to the house (cost, $100,000) for the house (market value, $150,000).

That exchange is disregarded under subsection 8-31A(1) because to apply the non-cash transaction rules when the right to get the house was satisfied would otherwise tax an unrealised gain of $50,000.

Provisions to avoid doubt

11.75 There are a number of provisions designed to remove doubt about the particular form an arrangement must take in order to be affected by the non-cash transaction rules.

Payment or receipt of money

11.76 The non-cash transaction rules can apply to transactions involving actual receipts and payments; it is only where one party to the arrangement pays *only* money that the rules have no application. Nothing in the non-cash transaction rules requires or allows actual receipts and payments to be disregarded.

11.77 However, to avoid doubt, amounts you are deemed to have received or paid under Subdivision 8-A are expressed to be 'in addition to' any amount you actually receive or pay under the arrangement. ***[Subsection 8-32(1)]***

Other features

11.78 A 2-sided non-cash transaction is simply an arrangement under which the entity gives and gets non-cash benefits; no other special features are required.

11.79 To make it abundantly clear, the following arrangements can be non-cash transactions:

Table 11.4 Arrangements that can be non-cash transactions to avoid doubt

Arrangement	*Illustration*
You get/give non-cash benefits *and* receive/pay money under the same arrangement. ***[Paragraph 8-32(2)(a)]***	Non-cash benefit Party A → Money → Party B Non-cash benefit
You *give* non-cash benefits to: • an entity that is not a party to the arrangement ***[paragraph 8-32(2)(b)]***; or • an entity other than the one from which you got benefits ***[paragraph 8-32(2)(c)]*** You *get* non-cash benefits from: • an entity that is not a party to the arrangement ***[paragraph 8-32(2)(b)]***; or • an entity other than the one to which you gave benefits ***[paragraph 8-32(2)(d)]***	Third Party Non-cash benefit Party A Party B Non-cash benefit
You give/get 2 or more benefits under the arrangement to/from different entities ***[paragraph 8-32(2)(e)]***	Party A Non-cash benefit Non-cash benefit Non-cash benefit Party B Party C

Why do we treat cash-like benefits that you give in a different way to other non-cash benefits that you give?

11.80 The deemed receipt for each cash-like benefit given is worked out on a different basis to the deemed receipts for other non-cash benefits. However, this difference is only important where the market value of what an entity gives is not the same as that of what it gets. This would be a rare case, because parties at arm’s length would normally be exchanging things of equal value.

11.81 This approach is necessary because our tax system treats disposals of money and financial assets (i.e. 'cash-like benefits') differently than disposals of other things. Disposals of cash and cash-like benefits for non-cash benefits are viewed as 'purchases', even though, economically, we could see them as sales of cash. In contrast, disposals of non-cash benefits for money are viewed as 'sales', even though, economically, we could see them as purchases of money. Because financial liabilities that you assume (and short-term financial liabilities in particular) are conceptually similar to money, the same reasoning applies.

Example 11.5 How cash-like benefits differ from other non-cash benefits

> If A pays $100 in cash in return for an asset which a court finds has a market value of $150 he acquires an asset with an embedded gain of $50. We don't think of A as disposing of cash for a profit of $50; rather, we could say he is purchasing an asset for a $50 'discount'. But if we had said that the 'proceeds of realisation' for the cash were $150, we would tax him on a profit of $50. This is not appropriate.
>
> The fact that A may promise to pay $100 in the future, as opposed to immediately, should not alter the treatment of this kind of transaction. A would not be regarded as assuming a liability (or 'disposing of his promise to pay money') at a profit.

11.82 By using this approach, any gain or loss on the giving of a cash-like benefit may be deferred, and embedded in the cost of an asset or proceeds of assuming a liability. That is, the disposal of a cash-like benefit may be treated as the acquisition of an asset or liability at a premium or discount, rather than the disposal of the cash-like benefit at a profit or loss.

Why are the deemed payments always equal to the deemed receipts?

11.83 It would be very easy to arrive at a rule for non-cash transactions if all transactions involved an exchange, and the items exchanged had the same market value; but this cannot be guaranteed in every case. Some transactions are one sided (e.g. a damages liability arising). Even those involving exchange might not necessarily have matching market values. It is conceivable that a court, applying existing case law, may find different market values being exchanged in these cases, even though the parties are dealing at arm's length (see paragraphs 11.115 to 11.119).

11.84 It would seem, at first blush, that there is an obvious approach for dealing with non-cash transactions – equate the proceeds of a sale with the market value of what you got, and equate the cost of what you got with the market value of what you gave. Typically, this is the approach of the existing law.

Example 11.6 Barter transaction

Martin has a truck with a written-down value of $100,000 and a market value of $100,000, and exchanges it for a bulldozer with a market value of $120,000. The current law treats him as having bought the bulldozer for $100,000 and sold the truck for $120,000.

11.85 However this approach is flawed – it will involve double counting where, as in the example, the values don't match.

Example 11.7 Barter transaction

In Example 11.6 above, Martin is taxed on the profit on disposal of the truck; $20,000 is included in his assessable income as a balancing charge, and he brings to account his new bulldozer at a cost of $100,000. If he then sold the bulldozer for its market value of $120,000, he would *again* be taxed on the profit on its disposal – that is, $20,000. Even though it is quite evident that the deal left Martin only $20,000 better off, he is taxed on a total of $40,000.

11.86 This approach treats an entity as if it obtained a profit on disposal *and* a discount at purchase – this is how the double counting arises.

11.87 In order to avoid this flaw it is necessary to determine just one figure which provides both the amount of the proceeds of sale and the cost of what you got.

11.88 There are 2 convenient ways that this could be done:

- Approach the transaction as if the disposal were made at a price equal to the market value of what the entity *gave*, and the proceeds were then used to fund the acquisition:

Example 11.8 Deemed sale of non-cash benefit at its market value

In Example 11.6 above, Martin could be taken to have made no profit on disposal of the truck but would later be taxed on $20,000 upon the sale of the bulldozer – he got a 'bargain' on the bulldozer.

- Approach the transaction as if the disposal were made at a price equal to the market value of what the entity *got*, and the proceeds were then used to make the acquisition:

Example 11.9 Deemed sale of non-cash benefit at market value of consideration received for it

In Example 11.6 above, Martin could be taken to have made a $20,000 taxable profit on the sale of the truck, but no profit would arise later upon the disposal of the bulldozer – he made a 'profit' on the truck.

11.89 Both approaches are appropriate, depending upon the nature of what is given in the transaction. So, to the extent that you give a cash-like benefit the non-cash transaction rules look at the value of what you gave. But to the extent that you gave other kinds of non-cash benefits, the non-cash transaction rules look at the value of what you got. Paragraphs 11.80 to 11.82 explained why this was appropriate.

11.90 In a majority of cases, the non-cash transaction rules will produce the same outcome as the current law. This is because the market values of the things exchanged in an arm's length transaction will usually be equal.

2-sided non-cash transactions with cash or cash-like benefits on each side

11.91 Subdivision 8-B contains special rules for non-cash transactions involving exchanges of cash-like assets and cash. These provisions effectively 'bifurcate' some non-cash transactions into a non-cash component and a financial asset/ cash component.

Why the rules are needed

11.92 These rules are necessary to give the correct treatment to financial assets and cash.

11.93 These rules would be expected to apply rarely. They will only have an impact where there is a transaction with cash and/or cash-like benefits on both sides, in addition to other kinds of non-cash benefits. In essence, the addition of cash and cash-like benefits to a transaction may provide a deferral effect on gains and losses in these cases.

Broadly, how do the rules approach these transactions?

11.94 When the money paid is in excess of the market value of the cash-like benefits and money being received, it is first netted off against the money received, then allocated to the cash-like benefits, with the remainder allocated to the remaining non-cash benefits.

11.95 This approach has the effect of producing an 'ordering rule'. Money is allocated to money and cash-like benefits first; any residue goes to the other non-cash benefits. If this weren't done, the money could be allocated to the financial assets and non-cash benefits in proportion to their market values. This could mean relatively more cash being allocated to non-cash benefits, and less to financial assets. In turn, this could mean greater deferral of gain or loss for the giver of the cash-like benefit, and a bringing forward of the gain or loss for the recipient.

Detailed description of the rules

11.96 The Subdivision alters the operation of Division 8 where both entities actually pay and actually receive money. The Subdivision will be developed further, however, to address transactions in which:

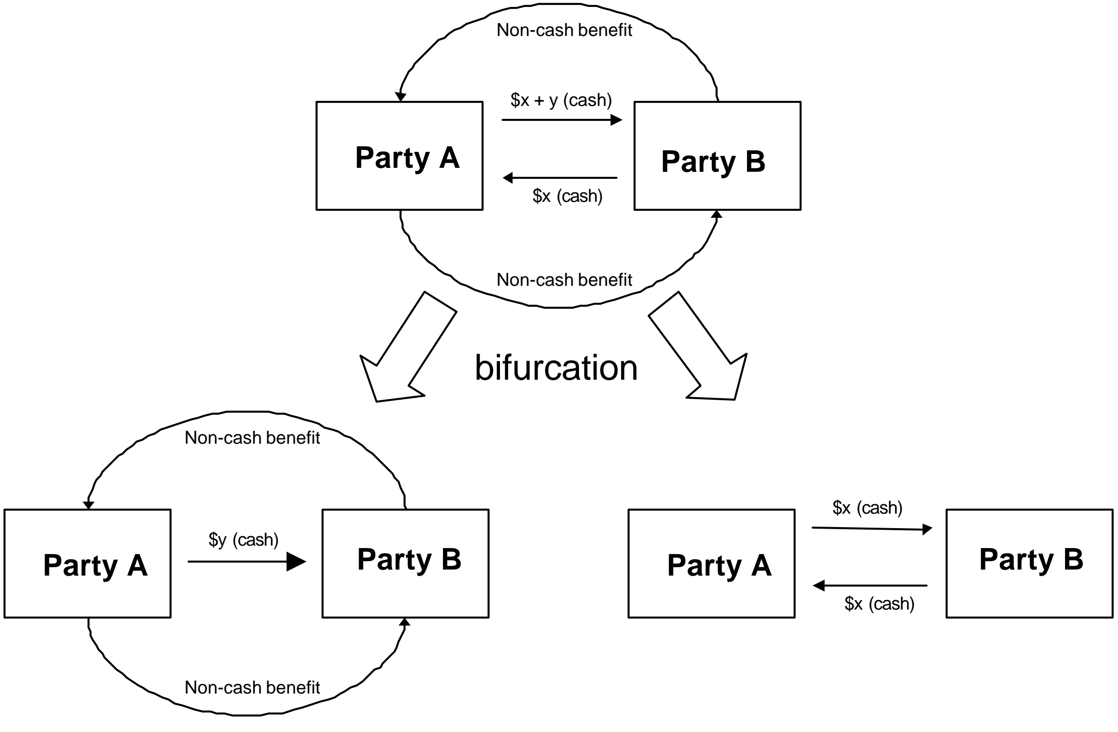
- one entity actually pays money and the other entity provides a cash-like benefit; or
- where both entities provide cash-like benefits.

11.97 The 'netting off' rule for non-cash transactions applies where an entity actually pays and actually receives cash under a non-cash transaction ***[subsection 8-34(1)]***. It should be recalled at this point that a non-cash transaction can involve one or more entities paying money, providing they also provide something else; see above, paragraph 11.38.

11.98 Receipts and payments that are deemed under Division 8 are not relevant for determining the application of the rule. However, a mutual set-off will be sufficient to constitute an actual payment for the purposes of these rules: *Re Harmony and Montague Tin and Copper Mining Company (Spargo's Case)* (1873) LR 8 Ch App 407.

11.99 Division 8 effectively reconstructs the arrangement for the purposes of the non-cash transaction rules. The reconstruction is shown in the following diagram:

Diagram 11.5 Reconstruction of 2-sided non-cash transaction with cash on both sides



11.100 The diagram shows that a non-cash transaction which involves both actual receipt and actual payment of money is treated as if it were split into 2 separate arrangements:

- An arrangement under which the non-cash benefits are exchanged, and only the payer with the larger payment pays an amount, equal to the excess of their payment over their receipt (the 'original arrangement').
- An arrangement under which the money disregarded in the original transaction is exchanged (the 'separate arrangement'). Of course, this is just a netting-off of the cash provided by each party and so can be ignored for practical purposes.

[Subsection 8-34(2)]

11.101 Where the amount of the payment equals the receipt, the rules remove any actual cashflow from the original arrangement. ***[Subsection 8-34(3)]***

Example 11.10 Cash on both sides of a 2-sided non-cash transaction

Homer issues a debenture to Antinous, and also pays him $10,000. The debenture entitles Antinous to $20,000 in 12 months. In return, Antinous gives Homer $10,000 in cash and promises to pay an additional $18,000 in 180 days.

Because there is cash on both sides of the transaction, the rule in section 8-34 applies. Accordingly, this unusual transaction is broken down into these 2 separate transactions for the purposes of applying the 2-sided non-cash transaction rule:

- the exchange of the debenture (market value $20,000) for a right to receive $18,000 (called the 'original arrangement' in the working draft); and
- the exchange of $10,000 cash for $10,000 cash (called the 'separate arrangement' in the working draft).

So, Homer is deemed to have received $20,000 under subsection 8-28(1) for the financial asset (the debenture) that he gave.

Homer is also deemed to have paid $20,000, under section 8-29, the amount he is taken to have received.

So, Homer's net income formula would look like this at the time of the transaction:

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

= [30,000 – 30,000] + [20,000 – 0] – [20,000 – 0] = $ 0

Note that the actual $10,000 receipt is included in Homer's net income calculation, as is his $10,000 payment. They are only ignored for the purposes of applying the 2-sided non-cash transaction rules.

Assuming that, in the following year, the debenture matures and Antinous meets his liability:

NI_{Homer} = [18,000 – 20,000] + [0 – 20,000] – [0 – 20,000] = –$ 2,000.

One-sided non-cash transactions

11.102 The rules for one-sided non-cash transactions are contained in Subdivision 8-C. The one-sided rule allows an entity to work out the costs and proceeds of realisation of its assets, and the proceeds of assumption and cost of extinguishment of its liabilities in a transaction where only one entity supplies consideration.

When will the one-sided non-cash transaction rule apply?

11.103 There are 2 types of one-sided non-cash transaction. One involves getting a non-cash benefit for nothing. The other involves assuming or increasing a liability for nothing.

Getting a non-cash benefit for nothing

11.104 The one-sided non-cash transaction rule will apply when the following 2 conditions exist (this is illustrated in Diagram 11.4, above):

- an entity gets one or more non-cash benefits from another entity; and
- the first entity pays nothing and gives no non-cash benefits.

[Sections 8-1 and 8-55]

11.105 In this case, the entity is taken to receive, from the other entity, an amount equal to the market value of the benefit, and to have paid the same amount for the benefit, at the time when it gets it. ***[Subsection 8-55(1)]***

11.106 However, this rule does not apply if the entity gets the benefit under an arrangement, and, under that same arrangement, also gives one or more non-cash benefits ***[subsection 8-55(2)]***. Where this occurs, the 2-sided non-cash transaction rules will apply.

11.107 Effectively, the rule treats the non-cash transaction as if the provider of the non-cash benefit had financed the purchase of that benefit by providing the other party with sufficient money to enable it to effect a purchase at market

value. The result is that the recipient's net income increases by the tax value the asset has at the end of the income year. However, there is no effect on taxable income if it is a service that the recipient gets or an asset that is no longer held at year-end.[92]

Assuming or increasing a liability for nothing

11.108 The second one-sided non-cash transaction occurs where an entity:

- gives a non-cash benefit to another entity by starting to have a liability or because there is an increase in a liability the entity already has; and
- receives no payment, and gets no non-cash benefit, for the non-cash benefit.

[Subsection 8-57(1)]

11.109 In this case, the entity is taken to pay to the other entity an amount equal to the market value of the benefit, and to receive the same amount from the other entity for the benefit, at the time when they give the benefit. ***[Subsection 8-57(1)]***

11.110 This puts the entity in the same position for income tax purposes that they would have been in, had they given money to the other entity, with the other entity lending that money back to the first entity.

11.111 This rule does not apply if the entity gives the non-cash benefit under an arrangement, and under that same arrangement, they get one or more non-cash benefits. In this case, the 2-sided non-cash transaction rules apply instead. ***[Subsection 8-57(2)]***

No effect on net receipts

11.112 It will be seen that the one-sided non-cash transaction rule will have no effect on the net receipts. This is because the amount taken to be received by each party will be the same as the amount taken to have been paid. However, the rule will have an impact for these reasons:

- One or more of the receipts or payments might be private or domestic in nature. This may mean that a receipt is included in working out net income while the payment is not, or vice versa.
- The deemed receipt and payment will determine, or form part of:
  - the cost of assets acquired;

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92 Subject to private or domestic rules.

- the proceeds of realisation of assets disposed of;
- the proceeds of assuming a liability;
- the cost of extinguishing a liability.

What about giving a non-cash benefit and getting nothing in return?

11.113 Under section 8-55, transactions are only one-sided from the perspective of the recipient of the non-cash benefit. From the donor's perspective, the transaction does not even fall into the non-cash transaction rules.

Example 11.11 Giving and getting something for nothing

> In the course of its promotional activities, Hermes Software Pty Ltd gave the Sirens Unit Trust one of its software packages (market value, $1,000) as a free sample. Hermes has given something for nothing; from its perspective, this is not a non-cash transaction. Upon giving the package to Sirens, Hermes ceases to hold it. The package disappears from Hermes' net income formula, and its net income therefore falls by the tax value the asset had to it.
>
> Appropriately, Hermes gets the equivalent of a 'deduction' for the package, which is a marketing expense.

Use of market value

11.114 For the purposes of Division 8, the *market value* of the non-cash benefit an entity gives or gets its determined at the time the entity gives or gets it. ***[Subsection 8-31(1)]***

Meaning of market value

11.115 'Market value' is a term that is used widely in the income tax law and other areas of the law. The non-cash transaction rules use this established concept, the principles of which have been considered on numerous occasions in the case law.

11.116 Market value is worked out on the basis of what a willing but not anxious provider of the benefit would agree on with a willing but not anxious acquirer of the benefit as payment for it. Determination of the market value of a non-cash benefit is a question of objective fact. It is necessary to consider a hypothetical transaction in a notional market place and ask what payment would be agreed as between willing but not anxious parties for the economic benefit that is sought to be valued.

11.117 This general rule is based upon the common law test for market value as developed in *Spencer v The Commonwealth* (1907) 5 CLR 418. The High Court provided a summary of this test in *Abrahams v FC of T* (1944) 70 CLR 23 where Williams J said at 29 that market value is "the price which a willing but not anxious vendor could reasonably expect to obtain and a hypothetical willing but not anxious purchaser could reasonably expect to have to pay … if the vendor and purchaser had got together and agreed on a price in friendly negotiation".

11.118 'Market value' is worked out without reference to anything that prevents or restricts the conversion of the benefit into money. These factors are, accordingly, disregarded in working out the market value of a non-cash benefit. ***[Dictionary items, definition of 'market value']***

11.119 The kinds of things that might prevent or restrict the conversion of the benefit into money include:

- conditions that affect transferability of the benefit to another entity, for example, where it is illegal to transfer a right; and
- the absence of an actual market for the economic benefit.

Special rules about market value

11.120 There is a significant modification to the general meaning of market value which applies for the purposes of Subdivision 8-A.

11.121 The market value of a financial asset or financial liability consisting of a right to receive, or an obligation to pay, an amount:

- that is due and payable; or
- for a non-cash benefit (other than a financial asset) if it must be paid within 12 months after the day the asset comes into existence;

is treated as if it were the amount the entity has the right to receive. ***[Subsections 8-31(2) and (3)].***

11.122 The effect of these provisions is to remove the need for entities to determine the market value of rights and liabilities which have a term of 12

months or less. Instead, such rights and liabilities are deemed to have a market value equal to their nominal or face value.

11.123 There is also a definition of market value of a liability in the dictionary items. This is explained in Chapter 8 (see paragraph 8.73).

The first $300 of notional receipts under non-cash transactions are exempt

11.124 Consistent with the position under the current law, up to $300 of notional receipts under non-cash transactions are exempt from income tax. This will be the case where the non-cash transactions arise in the course of carrying on a business. These are not yet included in the working draft, but will reflect the operation of subsection 23L(2) of the ITAA 1936.

What is the effect of the 2 and one-sided transaction rules on the income tax treatment of fringe benefits and entertainment?

11.125 The income tax law currently provides special treatment for non-cash benefits that are fringe benefits or entertainment. It is not the intention of the non-cash transaction rules to disturb this treatment. The Tax Value Method legislation will need to ensure that the present treatment of these non-cash benefits is preserved.

Appendix to Chapter 11

Examples of 2-sided non-cash transactions

11.126 This Chapter has so far explained how each deemed receipt and payment rule works. However, it is important to understand how the above rules interact with each other as all transactions involve applying receipt and payment rules.

11.127 The following examples illustrate how the non-cash transaction rules for 2-sided non-cash transactions operate.

Example 11.12 Non-cash transaction: no cash or cash-like benefits

Telemachus enters into a scrip-for-scrip transaction with Penelope. Under the transaction, Telemachus gives Penelope 1,000 shares in Odysseus Pty Ltd (cost $7,000 and market value, $10,000),[93] and Penelope gives Telemachus 500 shares in Zeus Pty Ltd (cost, $4,000 and market value, $6,000), and 500 shares in Poseidon Ltd (cost $3,000 and market value, $4,000).

Telemachus

Telemachus is deemed to have received $10,000 for the Odysseus shares he gave under subsection 8-28(4).

He is also deemed to have paid a total of $10,000 for the shares he received, under subsection 8-29(2), broken down like this under subsection 8-29(3):

$$\text{Payment}_{\text{Zeus shares}} = 10{,}000 \text{ X } \left(\frac{6{,}000}{10{,}000}\right) = \$6{,}000$$

$$\text{Payment}_{\text{Poseidon shares}} = 10{,}000 \text{ X } \left(\frac{4{,}000}{10{,}000}\right) = \$4{,}000$$

This means that the total cost of his new shares is $10,000. So, under the net income formula, the result for Telemachus is:

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

= [10,000 – 10,000] + [10,000 – 7,000] – [0 – 0] = $3,000

The gain Telemachus made under this transaction is recognised immediately, unless a roll-over applies. This gain will be reduced by the

93 Note that where there is no 'general market' (eg: as in the case of a share in a private company), a market value is to be assumed: *Brisbane Water County Council v Commissioner of Stamp Duties* (1979) 1 NSWLR 320 per Waddell J at 324.

CGT discount (via the taxable income adjustment rules) if the eligibility requirements for it are met.

Penelope

Penelope is deemed to have received $10,000 under subsection 8-28(4) for the shares that she gave:

$$\text{Receipt}_{\text{Zeus shares}} = 10{,}000 \text{ X } \left(\frac{6{,}000}{10{,}000}\right) = \$\ 6{,}000$$

$$\text{Receipt}_{\text{Poseidon shares}} = 10{,}000 \text{ X } \left(\frac{4{,}000}{10{,}000}\right) = \$\ 4{,}000$$

This separate apportionment may not be necessary, however. It will only be required where the tax consequences of ceasing to hold each parcel of shares are different. For example, if the Zeus shares were acquired before 20 September 1985, and the Poseidon shares afterwards, Penelope would need to determine to what extent the $10,000 receipt represents proceeds of realising the post-CGT shares.

She is also deemed to have paid a total of $10,000 for the Odysseus shares, under subsection 8-29(2). This means that the total cost of her new shares is $10,000.

So, under the net income formula, the result for Penelope is:

$$\text{NI}_{\text{Penelope}} = [10{,}000 - 10{,}000] + [10{,}000 - 7{,}000] - [0 - 0] = \$3{,}000$$

The gain Penelope made under this transaction is recognised in the year the transaction occurs, unless a roll-over applies. This gain will be reduced by the CGT discount (via the taxable income adjustment rules) if the eligibility requirements for it are met.

Example 11.13 Barter transaction – with cash

Telemachus enters into a scrip-for-scrip transaction with Penelope. Under the transaction, Telemachus gives Penelope 1,000 shares in Odysseus Pty Ltd (cost $7,000 and market value, $10,000), and Penelope gives Telemachus 500 shares in Zeus Pty Ltd (cost $3,000 and market value, $6,000), and $4,000 in cash.

Telemachus

Telemachus actually received $4,000, and is deemed to have received a further $6,000 for the Odysseus shares he gave under subsection 8-28(4). Therefore the proceeds of realisation of the Odysseus shares are $10,000.

He is also deemed to have paid $6,000 for the shares he received, under subsection 8-29(2).

This means that the total cost of his new shares is $6,000. So, under the net income formula, the result for Telemachus is:

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

$$= [10{,}000 - 6{,}000] + [6{,}000 - 7{,}000] - [0 - 0] = \$3{,}000$$

The gain Telemachus made under this transaction is recognised immediately, unless a roll-over applies. This gain will be reduced by the CGT discount (via the taxable income adjustment rules) if the eligibility requirements for it are met.

Penelope

Penelope is deemed to have received $6,000 under subsections 8-28(4) for the shares that she gave:

$$\text{Receipt}_{\text{Zeus shares}} = 10{,}000 \text{ X} \left(\frac{6{,}000}{10{,}000}\right) = \$\ 6{,}000$$

This means that Penelope's proceeds of realisation for the Zeus shares is $6,000. (She will only need to work out a proceeds of realisation if a taxable income adjustment applies).

She is also deemed to have paid of $6,000 for the Odysseus shares, under subsection 8-29(2), in addition to the $4,000 she actually paid. This means that the total cost of her new shares is $10,000. So, under the net income formula, the result for Penelope is:

$$\text{NI}_{\text{Penelope}} = [6{,}000 - 10{,}000] + [10{,}000 - 3{,}000] - [0 - 0] = \$3{,}000.$$

The gain Penelope made under this transaction is recognised in the year the transaction occurs, unless a roll-over applies. If the eligibility requirements are met, this gain will be reduced by the CGT discount.

Example 11.14 Barter transaction – with cash and cash-like benefits

Telemachus enters into a scrip-for-scrip transaction with Penelope. Under the transaction, Telemachus gives Penelope 1,000 shares in Odysseus Pty Ltd (cost $7,000 and market value, $10,000) and Penelope gives Telemachus 250 shares in Zeus Ltd (cost $5,000 and market value, $3,000), $6,000 in cash, and a promise to pay a further $1,000 in cash in 8 months.

Telemachus

Telemachus is deemed receive $4,000 for the Odysseus shares under subsection 8-28(4). This is the total value of non-cash benefits he gets under the arrangement, comprising the Zeus shares with a market value of $3,000, and a cash-like benefit valued at $1,000.

Telemachus gets more than one non-cash benefit under the arrangement, so subsection 8-29(2) applies. Under subsection 8-29(3), Telemachus' total deemed payment of $4,000 is allocated like this:

$$\text{Payment}_{\text{Zeus Shares}} = \$4{,}000 \text{ X } \left(\frac{3{,}000}{4{,}000}\right) = \$\ 3{,}000$$

$$\text{Payment}_{\text{Promise}} = \$4{,}000 \text{ X } \left(\frac{1{,}000}{4{,}000}\right) = \$1{,}000$$

So, under the net income formula, the result for Telemachus is:

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

= [10,000 – 4,000] + [4,000 – 7,000] – [0 – 0] = $3,000

Telemachus makes a capital gain of $3,000. This is recognised in the year the transaction occurs, unless a roll-over applies. This gain will be reduced by the CGT discount (via the taxable income adjustment rules) if the eligibility requirements for it are met.

Penelope

Penelope gives more than one non-cash benefit. Therefore, subsection 8-28(4) applies. The deemed receipt for the Zeus shares she gave is worked out, under subsection 8-28(4), like this:

$$\text{Receipt}_{\text{Zeus shares}} = 10{,}000 \text{ X } \left(\frac{3{,}000}{10{,}000}\right) = 3{,}000$$

Penelope is deemed to have received $1,000 for her promise to pay (a cash-like benefit), under subsection 8-28(1). Thus, her total deemed receipts are $4,000.

Her deemed payments for the Odysseus shares are also $4,000, under subsection 8-29(2).

This is combined with her actual payment of $6,000, to give a cost for the Odysseus shares of $10,000. So, under the net income formula, the result for Penelope is:

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

= [4,000 – 10,000] + [10,000 – 5,000] – [1,000 – 0] = –$2,000.

This loss will be quarantined by way of an adjustment, to the extent that she has no capital gains against which to offset it.

If Penelope were to dispose of the Odysseus shares and pay-off her debt in the following year, this would be the result (assuming the market value of the shares hadn't changed):

$NI_{Penelope}$ = [10,000 – 1,000] + [0 – 10,000] – [0 – 1,000] = $ 0.

Example 11.15 Credit transaction – purchasing a non-cash benefit with a cash-like benefit

Calypso purchases an item of plant on credit (market value of $45,000) from Cyclops. The plant has an tax value to Cyclops of $40,000. Under the terms of the arrangement, Calypso must pay Cyclops $50,000 within 10 months. This means that Calypso has a financial liability and Cyclops has a financial asset.

Calypso

Calypso, in promising to pay $50,000, is giving Cyclops a cash-like benefit (paragraph 8-28(2)(a)). Calypso will be deemed to receive $50,000 (the face value of the promise) for giving this benefit: subsection 8-28(1). This is the market value of her promise to pay under paragraph 8-31(3)(b), and will be her proceeds of assumption. As the promise requires payment within 12 months, the tax value of the liability will also be set at its face value, which will be the same amount (subsection 7-75(1), item 5 of the table).

Calypso is also deemed to have paid $50,000 under subsection 8-29(1) for the plant she received. This means that the cost of her new plant is $50,000.

So, under the net income formula, the result for Calypso is:

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

= [50,000 – 50,000] + [50,000 – 0] – [50,000 – 0] = $0.

Cyclops

Cyclops is deemed to have received $50,000 (the face value of the promise) under subsection 8-28(3).This is the market value of his right to receive payment under paragraph 8-31(3)(b), and will be his proceeds of realisation.

He is also deemed to have paid $50,000 for the cash-like benefit he got, under subsection 8-29(1). The initial tax value of Cyclops' right to receive an amount that must be paid within 12 months is the amount that he has the right to receive (subsection 6-40(1), item 6 of the table). This will also be $50,000.

This means that the total cost of his cash-like benefit is $50,000. So, under the net income formula, the result for Cyclops is:

$NI_{Cyclops}$ = [50,000 – 50,000] + [50,000 – 40,000] – [0 – 0] = $10,000

Cyclops is therefore assessed on a $10,000, representing the difference between the plant's tax value and what he got for selling it. Under the current law, this gain would be assessed via the 'balancing adjustment' rules, but they are not needed under TVM.

Example 11.16 Transaction involving cash-like benefits on both sides

Homer enters into an agreement to borrow $20,000 from Antinous in 20 days' time (but within the same income year). For this, Homer promises to pay Antinous $22,000 within 12 months.

Homer

Homer is deemed to have received $22,000 under subsection 8-28(1) for the cash-like benefit that he gave. This is the market value of his promise to pay under paragraph 8-31(3)(b), and will be his proceeds of assumption. The initial tax value of this liability will also be $22,000: subsection 7-75(1), item 5 of the table.

Homer is also deemed to have paid $22,000 for the cash-like benefit he got under subsection 8-29(1); this will be the cost of his right. However, the tax value of a right to receive an amount within 12 months is the amount the entity has the right to receive: subsection 6-40(1), item 6 of the table. This will be $20,000.

So, Homer's net income formula would look like this:

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

= [42,000 – 22,000] + [0 – 0] – [22,000 – 0] = –$2,000

Homer effectively gains a 'deduction' for an amount which represents interest on this transaction.

Antinous

Antinous is deemed to have received $20,000 for the cash-like benefit he gave: subsection 8-28(1). This is the market value of his promise to pay under paragraph 8-31(3)(b), and will be his proceeds of assumption. The initial tax value of this liability is also $20,000: subsection 7-75(1), item 5 of the table.

Antinous is deemed to have paid $20,000, under subsection 8-29(1), for the financial asset he got. This will be that asset's cost. However, its tax value will be the amount he has the right to receive, which is $22,000: subsection 6-40(1), item 6 of the table.

So, Antinous' net income formula would look like this at the time of the transaction:

$NI_{Antinous}$ = [20,000 – 40,000] + [22,000 – 0] – [0 – 0] = $2,000

Antinous is assessed on an amount which represents interest on this transaction.

Example 11.17 Transaction involving cash-like and non-cash-like non-cash benefits

Homer sells a zero-coupon debenture (which cost him $18,000) to Antinous, which carries a right to $20,000 in 6 months. For this, Antinous promises to pay Homer $19,000 within 20 days (which falls in the next income year).

Homer

The debenture Homer sells is a financial asset, but *not* a cash-like benefit. This is because the liability it represents is the issuer's and not Homer's. Homer is deemed to have received $19,000 under subsection 8-28(3) for the debenture. This is because the market value of Homer's right against Antinous is deemed to be the amount Homer has the right to receive, under paragraph 8-31(2)(b). The initial tax value of this right will also be the amount he has the right to receive; i.e. $19,000: subsection 6-40(1), item 6 of the table.

Homer is also deemed to have paid $19,000 for Antinous' promise, under section 8-29.This will be the cost of Homer's right. The initial tax value of this right will also be $19,000.

So, Homer's net income formula would look like this at the time of the transaction:

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

= [19,000 – 19,000] + [19,000 – 18,000] – [0 – 0] = $1,000

Assuming that, in the following income year, Antinous meets his liability to Homer:

NI_{Homer} = [19,000 – 0] + [0 – 19,000] – [0 – 0] = $0

Antinous

Antinous has given a cash-like benefit, because he is promising to pay $19,000. Therefore, he is deemed to have received, for the promise he gave, the market value of that promise: subsection 8-28(1). The market value of Antinous' liability is the amount he is liable to pay: paragraph 8-31(3)(b). The proceeds of assuming this liability will therefore be

$19,000. The tax value of this liability will also be $19,000: subsection 7-75(1), item 5 of the table.

Antinous is also deemed to have paid $19,000 for the financial asset he got: subsection 8-29(1). The initial tax value of this asset, being a right to money within 12 months, will also be $19,000.

So, Antinous' net income formula would look like this at the time of the transaction:

$NI_{\text{Antionous}} = [19{,}000 - 19{,}000] + [19{,}000 - 0] - [19{,}000 - 0] = \$\ 0$

And when he discharges his liability to Homer and the debenture matures (in the following year of income):

$NI_{\text{Antionous}} = [20{,}000 - 19{,}000] + [0 - 19{,}000] - [0 - 19{,}000] = \$1{,}000$

The different timing resulting from giving a cash-like benefit is evident. Antinous does not recognise a gain at the time of entering the transaction, as he is regarded as purchasing the debenture at a discount, rather than selling his promise to pay at a profit.

Chapter 19
Overview of capital gains treatment

Outline of Chapter

19.1 This Chapter outlines the current expectations of how the CGT core rules will operate under the Tax Value Method. The proposed operation of the CGT core rules is compared to the current CGT regime.

19.2 The preparation of the draft legislation dealing with capital gains treatment has commenced but is incomplete. It is not yet included in the working draft.

Context of reform

19.3 Under the current law, capital gains do not form part of ordinary income. Accordingly, the tax law requires special statutory income rules[94], for assets acquired after 19 September 1985, to include capital gains in taxable income and allow capital losses to be offset against such capital gains.

19.4 The Tax Value Method will, however, as a matter of principle and structure include such capital gains and capital losses in net income. This is because, under the Tax Value Method, the calculation of net income includes receipts, payments and changes in the tax value of assets and liabilities. Of course, capital gains and capital losses from CGT assets acquired before 20 September 1985 will be excluded from net income. This will be done using the same kind of mechanism proposed to be used under the Tax Value Method to exclude gains or losses from private assets.

19.5 The purpose of the CGT rules under the Tax Value Method is not to separately include capital gains in net income but rather to maintain:

- concessional treatment for some capital gains (e.g. the 50% discount for individuals and concessions for small business); and
- quarantining of capital losses.

[94] Parts 3-1 to 3-3 of the ITAA 97.

CGT events

19.6 A capital gain (or loss) can only occur under the current law if a CGT event happens. There are almost 40 different CGT events.

19.7 Under the Tax Value Method CGT rules many of these events can be dealt with by a single rule that isolates capital gains or losses from ceasing to hold a CGT asset. This is because the Tax Value Method's core rules automatically bring to account gains or losses in net income from ceasing to hold an asset. Many of the existing events will not be needed because their only function is to include amounts in taxable income. This job will be done by the net income formula under the Tax Value Method.

CGT asset

19.8 The current CGT regime defines CGT assets very broadly, causing overlaps with other rules in the law. However, the regime ensures that amounts are not double taxed by providing that an amount assessed under the CGT regime cannot include any amount assessable under any other provision of the Act.

19.9 For example, if a taxpayer's ordinary income includes a profit from the sale of a building bought with a profit making intention[95] then the taxpayer's capital gain will be reduced by the amount of that ordinary income.

19.10 The Tax Value Method's definition of a CGT asset will ensure that there can be no overlap between provisions. This is a change from the current law. Accordingly, if an asset is a CGT asset under the Tax Value Method it will not be subject to any other regime. For example, an asset will either be a depreciating asset and taxed as such or a CGT asset and subject to the Tax Value Method CGT rules. It will not be necessary to consider the tax consequences for an asset under different regimes.

Use of common core rules

19.11 Currently the CGT regime contains a range of provisions that deal with the cost base of assets, disposal proceeds, non-cash transactions and non-arm's length transactions. This is necessary because the current tax system deals with these issues differently in different statutory provisions.

19.12 The Tax Value Method contains cost and proceeds rules that apply to all assets, regardless of type. Also, there are non-cash transaction rules that apply to all non-cash transactions regardless of what type of asset the transaction applies to. Non-arm's length transaction core rules will also be included under the Tax Value Method.[96] Again this will mean that separate

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[95] The building is not trading stock.

[96] *ATSR* recommendation 6.17.

provisions are not needed in the Tax Value Method CGT rules to deal with such transactions.

Summary of proposed law

19.13 The Tax Value Method CGT draft provisions will retain the current concessional treatment of capital gains and the loss quarantining that applies to capital losses.

19.14 The Tax Value Method CGT rules will calculate the amount of the capital gains or capital losses included in net income (nominal capital gains or losses). This will then allow any CGT concessions and loss quarantining to be applied to these capital gains and losses as a taxable income adjustment.

19.15 The Tax Value Method CGT rules will use the existing structure of the CGT provisions where appropriate. This is because, to the extent that the existing provisions deal with concessions and quarantining, they continue to apply under the Tax Value Method. Using the same structure will also reduce the amount of time that practitioners and other users of the law will need to become familiar with the Tax Value Method CGT rules.

When will capital gains treatment apply?

19.16 Ceasing to hold an asset will be the main case in which the amount of a nominal capital gain or loss is identified. However, a limited number of CGT events that apply to assets in other situations will be needed under the Tax Value Method to identify the nominal capital gain or loss.

19.17 Current development work indicates that 5 further CGT events will be needed:[97]

- H1 (forfeiture of deposit);
- G1 (capital return by company);
- K2 (payment by bankrupt);
- K4 (asset becomes trading stock); and
- K5 (fall in value of collectable).

Working out the taxable income adjustments

19.18 Amounts included in the net income formula resulting from capital gains treatment applying under the Tax Value Method will be offset by upward

[97] It is possible that a small number of other existing events will be required.

and downward adjustments to produce the correct CGT outcome. Taxable income adjustments will:

- apply the discount to discount capital gains; and
- quarantine net capital losses.[98]

19.19 In essence, the taxable income adjustments for ceasing to hold an asset will be worked out in this way:

Step 1. The amount of any capital gain or loss will be worked out by subtracting the cost of the asset and certain expenses associated with the asset's disposal from the proceeds of realising the asset.

Step 2. The capital losses for the income year will be subtracted from the capital gains for the year. If the result is negative it is the ***net capital loss*** for the year. There will be an ***upward adjustment*** equal to the amount of the loss (to quarantine the loss).

Step 3. If the capital gains for the income year exceed the capital losses for the year, net capital losses of previous years are applied against the excess. There will be a ***downward adjustment*** equal to the amount of the prior year losses so applied.

Step 4. If any capital gains remain, there will be a ***downward adjustment*** equal to the discount percentage multiplied by each capital gain that qualifies as a discount capital gain.

What is a CGT asset?

19.20 A CGT asset will be defined as an asset whose tax value is worked out under item 8 or 9 of the table in subsection 6-40(1) of the working draft (other than purchased information that is not generally available). So, it will not include a listed zero tax value asset, trading stock, a depreciating asset or a financial asset. Some transitional matters will also need to be dealt with by the definition.

Comparison of key features of proposed law and current law

Comparison of core provisions

19.21 The following table sets out how some key concepts apply in the proposed law compared to the existing CGT provisions.

98 There will also be rules to deal with small business concessions, roll-over relief and exemptions for capital gains or losses (such as the main residence exemption).

Proposed Law	***Current Law***
Capital gains treatment will apply when a CGT event happens. It is expected that a small number of CGT events will continue to apply. The main case will be when a CGT asset ceases to be held.	Capital gains tax treatment applies when a CGT event happens. There are 39 CGT events under the current law.
CGT assets are broadly all assets other than depreciating assets, trading stock and financial assets (see items 8 and 9 of the table in subsection 6-40(1) in the working draft).	A CGT asset is any kind of property, or legal or equitable right that is not property.
Nominal capital gains and losses will be automatically included in the net income formula. CGT provisions isolate the amount of the gain or loss to allow concessional treatment to be applied and to quarantine losses.	The CGT provisions calculate the amount of net capital gains to be included in taxable income or the amount of a net capital loss to be quarantined.

Comparison of Divisions in current law to treatment under the Tax Value Method

19.22 The following table compares the Divisions in Part 3-1 of the ITAA 1997 (dealing with capital gains and losses – general topics) to their proposed treatment under the Tax Value Method. Part 3-3 will be analysed at a later time.

Proposed law	***Current Law***
Guide	
The working draft will have a Division with a guide to the Tax Value Method CGT rules and also the objects of the provisions.	Division 100 provides a guide to the rules on capital gains and losses.

Calculating capital gains	
The working draft will have a Division that identifies the amount of a nominal capital gain or capital loss and applies the CGT discount and loss quarantining. Downward or upward taxable income adjustments will apply. (See the discussion in paragraph 19.19).	Division 102 sets out how to work out a net capital gain or loss and the consequences of gains and losses arising (e.g. an amount being included in taxable income or losses being carried forward).
Non-cash transactions and currency conversion	
No Division is required to deal with this issue. The Tax Value Method core rules contain non-cash transaction rules and will contain currency conversion rules.	Division 103 deals with non-cash transactions and has rules for currency conversion.
CGT events	
Most of the existing CGT events will not be required because the Tax Value Method core rules automatically include amounts in net income. Ceasing to hold a CGT asset will be the main taxing point. Current expectations are that equivalents of CGT events H1 (forfeiture of deposit), G1 (capital return by company), K2 (payment by bankrupt), K4 (asset becomes trading stock) and K5 (fall in value of collectable) may be required.	Division 104 sets out 39 CGT events that result in capital gains or losses being recognised.
Entity making the gain or loss	
Provisions having a similar effect to Division 106 of the current law will be required.	Division 106 sets out circumstances when a capital gain or loss is made by an entity other than the entity to which the CGT event happens.
CGT assets	
Provisions defining CGT assets and collectables will be required. Personal use assets will be covered by the definition of private asset contained in the provisions dealing with private and domestic transactions and assets.	Division 108 defines CGT assets, collectables and personal use asset.
CGT assets will be defined by reference to the items in the asset tax value table (subsection 6-40(1)). (See paragraph 19.20).	Section 108-5 defines a CGT asset as any kind of property, or a legal or equitable right that is not property.

Collectables will broadly include tangible CGT assets, other than land. Capital losses from collectables will be quarantined and will only be able to be offset against gains from collectables.	Subdivision 108-B quarantines capital losses of collectables.
Personal use assets will be covered by the definition of private asset contained in the provisions dealing with private and domestic transactions and assets.	Subdivision 108-C deals with personal use assets and disregards capital losses from personal use assets.
The treatment of improvements to land will be covered by the Tax Value Method core rules. The provisions related to pre-CGT assets will be dealt with in the rules dealing with pre-CGT assets.	Subdivision 108-D deals with separate CGT assets.
Acquisition of CGT assets	
The Tax Value Method core rules deal with starting and ceasing to hold an asset (Division 6 of the working draft).	Division 109 sets out the ways that a CGT asset can be acquired and the time of acquisition.
Cost base and reduced cost base	
The Tax Value Method core rules (Division 6 of the working draft) deal with the tax value of assets. Provisions to adjust the amount of quarantined capital losses will be required to give effect to the existing reduced cost base rule.	Subdivision 110-A provides the cost base rules and Subdivision 110-B provides the reduced cost base rules.
Modification to cost base and reduced cost base rules	
The Tax Value Method core rules will deal with changes to tax values.	Subdivision 112-A provides general modifications to cost base and reduced cost base rules.
The Tax Value Method core rules will contain any guide material that is necessary.	Subdivision 112-B provides a guide to locate special rules modifying the cost base and reduced cost base.
Consideration will be given to providing Act-wide roll-over provisions. If this is done then the guide would be contained in the Tax Value Method core rules.	Subdivision 112-C is a guide to replacement-asset roll-overs. Subdivision 112-D is a guide to same-asset roll-overs.
Indexation of cost base	

Provisions will be required to adjust for indexation in appropriate circumstances. These will be transitional provisions.	Division 114 provides for indexing the cost base of an asset.

Discount capital gains	
The Tax Value Method will contain broadly similar provisions to Division 115 of the current law.	Division 115 provides for the application of a discount percentage to certain net capital gains, including special rules for trusts.
Capital proceeds	
These rules will be broadly dealt with by the Tax Value Method core rules (see cost and proceeds rules in Division 7A of the working draft).	Division 116 sets out how to work out the capital proceeds from a CGT event.
Exemptions	
Similar rules to those in Division 118 of the current law will be needed.	Division 118 sets out various exemptions for capital gains and losses.
Record keeping	
Act-wide record keeping rules will be considered.	Division 121 provides record keeping provisions for matters affecting capital gains and losses.