Preparing income tax returns under the Tax Value Method

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3. It is important to recognise also that in developing the Tax Value Method 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.

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5. Comments on this document are welcome. Comments in writing should be addressed to:

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PREPARING INCOME TAX RETURNS UNDER THE TVM

Significant work was undertaken during the Ralph Review, and subsequently, to examine the affect of the Tax Value Method (TVM) on how business taxpayers would prepare their income tax returns. The comments that follow are based on the experiences derived from that process. This work needs to be tested further as the TVM is developed.

2. The income tax assessment system is designed to provide a result: taxable income. The TVM is a *scheme* in the law for explaining that result.

3. As a scheme, the TVM *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 and its practical derivation.

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

Is accounting profit a good place to start?

4. Accounting profit is the difference between revenue and expenses. Revenue is the 'inflows or other enhancements, or savings in outflows, of future economic benefits in the form of increases in [net] assets … other than those relating to contributions by owners'.[1]

5. Expenses are the 'consumptions or losses of future economic benefits in the form of reductions in [net] assets … other than those relating to distributions to owners'.[2]

6. Thus, accounting profit (or income) is based on assets, in particular the *change* in an entity's net assets (to the extent that it does not result from contributions by, or distributions to, owners).

7. Likewise, taxable income as articulated under the TVM is based on net assets. The difference is that taxable income represents the change in the 'tax value' of an entity's net assets.

8. That makes accounting profit a logical place to start in working out taxable income, especially for taxpayers that have accounting systems in place, even if they are only rudimentary.

9. The profit and loss statement is a way of displaying the sources of that change in net assets (e.g. retail sales or debt defeasance). In this way, the profit and loss

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1 Statement of Accounting Concepts SAC 4 "Definition and Recognition of the Elements of Financial Statements", paragraph 111.

2 *Ibid,* paragraph 117.

statement explains how an entity's balance sheet at the start of the year comes to look like its balance sheet at the end (putting aside dealings with owners in their capacity as owners); it explains the movement of accounting values.

The scheme of the law and the Commissioner's administration of it

The scheme of the income tax law

10. Our income tax assessment system is designed to provide a result: an amount called taxable income and another called tax payable.

11. There is no difference between the current law and the TVM in the result sought. Rather the difference is in the scheme and building blocks used to explain that result.

12. Under the current law, taxable income is the difference between assessable income and deductions (section 4-15 of the *Income Tax Assessment Act 1997* (the 1997 Act)). Assessable income is comprised of ordinary income and statutory income (sections 6-5 and 6-10 of the 1997 Act). Deductions are comprised of general deductions and specific deductions (sections 8-1 and 8-5 of the 1997 Act).

13. Under the TVM, taxable income is the sum of net income, an income tax law adjustment and unused tax losses. Net income is the sum of:

- receipts less payments (that are not private); and
- increases in the tax value of net assets (i.e. assets less liabilities).

14. These schemes explain taxable income; they allow us to determine if an amount should be included in taxable income. But they do not prescribe the only method that can be used in working out taxable income.[3] Furthermore, they say nothing of how the items and amounts making up taxable income should be displayed.

15. As an example, corporate taxpayers generally do not work out their taxable income out by directly computing assessable income less deductions. Also, they do not generally keep an ongoing set of tax accounts in parallel to their accounting system, with accounts called ordinary income, statutory income, general deductions and specific deductions. Nevertheless, their taxable income, once computed, must be explicable on the basis of the scheme used in the income tax law.

16. Therefore, there is a distinction to be drawn between the concepts that work together to result in taxable income and its practical derivation.

The Commissioner's administration of the law

17. The income tax return is critical to the assessment of taxable income and tax payable.

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[3] Consider default assessments under section 167 of the of the *Income Tax Assessment Act 1936*.

18. The Commissioner generally makes assessments of taxpayers' taxable income and tax payable using their income tax returns if they do not self assess (section 166 of the 1936 Act).

19. In the case of taxpayers that self assess, the Commissioner is taken make assessments of taxable income (or net income) and taxable income equal to the amounts set out in their income tax returns (section 166A of the *Income Tax Assessment Act 1936* (the 1936 Act)).

20. The Commissioner is able to require the lodgment of annual returns of income by publishing a notice in the Gazette (section 161 of the 1936 Act).

21. Those returns must be in a form approved in writing by the Commissioner. Also, they must contain any prescribed information (section 161A of the 1936 Act).[4] This is elaborated on in Part 4 of the Income Tax Regulations (about returns and assessments). In summary, the regulations require:

- *all* returns to:
  - be made and furnished in such of the forms provided by the Commissioner for the purposes as is applicable;
  - contain the information and particulars mentioned or referred to in that form; and
  - be accompanied by all such balance sheets, profit and loss accounts, statements and other documents, as are mentioned in the form or as are requisite (regulation 15); and
- *company* returns to set out a statement that reconciles their net profit as shown in the profit and loss account to net taxable income (regulation 17).

22. The Commissioner's approved form effectively sets out the way taxable income is to be worked out. Importantly, there is no intention under the TVM to require taxpayers, particularly companies, to work out taxable income differently. Especially, when taxpayers have established systems in place.

Reconciling accounting profit to taxable income

The basics

23. Basically, accounting profit does not equal taxable income for these reasons:

- it includes items that it shouldn't;
- of the items that should be included, it uses different amounts; and
- it omits certain items.

24. On that basis, a reconciliation is needed because accounting profit takes into account different *items* and uses different *amounts.* These factors reduce to one: a

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[4] This extends to electronic returns (subsection 161A(2)).

difference in amount. Accounting profit, from an income tax perspective, includes amounts that it shouldn't and fails to include amounts that it should.

25. Thus a process of reconciliation is required. This entails a series of adjustments. The process, simply put, is one of deciding what's in and what's out. The result is a series of increasing and decreasing adjustments.

26. Importantly, it is accounting profit that is modified to get to taxable income. This means that any adjustments must work with items set out in the profit and loss account or statement (see paragraph 34).

Current law adjustments[5]

27. *Increasing* adjustments under the current law result from:

- an accounting expense that is *not* an allowable deduction, for example an expense that:
  - is not a 'loss or outgoing', such as income tax *expense*;[6]
  - is not 'incurred', such as provisions for leave;
  - is 'capital' in nature, such as expenses in building plant; or
  - is expressly denied deductibility, such as entertainment expenses;
- an accounting expense that is an allowable deduction, but the expense is more than the deduction;
- assessable income that is *not* accounting revenue, for example a notional or deemed amount, such as the amount by which franked dividends are grossed up; and
- assessable income that is accounting revenue, but the income is more than the revenue.

28. *Decreasing* adjustments under the current law are made for:

- an allowable deduction that is *not* an accounting expense, for example carry forward tax losses;
- an allowable deduction that is an accounting expense, but the deduction is more than the expense;
- accounting revenue that is *not* assessable income, for example some upward asset revaluations; and
- accounting revenue that is assessable income, but the revenue is more than the assessable income.

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[5] While all of the adjustments set out are technically possible, they are not all equally likely.
[6] This possibility is often subsumed under the consideration of 'incurred', but it is logically distinct.

TVM adjustments[7]

29. *Increasing* adjustments under the TVM would be made for:

- an accounting expense that does *not* decrease net income, for example an expense that is:
  - *not* an expenditure,[8] such as income tax expense and provisions for leave; or
  - an expenditure that is matched by an increase in the tax value of net assets, such as expenses in building plant;
- an accounting expense that decreases net income, but the expense is more than the decrease;
- an increase in net income that is *not* accounting revenue;
- an increase in net income that is accounting revenue, but the increase is more than the revenue; and
- an increasing adjustment (which forms half of the income tax law adjustment), such as in the case of entertainment expenses and franked dividends that must be grossed up.

30. *Decreasing* adjustments under the TVM would be made for:

- a decrease in net income that is *not* an accounting expense;
- a decrease in net income that is an accounting expense, but the decrease is more than the expense;
- accounting revenue that does *not* increase net income, for example some upward asset revaluations;
- accounting revenue that increases net income, but the revenue is more than the increase; and
- a decreasing adjustment (which forms the other half of the income tax law adjustment) and an unused tax loss.

What's the difference?

31. The difference is in how the adjustments are described, not in what they do and how they are calculated.

32. The TVM does not change the *nature* of the amounts that make up taxable income. But it does better reflect the concepts that show why certain amounts are taken into account. For example, the reason for deducting depreciation becomes clearer when it is seen as a fall in an asset's value. In better reflecting the concepts that underpin the income tax law, the TVM uses a new language (i.e. receipts, payments, assets, liabilities, income tax law adjustment, and unused tax losses). As a result, the adjustments required by the TVM are sometimes described in different

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7 Once again, all of the following adjustments are technically possible, but not all are likely.

8 Payment of money, transfer of an asset, or assumption of a liability.

terms or language, but the outcome remains the same as that achieved under the current law.

33. This is exactly how it should be because the TVM is not designed to change broad outcomes.

34. Importantly, the TVM does not change how items are reported in a profit and loss statement. Therefore, reconciliations of accounting profit to taxable income would continue to add back revenue and expense items when adjusting for movements in accounting value.

35. As an example, accounting depreciation may be less than what the income tax law would allow. Under the current law and the TVM, taxpayers would add back depreciation expense (as it appears in the profit and loss statement).[9] Then, under the current law, taxpayers would subtract their depreciation deduction for the asset. Under the TVM, taxpayers would add back their decrease in the tax value of the asset. While the name of the adjustment may sometimes change, the same calculation is performed – one which works out the decline in the asset for income tax purposes.

What should all this mean?

36. All this should mean that taxpayers will be able to continue reconciling from accounting profits when working out their taxable income. The same sort of calculations will be necessary; the same sort of results will be obtained; however, those results will be explained using different conceptual building blocks, with some consequent changes in language. It should also follow that taxpayers will not be required to maintain any new asset registers nor report the opening and closing tax values of every asset.

[9] Depreciation expense is the same thing as a decrease in accounting value.