Comments on Option 3[*]

1. Purpose

1.1 The purpose of this Paper is to provide the TVM Legislation Group's comments on Mr Geoff Lehmann's draft of the 'Option 3' proposal, dated 15 February 2002. We hope that these comments will be viewed as constructive input into the Option 3 process. By conducting 'quality assurance' on Option 3, we seek to contribute to the development of a better product for evaluation.

1.2 The paper covers 4 general matters:

- Legislative intent;
- Policy issues;
- Structure; and
- Technical issues.

2. Overview

2.1 The comments in this paper are to the effect that:

- Option 3 does not currently demonstrate any motivating principles, or if it does, they are not clear. Instead, it appears as a patchwork of miscellaneous rules. Its lack of coherence could cause it to be interpreted and applied in unintended ways.
- The policy foundation is unclear. To be a benchmark against which to assess the tax value method (TVM), it would need to apply the same policies as the TVM draft (e.g. *A Tax System Redesigned* (ATSR) recommendations on rights and financial arrangements).
- As a result of the above, the current structure of the legislation is complex.
- The legislation relies too much on the legal form of arrangements, meaning that it could lead to inequitable outcomes and is not robust.
- There appear to be a number of technical flaws in the current draft.

2.2 The Option 3 process could do the following to deal with these issues:

- Create a legislative intent document that clearly sets out the existing problems that Option 3 is seeking to address, and its motivating principles and policy platform.
- After that is done, undertake further legislative drafting to reflect more clearly that intent and fix the technical flaws that currently exist in it.

3. Legislative intent

3.1 Option 3 does not identify a set of core motivating principles that are intended to underpin the income tax system. It appears, like the current law, as a patchwork of miscellaneous rules.

---

[*] This paper has been prepared by the TVM Legislation Group. It has not been endorsed by the Government, Board of Taxation, Treasury or ATO.

3.2 What are the fundamental ideas driving Option 3? What does Option 3 recognise as being important to the tax system, and what does it recognise as being unimportant? In particular:

- *what* gains are taxed, *when* are they taxed, and *what is the amount* to be brought into the tax base?
- *what* losses are given relief, *when* are they given that relief, and *what is the amount* to be subtracted from the tax base?

3.3 Like the current law, Option 3 appears to be built upon an unstated set of policy principles. These principles are held in the collective consciousness of our tax policy makers; they are important because they explain the logic behind what is taxed and when.

Two approaches to tax law

3.4 There are 2 basic approaches to drafting income tax law:

- feed specific factual scenarios (e.g. 'loan' or 'equity raising') into the unstated policy principles, and see what 'answers' come out. Then draft rules to give those answers when the facts that were fed in happen; or
- take the unstated principles, and draft them into the law so that they are no longer unstated.

3.5 Option 3 appears to adopt the first approach. It seems to leave the true intention of the tax system unexplained. Instead, it provides a large list of narrow legal categories in order to arrive at the unstated policy outcome.

3.6 Take as an example the exclusion lists in sections 6-10 and 8-5 of the Option 3 draft. What is the principle lying behind these lists? Specifically, what characteristic does a receipt or expenditure have which causes it to become included in section 6-10 or 8-5? How would a practitioner, the ATO or a Court interpret the section if a matter does not squarely fall within the narrow legal forms expressed within it? (As explained below, the exclusion lists in sections 6-10 and 8-5 are likely to be long if they are to operate as intended.)

3.7 In order to make Option 3 a valid benchmark against which to assess TVM, it must have as a goal the achievement of a 'more robust and durable tax system'.[1] In our view, this cannot be achieved unless Option 3 has a stated intent which flows through, and colours, interpretation of the more specific categories it creates. Even if this intent is not drafted into the law, it should be a stated methodology to be consistently applied in shaping and structuring the provisions that appear in the law.

4. Policy issues

4.1 The stated purpose of Option 3[2] is to provide a benchmark against which to assess the merits of TVM. Logically, one cannot compare the performance of 2 systems unless they are (or aspects of them are) doing the same (or at least analogous) things.

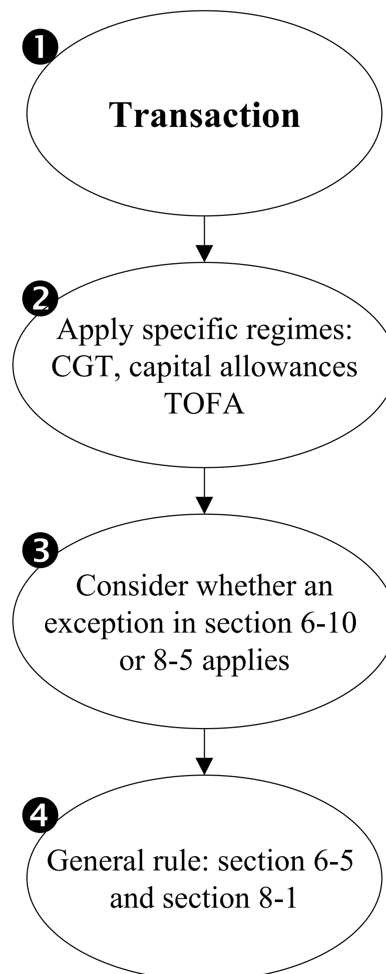
[1] ATSR, Recommendation 4.1(a).
[2] Refer to minutes of TVM Working Group meeting 14 February 2002, p. 2.

4.2 Accordingly, Option 3 is only a valid benchmark against which to assess TVM if it implements the same policy outcomes that TVM would. Option 3, it seems, fails to do this in a majority of cases. We intend to provide another document, as soon as we can, that sets out how Option 3 deals with each ATSR policy recommendation included in the TVM demonstration legislation.

5. Structure

5.1 Applying legislation usually involves a 'decision-making process' of some kind. For example, TVM has the pattern: 'is there an asset? → is it held? → what is its tax value?'.

5.2 Arguably, the structure of Option 3 is difficult to follow because it requires a complex decision-making process. The 'decision tree' behind Option 3 appears to follow this pattern:



5.3 The first thing a reader needs to consider for any transaction is whether it falls within CGT, capital allowances, or TOFA.[3] If it does, the reader jumps immediately into those rules and has little further to do with the core provisions, other than to determine the meaning of 'cost' and 'proceeds'. If none of the specific regimes apply, the reader then needs to consider whether any of the exceptions in sections 6-10 or

[3] The latter two are assumed, since they do not appear in the Option 3 draft.

8-5 apply to the transaction. If none apply, the reader is then free to apply the general rule in section 6-5 or 8-1.

5.4 The result of this structure is a recursive, 'bottom-up', and 'fractured' narrative:

- *Recursive* – because it requires the reader to first consider particular regimes and then refer to core provisions;
- *Bottom-up* – because it turns the pyramid in section 2-5 of the *Income Tax Assessment Act 1997* (ITAA 1997) upside-down by making the 'specialist groupings' in the tax law more important in the decision-making process than the 'core provisions'; and
- *Fractured* – because it places unrelated provisions next to each other without explaining any linkage between them.[4] For example, a reader unfamiliar with tax law would be at a loss to know why Division 9 includes rules about the cost of an asset, given that they have read nothing elsewhere in the legislation to suggest why cost, or indeed assets, are relevant to the tax law.

6. Technical issues - overview

6.1 In sections 7 to 15 of this Paper, there are a number of specific comments about particular provisions in the Option 3 draft. Although they are diverse in nature, many of the comments have a recurrent theme. Because Option 3 relies upon narrow legal concepts to articulate the subject-matter of the tax base, great efforts will be necessary to articulate every different type of legal arrangement which has a similar economic effect. This is likely to lead to legislation that is complex. Frequent amendment would likely be required as new forms of arrangement are devised in the future.

6.2 Failure to articulate these matters will lead to horizontal inequity, as well as exploitation through aggressive tax planning.

7. Assessable income

7.1 In a sense, subsection 6-1(1) is tautologous. It specifies that assessable income means 'the eligible income you derived'. Yet eligible income is, *by definition*, an amount derived: subsection 6-5(1). Thus, the only thing which subsection 6-1(1) adds is the notion of derivation occurring 'directly or indirectly from all sources' during a year.

7.2 But a threshold requirement of subsection 6-1(1) is that 'eligible income' can be identified. If subsection 6-5(1) is not satisfied, there is nothing to which subsection 6-1(1) can apply. Arguably, therefore, the 'directly or indirectly requirement' adds nothing. If an amount derived 'indirectly' is not something which subsection 6-5(1) naturally covers, subsection 6-1(1) cannot operate, because there is no 'eligible income' to which it can attach.

7.3 The fact that the drafter of subsection 6-5(2) of the ITAA 1997 found it necessary to refer to 'directly or indirectly' implies that, without these words, indirect

---

[4] See further, paragraph 13.1, below.

derivation may not occur. There is a risk, therefore, that indirect derivation would not occur under subsection 6-5(1) of Option 3, either.

8. What is eligible income?

8.1 Under subsection 6-5(1), eligible income 'includes' all amounts that an entity 'derives', except the amounts referred to in section 6-10. The word 'includes' implies that there are amounts *other than* 'amounts you derive' that are included in the concept of eligible income; i.e. that the term 'eligible income' has some inherent or ordinary meaning. This can be contrasted with subsection 6-5(1) of the ITAA 1997, which includes ordinary income within the intentionally broader concept of assessable income ('ordinary income' has an inherent or ordinary meaning). What is the inherent or ordinary meaning of 'eligible income'? Does it refer to what we now understand to be income according to ordinary concepts?

Deriving 'income' vs deriving 'an amount'

8.2 Subsection 6-5(1) refers to the derivation of *amounts* rather than *income*; it therefore ventures into unfamiliar territory. What conceptual gap, if any, exists between the concept of deriving income and deriving an 'amount'?

8.3 This is not a mere splitting of hairs. The case law on derivation[5] has as much to do with *what income is*, as it has to do with *what 'derive' means*. As Professor Parsons notes, derivation is:[6]

> *... an element in the notion of income*

8.4 This is why Dixon J's judgment in *Carden's case* turned upon the nature of 'income, profits and gains',[7] 'recurrent accrual of advantages',[8] or 'true income'[9]; not upon the word 'derive'.

8.5 Indeed, the structure of Option 3 itself, and in particular, the existence of section 6-10, confirms that the concept of 'amounts you derive' does not cover the same ground as that covered by the concept of deriving income. If amounts you derive' was the same thing as 'ordinary income you derive', section 6-10 would be unnecessary.

8.6 There are 2 reasonable interpretations of 'amounts you derive' which produce results that lie at opposite ends of the tax spectrum.

The expansive interpretation

8.7 Firstly, subsection 6-5(1) could be read as creating a substantial expansion in the tax base.

---

[5] e.g. *C of T (SA) v Executor Trustee & Agency Co of South Australia* (1938) 63 CLR 108; 1 AITR 416; *Henderson v FC of T* 70 ATC 4016; 1 ATR 596.
[6] Parsons R.W. *Income Taxation in Australia*, paragraph 2.24.
[7] *C of T (SA) v Executor Trustee & Agency Co of South Australia* (1938) 63 CLR 108 at 152.
[8] As above.
[9] As above at 154.

8.8 In *Evans v FC of T (SA)* (1936) 55 CLR 80, mining company Guinea Gold NL acquired leases in New Guinea, which it eventually sold to independent companies, in return for paid-up shares in those companies. Most of these shares had a market value that was less than their face value, such that the transaction represented a book profit, but an economic loss, on the sales. These shares were distributed by Guinea to its members, including Mr Evans. By majority, the High Court included the accretion in market value of Mr Evans' shares in his assessable income, under sub-subparagraph 16(b)(i)(1) of the *Income Tax Assessment Act 1922-1930*. That provision specified that the assessable income of a shareholder:

> *shall include dividends, bonuses or profits paid or distributed by the company to a shareholder… out of profit derived by the company from any source.*

8.9 An exception to this rule provided that an amount would *not* be income where the profit arose from the sale of assets not acquired for the purpose of resale at a profit. The shares Guinea had received were not exchanged for assets acquired for this purpose. Since the shares were recorded at a value that was more than the cost of the leases, Guinea shareholders sought refuge under the exception for the entire share dividend.

8.10 Amongst other things, it was argued that, since the expenses incurred in connection with the leases were well in excess of the market value of the shares, there was no realised profit from the leases and therefore no derivation of a profit for the purposes of sub-subparagraph 16(b)(i)(1). In rejecting this argument, the High Court noted at 101:

> *The word 'derived' does not connote that the profit must be a realised profit. It is enough at least if it is an ascertained profit, ascertained by a proper account.*

8.11 Thus, the concept of eligible income opens up the possibility, at least, of bringing unrealised gains into the tax base. There is arguably no inherent requirement in the word 'amount' or 'derive' limiting gains to things that are realised. No recourse can be had to Professor Parsons' Proposition 1 here, which only provides that items '*of an income character*' are derived when they 'come-home'.

8.12 The interaction here with the timing rule in section 9-75 is difficult to conceptualise. If an unrealised amount is 'derived' under section 6-5, but is never reflected in the taxpayer's accounts, when is it brought to account? But, in any event, sometimes asset revaluations are recognised in a taxpayer's accounts,[10] so, at least in these cases, that fact in itself would strengthen the broad interpretation of 'derive' set out here.

8.13 Is the expansive interpretation of subsection 6-5(1) a good one? Perhaps; perhaps not. But the fact that this issue is arguable at all is surely cause for concern.

---

[10] See AASB 1041, *Revaluation of non-current assets*.

The narrow interpretation

8.14 Secondly, subsection 6-5(1) could alternatively be read far more narrowly, leading to a substantial shrinkage in the tax base. That is, only 'amounts' that are received, actually or constructively, are to be regarded as being derived. On this view, 'derived' simply means 'obtained' or 'got' or 'acquired'.[11]

8.15 If that interpretation was adopted, accruals tax accounting would be at an end, unless subsection 6-20(1) is to be relied upon to keep it alive. If not, a right to payment on 1 July Year 2 is not income as at 30 June Year 1.

8.16 How are the facts of *Arthur Murray (NSW) Pty Ltd v FC of T* (1965) 114 CLR 314 treated if this interpretation is correct? Would the dance teacher would be assessed up-front on amounts received, regardless of what services are performed or when? Or would the timing rule in section 9-75 resolve this?

8.17 Further, the body of law holding that reductions in liability can be ordinary income would seem to fall away.[12] On the face of it, this seems inconsistent with the ATSR recommendations on extinguishment gains.[13]

What is the 'amount' we are talking about?

8.18 Another difficult issue arises from the 'amounts that you derive' approach, even if we assume that it means something similar to section 6-5 of the ITAA 1997.

8.19 This difficulty is analogous to the difficulty in the current income tax law, which contains both gain and flow concepts of income, yet provides us with no coherent principles for distinguishing between the two.[14]

> Example 1 Willford Pty Ltd acquires a building in Year 1, to secure access to beachside accommodation for its shareholders. Willford's principal function is to hold the building for that purpose. In Year 13, all the shares in Willford are purchased by an insurance company and a land development company for $1.6 million. This amount represents the market value of the building.
>
> Willford's articles are changed on that date to enable refurbishment of the building. The article relating to the original purpose of providing shareholders with access to the building is removed. Willford commences refurbishment of the building on a massive scale, spending $6 million in the following 5 years. The building is then sold at the end of Year 18 for $13 million.
>
> What 'amount' has Willford derived? $7 million, $5.4 million, or $13 million?

8.20 This raises the question of how subsection 6-5(1) interacts with subsection 8-1(1). Does one ignore subsection 8-1(1) if a 'gain theory' of amounts derived is applied, or does one rely upon the anti-overlap rule in section 9-5 to prevent tax relief

---

[11] *FC of T v Clarke* (1927) 40 CLR 247 per Isaacs ACJ at 260.
[12] e.g. *Warner Music Australia Pty Ltd v FC of T* 96 ATC 5046; *International Nickel Australia Ltd v FC of T* 77 ATC 4383.
[13] ATSR Recommendation 6.8.
[14] e.g. *Australian Catholic Assurance Co Ltd v FC of T* (1959) 11 ATD 577, *FC of T v McClelland* 69 ATC 4001, *FC of T v Whitfords Beach Pty Ltd* (1982) 150 CLR 355; 12 ATR 692; 82 ATC 4031; *Commercial & General Acceptance Ltd v FC of T* 77 ATC 4375;

from being claimed twice for a single set of expenses? There are problems with both approaches. The first, because it is not supported by the words of the legislation. The second, for similar reasons. If you claim an 'implicit deduction' by assessing a net amount under subsection 6-5(1), you are not really being allowed a deduction at all; you are simply being assessed on less income. Technically, therefore, section 9-5 has no application in these circumstances.

8.21 These problems are exacerbated by the mixture of gain and flow concepts that arise from the interaction between subsections 6-5(2) and (3) and section 10-5.

Adding to or changing what would otherwise be included in your eligible income

8.22 Subsections 6-5(2) and (3) provide that where an amount 'that would otherwise be included in your eligible income' is changed by a provision in section 10-5, the changed amount is included in eligible income.

8.23 Subsection 6-5(3) is not very clear. The problem with this provision arises, in part, from Option 3's attempt to create a workable interaction between a flow concept and a gain concept. This is done by providing that certain flows should be ignored where they are subject to gain calculations. The legislation then lists a whole variety of provisions that give rise to gain calculations. This means that Option 3 deals with flows and gains separately and then has multiple gain calculations. As a result, the current design of Option 3 is disjunctive and repetitive.

Amounts applied or dealt with

8.24 An entity is taken to have received an amount as soon as it is applied or dealt with in any way on the entity's behalf or as they direct: subsection 6-5(4). This provision raises the prospect of economic double-taxation because there is no symmetrical constructive payment rule.

Example 2 Federal Coal Pty Ltd is a subsidiary of Bembi Co Ltd, a coal producer. Bembi's supply contract with a French nickel company Societe Anonyme Le Dime is cancelled. Le Dime offers to pay Bembi $1 million in compensation for lost revenue, but upon legal advice, Bembi instructs Le Dime to pay the money to Federal instead.

Federal is arguably taxed on $1 million under subsection 6-5(1). Meanwhile, Bembi is also taxed on the same amount under subsection 6-5(4).

9. What is not eligible income

9.1 Section 6-10 lists a number of things that are *not* eligible income. Given the enormous scope of section 6-5, this is a very important provision, which has a lot of work to do.

9.2 As foreshadowed,[15] we believe this provision would be better put together if it expressed some type of principle in a more abstract sense, which could then have an operation in a range of circumstances. The default outcome arising from section 6-5 seems to be that if something is not specifically listed, it gets assessed, even though, economically, it may be matched by a liability. This approach will give rise to

[15] See above, paragraph 3.6.

positive 'black holes'. It implies that the legislative process would involve constant amendment to section 6-10, in order to respond each time economic circumstances arise that do not fall within the narrow legal confines of the section 6-10 list.

What is a 'loan'?

9.3 Paragraph 6-10(b) excludes from eligible income repayments of the principal of a loan made by an entity and deposits of money held by that entity with a financial institution.

9.4 What is a 'loan'? Legally, it is the delivery by one party to and receipt by another party of a sum of money upon agreement, express or implied, to repay it with or without interest (*Black's Law Dictionary*; *McGain v FC of T* (1965) 13 ATD 556; (1965) 112 CLR 523).

9.5 It is important to note that judicial characterisation of debt instruments turns largely upon legal form rather than economic substance. In particular, because a loan is legally a delivery of money coupled with a promise of 'repayment', it would arguably not cover arrangements which are regarded as the purchase and sale of an asset.

Discounted bills are arguably not loans

9.6 For example, in most cases a discounted bill is economically identical to a loan. But is it a 'loan' for the purposes of paragraph 6-10(b)? There are very sound arguments to suggest that it is not.

9.7 The juridical nature of a discounted bill was discussed by the House of Lords in *Willingdale (Inspector of Taxes) v International Commercial Bank Ltd* [1978] 1 All ER 754. There, the House drew a distinction between a discounted bill and a loan at interest on the basis that a bill was the sale of an asset whereas a loan was the provision of a service (i.e. the making available of loan funds).[16] The case discusses bills in the context of the party acquiring them, but the reasoning is clearly applicable to the issuer as well (see below, paragraph 12.6).

9.8 Lord Salmon held at 756:

> *The difference between the price at which the bank buys the bill, and the bill's face value is something referred to as 'a discount'. A discount however is different from interest; it is not earned nor does it accrue from day to day.*

9.9 And, Lord Fraser of Tullybelton noted at 759-760:

> *The solution to the problem depends in my opinion on the true nature of what the bank is doing when it discounts or purchases a bill. In my view it is acquiring an asset and, so long as it continues to hold that asset, it does not, and cannot, realise any profit or loss in respect of it.*

---

[16] See also: *Chow Yoong Hong v Choong Fah Rubber Manufactory* [1962] AC 209*; Olds Discount Co Ltd v John Playfair Ltd* [1938] 3 ER 275.

9.10 His Lordship continued later, at 761:

> *When the bank purchases or discounts a bill it does not, except in a very loose sense, render services to the borrower; it acquires an asset. Accordingly, no payment has been earned by services given in the earlier years (i.e. years between the date of purchase of the bill and its maturity) nor are any services completely rendered then.*

9.11 And, Lord Keith of Kinkel at 766:

> *The substance as well as the form of these transactions are such, in my opinion, that the bank is by them acquiring assets which in the future it expects to realise at a profit. It is not reasonably to be regarded as rendering services to the issuers of the bills for which the latter there and then becomes liable to pay.*

9.12 Thus, the proceeds (both 'capital' and 'interest') received on maturation of a bill of exchange are likely to be fully assessable under section 6-5. This represents a significant departure from current tax policy.

9.13 Of course this could be remedied simply by adding the capital component of the proceeds from maturation of a bill of exchange to the list in section 6-10. Arguably, however, this example is illustrative of a more significant problem with Option 3.

9.14 If one excludes bills of exchange, where does it end? Excluding 'bill of exchange' within the meaning of section 8 of the *Bills of Exchange Act 1909*, would still not cover many debt arrangements which, although economically very similar to a bill, will not satisfy this definition (e.g. because they are 'conditional' in some way).[17] Do we add 'and instruments with substantially the effect of a bill of exchange'? If so, what will this mean? In particular, the whole approach of section 6-10 appears incapable of dealing with financial innovation.

Purchased annuities are not loans

9.15 Most purchased annuities are economically identical to loans, but are not regarded as such at common law.[18]

9.16 In the absence of special provisions such as section 27H of the *Income Tax Assessment Act 1936* (ITAA 1936), it would seem that repayments of what is, economically, the principal amount of purchased annuities would be fully assessable under section 6-5 of the Option 3 draft. Where the economic cost of the annuity is not cash, returns of capital in these circumstances are seemingly fully assessable.[19]

[17] Under subsection 8(1) of the *Bills of Exchange Act*, a bill must be an 'unconditional order'.
[18] *Australian & New Zealand Savings Bank Ltd v FC of T* (1993) 25 ATR 369; 93 ATC 4370; *Egerton-Warburton v DFC of T* (1934) 51 CLR 568.
[19] *Egerton-Warburton v DFC of T* (1934) 51 CLR 568.

Payments of principal by trustee

9.17 Paragraph 6-10(c) is very broad. Seemingly, it renders all distributions by a trustee tax-free in the hands of the beneficiary. It refers to a 'principal amount' of money, yet there does not seem to be any requirement of a loan or debt.

What are the proceeds of 'borrowings'?

9.18 Paragraph 6-10(d) raises parallel issues to those discussed above at paragraphs 9.6 to 9.12. Borrowing is not the same as discounting a bill; as Somerville LJ noted in *Revenue Commissioners v Rowntree & Cot Ltd* [1948] 1 All ER 482 at 486:

> *... there are two ways at least (there may be more) of raising money. One is by borrowing it and the other is by discounting a bill of exchange. They are both quite well known methods. One is borrowing and the other is discounting a bill. The fact that in many cases they produce the same result of providing financial resources for carrying on a business does not mean that the words which are apt to describe one must be construed as covering the other.*

9.19 It seems highly arguable, therefore, that the proceeds of issuing or selling a bill of exchange are fully assessable under section 6-5.

9.20 It is far from clear how paragraph 6-10(d) is intended to interact with item 5 of the table in section 10-5. Transactions falling with the TOFA regime would appear to be covered by subsection 6-5(3). Does this mean that any amount which arises from a borrowing is picked up by item 5 in section 10-5? If so, paragraph 6-10(d) would seem unnecessary.

What are the proceeds of an equity raising?

9.21 Paragraph 6-10(e) raises similar issues. What does 'equity raising' mean? It does not appear to be a term with any particular meaning at common law.

Mutuality principle

9.22 Paragraph 6-10(h) is of concern. It identifies something called 'the mutuality principle'. Yet with section 6-5 having removed the notion of ordinary income, it follows there can be such no such thing as a 'mutuality principle' in the tax law, at least as currently understood.

9.23 The principle of mutuality derives from the proposition that one cannot derive income from oneself: *Bohemians Club v Acting FC of T* (1918) 24 CLR 334. That is:[20]

> *A man is not the source of his own income.*

9.24 Note that the principle applies to *income*; not to 'amounts' generally.

Loyalty programs

9.25 Paragraph 6-10(j) ignores the fact that in some circumstances, benefits from loyalty programs are properly assessable under current law. For example, such benefits can be assessable where:[21]

---

[20] *Bohemians Club v Acting FC of T* (1918) 24 CLR 334 per Griffith CJ at 337.

- a person renders a service on the basis that an entitlement to a flight reward will arise (e.g. a person enters into a secretarial service contract with an understanding that they will get a flight reward); or
- in a business context, where the activities associated with the obtaining of the benefits amount in themselves to a business activity.

10. Consideration not in money

10.1 Subsection 6-20(1) contains the core non-cash transaction rule in Option 3.

Deemed derivation

10.2 Does subsection 6-20(1) operate as intended? Rather than removing illiquidity as a barrier to derivation,[22] section 6-20 actually makes illiquidity *a trigger-point for derivation*. So, while cash consideration must be actually 'derived', non-cash consideration received is always derived because it is deemed to be so. This means, for example, that the *Arthur Murray*[23] principle, and the timing test in section 9-75 could never apply in a non-cash transaction.

> Example 4 Kurt settles a parcel of shares on the Nirvana Unit Trust, and in return is given units in the trust. The market value of the shares is deemed to be included in Nirvana's net income under subsection 6-20(1).
>
> The exception in paragraph 6-10(g) does not apply, because the shares are not an 'amount' settled on the trust.

Use of the term 'consideration'

10.3 Subsection 6-20(2) states that consideration can arise under non-contractual arrangements. This particular specification suggests that the word 'consideration' is not appropriate. Even though the arrangement can be non-contractual it still needs to be a transaction and there is some doubt as to whether a grant, for instance, could be called a transaction.

Timing

10.4 Section 6-20 refers to 'an amount equal to the market value' of the consideration, but gives no indication of the time at which that market value is to be worked out.

Executory contracts

10.5 An executory promise is good consideration under a contract. Seemingly, Option 3's non-cash transaction rule will tax an entity on the market value of any unperformed promise it gets, even if it is contingent in nature.

> Example 5 On 30 June, Year 1, Accountant Henderson agrees to perform accounting services for client Coughlan. In return Coughlan promises to pay Henderson in the future, should the services be performed and be properly billable.
>
> Under subsection 6-20(1), the market value of Coughlan's contingent promise is included in Henderson's assessable income for Year 1.

---

[21] See *Taxation Ruling* TR 1999/6, paragraph 9.
[22] This is what section 21A of the ITAA 1936 does, for example.
[23] *Arthur Murray (NSW) Pty Ltd v FC of T* (1965) 114 CLR 314.

Does Henderson have an offsetting deduction under subsection 8-15(2)? Clearly not, as Henderson does not 'use' the contingent right to payment in circumstances which make the market value of his services deductible (indeed, these are *never* deductible).
.

10.6 There are 2 problems with this treatment:

- firstly, the value of a contingent right is being brought into the tax base; and
- in any case, Henderson's offsetting liability to provide services to Coughlan is not recognised at all.

10.7 Effectively, the accountant is taxed on money *he has not earned and may never receive*.

Non-arm's length transactions

10.8 Subsection 6-20(3) provides for a very harsh anti-avoidance treatment.

10.9 Subsection 6-20(3) excludes deemed derivation only where what is received is 'arm's length' consideration for money. This means that where the payment of money is *not* arm's length consideration, an entity is deemed to derive the market value of the asset received under subsection 6-20(1).

10.10 The treatment is unfair if the party paying money pays a less-than-arm's-length amount:

Example 6 Buckstar Pty Ltd purchases professional services from Max Macro for $5,000 cash. Buckstar and Mr Macro are not dealing at arm's length. The consideration which might reasonably be expected to have been received for the services in respect of this transaction between arm's length parties is $10,000.

Under subsection 6-20(3), Buckstar must include $10,000 in its income (the market value of the services). As there is no arm's-length rule for below-market payments, Buckstar only gets a deduction of $5,000 for the services. Overall, therefore, Buckstar has taxable income of $5,000. Buckstar is being taxed on a net sum of $5,000, when in fact it should be getting a deduction for the $5,000 it has paid.

Mr Macro has received $5,000; there is no rule to increase this amount to the arm's length value.

Government grants etc

10.11 Subsection 6-20(5) represents a departure from current tax policy in some cases. Approvals, permits, licenses and other rights received in consideration for the performance of services could be assessable under section 6-5 of the ITAA 1997 and section 21A of the ITAA 1936.

Exercising a right or option

10.12 Subsection 6-20(6) provides that the market value of an asset acquired through the 'exercise' of an option or right is not an amount that is included in an entity's eligible income.

10.13 Because this provision only applies to an 'exercise', it would seem to allow the taxation of unrealised gains (or recognition of unrealised losses) in some circumstances.

Example 7 On 30 June, Year 1, Unrealised Ltd sells an office block and land to Gain Pty Ltd for $5 million. Settlement will not occur until 14 August, Year 2.

As at 30 June, Year 1, Gain Pty Ltd has a right to conveyance of building and land.[24]

In Year 2, Gain's right to conveyance is discharged and it receives legal title to the building and land. The market value of the building and land at this time is $6 million. Arguably, subsection 6-20(1) deems Gain to have derived $6 million. Subsection 6-20(6) has no application, because there is no 'exercise' of anything by Gain. Seemingly, the disappearance of Gain's right does not give rise to a deduction of $6 million under subsection 8-15(2). This is because the cost of the right is included in the cost of the land and building under subsection 9-30, and subsection 8-5(3) would therefore apply. It would seem that Gain is either taxed on:

- $6 million at the time of conveyance; or;
- $1 million if the right is treated like a depreciating asset and a 'balancing charge' arises upon conveyance.

11. General deductions

11.1 Arguably, section 8-1 gives an entity an up-front deduction for the purchase price of all assets other than those falling within the capital gains tax rules. It must be assumed that this approach is not intended.[25]

11.2 Presumably, the intention is to allow a prima facie deduction for this expenditure, but then to overlay a capital allowances regime onto it, so that the 'no double counting' rule in section 9-5 effectively excludes the operation of section 8-1.[26] Is this a correct understanding of what is intended?

Properly referable

11.3 The use of the 'properly referable' concept in subsection 8-1(1) is difficult to understand. It appears to be a defined term, yet the 'definition' in subsection 9-75(2) has recourse to the principles of accounting; principles which do not include any 'properly referable' concept. See further, paragraphs 15.1 to 15.5 below.

12. Outgoings that are not deductible

12.1 The problems outlined above with respect to section 6-10 apply equally to section 8-5.This provision removes the income-capital dichotomy from the law and replaces it with a list. Because this list is made up of narrow legal categories, this is

---

[24] In a sense, it is the equitable owner of the land: *Lysaght v Edwards* (1876) 2 Ch D 499.
[25] This seems to be implied in the note at the end of section 9-75 and item 6 of the table in section 10-5, which indicate that Option 3 would have a capital allowances regime.
[26] It is not clear whether, technically, section 9-5 would perform this task. The 'amount' an entity pays to purchase a depreciating asset is arguably not the same 'amount' that it deducts over time as the adjustable value of the asset declines in accordance with the prime cost or diminishing value formula. Under the current law, section 40-215 is used to remove doubt.

likely to be an inefficient structure. We believe this provision would be better put together if it expressed some type of principle in a more abstract sense, which could then have an operation in a range of circumstances.

12.2 The default outcome arising from section 8-1 seems to be that if something is not specifically listed, it is deductible, even though some enduring or future benefit is created by it. This approach will give rise to 'white holes' (that is, tax relief for non-existent expenditure). It implies that the legislative process would involve constant amendment to section 8-5, in order to respond each time economic circumstances arise that do not fall within the narrow legal confines of the section 8-10 list.

12.3 Section 8-5 also seems to highlight a potential discontinuity in the structure of Option 3. That is, where an amount is paid by a taxpayer that amount may be excluded by virtue of section 8-5. However, the amount excluded by section 8-5 is not picked up by any other of the operative provisions of the legislation that may need to deal with the subject matter of the exclusion. It is necessary to have another provision in the legislation which does that. This creates the risk of discontinuity which may lead to double counting of gains or losses, or gaps. For instance, a repayment of a principal amount on a borrowing is excluded. It is then necessary to have in the debt forgiveness provisions another provision which seeks to identify this payment to then determine whether any amount is forgiven. This is a duplication and means that the structure of the legislation is currently inefficient.

Payments of a private or domestic nature

12.4 Paragraph 8-5(1)(a) excludes payments of an individual or partnership of a private or domestic nature from general deductions. Presumably, therefore, the market value of private or domestic assets provided by such an entity is fully deductible under section 8-15 provided what is received is assessable. This would be the case, even if the thing received is of a private or domestic nature (as noted above at paragraph **Error! Reference source not found.**, non-cash private assets are assessable under section 6-5).

Borrowings

12.5 Paragraph 8-5(1)(c) specifies that an outgoing is not deductible to the extent that it is repayment of 'the principal amount of a borrowing'. This provision highlights a difficulty that has already been noted. It is likely that this provision will only apply to those arrangements which are regarded as loans at general law.

Bills of exchange

12.6 As the analysis at paragraphs 9.6 to 9.12 above suggests, the purchaser of a bill is not technically making a loan. It is unlikely, therefore that paragraph 8-5(1)(c) would apply to a bill of exchange.

Purchased annuities

12.7 A purchased annuity is economically identical to a loan but the juristic nature of each is different.[27] Even though every payment under a purchased annuity typically contains what is, economically, a return of principal, the courts do not view it as such.

[27] e.g. *Australian & New Zealand Savings Bank Ltd v FC of T* (1993) 25 ATR 369; 93 ATC 4370; *Egerton-Warburton v DFC of T* (1934) 51 CLR 568.

Thus, without special rules, Option 3 would effectively allow deductions for principal and interest under arrangements of this kind.

Finance leases

12.8 Equally, a finance lease can be structured in such a way that it is commercially indistinguishable from a loan.[28] Yet Option 3 as it stands would seem to confirm an entity's ability to deduct what amounts, economically, to a return of principal in these circumstances.

A 'mutuality principle' for deductions?

12.9 The reference to 'outgoings that come within the mutuality principle' in paragraph 8-5(i) is likely to give rise to uncertainty.

12.10 Arguably, the mutuality principle is about income; it only has an effect on the general deduction provisions under the current law because of the apportionment mechanism contained in the nexus test in subsection 8-1(1) of the ITAA 1997. But there is no such nexus in Option 3. Subsection 8-1(1) contains no linkage between deductibility and income.

13. Cost of an asset – general

13.1 A reader is likely to be confused when coming to the cost rule in section 9-20. How does the notion of 'cost' fit into the formula for assessable income? Moreover, where does the notion of an 'asset' fit? Once a reader finds out what the cost of an asset is, what do they do with the answer? Because of the disjunctive or fractured structure used, the relevance of the cost rule may be at-large for many readers.

13.2 Also, the general cost rule gives rise to black holes and duplicated tax relief.

Black holes for non-monetary costs

13.3 There is an obvious lacuna in the general cost rule. As subsection 9-20(2) is currently drafted, only those assets acquired for *monetary* expenditure occurring within the year of acquisition will have a cost. This represents a significant departure from current tax policy.

Example 8 Cornell Ltd purchases an item of industrial plant on 15 January, Year 1, for $20 million. Cornell undertakes to pay for the plant in 6 months time.

As Cornell pays nothing to hold the plant during Year 1, the cost of the plant for that year is nil. (Compare this to the current law, where Cornell would have 165 days of depreciation on the plant during Year 1).

13.4 Even if 'amount you pay' is read broadly enough to make it apply to amounts that will be paid in the future, the cost rule does not implement the TOFA recommendations relating to the use of discounted values to reflect embedded debt in arrangements spanning more than 12 months.[29]

---

[28] e.g. *FC of T v South Australian Battery Makers Pty Ltd* (1978) 8 ATR 879; 78 ATC 4412; *Metal Manufactures Ltd v FC of T* (2001) 46 ATR 497; 2001 ATC 4152.

[29] See ATSR Recommendations 9.2 and 4.7.

13.5 There are a number of other ways in which subsection 9-20(2) does not properly recognise the concept of cost. In particular, the following economic costs are ignored:

- market value of non-cash assets given in return for the asset;
- services performed for the asset;
- reductions in another entity's pre-existing liabilities agreed to in return for the asset.

Duplicated tax relief

13.6 Section 9-20 seems to allow entities double tax relief for most capital expenditure. Provided the asset is not a CGT asset, an entity can claim relief for the purchase price under section 8-1, and then *also* include the expenditure in the cost of the asset under section 9-20. The 'no double deduction' rule in section 9-5 does not apply, because inclusion in cost is not a 'deduction'.

14. Proceeds of realising an asset – general

14.1 The above comments regarding section 9-20 apply *mutatis mutandis* to section 9-55; for example, non-cash consideration (including promises to pay money) is not taken into account at all.

15. Timing of assessable income and deductions

15.1 Subsection 9-75(2) provides that the 'treatment' that would result from applying generally accepted accounting principles determines the timing of derivation and referability for income tax purposes. Yet there is no 'treatment' of income or deductions in the accounting standards; these are revenue law concepts. Accountants do not recognise derivation, nor do they rely on any concept of referability[30] (even though they may recognise concepts which are arguably analogous to these things).

15.2 If an accountant were to consider the items which under tax law are regarded as being derived or incurred, one would expect them to come up with a 'treatment' along the following lines:

- 'This amount is revenue';
- 'This amount is an expense';
- 'This amount forms part of the cost of an asset';

15.3 These treatments say little, if anything, about the timing for tax purposes. Do they mean, for example, that a receipt regarded as being revenue in the profit and loss statement in Year 1 should be regarded as income derived in Year 1? If so, arriving at this interpretation involves reading a very large amount into the actual words of subsection 9-75(2).

15.4 Consider the following example.

Example 9 At the start of Year 1, Gossard Pty Ltd promises to pay the Vedder Trust $10,000 at the end of Year 2. Under SAC 4, Gossard is regarded as having a present obligation in Year 1 to make a future sacrifice of service potential in Vedder's

[30] The 'referability' concept was invented by the High Court in *New Zealand Flax Investments Pty Ltd v FC of T* (1938) 61 CLR 179; it does not appear anywhere in *Statement of Accounting Concepts* SAC 4.

favour.

Further, under SAC 4 the $10,000 is not recognised as an expense in Year 1, because the loss of service potential represented by the $10,000 liability has not yet occurred.

What does the existence of an accounting liability tells us about when the $10,000 can be deducted? The test for deductibility proposed under section 8-1 requires one to consider whether there is an 'outgoing' that has been 'incurred'. How is this reconciled with the accounting 'treatment' referred to in section 9-75?

Equally, what does the fact that the liability is not expensed in Gossard's Year 1 operating statement say about when section 8-1 recognises it as deductible for tax purposes? The accounting 'treatment' referred to in subsection 9-75(2) will never involve claiming (or refraining from claiming) a deduction, because deductions are a taxation concept.

15.5 There may well be an analogy between accounting revenue and assessable income, and between accounting expenses and income tax deductions. Equally, there may be an analogy between the concept of 'properly referable' referred to in *Coles Myer Finance Ltd v FC of T* 93 ATC 4214; (1993) 25 ATR 524 and the concept of 'matching' in SAC 4.[31] Yet taxpayers should not be required to invent imaginative economic analogies in order to comply with the taxation laws.

Incongruence between accounting and tax

15.6 How is section 9-75 supposed to apply where there is an incongruence between the amounts recognised for the purposes of the tax law and the amounts recognised in the accounts? Consider the following example.

Example 10 During Year 1, Gore Pty Ltd incurs expenditure of $140. At the end of Year 1, Gore has a deduction of $175 under the section 8-1 / the R&D provisions. For accounting purposes, however, Gore only records $80 dollars as an expense in Year 1. It will record $60 in Year 2.

How does the test in subsection 9-75(2) apply here? Does Gore:

- get a deduction of $80 in Year 1 and the remaining $95 in Year 2? (a 'quantum' approach); or
- get a deduction of $100 in Year 1 and $75 in Year 2? (a 'pro-rata' approach); or
- something else?

Method applied 'consistently'

15.7 Several of the provisions in section 9-75 refer to applying one method or other 'consistently'. There seems to be uncertainty about what this might mean.

15.8 For example, does it mean that one method, once chosen, must be applied forever more? Can the method change as the taxpayer's circumstances change? If so, how are the transitional issues dealt with, for example to ensure there is no lacuna in the gains or losses recognised?

[31] See SAC 4, paragraph 138.

‘True and fair result’

15.9 Subsections 9-75(4) and (5) seem to introduce uncertainty. What does ‘true and fair result’ mean?

15.10 Does it have the same meaning as the concept of ‘true and fair view’ used in section 297 of the *Corporations Act 2001* or is it an oblique reference to some notion of a ‘substantially correct reflex’?[32] Arguably, the linkage between what is a ‘true and fair view’ for auditing purposes and what is a ‘true and fair result’ for tax purposes is tenuous at best. In an audit context, trueness and fairness involves a judgment about the economic position of the reporting entity. The notion of considering the fairness of a *result* in a tax context suggests that a court should have regard to general notions of fairness when determining how much tax a business should pay.

Individuals

15.11 Subsection 9-75(4) seems very uncertain. It implies that an individual can choose exclusively between a cash system and an accruals system, and if it chooses the latter it must apply something close to accounting standards (implying that the approach cannot be exactly like accounting standards).

15.12 This approach seems inconsistent with current tax policy.

15.13 First, the cash accounting system in the current law is only a cash system in respect of some transactions and amounts. It is an accruals system in respect of other amounts (e.g. amounts receivable for disposal of assets, amounts paid that are the cost of assets, accrual on some financial assets). Subsection 9-75(4) implies that an individual can choose a pure cashflow system, where all cash outgoings are deductible and all cash incomings are assessable.

15.14 Second, it implies that individuals must have some knowledge of, and actually apply, accounting standards in some loose sense. This seems problematic from a compliance, and probably also a political, perspective.

16. List of additions and changes to eligible income

16.1 Section 10-5 sets out a number of instances where separate mechanisms will be necessary to calculate net gains. This repetition indicates that the current structure of Option 3 is unlikely to be efficient.

16.2 All of the provisions listed in section 10-5 include *amounts of income* in eligible and assessable income. Yet items 1 and 5 refer to ‘changes’. Having regard to the wording of subsection 6-5(3), it appears clearly arguable that an amount of income arises, *even if the value of an asset falls*. So, for example, an entity would appear to be taxed on the *fall* in the value of their trading stock over an income year. We assume this is not intended.

16.3 Perhaps section 10-5 should be amended so that it includes

- increases in the value for tax purposes of assets (e.g. trading stock and financial assets that accrue);

[32] *C of T (SA) v Executor Trustee & Agency Co of South Australia* (1938) 63 CLR 108; 1 AITR 416.

- decreases in the value for tax purposes of liabilities (e.g. debt forgiveness and gains on the redemption of liabilities).

16.4 Section 12-5 could then deal with the converse.

TVM Legislation Group
25 March 2002