FOR DISCUSSION PURPOSES

TAX VALUE METHOD WORKING DRAFT (Revised Chapter 19, September 2001)

EXPLANATORY MATERIAL

Status of the working draft

1. This explanatory material that is accompanying the draft Tax Value Method (TVM) legislation has been prepared under the auspices of the Board of Taxation. It will form part of a broader legislative framework that the Board is seeking to develop to effectively demonstrate the TVM concept and to allow comprehensive evaluation and testing of it. Depending on outcomes, the Board ultimately will make recommendations to the Government as to whether the TVM should or should not proceed.

2. As such, the draft legislation and this explanatory material have not been endorsed by the Treasurer or any other Minister, nor does it reflect the official views of the Treasury, the Australian Taxation Office, the Office of the Parliamentary Counsel or the Board of Taxation.

Work in progress

3. The draft legislation and this explanatory material are works in progress ('prototypes'). They are not being put forward as the final product or even as what the final product would look like. Rather, they are being exposed as the present state of the draft TVM legislation. Significant additions and deletions may be made to these drafts.

4. It is important to recognise also that in developing the TVM legislative framework it has been necessary, in some circumstances, to make assumptions about the taxation treatment of particular transactions. As with the structure of the legislation itself, those assumptions may be subject to change with further consideration of the issues, and should be regarded as in no way prejudicing any future consideration the Government may give to the relevant issues.

5. Further elements of the draft TVM legislative framework and associated explanatory material will be released on this website as and when they are developed.

Comments Welcome

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

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

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

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

Chapter 19
Overview of investment asset treatment (formerly capital gains tax regime)

Outline of Chapter

19.1 This Chapter outlines how the investment asset rules will operate under the Tax Value Method. The proposed operation of the investment asset rules is compared to the current Capital Gains Tax (CGT) regime which they replace.

Context of reform

19.2 Under the current law, capital gains do not form part of ordinary income. Accordingly, the tax law requires special statutory income rules[1], 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.

19.3 The Tax Value Method will, however, as a matter of principle and structure include such gains and 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, gains and losses from pre-CGT assets (as defined in the current law, which covers 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.

19.4 Under the Tax Value Method, the regime will be known as investment asset treatment. The language of ‘capital gains tax’ under the current law reflects that without the special rules in that regime, gains or losses to which the CGT regime applies would not be included in the income calculation of a taxpayer. The term ‘investment asset treatment’ reflects that the gains or losses covered by this regime are simply another class of assets (like depreciating assets and trading stock) that gets a specific treatment under the law.

19.5 The purpose of the investment asset rules under the Tax Value Method is not to separately include investment asset gains and losses in net income but rather to maintain:

[1] Parts 3-1 to 3-3 of the ITAA 97.

- concessional treatment for some investment asset gains (e.g. the 50% discount for individuals); and
- quarantining of investment asset losses.

Investment asset 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 investment asset rules many of these events can be dealt with by a single rule that isolates investment asset gains or losses from ceasing to hold an investment 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.

Investment 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 an asset bought with a profit making intention[2] 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 an investment asset will limit the definition to those assets that should get the investment asset treatment, ensuring that there can be no overlap between provisions.

Use of common core rules

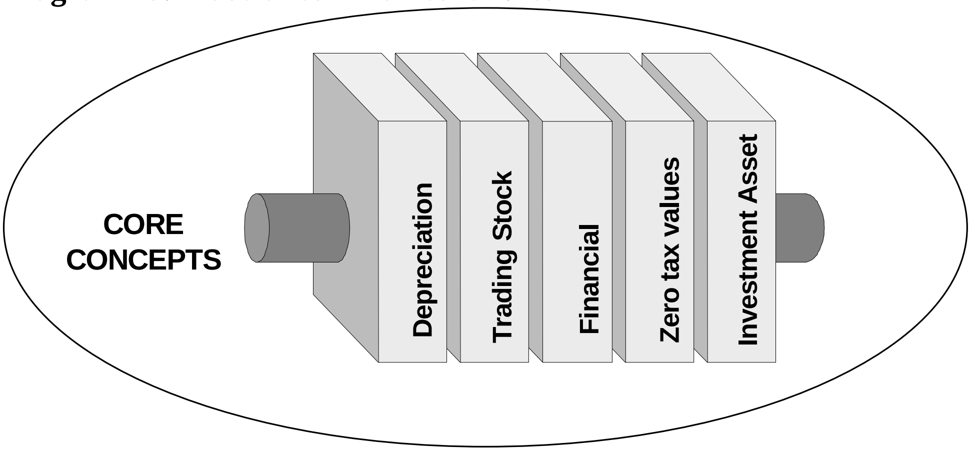
19.11 Currently the CGT regime contains a range of provisions that deal with the cost base of assets, disposal proceeds, non-cash transactions and non-arm's length transactions. This is necessary because the current tax system deals with these issues differently in different statutory provisions.

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

2 The asset is not trading stock.

will also be included under the Tax Value Method.[3] Again this will mean that separate provisions are not needed in the Tax Value Method investment asset rules to deal with such transactions. The following diagram illustrates this:

Diagram 19.1 Use of common core rules



Summary of proposed law

19.13 The Tax Value Method investment asset treatment provisions will retain, for investment assets, the discount treatment and the loss quarantining that applies under the current law to CGT assets.

19.14 The Tax Value Method investment asset rules will identify the amount of the investment asset gains or losses included in net income. This will then allow any investment asset discounting and loss quarantining to be applied to these investment asset gains and losses as a taxable income adjustment.

19.15 The effect of the current CGT rules dealing with roll-overs, exemptions and small business concessions will be retained under the Tax Value Method. These provisions will not be part of the investment asset treatment rules but, rather, will be dealt with separately.

When will investment asset treatment apply?

19.16 Ceasing to hold an investment asset will be the main case in which the amount of an investment asset gain or loss is identified. However, a limited number of other investment asset events that apply to investment assets in other situations will be needed under the Tax Value Method to identify the investment asset gains or losses that do not arise from ceasing to hold the asset. ***[Section 100-25]***

3 *ATSR* recommendation 6.17.

19.17 The working draft includes 2 further investment asset events:[4]

- Capital return by company event[5];
- Trust capital distribution event.[6]

[Subdivision 100-D]

19.18 See the Attachment 'Proposed outcome under TVM of existing events' for further analysis of each current event.

Working out the taxable income adjustments

19.19 Amounts included in the net income formula from investment asset gains or losses may be fully or partially offset by upward and downward adjustments to produce the correct investment asset treatment outcome. Taxable income adjustments will, for example[7]:

- apply the discount to discountable gains; and
- quarantine carry forward investment asset losses.

19.20 In essence, the taxable income adjustments for ceasing to hold an investment asset will be worked out in this way:

Step 1 Work out each investment asset gain or loss

The amount of any investment asset gain or loss will be worked out by subtracting the tax value of the asset (which is usually cost) and certain expenses associated with ceasing to hold the asset from the proceeds of realising the asset. ***[Subsection 100-45(1)]***

Step 2 Apply exemptions and roll-overs

The gain or loss is then adjusted for any exemptions or roll-overs that apply. ***[Section 100-65]***

Step 3 Compare gains and losses to work out adjustments

The investment asset losses for the income year will be subtracted from the investment asset gains for the income year:

4 It is possible that a small number of other events analogous to existing CGT events will be required (E3 – converting a trust to a unit trust; J1 - Company stops being member of wholly-owned group after roll-over; K2 - Bankrupt pays amount in relation to debt; K4 – conversion of CGT asset to trading stock; and K7 - Disposal of depreciating asset used for private purposes). An equivalent of Event K5 will not be required, however a special rule will attach to ceasing to hold the shares or trust interests.

5 This is the current G1.

6 This is the current E4.

7 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).

- if the investment asset losses for the income year exceed the investment asset gains for the year you have a ***carry forward investment asset loss*** for the year, equal to the excess. There will be an ***upward adjustment*** equal to the amount of the loss (to quarantine the loss).

- if the investment asset gains for the income year exceed the investment asset losses for the year:
  - carry forward investment asset 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;
  - for any remaining investment asset gains, there will be a ***downward adjustment*** equal to the discount percentage multiplied by each investment asset gain that qualifies as a discountable gain.

[Section 100-75]

What is an investment asset?

19.21 An investment asset will be defined as an asset whose tax value is worked out under item 8, 8A[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. ***[Section 100-35]***

Treatment of collectables

19.22 Under the current law special rules about collectables and personal use assets are dealt with in the CGT provisions in Division 108 (subdivisions 108-B and 108-C). Under the Tax Value Method, collectables will be dealt with as part of the private or domestic rules. The main effect of the rules on collectables will be to quarantine investment asset losses from certain collectables to investment asset gains from those collectables. ***[Division 12A]***

Comparison of key features of working draft and current law

Comparison of core provisions

19.23 The following table sets out how some key concepts apply in the working draft compared to the existing CGT provisions.

8 Item 8A of the main tax value table in section 6-40 is a new item applying to shares in companies and interests in trusts.

Working draft	***Current Law***
Investment Asset Events	
Investment asset treatment will apply when an investment asset event happens. It is expected that a small number of events will apply. The main case will be when an investment asset ceases to be held.	Capital gains tax treatment applies when a CGT event happens. There are 39 CGT events under the current law.
Investment Assets	
Investment assets are broadly all assets other than depreciating assets, trading stock and financial assets (see items 8, 8A 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.
Net Income	
Gains and losses from investment assets will be automatically included in the net income formula. The investment asset 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 key terms

19.24 The following table compares the key terms used in the Tax Value Method investment asset rules with the equivalent terms in the existing CGT provisions.

Working draft	***Current Law***
Investment asset	CGT asset
Investment asset event	CGT event
Investment asset gain	Capital gain
Discountable gain	Discount capital gain
Investment asset loss	Capital loss
Carry forward investment asset loss	Net capital loss
[No equivalent needed]	Net capital gain

Comparison of Divisions in current law to treatment under the Tax Value Method

19.25 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.

Working draft	***Current Law***
Guide	
Section 100-1 is a guide setting out how the investment asset treatment rules apply.	Division 100 provides a guide to the rules on capital gains and losses.
Objects	
Subdivision 100-A sets out the objects of investment asset treatment.	No equivalent.
Identifying investment asset gains and losses	
Subdivision 100-B sets out how to identify the investment asset gain or loss that has been included in net income. The subdivision identifies each investment asset gain or loss for the income year.	Section 102-5 provides that assessable income includes a net capital gain. Section 102-20 provides that you make capital gains or losses from a CGT event.
Investment assets	
Investment assets are defined in section 100-35 by reference to the items in the asset tax value table (subsection 6-40(1)). (See paragraph 19.21.)	Section 108-5 defines a CGT asset as any kind of property, or a legal or equitable right that is not property.
Taxable income adjustment	
Subdivision 100-C aggregates the investment asset gains or losses for an income year and shows you how to calculate your taxable income adjustments.	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).
Other investment asset events	
Subdivision 100-D sets out the other investment asset events. These are the events that apply in addition to the main case – ceasing to hold an asset. They are the non-dividend payment for shares event and the trust capital distribution event. As indicated at paragraph 19.17 up to 5 further events may be required.	Division 104 sets out 39 CGT events that result in capital gains or losses being recognised.

Working draft	***Current Law***
Discountable gains	
Subdivision 100-E provides for certain gains 'discountable gains' to be reduced by the discount percentage when working out downward adjustments.	Division 115 provides for the application of a discount percentage to certain net capital gains, including special rules for trusts.
Non-cash transactions and currency conversion	
No investment asset rules are required to deal with this issue. The Tax Value Method core rules contain non-cash transaction rules (Division 8 of the working draft) and will contain currency conversion rules.	Division 103 deals with non-cash transactions and has rules for currency conversion.
Entity making the gain or loss	
Provisions having a similar effect to Division 106 of the current law may 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.
Acquisition of investment 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.

Working draft	***Current Law***
Indexation of cost base	
Provisions will be required to adjust for indexation in appropriate circumstances by way of a taxable income adjustment.	Division 114 provides for indexing the cost base of an asset.
Proceeds of realisation	
These rules will be 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.

Attachment

Proposed outcome under TVM of existing CGT events

Event	Description	Fully Considered	Retain Yes/No/?	Explanation
A1	A1 Disposal of a CGT asset	Yes	Yes	Main case – ceasing to hold an asset – covered by working draft, see section 100-45.
B1	B1 Use and enjoyment before title passes	Yes	No	Main case - ceasing to hold rule applies under the working draft, as the hold rules state that holding starts/ceases when the use and enjoyment passes (item 5 of the table in subsection 6-21(1)).
C1	Loss or destruction of a CGT asset	Yes	No	Main case – ceasing to hold rule applies under the working draft– you will no longer hold the asset at the point of loss or destruction.
C2	Cancellation, surrender and similar endings	Yes	No	Main case – ceasing to hold rule applies under the working draft.
C3	End of option to acquire shares etc.	Yes	No	Core rules and depreciating liability rules to apply.
D1	Creating contractual or other rights	Yes	No	Core rules and depreciating liability rules to apply.
D2	Granting an option	Yes	No	Core rules and depreciating liability rules to apply.
D3	Granting a right to income from mining		No	Core rules and depreciating liability rules to apply.
E1	Creating a trust over a CGT asset		No	Main case - *ceasing to hold applies under the working draft.
E2	Transferring a CGT asset to a trust		No	Main case - *ceasing to hold applies under the working draft.
E3	Converting a trust to a unit trust		?	*May be required.
E4	Capital payment for trust interest	Yes	Yes	*Event will be required.
E5	Beneficiary becoming entitled to a trust asset		No	Main case - *ceasing to hold applies under the working draft.
E6	Disposal to beneficiary to end income right		No	Main case - *ceasing to hold applies under the working draft.

Event	**Description**	**Fully Considered**	**Retain Yes/No/?**	**Explanation**
E7	Disposal to beneficiary to end capital interest		No	Main case - *ceasing to hold applies under the working draft.
E8	Disposal by beneficiary of capital interest		No	Main case - *ceasing to hold applies under the working draft.
E9	Creating a trust over future property		No	Core rules apply.
F1	Granting a lease		No	Core rules and depreciating asset/liability regime to apply.
F2	Granting a long term lease		No	Main case - issue to be dealt with in asset holding rules.
F3	Lessor pays lessee to get lease changed		No	Core rules and depreciating asset/liability regime to apply.
F4	Lessee receives payment for changing lease		No	Core rules and depreciating asset/liability regime to apply.
F5	Lessor receives payment for changing lease		No	Core rules and depreciating asset/liability regime to apply.
G1	Capital payment for shares	Yes	Yes	CGT event included in the working draft – see section 100-85.
G2	Shifts in share values		No	Act-wide rules dealing with value shifting.
G3	Liquidator declares shares worthless		No	Main case – issue to be dealt with in asset holding rules, or perhaps the shares cease to be an asset.
H1	Forfeiture of a deposit	Yes	No	Core rules apply. CGT discount not available on gain currently.
H2	Receipt for event relating to a CGT asset	Yes	No	Core rules apply.
I1	Individual or company stops being a resident		No	Act-wide rules dealing with international issues.
I2	Trust stops being a resident trust		No	Act-wide rules dealing with international issues.
J1	Company stops being member of wholly-owned group after roll-over		?	May be required – to be considered when roll over provisions dealt with.

Event	**Description**	**Fully Considered**	**Retain Yes/No/?**	**Explanation**
J2	Change in status of a CGT asset that was a replacement asset in a roll-over under Subdivision 152-E		No	Will be addressed in the roll over provisions.
J3	A change happens in circumstances where a share in a company or an interest in a trust was a replacement asset in a roll-over under Subdivision 152-E		No	Will be addressed in the roll over provisions.
K1	Partial realisation of intellectual property right		No	Not a CGT asset, depreciating asset/liability regime to apply.
K2	Bankrupt pays amount in relation to debt		?	May be dealt with together with non-CGT losses.
K3	Asset passing to tax-advantaged entity		No	Will be addressed in cost/proceeds rules.
K4	CGT asset starts being trading stock		?	The existing trading stock provisions deems a disposal of the asset when it becomes trading stock. Recommendation 4.9 in *ATSR* deals with the change in the status of an asset to or from a CGT asset. This issue could be examined further when trading stock and roll-over rules are developed.
K5	Special capital loss from collectable that has fallen in market value when CGT event A1, C2 or E8 happens to shares in the company, or an interest in the trust, that owns the collectable	Yes	No	No event needed under TVM but there is a special rule in the working draft to deal with this – see section 12A-170.
K6	Pre-CGT shares or trust interest		No	Similar treatment to be provided in the provisions dealing with pre-CGT assets.

Event	**Description**	**Fully Considered**	**Retain Yes/No/?**	**Explanation**
K7	Disposal of depreciating asset used for private purposes		?	May be required.
		Total 12	**Total** Yes 3 No 31 ? 5	

* The treatment may be affected by any future review of trust issues.