
TAX VALUE METHOD
Demonstration legislation
(Prototype 4, March 2002)

EXPLANATORY MATERIAL

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Status of the demonstration legislation and explanatory material

1. The tax value method (TVM) demonstration legislation and accompanying explanatory material have been prepared under the auspices of the Board of Taxation. They set out the legislative framework that the Board has developed 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 TVM should or should not proceed.
2. As such, the demonstration legislation and 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 demonstration legislation and explanatory material are works in progress ('prototypes'). This is the fourth prototype TVM demonstration legislation to be released since the Board's consultative process began early in 2001. This prototype and explanatory material are not being put forward as the final product or even as what the final product would necessarily look like. Rather, they are being exposed as the present state of the TVM demonstration legislation. Should the process continue, significant additions and deletions could be made to these drafts in the future.
4. It is important to recognise also that in developing the TVM demonstration legislation and explanatory material it has been necessary, in some circumstances, to make assumptions about the taxation treatment of particular transactions. As with the demonstration legislation and explanatory material themselves, 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.

Comments Welcome

5. The exposure of the demonstration legislation and explanatory material reflects a broad consultative approach being taken to this particular piece of legislation by the Board of Taxation. This recognises the potential importance of TVM to the income tax system and the Board's wish to evaluate TVM in light of all perspectives.

6. Comments on the demonstration legislation and explanatory material are welcome. Comments in writing should be addressed to:

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7. Alternatively, comments can be e-mailed to the Board of Taxation Secretariat through its website at 'www.taxboard.gov.au'.

How to use the explanatory material

1. The explanatory material is designed to help readers understand the Prototype 4. It is divided into 3 parts:

- An introductory part that gives an overview of TVM and explains its relationship to Australia's current income tax and accounting systems (Part 1).
- A part that provides a detailed explanation of the various provisions in the prototype legislation (Part 2).
- A part that sets out the anticipated legislative treatment of various subjects for which prototype legislation has not yet been drafted, including a proposed legislative structure for TVM (Part 3).

Chapters in Part 2

2. Each chapter in Part 2 of this explanatory material is structured in the same way. They each set out:

- an 'overview' setting out what is explained in the chapter;
- a section dealing with the 'context of reform' explaining what reforms (if any) are dealt with in the chapter and what existing areas of law are relevant;
- a 'summary of prototype legislation' giving an overview of how the proposed law explained in the chapter works;
- a 'comparison of key features of prototype legislation and current law' showing how the prototype legislation compares to the equivalent provisions (if any) in the current law; and
- a 'detailed explanation of prototype legislation' giving an in-depth technical explanation of the proposed law covered by the chapter.

Acronyms and abbreviations used in the explanatory material

3. The Glossary that follows explains acronyms and abbreviations used in this explanatory material.

References to provisions in the prototype legislation

4. Wherever the explanatory material explains the effect of a provision in the prototype legislation, it contains a reference to that provision in square brackets with bold italic text. The index at the back of this explanatory material shows where in the material that provision is mentioned.

Examples used in the explanatory material

5. The explanatory material sets out a large number of examples of how the prototype legislation would be intended to operate. Where these examples show calculations under TVM's net income formula, they first set out that formula for the convenience of readers. That formula, which is explained at paragraph 1.9 of Chapter 1, is:

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

6. You should note the following when reading these examples:

- For convenience, the element 'receipts – payments' only is shown, but the prototype legislation provides for taxpayers who are not individuals¹ to work out this component as 'closing cash – opening cash'.
- To make it easier to understand how TVM works, the effect of GST has not been taken into account in the examples. Instead, Chapter 20 explains the anticipated effect on TVM of GST.

¹ Including partnerships with one or more partners who are individuals.

Glossary

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

<i>Abbreviation</i>	<i>Meaning</i>
ATSR	<i>A Tax System Redesigned: Overview, Recommendations, Estimated Impacts, July 1999. (Often referred to as the ‘Ralph Report’)</i>
CGT	capital gains tax
GST	goods and services tax
ITAA 1922	<i>Income Tax Assessment Act 1922</i>
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
PE	permanent establishment
prototype legislation	tax value method demonstration legislation (Prototype 4)
RBT	Review of Business Taxation (1999)
SAC 4	Statement of Accounting Concepts 4
STS	simplified tax system for small business
TOFA	taxation of financial arrangements
TVM	tax value method

PART 1:
OVERVIEW

Chapter 1

What is TVM?

Outline of Chapter

1.1 This Chapter explains what the tax value method (TVM) is and how it would tax income.

TVM provides a new structure for the income tax law

In short

1.2 TVM 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 TVM 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.

1.4 TVM's 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 and rules for the cost of assets.

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:

- TVM's core rules would get directly to the result that some existing detailed rules are needed to get to; and²
- the number of disparate rules that currently exist would be reduced by standardising the treatment of assets and liabilities under TVM.

Taxable income under TVM

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 TVM. Instead of being:

assessable income – deductions

as it is in the ITAA 1997, taxable income under TVM 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' component 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 TVM, however, is done in the 'net income' part of taxable income. This is the net income formula:³

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

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

TVM would apply to all taxpayers

1.10 Given that TVM 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

² The 'investment asset' rules in the prototype legislation, that replace the current CGT rules, are an example of the reduction in detail that is possible under TVM (see Chapter 15).

³ 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). Taxpayers that are not individuals, or partnerships with one or more individuals as partners, may work out 'receipts – payments' as their 'closing cash – opening cash'.

were being calculated under the new approach.⁴ 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 TVM recognises gains and losses

1.11 TVM 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 TVM applies to all transactions, other than private or domestic transactions.

Receipts and payments

1.12 The first component of net income under TVM 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). Indeed, the TVM prototype legislation allows taxpayers, other than individuals and partnerships with individuals as partners, to work out their cash flow in this way.

Matched receipts and payments

1.13 Under TVM, 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.

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 TVM recognises a taxpayer's assets and liabilities, other than private assets and liabilities. It does this by assigning them a tax value.

⁴ This is discussed further in the *Tax Value Method Information Paper* (March 2002) issued with the prototype legislation.

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.⁵

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.⁶

How common situations are treated under TVM

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 TVM law in producing tax outcomes, and illustrates the earlier discussion at paragraphs 1.11 to 1.17. The methodologies taxpayers could use to work out their taxable income in practice are further discussed in the *Tax Value Method Information Paper* (March 2002).

Simple revenue expense

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

Example 1.1

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

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

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

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

⁵ ‘Taxing points’ are the times at which gains are taxed and tax relief is given for losses.

⁶ This is part of the policy recommendations dealing with the taxation of financial arrangements (TOFA) – see section 9 of ATSR.

The payments side of the formula has increased, so that ‘deductions’ have gone up. The result is the same because a payment under TVM 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 retains that character 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 rules⁷ 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.

TVM 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 prepayment has this effect on net income:

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

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

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’.

⁷ For example, section 82KZM and following of the ITAA 1936 and section 70-15 of the ITAA 1997.

1.22 The result is that the current law's special prepayment rules are not needed to get the same policy outcome under TVM.

1.23 However, under TVM 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 FC of T*⁸ would support the cleaner bringing the prepayment to account as the work is 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.

TVM 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:

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

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

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 TVM.

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.

⁸ (1965) 114 CLR 314.

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 TVM 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:

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

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

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 TVM 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 (‘CGT assets’ are called ‘investment assets’ under TVM).

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.

TVM 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 investment assets under TVM is their cost.⁹ So, applying the net income formula to the transaction in the income year you bought the land would look like this:

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

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

Note how, instead of deciding deductibility by asking whether an expense was income or capital, TVM allows a reduction for *all* payments¹⁰ 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.

Now see what happens when the land is sold in the tenth year:¹¹

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

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

1.30 In the case of investment asset gains, though, a number of special rules are needed to achieve particular policy objectives. The 2 main ones are:

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

⁹ 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.

¹⁰ Subject to the exclusion for private or domestic amounts.

¹¹ Assume the sale proceeds go into cash on hand and are not used to buy a new asset.

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

Depreciation

1.32 Although many 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.

TVM 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:¹²

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

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

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.

¹² 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.

Under TVM, 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:¹³

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

The \$500 gain is a normal incident of TVM. No special balancing adjustment rules are needed.

Trading stock

1.33 Trading stock under TVM 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 TVM.

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.¹⁴

1.35 TVM achieves the same result without the need for a special rule.

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:

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

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

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.¹⁵

¹³ Again, assume the sale proceeds go into cash on hand and are not used to buy a new asset.

¹⁴ See subsection 70-15(3) of the ITAA 1997.

¹⁵ This assumes a continuation of the current trading stock valuation methods. ATSR recommended different valuation methods (see recommendation 4.17).

Chapter 2

The relationship between TVM and the current income tax law

Outline of Chapter

2.1 This Chapter broadly explains how TVM has evolved out of our current income tax law and compares it to the way the current law sets out the tax base. The *Tax Value Method Information Paper* (March 2002) also discusses this issue.

The evolution of our income tax law

Our early income tax law

2.2 The British government enacted the world's first significant income tax law during the Napoleonic wars in the late eighteenth century. The Commonwealth of Australia enacted its first income tax law in 1915.¹⁶

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).¹⁷

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.

¹⁶ The Australian States had income tax laws before this.

¹⁷ 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.¹⁸

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.¹⁹ 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*²⁰ 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.

¹⁸ 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).

¹⁹ Paragraph (ba) of the definition of ‘income’ in section 4 of the ITAA 1922; paragraph 26(a) of the ITAA 1936.

²⁰ 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 has made the trend quite 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 TVM structure). The TOFA proposals, for instance, would bring to account gains and losses on some financial assets on an accruals basis.²¹

2.17 What became clear to the Ralph Committee was that the existing description of the tax base had become outdated.²²

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.²³

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

How is TVM similar to the current income tax system?

2.20 The general income and deduction provisions²⁴ 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 are 'depreciating assets' and whether they are used in the required circumstances. Those depreciating assets can then be written off, and for

²¹ Some gains on financial assets are already accrued under the current law (see Division 16E of Part III of the ITAA 1936).

²² ATSR, page 156.

²³ See more on this at paragraphs 2.33 to 2.37.

²⁴ Divisions 6 and 8 of the ITAA 1997.

that purpose they are given a cost by the depreciation provisions. 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.²⁵

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 of the TVM. In essence, it is a tax value method provision.²⁶

2.26 It operates by the application of the TVM 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 TVM.

²⁵ Section 25-25 of the ITAA 1997.

²⁶ To demonstrate this conclusion refer to ATSR, page 159.

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 TVM principles are also relevant to more fundamental areas found originally in the ITAA 1936. In *Whitford's Beach Pty Ltd v FCT*²⁷, 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*²⁸ 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 TVM. Under the accruals method, income is assessed when it is derived. In essence, this means that where a taxpayer holds a receivable at year end (that was not held at the beginning of the year), the value of that receivable should be included in the taxpayer's assessable income. Under the general deduction provision, a taxpayer is allowed a deduction for a loss or outgoing incurred, even if not yet paid. Restated, where a liability exists at year end, the amount of the liability, its tax value, should be an allowable deduction in the calculation of the taxpayer's assessable income.

2.32 As this discussion demonstrates, the principles of TVM 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

²⁷ 82 ATC 4,031.

²⁸ 74 ATC 4,169.

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 TVM.

Will TVM always produce the same tax outcomes as the current law?

2.33 As a general statement, TVM 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.²⁹

2.36 Also, inherent in TVM 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 TVM 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 TVM 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 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 TVM.

2.37 The *Tax Value Method Information Paper* (March 2002) discusses these issues further.

²⁹

Section 9 of ATSR.

Chapter 3

The relationship between TVM and current accounting concepts

Outline of Chapter

3.1 TVM uses asset and liability concepts to express the calculation of taxable income in the prototype legislation.

3.2 By drawing together the conceptual similarities of TVM and accounting, this Chapter also highlights TVM's relationship to contemporary accounting practice.

Synopsis

3.3 The cornerstone of TVM are the rules relating to:

- what is an asset or liability;
- who holds the asset or has the liability; and
- what is the tax value of that asset or liability.

3.4 These rules would play a major role in re-configuring the current system of calculating taxable income into a framework that would narrow the conceptual gap between income tax law and accounting. This Chapter illustrates that by showing the commonality that is evident between TVM and accounting; for instance when an entity accounts for the tax effect of transactions and when it reports on its financial performance.

3.5 Even though TVM's framework is largely the same as that used in accounting that does not mean that taxable income would always equate to accounting profit. Rather, the results generated by TVM are to be engineered to achieve the Government's tax policy outcomes. However TVM's standardised structure will make those adjustments more readily identifiable than they are under the current law.

Extent of the relationship

3.6 Accounting concepts exist for financial reporting reasons (i.e. to provide information useful to users for making and evaluating decisions about the allocation of scarce resources).³⁰ Taxation law, however, “is designed to raise revenue for the government or to encourage investment in specified areas which the government sees as socially desirable”.³¹

3.7 Underlying these distinct purposes, both accounting and income tax law require the calculation and measurement of financial performance.³² It is at this level that a common relationship can exist between accounting practice and income tax law.

The relationship under the current law

3.8 Some features of the current law are analogous to accounting concepts. But even in its most basic elements, the current law differs from the accounting conceptual framework because it does not provide a consistent and systematic model for recognising assets and liabilities.

3.9 However, when the law gives no direction, business conceptions and the principles and practices of accountancy may be relevant to determining whether and when income is derived.³³

The relationship under TVM

3.10 While not adopting accounting in its entirety, TVM would reduce the conceptual disparity between accounting and income the tax law.

3.11 SAC 4 provides accounting with a framework that emphasises a business’s assets and liabilities. TVM provides a similar framework by calculating net income according to the change in the tax value of a business’s assets and liabilities. In doing so, it abandons the detailed legal notions of ‘assessable income’ and ‘deductions’ in favour of the more commercially approachable notions of ‘assets’ and ‘liabilities’.

³⁰ This actually reflects the broader notion of the purpose of ‘general purpose financial reports’, as stated in SAC 2 *Objective of General Purpose Financial Reporting* (August 1990).

³¹ Lehmann, G. & Coleman, C. *Taxation Law in Australia: 4th Edition*, LBC Information Services, Sydney, 1996., page 515.

³² Financial performance is a general reference to what might otherwise be considered ‘income’ or ‘profit’.

³³ *J Rowe & Son Pty Ltd v FC of T* 71 ATC 4001; *C of T (SA) v Executor Trustee & Agency Co of South Australia* (1938) 63 CLR 108; 1 AITR 416; *Arthur Murray (NSW) Pty Ltd v FC of T* (1965) 114 CLR 314.

A consistent conceptual base

3.12 The accounting conceptual framework is grounded in the elements that make up the balance sheet. The primary elements of the balance sheet, being assets and liabilities, are then used to derive the secondary elements of revenue and expenses. To that extent, the result disclosed by a profit and loss statement will be driven by the concepts underlying a balance sheet.

3.13 This is also an explanation of the conceptual basis for TVM's calculation of net income (and consequently taxable income); however the value TVM seeks to establish is an asset or liability's *tax* value.³⁴

Treatment of assets³⁵ under the financial reporting framework

3.14 Appendix A sets out the building blocks of the conceptual framework for financial reporting. Assets are a fundamental element of that framework. In essence, accounting deals with assets in the manner that is illustrated in the following paragraphs.

Is there an asset?

3.15 'Asset' is defined broadly as "future economic benefits *controlled* by the entity as a result of *past transactions or other past events*" [emphasis added].³⁶

3.16 An entity must have the capacity to control future economic benefits. The capacity to control enables the entity to enjoy those benefits and also deny or regulate access by others to those benefits. It is a test based on economic substance rather than legal form. Accordingly, ownership and possession are not always determinative characteristics of control.

3.17 Only present abilities to control future economic benefits are assets. Assets may be obtained by an entity through:

- transactions involving the exchange of cash, services or other assets;
- non-reciprocal transfers such as gifts or contributions to an entity; or
- other events such as accretion or discovery.

³⁴ This does not mean that a taxpayer would need a balance sheet to work out their taxable income under TVM (see the *Tax Value Method Information Paper* released with the prototype legislation).

³⁵ Accounting applies an equivalent process for liabilities.

³⁶ SAC 4, at paragraph 14.

3.18 No matter what type of transaction or event gives rise to the asset, it must have occurred. So, an entity cannot account for an asset if it has merely decided to acquire the asset.

Should an asset be recognised?

3.19 Under SAC 4, not all assets are recognised. An asset should only be recognised when it is *probable* that the future economic benefits embodied in the asset will eventuate and the asset possesses a cost or other value that can be *measured reliably*” [emphasis added].³⁷

3.20 ‘Probable’ refers to the likelihood of future economic benefits arising from the asset – if those benefits are more likely rather than less likely to arise, the asset will be recognised. Even if the probability of future benefits arising is high, an asset will not be recognised unless its cost or other measure of value can be reliably³⁸ measured.

3.21 These recognition criteria are designed to promote the relevance and reliability of financial reporting for its intended purpose. The concept of materiality is employed in conjunction with the recognition criteria to provide a practical limit on the degree of accuracy and comprehensiveness sought in the preparation and audit of financial reports.

What is an asset’s value?

3.22 The value of recognised assets is measured using applicable accounting standards or principles. The conceptual framework in Australia does not, at this stage, have a statement of accounting concept dealing with measurement.³⁹ Contemporary practice is characterised by a mixed valuation model that employs both cost and value-based measurements.

Treatment of assets⁴⁰ under TVM

3.23 The building blocks under TVM parallel those under financial reporting, as indicated in Appendix B. More specifically, at a conceptual level the treatment of assets under TVM parallels that under financial reporting. This is illustrated in the following paragraphs.

Is there an asset?

3.24 ‘Asset’ is defined broadly in a manner consistent with the accounting definition as “anything that embodies future economic benefits”.⁴¹

³⁷ SAC 4, at paragraph 38.

³⁸ SAC 3 *Qualitative Characteristics of Financial Information* (August 1990) discusses what is meant by reliability, see paragraphs 16 to 26.

³⁹ Note, however, that a monograph on measurement was released for discussion. (Accounting Theory Monograph 10, *Measurement in Financial Accounting*, Australian Accounting Research Foundation, 1998.)

⁴⁰ TVM also applies an equivalent process for liabilities.

3.25 While the TVM definition does not refer to ‘control’ or ‘past transactions’, those concepts are reflected in the ‘hold’ rules which determine whether the tax system will recognise the asset.

3.26 While it might be said that there is a technical difference between the definition of an asset under SAC 4 and the definition under TVM, in practice, there is no difference. Accountants and people of commerce would generally identify an asset as an object or right. And ultimately, even under general purpose financial reporting, assets are categorised according to their type of object or right (e.g. intangibles, or plant and equipment).

Should an asset be recognised?

3.27 Not all assets are recognised under TVM. Those that are to be recognised are those that are ‘held’. Generally, TVM will recognise the owner of the asset as being the entity that ‘holds’ the asset. While accounting emphasises the economic owner of the asset through the ‘control’ test, TVM’s hold rules are not a marked departure from SAC 4. For example, SAC 4 acknowledges that the legal form of transactions is often synonymous with the economic substance of those transactions:

- “The capacity of an entity to control the future economic benefits would normally stem from legal rights and may be evidenced by title deeds, possession, or other sanctions and devices that protect the entity’s interests”;⁴²
- “Possession or ownership of an object or right would normally be synonymous with control over the future economic benefits embodied in the object or right”;⁴³ and
- “While the ability of an entity to exercise control will often stem from the existence of legally enforceable rights, the absence of legal ownership does not preclude the existence of control”.⁴⁴

3.28 SAC 4 emphasises the economic substance over legal form of a transaction because, for instance, “an entity may possess an object or right but not expect to enjoy the benefits embodied in it”.⁴⁵ While the default hold rule in TVM focuses on legal notions of ownership to generally determine whether an entity holds an asset, it does have special rules to determine if an asset is held where the legal form is not consistent with the economic substance.⁴⁶ Examples where the hold rules focus on economic

⁴¹ Section 10-15 of the prototype legislation.

⁴² SAC 4, at paragraph 25.

⁴³ SAC 4, at paragraph 26.

⁴⁴ SAC 4, at paragraph 37.

⁴⁵ SAC 4, at paragraph 26.

⁴⁶ The emphasis on economic ownership is noted in Chapter 7, at paragraph 7.57.

owners over legal owners are hire-purchase arrangements, retention of title clauses, and chattel mortgages.⁴⁷

What is an asset's tax value?

3.29 Recognised assets are given a tax value (measured) in accordance with specific tax value rules aimed, with limited exceptions, at producing a realisation basis of taxation. In certain cases, that tax value will be taken to be zero regardless of the asset's cost.

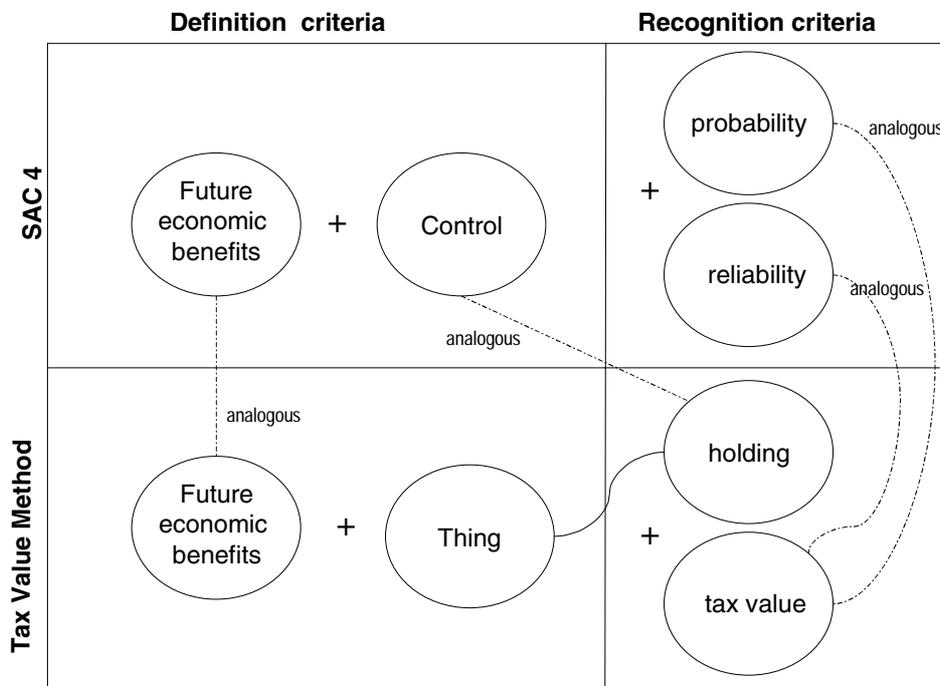
3.30 TVM will also provide for 2 classes of assets to be subject to revaluations but *only* if the entity so elects. Those assets are trading stock and some financial assets that can be valued on a mark-to-market basis.

A comparison

3.31 While TVM is consistent with accounting at a conceptual level, TVM will not recognise every asset that is recognised for accounting purposes and will not always measure the value of recognised assets in the same way. This accommodates tax policy and, importantly, the practical considerations that underlie a workable and certain taxation system.

3.32 As a broad summary, Diagram 3.1 illustrates the relationship between TVM and accounting (specifically SAC 4).

Diagram 3.1 The relationship between SAC 4 and TVM



⁴⁷ Section 24-10, item 1 of the table.

Moving towards complementary practices

3.33 One of the aims of the conceptual framework is to promote the development of accounting standards that are consistent and logically formulated.⁴⁸ Developing standards that are consistent with the conceptual framework should also result in those standards being consistent with other accounting standards. So, aligning TVM, as much as practicable, to the conceptual framework for accounting should also more closely align the income tax framework with contemporary accounting practice.

3.34 The degree of this alignment is evident in 2 recent accounting standards:

- accounting for income taxes (which is the revised standard on ‘tax effect accounting’); and
- the statement of financial performance.

Accounting for income taxes

3.35 The revised AASB 1020 *Income Taxes*⁴⁹ adopts a ‘balance sheet’ approach to accounting for income tax by prescribing the accounting treatment of current and future tax consequences of transactions and other events that give rise to current or deferred tax liabilities and assets.⁵⁰ That is to say, it uses the concepts of assets and liabilities to recognise deferred tax assets and liabilities.

3.36 AASB 1020 bases the determination of a tax asset or liability on the existence of a ‘temporary difference’. A ‘temporary difference’ is the difference between the carrying amount of an asset or liability in the statement of financial position (i.e. balance sheet) and the amount attributed to the asset or liability for tax purposes.⁵¹ This latter amount is known as the ‘tax base’. In TVM language, the ‘tax base’ is generally referring to an asset or liability’s ‘tax value’.

3.37 These temporary differences are determined on an item-by-item basis. In identifying temporary differences, it has been suggested that “one useful way ... is to prepare a tax balance sheet showing all assets and liabilities which are recognised in the statement of financial position, but measured at their tax base (and) all other items, which are not recognised as assets or liabilities in the statement of financial position, but which have a tax base”.⁵²

⁴⁸ Hoggett, J. & Edwards, L. *Accounting in Australia: 4th Edition*, John Wiley & Sons, 2000., page 593.

⁴⁹ The revised AASB 1020 *Income Taxes* (December 1999) applies for financial years ending on or after 30 June 2003. AASB 1020, paragraph 2.1

⁵⁰ AASB 1020, at paragraph 3.1.

⁵¹ AASB 1020, at paragraph 15.1.

⁵² PricewaterhouseCoopers, *Applying the new income tax standard*, publication date not known.

3.38 While TVM does not require a notional tax balance sheet to be prepared, if one was prepared, it is anticipated that it would assist the entity in determining both its taxable income⁵³ and any tax assets or liabilities that it has to account for.

Calculating financial performance

3.39 AASB 1018 *Statement of Financial Performance* also emphasises the ‘balance sheet’.⁵⁴ Essentially the standard determines profit or loss for a period as being the net change in equity in an entity after allowing for capital transactions with owners. For this purpose, ‘revenue’ and ‘expenses’ are defined in a manner consistent with SAC 4.⁵⁵

3.40 In that regard, the standard’s similarity with the mechanism TVM uses to calculate net income is evident. The ‘balance sheet’ approach requires “identify(ing) whether there are assets and liabilities and then establish(ing) what their value is”, with the profit or loss “derived from that process as the change in value of those assets and liabilities”.⁵⁶

Possible future developments

3.41 As noted in paragraph 3.33, with the conceptual framework being used to guide the development of future accounting standards, it is expected that subsequent standards may further reduce the disparity in the accounting treatment of transactions.

3.42 One change to accounting practice that has been proposed is to move away from a ‘risks and benefits’ approach when accounting for leases. In an attempt to report on the economic substance of transactions, AASB 1008 *Leases* applies a ‘risks and benefits’ approach (i.e.

⁵³ Australia Post, which participated in testing of TVM, acknowledged that it found it easier to calculate taxable income under TVM if it followed a balance sheet approach. (Dimech, P ‘Pro Testing, Through Protesting, to ‘Maybe it Works’?’, *Tax Value Method Consultative Conference* (Eds: Grbich & Warren), The Australian Tax Research Foundation, Sydney, 2001, pages 69 – 71). However, it should be noted that entities will not be disadvantaged if they do not prepare balance sheets. For instance, individual taxpayers will continue to use a return form to calculate their taxable income and that return form will be similar to the one that is currently used (see the *Tax Value Method Information Paper* released with the prototype legislation).

⁵⁴ See paragraph 3.12.

⁵⁵ AASB 1018 *Statement of Financial Performance* (October 1999) at paragraph 8.1 defines ‘revenues’ as “inflows or other enhancements, or savings in outflows, of future economic benefits in the form of increases in assets or reductions in liabilities of the entity, other than those relating to contributions by owners, that result in an increase in equity during the reporting period”. It also defines ‘expenses’ as “consumptions or losses of future economic benefits in the form of reductions in assets or increases in liabilities of the entity, other than those relating to distributions to owners, that result in a decrease in equity during the reporting period”.

⁵⁶ Gammie, M ‘TVM, The Tax Base and its Relationship to Commercial Accounting Methods’ in Grbich & Warren, op.cit., at page 168. However note that while Professor Gammie is speaking about accounting practice in the UK, his comments do correspond with Australian accounting practice. This is evidenced in SAC 4 and AASB 1018.

determining the economic owner on the basis of who effectively retains substantially all the risks and benefits incidental to ownership). Instead, it has been proposed that a ‘rights and obligations’ approach should be adopted. That approach involves the “application of the conceptual framework definitions and recognition criteria to accounting for lease contracts” and in doing so, it is argued “would overcome many of the perceived deficiencies of current lease accounting standards”.⁵⁷

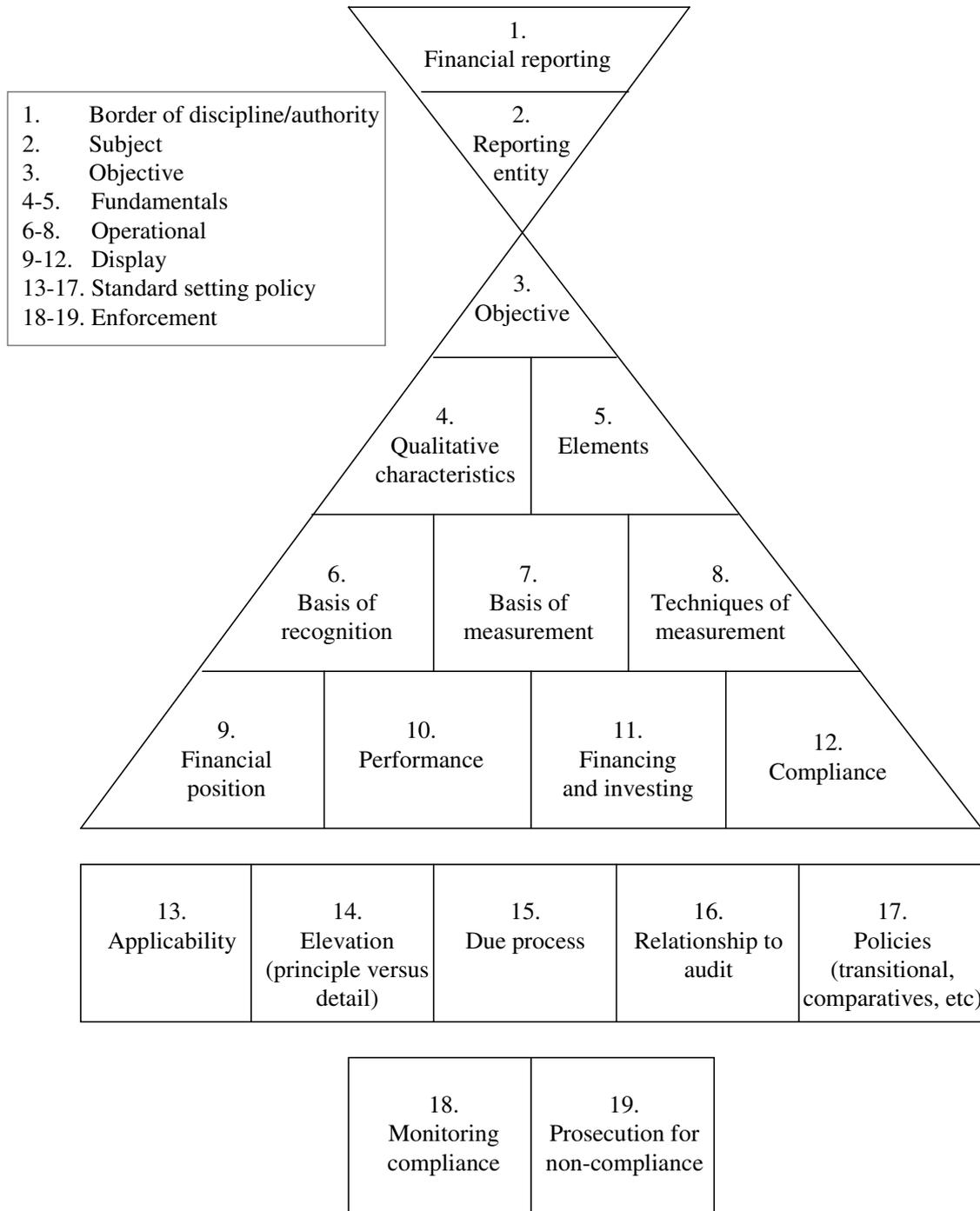
3.43 Adopting a rights and obligations approach has also been suggested as the preferred means for accounting for Build Own Operate and Build Own Operate Transfer arrangements.⁵⁸ The rights and obligations approach reflects the TVM treatment of these arrangements.

⁵⁷ Financial Accounting Standards Board *Accounting for Leases: A New Approach – Recognition of Lessees of Assets and Liabilities under Lease Contracts*, July 1996 (principally written by Warren McGregor of the Australian Accounting Research Foundation). As quoted in (Eds: Leo, K. & Radford, J.), *Financial Accounting Issues: 2nd Edition*, John Wiley & Sons, Brisbane, 1999. page 535.

⁵⁸ See (former) Public Sector Accounting Standards Board *Private Sector Provision of Public Infrastructure: Accounting by Public Sector Entities for BOO and BOOT arrangements*, Preliminary Views Paper, Australian Accounting Research Foundation, 1997.

Appendix A

Diagram 3A.1 Building blocks of the conceptual framework for financial reporting



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Annotation of Conceptual Framework for Financial Reporting

1. *Financial Reporting*

This part of the Framework is concerned with defining the discipline of financial reporting and is relevant for determining the borders of the domain to which accounting requirements apply.

2. *Reporting Entity*

The reporting entity is the entity (for example, economic entity, legal entity etc.) that is to be subject to financial reporting requirements. Its borders also need to be defined and this definition will then help determine the characteristics of the elements (see below) used to compile financial statements.

3. *Objective of Financial Reporting*

This building block is concerned with specifying the basic reason for financial reporting to occur (e.g. usefulness for the allocation of scarce economic resources) and for whose benefit it is intended (e.g. external users) and the types of information that they will need. This block again shapes the definition of the elements of financial reports and indeed the measurement and display aspects of the Framework.

4. *Qualitative Characteristics of Financial Information*

This part of the framework establishes that hierarchy of characteristics that financial information should have to be able to serve the objective of financial reporting. The Framework specifies that relevance and reliability are the primary characteristics for inclusion of financial information in financial reports. These characteristics are supported by those relating to the preparation and presentation of financial information: comparability, understandability, timeliness, and cost versus benefit.

Materiality is used as a filter of relevant and reliable information so that only information which could alter the decision-making of users in the context of a particular reporting entity is required to be reported.

Relevance and reliability are fundamental drivers for when the elements of financial reports need to be recognised. Materiality also limits the applicability of requirements.

5. *Elements*

This is a critical part of the Framework. It is concerned with defining the economic phenomena to be reported; equity, assets, liabilities, revenues and expenses. An economic objective (see above) demands an economic definition (e.g. assets are future economic benefits controlled by the entity). The border of the reporting entity likewise must relate to net assets controlled (as opposed to owned).

6. *Basis of Recognition*

Having decided what to include in financial statements, this part of the Framework is concerned with when to recognise those elements. The recognition criteria established revolve around probability of existence of the elements (e.g. probability of enjoyment of future economic benefits in the case of an asset) and the ability to reliably measure their stock or flow.

7-8. *Basis of Measurement/Techniques of Measurement*

Having decided what to include in financial reports (elements) and when (basis of recognition), it remains to specify the basis and techniques of measurement. An economic objective, for example, may suggest a current value based measurement system. This part of the Framework is not complete.

9-12. *Display*

In the presentation of financial statements categories of information are needed to serve the objective of financial reporting. The structure of financial statements and the type and level of disclosure flow from that objective.

13-17. *Standard-setting Policy*

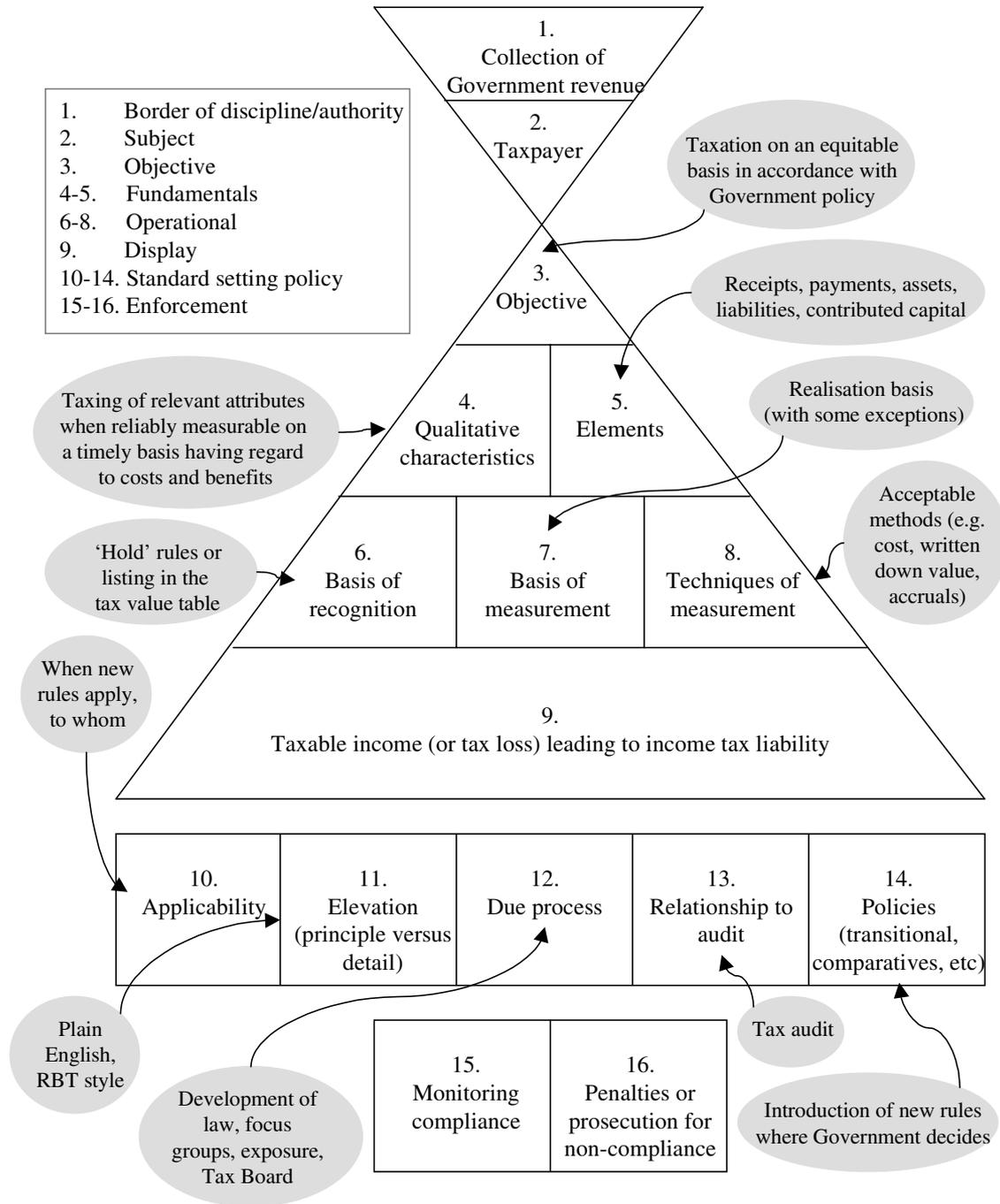
These are the guiding rules/policies for the development of financial reporting requirements.

18-19. *Standards Monitoring/Regulation*

Application of standards need to be monitored both for the sake of future development of requirements and to facilitate compliance activity.

Appendix B

Diagram 3B.1 Building blocks of the conceptual framework under TVM



Chapter 4

The core components of TVM

Outline of Chapter

4.1 This Chapter explains, in broad terms, the legislative mechanics of TVM by illustrating its core components.

Overview

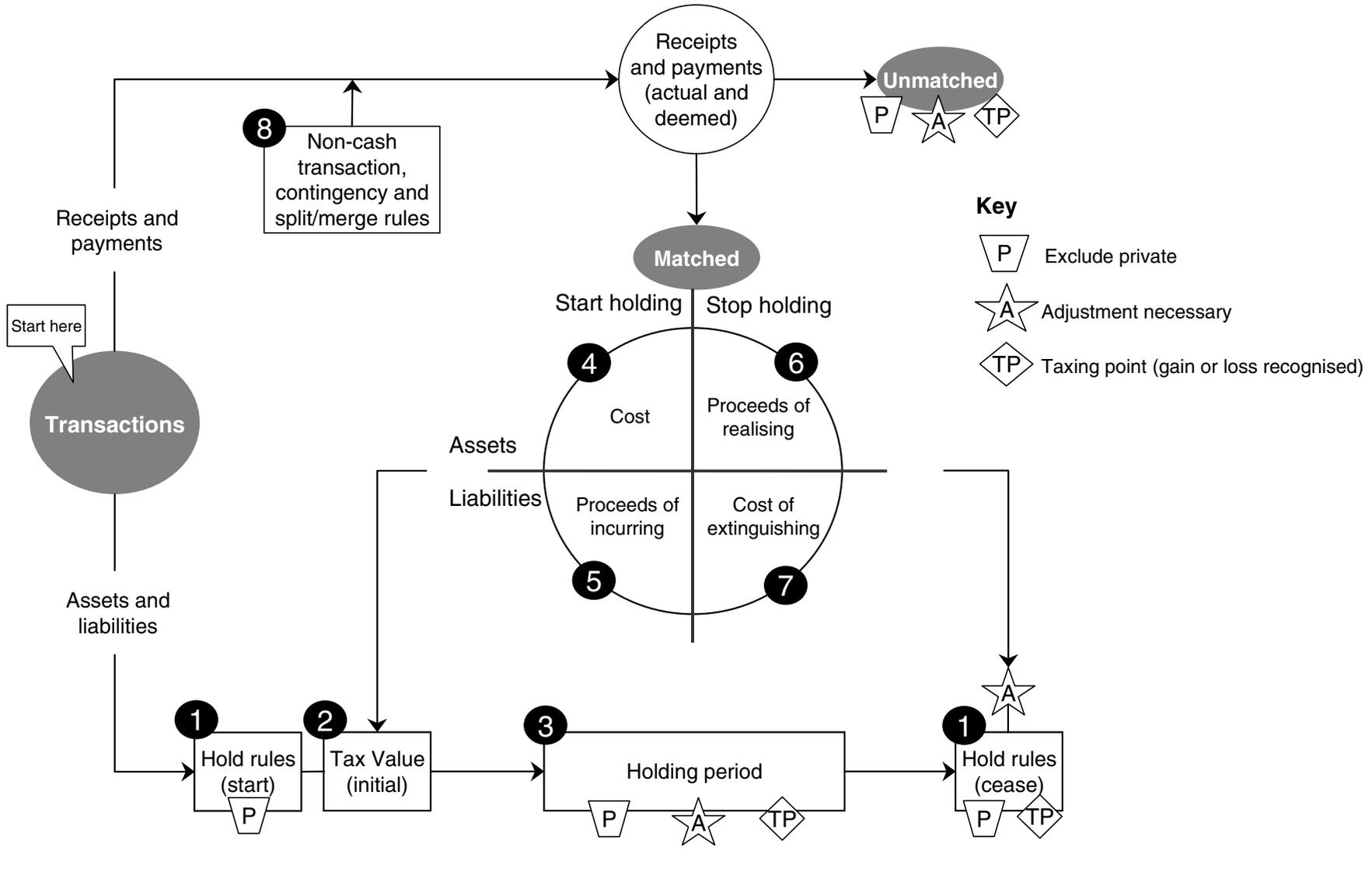
4.2 TVM is comprised of a number of components that are described below. The system map on the next page illustrates the relationships between them. The bracketed numbers (#) and symbols are references to the map. The discussion that follows the map provides more detail on several of these components.

4.3 As discussed in Chapter 1, TVM is based upon the following formula, which determines the net income of a taxpayer for an income year:⁵⁹

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

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

⁵⁹ Taxpayers that are not individuals, or partnerships with one or more individuals as partners, may work out 'receipts – payments' as their 'closing cash – opening cash'.



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.

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 incurring the liability (e.g. the funds borrowed under a loan). Therefore there are ‘cost’ (4) and ‘proceeds of incurring’ (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 included in net income in respect of that asset or liability. However, in some cases it may be necessary to isolate a gain or loss to give effect to a taxable income adjustment (e.g. the discount on an investment asset gain⁶⁰). To do that, there are rules specifying the ‘proceeds of realising’ an asset (6) and the ‘cost of extinguishing’ 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 barter transactions are common examples. To ensure that all transactions can be described in dollar terms, there are rules for credit and non-cash transactions and contingent arrangements (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 . They apply only to individuals, and partnerships with one or more individuals who are partners.

4.10 There are also rules to make taxable income adjustments  to the net income result, mainly for policy reasons (e.g. to give effect to research and development concessions). 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

⁶⁰ Called a ‘capital gain’ under the current law.

items and legal or equitable rights, less obvious kinds of *economic advantage*, such as information. [Section 10-15]

4.12 A ‘liability’ is one or more obligations 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 a *present* obligation, even if eventual performance is subject to a contingency. [Section 12-15]

4.13 There are rules for how to identify certain assets and liabilities [Division 22], and for merging, splitting and transforming them [Subdivision 16-E].

4.14 It is only the assets a taxpayer ‘holds’, or the liabilities a taxpayer ‘has’, that are included in the tax calculation. [Section 6-55]

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 10-20]

4.17 That third point means that less obvious advantages, such as market recognition from an advertising campaign or the advantage gained from staff training, 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). [Division 24]

Who ‘has’ a liability?

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

4.20 Under the *general rules*, an entity ‘has’ a liability if it owes a *present* legal or equitable obligation to provide the future economic benefits **(1)**. [Section 12-20]

4.21 The *special rules* deal with exceptions to the general rule. [Division 24]

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 taxpayer’s net income calculation.

4.23 Every asset and liability gets an initial tax value when it starts being held⁶¹ **(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 incurring the liability **(5)**.

4.24 It follows that, in the vast majority of cases, purchasing an asset or incurring 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 3 main types of asset and liability that are given an initial tax value **(2)** of *zero*, as set out in this table. [Division 68]

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

<i>Type of asset</i>	<i>Explanation</i>	<i>Examples</i>
Assets and liabilities ignored for policy or compliance reasons.	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, the results of mining exploration or prospecting.

⁶¹ Strictly, ‘had’ in the case of liabilities.

<i>Type of asset</i>	<i>Explanation</i>	<i>Examples</i>
Some assets and liabilities pertaining to the relationship between an entity and its members.	Giving these assets and liabilities a zero tax value reflects the current law.	A shareholder's right to a dividend.
Matching (or 'routine') rights and liabilities.	Where a taxpayer has both a right and a matching obligation, and over time any changes in the value of the right are substantially 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.

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 nominal (or face) value and, as such, is treated in much the same way as money. [Section 76-15 and 76-115]

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.⁶²

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

⁶² 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.

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

<i>Type of asset</i>	<i>Explanation</i>	<i>Examples</i>
Depreciating assets and liabilities. <i>[Division 72]</i>	This is a highly significant category covering most assets and liabilities with a limited life. 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 a subset of this approach.	Rights to use assets or get services, the liabilities to provide those assets or services, plant and equipment, intellectual property.
Trading stock. ⁶³	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 TVM.	Goods available for sale in a retail store.
Financial assets and liabilities. <i>[Division 76]</i>	These will have a tax value designed to implement the recommendations on the taxation of financial arrangements. ⁶⁴ When the gain (or loss) on such assets (or liabilities) is certain, they will have a rising tax value, computed on the basis of internal rates of return, because of their relatively high liquidity. Even in the case of these 'near money' items, any taxation before realisation is based on accrued returns rather than on changes in the market value. In certain circumstances, a tax value can be set by reference to the market, <i>but only at the option of the taxpayer.</i>	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.

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

⁶³ These rules will be contained in Division 70, which is not yet included in the prototype legislation.

⁶⁴ See Section 9 of ATSR. TVM could, of course, be implemented independently of those recommendations, or vice versa.

Example 4.2

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

4.31 The proceeds of realising an asset **(6)** and the cost of extinguishing a liability **(7)** are also core concepts for TVM. They allow the profits and losses that are often subject to taxable income adjustments (such as the adjustments for discounted investment asset gains and part private use) to be worked out.

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, TVM 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.

Cost of an asset

4.32 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; and
- any amounts paid to bring the asset to its condition and location. This would include, for example, the cost of improving the asset, but not the cost of repairs or maintenance, which are expenses to preserve its existing condition rather than to bring the asset to a new condition. *[Division 14]*

Proceeds of incurring a liability

4.33 The proceeds of incurring a liability **(5)** are made up of:

- the amounts received for starting to have the liability; and
- any amounts received for increasing the liability. *[Division 14]*

Proceeds of realising an asset

4.34 The proceeds of realising an asset **(6)** are the amounts received because you stopped holding it. *[Division 14]*

Cost of extinguishing a liability

4.35 The cost of extinguishing a liability (7) is the amount paid to stop having it. [Division 14]

Non-cash arrangements and contingencies

4.36 There are rules (8) dealing with credit and non-cash transactions, contingent arrangements and splitting and merging of assets and liabilities that cause every kind of transaction to be seen in terms of dollar cash flows. The table sets out what these rules provide.

Table 4.3 Situations where amounts are taken to be received and paid

<i>Explanation</i>	<i>Examples</i>
<p><i>Non-cash transactions</i></p> <p>A taxpayer is taken to receive an amount for what they give, and to pay an amount for what they get, in a non-cash transaction.</p> <p>[Division 16]</p>	<p>If you exchange your truck for a bulldozer, 2 amounts are worked out under the non-cash transaction rules – what you <i>got</i> for the truck and what you <i>paid</i> for the bulldozer.</p>
<p><i>Arrangements with contingencies</i></p> <p>Rights and obligations that are contingent in substance or effect are ignored under the non-cash transaction rules unless they relate to the acquisition or disposal of assets (that are not mere unperformed obligations).</p> <p>[Subdivision 28-A]</p> <p>When the contingency is met, amounts will be taken to be received and paid so that these can be worked out:⁶⁵</p> <ul style="list-style-type: none"> • the cost of a right no longer affected by the contingency; and • the proceeds of incurring a liability no longer affected by the contingency. <p>[Subdivision 28-B]</p>	<p>If you have an obligation to provide professional services, but have a contingent right to be paid for them, you will be taken to:</p> <ul style="list-style-type: none"> • receive nothing in return for assuming your obligation; and • pay nothing for your right. <p>However, when the contingency is met, so that you have a non-contingent right to be paid for your services, you will be taken to receive and pay an amount equal to the value of that right.</p> <p>The receipt will be the proceeds of incurring your liability and the payment will be the cost of your right.</p> <p>This means there will be no tax consequences until that contingency is met.</p>

⁶⁵ This does not apply to arrangements for the acquisition of assets. For example, when the contingency is the exercise of an option to acquire an asset, this rule does not apply at the time of that exercise.

<i>Explanation</i>	<i>Examples</i>
<p><i>Splitting, merging and transforming assets and liabilities</i></p> <p>If you split, merge or transform assets or liabilities, there will be no taxing point. You will be taken to receive and pay amounts equalling the tax value of the original assets or liabilities, so that:</p> <ul style="list-style-type: none">• there will be no gains or losses recognised at the time of the split, merge or transformation; and• the cost of the new assets, or proceeds of incurring the new liabilities, will be the same as the original assets or liabilities. <p><i>[Subdivision 16-E]</i></p>	<p>If you merge 2 blocks of land under one title, you will be taken to:</p> <ul style="list-style-type: none">• receive for the original blocks an amount equal to their tax value; and• pay the same amount for the new block.

4.33 These rules do not, of themselves, have tax consequences. They are merely inputs into the rules about cost and proceeds. Those rules then determine which transactions have taxation effects.⁶⁶

⁶⁶ The rules on private or domestic transactions may also be relevant in determining tax effects.

PART 2:

**EXPLANATION OF PROTOTYPE
LEGISLATION**

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 TVM. The relevant provisions are in Parts 1-3 and 1-5 of the prototype legislation.

Context of Reform

5.2 The core rules dealing with how to work out income tax liability using TVM largely replicate those found in the current law⁶⁷. Some minor changes have been made, most of which do not affect the substance of the law.

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

Summary of prototype legislation

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

⁶⁷ Division 4 of the ITAA 1997.

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

5.7 These steps are represented in the following formula:

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

Comparison of key features of prototype legislation and current law

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

Table 5.1 Comparison of key features of prototype legislation and current law

<i>Prototype legislation</i>	<i>Current law</i>
Income tax is payable by individuals, companies and some other entities.	Same as prototype legislation.
'You' covers any entity, unless the term is used in an expressly limited way.	Same as prototype legislation.
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 prototype legislation.
A different period of 12 months can be adopted as an 'income year', with the Commissioner's approval.	Same as prototype legislation.
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. ⁶⁸	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 prototype legislation.

⁶⁸

Chapter 21 explains the anticipated treatment under TVM of foreign residents.

Detailed explanation of prototype legislation

Introductory material

5.9 The prototype legislation contains introductory material similar to that found in the ITAA 1997. [*Divisions 1, 2 and 3*]

Meaning of ‘you’

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

5.11 Most of the prototype legislation is drafted in the second person, using the term ‘you’. For example, the prototype legislation would generally say ‘you are liable to income tax’ rather than ‘an entity is liable to income tax’. 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, which would be replicated under TVM).

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 prototype legislation 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 prototype legislation 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:

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

5.21 The prototype legislation 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 & 4. 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.

[Section 5-10]

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 6-15(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 *[section 5-10, steps 3 and 4 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 prototype legislation. *[Section 8-15]*

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 *[section 8-10]*. 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 TVM 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 6 of the prototype legislation. It also outlines other provisions that are dealt with in more detail in later chapters.

Context of Reform

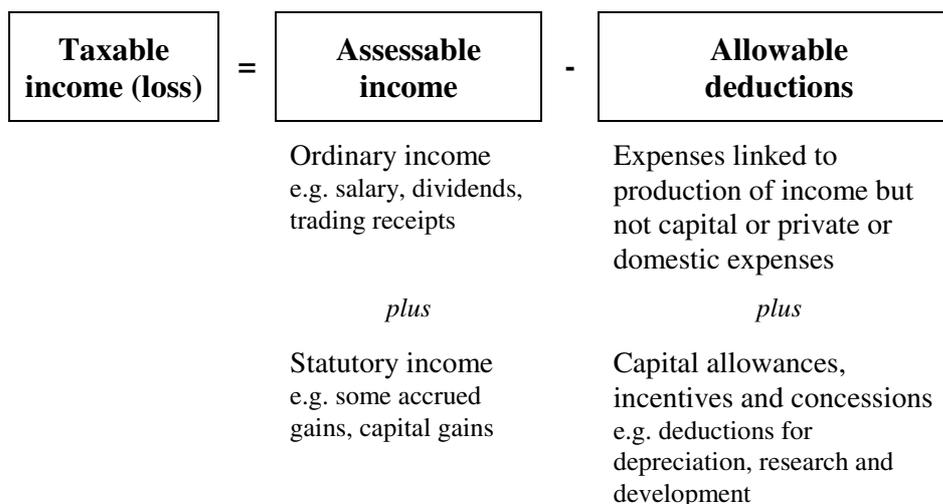
6.3 TVM links the calculation of taxable income and tax loss more closely to accounting concepts. The prototype legislation, however, is necessarily formulated in its own terms to recognise tax policy and administrative considerations, such as those underlying the treatment of net exempt income.

6.4 TVM 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

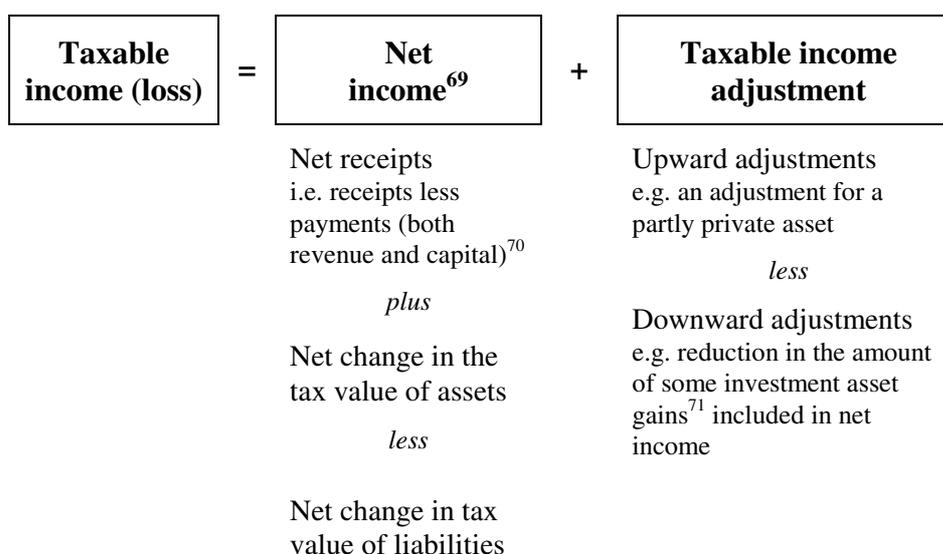


6.6 The allowable deductions under the current approach include unused tax losses of earlier income years. These are normally deductible to the extent that assessable income exceeds other deductions.

Summary of prototype legislation

6.7 Diagram 6.2 summarises TVM 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



⁶⁹ Most private or domestic amounts are excluded.

⁷⁰ Taxpayers that are not individuals or partnerships with one or more individuals as partners can work out this component as 'closing cash – opening cash'.

⁷¹ Called 'capital gains' in the current law.

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 TVM, 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.
- TVM will apply to Australian resident taxpayers, and to foreign 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 (these are called 'investment asset' gains and losses under TVM). However, investment asset treatment will apply to certain capital gains (e.g. the 50% investment asset discount for individuals).
- 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 prototype legislation and current law

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

Table 6.1 Comparison of key features of the prototype legislation and the current law

<i>Prototype legislation</i>	<i>Current law</i>
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 prototype legislation

How is 'taxable income' worked out?

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

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

[Subsection 6-15(1)]

6.12 If the result is a positive amount, there is taxable income equal to that amount *[subsection 6-15(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 6-15(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):

$$\text{Net income} + \text{Taxable income adjustment}$$

[Subsections 170-10(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):

$$\text{Net income} + \text{Taxable income adjustment} + \text{Net exempt income}$$

[Subsections 170-10(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 years⁷².

Who will use TVM for working out taxable income (loss)?

6.16 As noted in Chapter 5, TVM will apply to Australian residents, and to foreign residents for their Australian sourced income and gains that are not subject to a final withholding tax. It will not otherwise apply to foreign residents and it will not apply to entities that are entirely exempt from income tax. Specific rules for foreign residents are anticipated but are not included in the prototype legislation.⁷³ 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).⁷⁴
- 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.
 - Net increases in tax value will reduce net income.
 - Net decreases will add to net income.

[Section 6-55]

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.

⁷² Certain kinds of losses (like investment asset losses) are quarantined so that they can be offset only against income of the same kind.

⁷³ An explanation of the anticipated rules is in Chapter 21.

⁷⁴ Taxpayers that are not individuals or partnerships with one or more individuals as partners can work out this component as 'closing cash – opening cash'.

Net income formula

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

$$\text{Receipts} - \text{Payments} +/\text{- Net change in tax value of assets and liabilities}$$

6.20 More fully expressed, the net income formula is:

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

Net income method statement

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

Method statement

Step 1. Add all 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 on hand) held at the *end* of the income year.

Step 4. Subtract the opening tax value of each asset (other than money on hand) 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,⁷⁵ 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 gains in respect of them can be included in taxable income.⁷⁶ Division 222 will contain provisions dealing with the private or domestic amounts that are not included in working out net income.

⁷⁵ And also partnerships with one or more individuals as partners.

⁷⁶ This is consistent with their treatment under the current law.

Working out cash flows for taxpayers that are not individuals

6.23 Steps 1 and 2 of the net income method statement are about receipts and payments. However, taxpayers that are not individuals, or partnerships with one or more individuals as partners, can use an alternate calculation in place of these 2 steps. That alternate calculation is to subtract from the money (i.e. cash) the taxpayer held at the end of the year the money the taxpayer held at the start of the year [section 6-60]. This provision is included to make it clear that these taxpayers will not need to track all their receipts and payments during the income year.

6.24 Individuals, and partnerships with one or more individuals as partners, will not be able to use this alternate method. This is because it is necessary to refer to all receipts and payments so that those of a private or domestic nature can be determined. Private or domestic receipts do not normally come into the calculation of taxable income (see paragraph 6.22).⁷⁷

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

6.25 Assets that are money 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.

What receipts and payments are included in net income?

6.26 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 prototype legislation.

Constructive receipts are explicitly included in net income under step 1

6.27 TVM 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.

6.28 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). [Subsection 6-70(1)]

⁷⁷

See also Chapter 17.

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

6.30 This constructive receipt rule is based on the rule under the current law⁷⁸.

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

6.31 TVM also explicitly treats certain constructive payments as amounts that are paid for the purposes of working out net income [subsection 6-70(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.

6.32 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

6.33 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

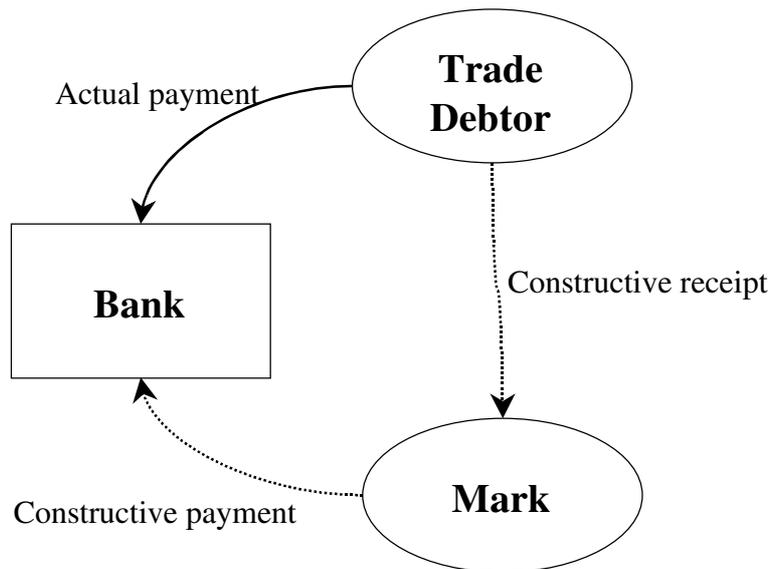
In carrying on his business, Mark has an outstanding loan account with his bank. One of Mark's trade debtors pays amounts it owes to Mark by crediting amounts to his loan account. These amounts reduce the amount he owes to the bank and are, therefore, amounts he is taken to have received.

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.

⁷⁸ See subsections 6-5(4) and 6-10(3) of the ITAA 1997.

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.

Are deemed receipts and payments included in steps 1 and 2?

6.34 TVM will take (or deem) amounts to be received and paid in some cases, for example in non-cash transactions [Section 6-75].⁷⁹ These receipts and payments will need to be included under steps 1 and 2 of the net income method statement. This is necessary because either the deemed receipt or deemed payment may be private or domestic in nature, and so will need to be excluded. The remaining receipt or payment will be included to achieve the appropriate tax outcome.

⁷⁹

See Chapter 10.

Example 6.4 Individual paid in kind for work

Claudius, a house painter in business, paints Henry's shed. In return Claudius is given food (market value \$500) which he consumes himself. Under Division 16, Claudius is taken to have received \$500 for his painting services, and to have paid the same amount for the food. The deemed receipt for the services is not private in nature, and so is included in net income, but the deemed payment for the food is private, and so is excluded. This ensures Claudius is taxed on the \$500 value he received as part of his business.

6.35 However, because taxpayers that are not individuals, or partnerships with one or more individuals as partners, will not need to include receipts and payments (see paragraph 6.23), they can ignore these deemed receipts and payments in working out net income. For them, they will only be relevant to working out the costs and proceeds of assets and liabilities.⁸⁰

What if amounts are lost or found in a non-private context?

6.36 A taxpayer may lose money in a non-private context, and equally may find money in a non-private context. These things will be taken into account in working out net income.

6.37 For individuals, and partnerships with one or more individuals as partners, amounts lost in a non-private context will be included as payments and amounts found in a non-private context will be included as receipts [section 6-65]. For other taxpayers, the lost or found cash will be reflected in the difference between their closing and opening cash.

Example 6.5 Shopkeeper loses cash

Lottie runs a newsagency. One year she loses \$200 cash from her takings. She does not know exactly what happened to it, but does know it was lost somewhere in the shop. She includes the \$200 as a payment in that year. The following year, Lottie is renovating her shop and discovers the \$200 cash in a crevice beneath her retail counter. She includes that \$200 as a receipt in that later year. (In effect, this is a recoupment of her earlier 'deduction' for that lost cash.)

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

6.38 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.

⁸⁰

See Chapter 9.

What is the effect of including receipts and payments?

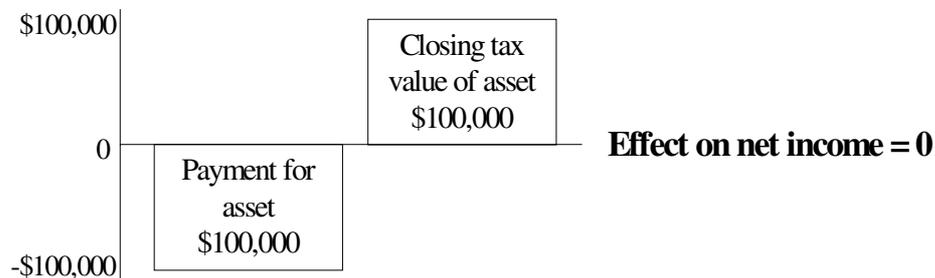
6.39 The interaction between steps 1 and 2 (net receipts) and steps 3 to 6 (net assets and liabilities) of the net income method statement ensures that receipts and payments that relate to the tax value of assets and liabilities do not affect a taxpayer’s net income. Rather, they will be taken into account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

Example 6.6 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



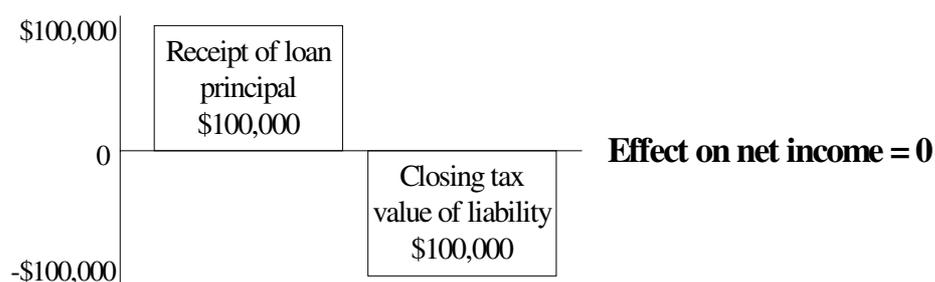
Example 6.7 A loan is taken out

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



What is an asset?

6.40 An asset is a thing (such as land, chattels or a right) that embodies future economic benefits [section 10-15]. 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 TVM other rules will apply to determine who holds certain kinds of assets [sections 24-10 and 24-100]. Intangible advantages not capable of ownership⁸¹ (such as the market penetration that may arise from a successful advertising campaign) are taken not to be held by any entity [section 10-20].

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 12-15]. 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 prototype legislation contains rules to determine the tax value of assets and liabilities [sections 10-40 and 12-40]. 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 (or depreciated cost), so that gains will only be taxed when the asset is disposed of.

⁸¹ Other than acquired information that is not generally available.

6.45 Later chapters contain a detailed explanation of how the tax value is determined for particular types of assets and liabilities. However, Table 6.2 briefly outlines the tax value of the main kinds of assets.

Table 6.2 Tax value of assets

<i>Kind of asset</i>	<i>Tax value</i>
An asset whose increase in value is to be taxed only upon realisation (these are called ‘investment assets’ in the prototype legislation). 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).
Goodwill (also an ‘investment asset’).	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).
Rights to receive an amount that is due and payable or must be paid within 12 months for supplying a non-cash benefit (e.g. trade debtors).	The amount to be received (see Chapter 14).
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 (see Chapter 12).
Trading stock.	There would be the same choice of methods as under the current law.
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 (see Chapter 14).
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 (see Chapter 7).
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. [Section 6-80]

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. [Section 6-85]

What is the ‘taxable income adjustment’?

6.48 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

6.49 A taxpayer’s taxable income adjustment is worked out as:

$$\text{Upward adjustments} - \text{Downward adjustments}$$

[Subsection 6-90(1)]

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

6.51 The taxable income adjustment can, as a result of the application of the above formula, be a positive or negative amount [subsection 6-90(2)]. If the result of the formula is zero, there is no taxable income adjustment.

What are the upward and downward adjustments?

6.52 Various provisions throughout the prototype legislation specify when an upward adjustment or downward adjustment arises. Part 2-15 of the prototype legislation:

- sets out many adjustments [Divisions 100, 101 and 103]; and
- directs the reader to where in the proposed law these various provisions can be found [section 95-20].

6.53 Table 6.3 sets out some of the key upward adjustments while Table 6.4 sets out some of the key downward adjustments.

Table 6.3 Key upward adjustments

<i>Upward adjustment</i>	<i>Reason for the adjustment</i>
<i>Apportioning private or domestic reductions</i>	
<p>An upward adjustment to reflect an apportionment for the private or domestic part of amounts that have <i>reduced</i> net income.</p> <p>An example is the decline in tax value of a depreciating asset that is used partly for private or domestic purposes.</p> <p><i>[Subdivision 222-E]</i></p>	<p>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.</p> <p>Chapter 17 will explain these issues in detail.</p>
<i>Negative net exempt income</i>	
<p>If the taxpayer has a negative amount of net exempt income, there is an upward adjustment for that amount.</p> <p>For example, a taxpayer with a net exempt income of -\$100 has an upward adjustment of \$100.</p> <p>The meaning of the term 'net exempt income' is set out at paragraphs 6.61 to 6.63.</p> <p><i>[Subsection 6-95(3)]</i></p>	<p>Because exempt amounts are not taxable (see Table 6.4), any expenses that arise in respect of them should not usually reduce taxable income. This is the position under the current law.</p> <p>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.</p>
<i>Gifts included in net income</i>	
<p>An upward adjustment equal to the amount of any gift or contribution (except to the extent that it is covered by the gift rules⁸²) from which the taxpayer did <i>not</i> intend to gain an economic benefit.</p> <p>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.</p> <p><i>[Subsection 103-15(1)]</i></p>	<p>Under TVM, 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:</p> <ul style="list-style-type: none"> • gifts that are made to obtain a benefit; or • gifts to bodies that qualify for a deduction under the tax law (these will be set out in provisions equivalent to current Division 30 of the ITAA 1997). <p>Accordingly, it is necessary to add back gifts not meeting these criteria.</p>

82

Currently in Division 30 of the ITAA 1997.

Table 6.4 Key downward adjustments

<i>Downward adjustment</i>	<i>Reason for the adjustment</i>
<i>Apportioning private or domestic increases</i>	
<p>A downward adjustment to reflect apportionment for the private or domestic part of amounts included in working out net income that have <i>increased</i> that net income.</p> <p>An example is a gain on disposal of a depreciating asset that has been used partly for private purposes.</p> <p>[Subdivision 222-E]</p>	<p>It is intended that amounts that are private or domestic should not be taxable. This adjustment will ensure that outcome.</p> <p>Chapter 17 will explain these issues in detail.</p>
<i>Positive net exempt income</i>	
<p>If the taxpayer has a positive net exempt income, there is downward adjustment for the amount by which it is positive.</p> <p>For example, a taxpayer with a net exempt income of \$100 has a downward adjustment of \$100.</p> <p>The meaning of the term ‘net exempt income’ is set out at paragraphs 6.60 to 6.62.</p> <p>[Subsection 6-95(2)]</p>	<p>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.</p>
<i>Gifts not included in net income</i>	
<p>A downward adjustment equal to the amount of any gift or contribution that:</p> <ul style="list-style-type: none"> • 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 the gift rules.⁸³ <p>[Subsection 103-15(2)]</p>	<p>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. 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.</p>

⁸³

Currently in Division 30 of the ITAA 1997.

<i>Downward adjustment</i>	<i>Reason for the adjustment</i>
<i>Policy concessions</i>	
A downward adjustment for expenditure concessions.	<p>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.</p> <p>For example, under TVM a downward adjustment will be needed to fully incorporate the current law's tax incentives for research and development expenditure.</p>

Unused tax losses reduce taxable income

6.54 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 prototype legislation is not yet complete in its treatment of losses. Accordingly, the paragraphs that follow discuss the anticipated treatment of prior year losses.

6.55 Under TVM, only a taxpayer's prior year losses that meet the relevant tests⁸⁴ 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 income⁸⁵ (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'?

6.56 Under TVM, '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?

6.57 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 6.5.

⁸⁴ Such as the continuity of majority beneficial ownership tests applying to companies and trusts.

⁸⁵ The meaning of the term 'net exempt income' is set out at paragraphs 6.60 to 6.62.

Table 6.5 Amount of unused tax losses used up in an income year

<i>If net income plus the taxable income adjustment is:</i>	<i>The amount of the tax loss used up is:</i>
Equal to, or greater than, the tax loss.	The whole amount of the tax loss.
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?

6.58 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 arose. 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.

6.59 Example 6.8 illustrates how unused tax losses are used.

Example 6.8 A taxpayer has a tax loss from each of the previous two income years

Jacob is preparing his tax return for Year 3. 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 Years 1 and 2.

For Year 3, 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 Year 1 tax loss has been used up. He has \$10,000 of his tax loss from Year 2 left over to be carried forward to future income years.

'Net exempt income' is relevant to calculating taxable income

6.60 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 prototype legislation does not set out the provisions for working out net exempt income. Accordingly, the paragraphs that follow discuss the anticipated framework for doing that.

6.61 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?

6.62 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?

6.63 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.⁸⁶

⁸⁶ As to STS taxpayers, see Chapter 19.

Chapter 7

Assets and their tax value

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 10 and in Parts 2-5 and 2-10 of the prototype legislation.

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.⁸⁷ 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 (section 8-1 of the ITAA 1997) applies an asset concept based on 'capital' outgoings – expenditure that provides an *enduring* benefit – whereas, the capital gain and loss provisions (i.e. Parts 3-1 and 3-3) apply an asset concept based, in part, on legal property.
- 7.5 As a result, assets are *treated* in different and often inconsistent ways. For example:
- some expenditure that gives rise to items of a capital nature may be deducted over time (e.g. plant and equipment), but some is recognised only when the item is disposed of (e.g. long-term rights that are only covered by the CGT regime).
- 7.6 Contributing to the inconsistent treatment of assets is the current law's *ad hoc* approach. That approach requires each regime to provide its

⁸⁷ Chapter 2 discusses this in some detail.

own rules for recognising the revenue and capital expenditure that gives rise to an asset. Those regimes are not consistent about when the asset starts being held, when it stops being held, when gains and losses are recognised, or 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 prototype legislation 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 uniform rules about who holds an asset, when they hold it, what is its cost and for working out any gain or loss on its disposal.

Summary of prototype legislation

7.9 The prototype legislation divides the rules about assets into 3 main places. Division 10 contains all the general rules:

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

7.10 Parts 2-5 and 2-10 then have some further rules about each of those things. They sometimes modify the general rules and sometimes provide details about particular aspects of the general rules.

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

7.12 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.

7.13 The value at which the prototype legislation recognises an asset (its *tax value*) at any particular time will usually be one of these:

- its *cost*; or
- its *nominal value* (for debts due and payable and some short term debts); or

- its *market value* (although this will be only rarely available and only used if the taxpayer chooses to use it); or
- its *estimated value* (i.e. its cost +/- the amount it is estimated to have changed by that time, typically downwards); or
- *nil* (this will mostly be used to reduce compliance costs or for policy reasons).

7.14 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 prototype legislation and current law

7.15 Chapter 2 compares the treatment of assets under the current law to the treatment proposed under TVM.

Detailed explanation of prototype legislation

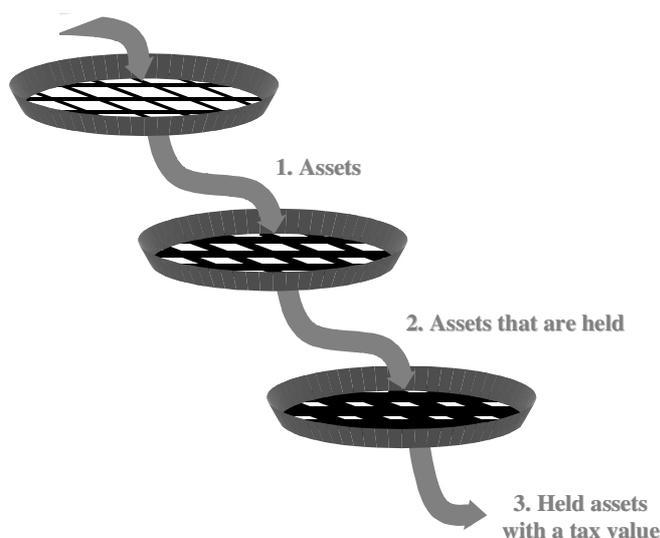
7.16 Taxpayers' net income for an income year will include any change in the *tax value* of *assets* that they *hold* [section 6-55].⁸⁸ So, an increase in the tax value of an asset will increase taxable income and a decrease in its tax value will decrease taxable income.

7.17 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 an effect 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, or any other value, is not enough; the change must be in their *tax value*.

7.18 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 of them have no tax value.

⁸⁸ Private assets are excluded (see Chapter 17).

Diagram 7.1 The asset filters



7.19 An *asset* is, broadly, anything that embodies future economic benefits [section 10-15]. So, a physical thing is an asset because you can get economic benefits from selling it or using it. Rights (including debts, which are rights to get money) will also be assets, and so will information.

7.20 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, an asset's economic owner will be its legal owner. [Sections 10-20, 24-10 and 24-100]

7.21 The prototype legislation sets out rules for working out the *tax value* of assets [section 10-40]. Those rules will usually work to prevent a gain on an asset being taxed until the asset is disposed of.

Importance of the asset concept

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

7.23 The current law does that job by:

- distinguishing between items of revenue and capital and providing special rules for each (e.g. 'derived' 'received', 'earned'); and
- establishing specific regimes to deal with particular types of gain and loss (e.g. trading stock, depreciation, CGT, securities).

7.24 TVM 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’ (to use the terminology of the current law) 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’.

7.25 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

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

Table 7.1 Continued deductibility of ‘revenue type’ expenditure

<i>Case</i>	<i>Comment</i>
No asset arises from the expenditure (i.e. it does not lead to anything that provides future economic benefits).	<i>Example:</i> Some gifts.
The asset is created during the income year, but its future economic benefits are wholly consumed during that year.	<i>Example:</i> 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.	<i>Examples:</i> 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. <i>Example:</i> 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. <i>Example:</i> Payments for legal advice about the implications of acquiring an asset do not form part of the asset’s cost.

What is an asset?

7.27 An *asset* is a thing that embodies (i.e. is the source of) economic benefits in the future [section 10-15]. Put another way, assets are things of *positive* economic value.

7.28 The *relationship* between the thing and a particular taxpayer does not affect whether the thing is an asset.⁸⁹ 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.

7.29 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.⁹⁰ 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).

7.30 However, although ‘asset’ is a very wide concept, many things that are assets will not affect net income because:

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

7.31 These things are discussed in some detail later.

What is an economic benefit?

7.32 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 7.37).

7.33 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 to whether the thing is an asset.

7.34 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

⁸⁹ Although it can be important in determining whether it is an asset in its own right or part of a larger asset, in working out whose asset it is and in working out what is its tax value.

⁹⁰ The use of the term ‘embodies’ should be seen as a metaphor in the case of incorporeal assets that, of course, don’t really have a body.

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.

7.35 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).

7.36 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).

7.37 A thing can 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

7.38 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. a stock-take of trading stock).

7.39 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).

7.40 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?

7.41 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.

7.42 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.

7.43 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.

7.44 There are some special rules that affect the identification of assets. They are discussed later (starting at paragraph 7.80).

Splitting and merging

7.45 The function and structure of an asset can change over time. It could be split into several assets. For example, a developer might split a block of land into several assets by subdividing the block. It could be merged with another asset into a single new asset. For example, a keyboard, hard-disk drive and motherboard can be assembled into a computer. It could be transformed into a different asset. For example, an ingot of metal could be cast into an engine block.

7.46 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 to split, merge or transform them). These matters are discussed in Chapter 11.

Who holds an asset?

7.47 The change in the tax value of an asset is included in the net income of the taxpayer who *holds* the asset. [Section 6-55, steps 3 and 4 of the method statement]

7.48 As a broad statement, an asset will be held by its economic owner; that is, the taxpayer who can access its economic benefits *while* stopping other taxpayers from doing the same. [Sections 10-20, 24-10 and 24-100]

The general rules

7.49 The *general* rules about who holds an asset will apply in most cases. However, there are some special rules about holding assets and, if they apply, they prevail over the general rules [subsection 24-10(1), section 24-100]. The special rules are discussed later (starting at paragraph 7.88).

No one holds some assets

7.50 The general rules explain that *no one holds* an asset, unless it is:

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

[Section 10-20, item 4 in the table]

7.51 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 may be possible to characterise a wide range of generally advantageous things as assets (such as, say, a favourable exchange rate) because they embody future economic benefits, they are not assets that anyone *holds*. Therefore, they do not appear in anyone's calculation of net income.

7.52 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, that information⁹¹ is not *held* by anyone, so your payments towards acquiring it will be 'deductible' straight away (see paragraphs 7.59 and following).

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

⁹¹ As opposed to any tangible thing on which the information is recorded.

Property

7.54 The first general rule is that an asset that is *property* is held by its owner [section 10-20, item 1 in the table]. In broad terms, *property* is anything that can be owned. Sometimes, lawyers also talk about property as the ownership interests in things that can be owned (e.g. “property in the land has vested in the Crown”). Both of those meanings of the words are relevant to the prototype legislation. 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.

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

7.56 In some cases, an asset might have an equitable owner who is different from its legal owner. Under the first general rule, if there is *both* a legal and an equitable owner of an asset, it is held by the legal owner. That clarifies what is sometimes ambiguous in the current law but is the most widely accepted view.

Non-proprietary rights

7.57 Some rights recognised by law or equity are not property. The scope of such rights is not clear but some have suggested that any rights that are not capable of assignment are personal rights, rather than proprietary rights.⁹² An example of such a right is the beneficiary’s right to enforce the terms of a trust.

7.58 To the extent that such personal rights are legal or equitable, they would be held by whoever has that right. That preserves the outcome under the capital gains rules in the current law.⁹³ Again, if the right has both a legal and an equitable owner, the legal owner holds it. [Section 10-20, item 2 in the table]

Information

7.59 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.

7.60 Therefore, the third general rule says that a taxpayer only holds information if:

⁹² For example, see the judgment of Gummow J. in *Hepples v FCT* (1990) 22 FCR 1.
⁹³ See the definition of *CGT asset* in section 108-5 of the ITAA 1997.

- 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 10-20, item 3 in the table]

7.61 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.

7.62 It is 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.

7.63 What is 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.

7.64 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 allows immediate tax relief for expenditure on such activities and preserves the general treatment given by the current law.⁹⁴

7.65 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.

7.66 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 (or engaged someone else to generate for you) is not recognised in net income, either because it is not held (in the case of information) or because it has a zero tax value (in the case of goodwill).

⁹⁴

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.

7.67 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.

What is an asset's tax value?

7.68 While *economic value* is an important concept underlying whether or not something is an asset, the prototype legislation generally does not use the concept to work out taxable income. Instead, it contains its own rules to work out the value of assets. Those values are called *tax values*. [Section 10-40]

Opening tax value

7.69 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 [section 6-85]. That was discussed in Chapter 6. The rest of this discussion explains the tax value an asset has at other times.

No negative tax values

7.70 The tax value of an asset can never be less than nil. If it would otherwise be reduced to less than nil, it is nil instead. This will be mostly relevant to depreciating assets and financial assets. [Subsection 10-40(2)]

Effects of particular tax values

7.71 In very broad terms, the *rules* about the tax values of assets after the start of a year can be categorised into 5 general *approaches*:

- cost;
- nominal value;⁹⁵
- market value;
- estimated value; and
- nil.

Cost

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

⁹⁵ See Chapter 14, about financial assets.

Example 7.1 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.⁹⁶

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

Market value

7.74 For some assets, taxpayers can choose to use their market value as the tax value. Using this method, gains and losses from market fluctuations between the start and end of the year would be brought to account.

7.75 However, that method will not be available for every asset. It will only apply when a taxpayer who qualifies chooses to apply it to one of the specified assets whose market value is readily ascertainable (e.g. trading stock and some financial assets).

Estimated value

7.76 This approach spreads an asset's expected gains or losses over time. It 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.

7.77 However, different techniques will be used to spread an asset's expected gains or losses depending on the kind of asset.

Example 7.2 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.

⁹⁶

This loss would be a quarantined investment asset loss (see Chapter 15).

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. The tax value of the computer declines by reference to expectations; it doesn't matter whether or not the computer's real economic value declines as expected.

Example 7.3 Tax value of appreciating financial assets

At the start of Year 1, Adequate Finance Corporation 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,⁹⁷ 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 a \$1,100 gain in Year 2.

7.78 Under the estimated value approach, the tax value of an asset at any time would equal its cost plus (or minus) the amount of the expected gain (or loss) that has accrued to that time.

Nil value

7.79 Some assets are given a nil tax value, either to make it clear in the case of doubt that nil is their actual value, or for reasons of policy (e.g. to encourage investment in particular activities) or to reduce the compliance costs otherwise involved in working out their tax value. The specific cases are discussed below (starting at paragraph 7.115).

Special rules for identifying assets

7.80 In general, the prototype legislation leaves it to common sense to determine whether or not something is one asset or a collection of assets. However, there are a number of cases where a specific outcome is required and rules are included in the prototype legislation to ensure that result.

Fixtures separate from the land

7.81 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). [Section 22-20]

7.82 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

⁹⁷ See section 76-210 of the prototype legislation (discussed in Chapter 14).

building). An improvement is a separately identifiable change to the land itself (e.g. a road or an earthen dam).

7.83 The reason for separating these things from the land is that the income tax 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, at general 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.

Extension or renewal of a right

7.84 When a right is renewed or extended, the renewed or extended right is treated as a continuation of the original right rather than as a separate asset [section 22-25]. This would apply, for example, to the renewal of a leasehold interest in land.

Insurance contracts

7.85 The rights of an insured taxpayer under an insurance contract are treated as 2 separate types of asset.⁹⁸ The first asset is the protection against risk. The second is the right to have any claims satisfied. An asset of that type arises each time the insured event occurs. It is contingent on that event (and sometimes also on a claim being lodged). The two types of right have to be separated because the policy is to treat the benefits of an insurance contract as generally being consumed evenly over the insured period, not as insured events occur. That is consistent with the result of the current law's prepayment rules.⁹⁹ [Subsection 22-30(1)]

7.86 The insured's costs under the insurance contract (mostly the premiums) will be allocated fully to the right to protection against risk [subsection 22-30(2)]. No part will be allocated to the contingent rights but, if one of them becomes non-contingent, or certain, it will be taken into account at its market value. How that happens is discussed in Chapter 10.

Example 7.4 Rights under typical insurance case

Big Bob's Bagels Pty Ltd (well known for its patented crusty cheese bagel) takes out a 3 year insurance policy against the risk of fire damage to its bagel factory. When it enters the insurance contract, it acquires both a non-contingent asset (protection against the risk of fire damage), and contingent assets (the rights to be compensated each time fire damage occurs). Big Bob's Bagels will allocate its premium payments solely to the non-contingent asset and ignore the contingent rights.

⁹⁸ Consideration is being given to whether rules similar to those for insurance contracts should apply in other cases (e.g. to warranties).

⁹⁹ See in particular, paragraph 82KZL(2)(c) of the ITAA 1936.

In the second year, the dough plant causes a fire in the west wing of the bagel factory. When the fire damage happened, a contingent right became certain and Big Bob's Bagels would bring it to account at the amount payable under the contract.

Other special asset identification rules

7.87 There may be some other special rules about identifying assets located in other areas of the TVM law. All of those cases will be listed in an index table so that readers can find them easily. *[Section 22-100]*

Special rules for holding assets

7.88 The general rules about who holds an asset have been discussed already (see paragraphs 7.49 and following). However, there are a few special rules that override the general rules in particular cases *[subsection 24-10(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.

7.89 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 the table). In those cases, the entity identified as not holding the asset is not the holder for any purposes of the Act *[subsection 24-10(2)]*.

Hire purchase, retention of title clauses and chattel mortgages

7.90 The first 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 they are 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.

7.91 The special rule only applies to assets that are either property or any other kind of legal or equitable right. It does not apply to any other sort of asset, including information. So, whether or not information that would otherwise satisfy the rest of this special rule is held by anyone is dealt with under the general rules. *[Subsection 24-10(1), item 1 in the table]*

7.92 A taxpayer *holds* one of those assets if they have the use and enjoyment of it under an arrangement (except as a beneficiary under a trust) and, by the time the arrangement ends, they will, or may, start to hold it under the general hold rules or under another special rule. *[Subsection 24-10(1), item 1 in the table]*

7.93 'Will or may' 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 the taxpayer starting to hold the asset and the totality of

the arrangements (*Case 2/93*, 93 ATC 107 at page 111). However, it is not necessary for there to be either an express right to acquire, or an express obligation to pass, title in the asset.

7.94 This rule will apply typically in hire purchase cases where the hiree is expected to buy the hired asset at the end of the agreement.

Example 7.5 Holding hire purchase assets

Amanda needs a car for use in her home swimming lessons business and decides to acquire it on hire purchase terms from a finance company. She pays a monthly hire charge and has 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 will hold the car, rather than the finance company.

7.95 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). In most of those cases, that title will pass to the purchaser, so the purchaser, not the vendor, will *hold* the asset.

7.96 Sometimes a taxpayer might cease to be the legal owner of an asset but retain use and enjoyment of it. If title to it is likely to pass back to them, they would still hold it. The typical case 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.

7.97 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. It will ensure that the mortgagor continues to hold the land for tax purposes for as long as they remain in possession.

Bare trusts

7.98 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 actual asset, instead of just their beneficial interest in it, and the trustee does not. 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. [*Subsection 24-10(1), item 2 in the table*]

Partnership assets

7.99 Assets that are partnership assets are *held* by the partnership and not by any of the partners. The partners also do not hold any interest in the partnership asset. This may not reflect the real economic ownership 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 asset's economic owner. [*Subsection 24-10(1), item 3 in the table*]

7.100 A partner's actual interest in each asset of the partnership is recognised under this system indirectly as a right to an appropriate share of the partnership's net income. That entitlement is a part of the partner's interest in the partnership as a whole, which *is* recognised as an asset the partner holds.¹⁰⁰

Other jointly held assets

7.101 Assets that would otherwise be held by 2 or more taxpayers are held by neither of them so long as each also holds an ownership interest in the jointly held asset (i.e. they are co-owners of the asset). In such cases, each of the co-owners is treated as if they only held their interest instead. [*Subsection 24-10(1), item 4 in the table*]

7.102 This is simply a rule to avoid counting assets twice. It ensures that there will seldom be more than one holder of each asset.

Example 7.6 Jointly holding assets

As a cost saving measure, Ripsnorter Productions and Crazy Kelly's Discount Advertisements go halves in the purchase of the latest video editing equipment. They jointly own the equipment but are not in partnership. 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 asset under the general rules.

Fixtures and improvements on land

7.103 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.

7.104 In both of those cases though, the economic owner may not be the landowner. 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.

¹⁰⁰ The Ralph Committee recommended some changes to the treatment of partnerships (which are not reflected in the prototype legislation) and further consultation on partnership issues (see ATSR, recommendation 16.16).

7.105 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 [section 22-20]. 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.

7.106 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 24-10(1), item 5 in 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 cease to be held by the owner of the quasi-ownership right and the landowner would hold it under the general rules.

7.107 Improvements, and fixtures that cannot be removed, on land subject to a quasi-ownership right are held by the owner of that right [subsection 24-10(1), item 6 in the table]. However, that is only the case if the owner of the quasi-ownership right, or a previous owner of a quasi-ownership right over the land, made the improvement or fixture *for their own use*.

Example 7.7 Holding tenants' non-removable assets

Simon leases a shop and installs a permanent wood-fired pizza oven. Because he owns a quasi-ownership right (the lease) over the land and affixed the oven for his own use, *Simon* would hold the pizza oven while the lease lasted. If the shop is later leased to Renee, she would become the oven's holder because it was affixed by a former lessee.

7.108 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 and so would continue to be the asset's economic owner. In such cases, the lessor will *hold* the asset. [Subsection 24-10(1), item 7 in the table]

Example 7.8 Leasing recoverable fixed assets

Terry leases a remote surveillance system to Pitterpatter Child Minding Services. It is installed on premises that Pitterpatter rents from another taxpayer. Pitterpatter has the right to remove the system under the State's tenants' fixtures law and Terry's lease agreement requires Pitterpatter to exercise that right. Because Terry has the right to recover the system, he would still hold it.

Dealing with inconsistent rights

7.109 One consequence of having special rules that make 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 result created

by the special rule. For example, treating a lessee of land as the holder of a fixture added by a previous lessee is inconsistent with the lessee's actual legal rights under the lease agreement.

7.110 Therefore, there is a final special rule to deal with those inconsistencies by treating the inconsistent actual rights as being held by no one for taxation purposes.

7.111 An entity that holds interests or rights in an asset that would make it the asset's holder is taken not to hold those interests or rights if someone else holds the asset itself *because of* one of the special rules. [Paragraph 24-10(3)(b)]

Example 7.9 Excluding inconsistent assets

Clare enters into a finance lease with Adequate Finance Corporation to acquire a car. Because the usual course with such finance leases is that Clare will become the car's owner, the special rules tell us that Clare holds the car and Adequate Finance does *not*. But Adequate is the car's legal owner and has all the rights that go with ownership (a right to sell the car, a right to retake possession at the end of the lease and so on). Those rights are inconsistent with Clare holding the car. The special rule deals with that inconsistency by providing that, for tax purposes, Adequate does not hold those rights.

7.112 Similarly, a taxpayer does not hold interests or rights in an asset if, because of those interests or rights, a special rule makes them the holder of the asset itself. [Paragraph 24-10(3)(a)]

Example 7.10 Excluding inconsistent assets

Continuing the previous example – because the special rules make Clare the holder of the leased car, she is taken not to also hold her actual right to use the car during the lease period.

The additional special rules

7.113 There will inevitably be some special rules about who holds an asset that are more appropriately included in a particular place in the prototype legislation because they relate to the other provisions there (e.g. the rules about STS taxpayers holding pools of depreciating assets are in Division 545 with the rest of the STS rules). All of those cases will be listed in an index table so that readers can find them easily. Like all the special rules about holding assets, those provisions override the general rules in section 10-20. [Section 24-100]

The particular tax value rules

7.114 Apart from the rule that prevents an asset's tax value being less than nil (see paragraph 7.70), the general rules about the tax value of assets is just a table. In most cases, the table simply provides a cross-

reference to the part of the prototype legislation that contains the detailed rules about those tax values. In the 2 cases where the table does provide the tax value directly, the details about the types of assets that it applies to are provided elsewhere and the table cross-references those places.

[Subsection 10-40(1)]

Listed zero tax value assets

7.115 Some assets will specifically be given a nil tax value [subsection 10-40(1), item 1 in the table]. They are called **listed zero tax value assets**. Expenditure on those assets will get immediate tax relief, because no increase in tax value will match the expenditure. The converse is true for receipts relating to those assets.

7.116 A nil tax value may be given to an asset because there is a policy reason to give immediate tax relief for expenditure on it (e.g. to encourage investment in those assets). A nil tax value may also be given to an asset for pragmatic reasons (e.g. to remove uncertainty or to reduce compliance costs).

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

- Routine rights [paragraph 68-10(1)(a)]. Typically, these are rights under equally and proportionately unperformed contracts. They are explained in more detail later but this is essentially a compliance cost saving measure made possible because the right's tax value would otherwise be matched by an equal and opposite liability.¹⁰¹
- Consumable stores and spare parts that are not trading stock [paragraph 68-10(1)(b)]. This is a compliance cost saving measure.¹⁰²
- Office supplies that are *not* trading stock [paragraph 68-10(1)(c)].
- Crops (including timber) planted either for sale or for environmental works on rural land [paragraph 68-10(1)(d)]. This measure maintains the treatment of crops under the current law, which only become trading stock when severed from the land. It is made necessary by the provision (subsection 22-20) that treats fixtures and improvements as separate from the land. The inclusion of planting for environmental works preserves an existing policy decision to encourage such activities.

¹⁰¹ This performs a similar function to the 'equally and proportionately unperformed contracts' concept found in accounting (see SAC 4, paragraphs 76 and 77).

¹⁰² The Ralph Committee recommended a ceiling of \$25,000 on the total amount 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 prototype legislation.

- The results of exploration and prospecting activities [*paragraph 68-10(1)(e)*]. 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 68-10(1)(f)*]. 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 an amount from a company by way of dividend or return of capital [*paragraph 68-10(1)(g)*]. This preserves the present treatment of such amounts.
- Rights of companies and trusts to receive capital contributions from members and beneficiaries [*paragraph 68-10(1)(h)*]. Again, this preserves the present treatment.

Routine rights and liabilities

7.118 Routine rights are listed zero tax value assets, and therefore have 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 you get the same outcome by giving them both a nil tax value.

7.119 This part of the Chapter describes when a right and its accompanying liability are *routine*; i.e. the circumstances in which you can say that the tax values of the right and the liability are likely to be equal without knowing what those tax values are.

7.120 The prototype legislation proposes 2 broad cases. Under both of them, 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 68-45(1)]

7.121 The first case also requires that the contract is *entirely unperformed* (i.e. neither party has yet provided or received any economic benefits under the contract). [Subsection 68-45(2)]

7.122 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 the second case applies.

7.123 The second case requires that, at the end of the year, the proportion of the total value of the economic benefits *provided* under the contract so far is substantially the same as the proportion of the total value of the economic benefits *received* so far. [Subsection 68-45(3)]

7.124 There are some important points to note here. First, it is not necessary that the values of the economic benefits received and provided match each other. It is only necessary that the *proportions* do. Of course, in most contracts the total value of what each party provides will be much the same, so in those cases the values of what has been provided and received to any point will be the same if the proportions are.

7.125 Secondly, the currency of proportionality is not the benefits themselves but the *value* of those benefits. It would not be enough that both parties have done, say, half of what they agreed to do; what is necessary is for each party to have provided the same proportion of the total *value* of what they have to do.

7.126 Thirdly, it does not matter that the proportions that each party provided in earlier years did not match; it only matters that they do match by the end of the current year. So, it is entirely possible for a right to move from being non-routine to routine from one year to another.

7.127 In working out whether the proportions of the values received and provided are substantially the same, the assumption is that the values have not changed since the parties entered into their agreement. This does *not* require market valuation, only that the assumption be made. [Subsection 68-45(3)]

Example 7.11 Routine rights and liabilities

Meryl enters into a lease of business premises from Senotni Pty Ltd in Year 1. The agreement provides that Meryl will take possession in the last month of Year 2 and will relinquish it at the end of Year 4 (25 months in total). The rent will be \$6,000 for Year 2, \$20,000 for Year 3 and \$24,000 for Year 4.

At the end of Year 1, Meryl's rights and liabilities under the lease contract are routine because it is, as yet, completely unperformed. It falls into the first case.

In Year 2, the rights and liabilities Meryl has will not be routine because she has provided 12% of the total value of the benefits under the lease (\$6,000 out of \$50,000) but received only 4% of the value of the benefits she is to receive (1 month out of 25). Economically, she has prepaid part of the rent for her future occupation of the premises.

In Year 3, the market value of the annual use of the premises has increased to \$30,000. Even so, Meryl's rights and liabilities are now routine because the \$26,000 she has paid in Years 2 and 3 is 52% of the value of what she agreed to pay, looked at when the contract was entered into. That is the same percentage of the benefits she has received (13 months out of 25).

7.128 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.

Ceasing to be routine

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

7.130 In those cases, the right and liability take the tax value they would have had if they had never been routine [subsections 68-50(1) and (2)]. 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 68-50(3)].

Trading stock

7.131 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 10-40(1), item 2 in the table]

7.132 The prototype legislation refers to the tax value being found in Division 70, which is not yet drafted, but will reproduce the taxpayer's existing choice of values.¹⁰³

Depreciating assets

7.133 Depreciating assets will have a tax value that declines as the economic benefits the asset provides are consumed [subsection 10-40(1), item 3 in the table]. In essence, that will replicate the present depreciation system¹⁰⁴ and prepayment rules.¹⁰⁵ However, instead of the amount of

¹⁰³ 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 prototype legislation.

¹⁰⁴ Division 40 of the ITAA 1997.

¹⁰⁵ Sections 82KZM and following of the ITAA 1936.

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.

7.134 Some things will be deemed to be depreciating assets so that they can get the same treatment as depreciating assets. That will apply to things like the ‘pools’ of assets and payments (e.g. project pools) created for regimes like STS¹⁰⁶ and capital allowances¹⁰⁷ either to reduce compliance costs associated with separately tracking many small assets or to spread the ‘deduction’ for a payment that would otherwise be deductible immediately.

7.135 The core tax value rules cross reference to Divisions 72 and 545 in the prototype legislation which work out the tax value of depreciating assets. Those rules are discussed in Chapters 12 and 19.

Market value assets

7.136 Some assets will be able to have a tax value equal to their market value [*subsection 10-40(1), item 4 in the table*]. That type of tax value will be available for these assets at the *election* of the taxpayer.

7.137 The types of assets that can have a tax value equal to their market value will mostly be financial assets whose market value is readily ascertainable. However, it may extend to assets with similar qualities, like shares, options and trading stock. The rules for how and when this method would be available have not yet been considered.¹⁰⁸

Financial assets

7.138 Financial assets are essentially rights to receive money or to get another financial asset (e.g. a right to get a bill of exchange). Consideration is being given to whether any other things (e.g. some shares, gold) properly belong within the definition.

7.139 If the taxpayer who holds them does not choose to give them a tax value equal to their market value, they will take one of several tax values provided by Division 76 based on whether or not they are short term debts, or debts that are due and payable immediately [*subsection 10-40(1), item 5 in the table*]. These issues are discussed in Chapter 14.

Investment assets

7.140 Every other asset is an investment asset [*subsection 10-40(1), item 6 in the table; section 78-10*]. Their treatment is described in Chapter 15.

¹⁰⁶ Division 328 of the ITAA 1997 and Division 545 in the prototype legislation.

¹⁰⁷ Division 40 of the ITAA 1997.

¹⁰⁸ This category is based on a recommendation of the Ralph Committee (see ATSR, recommendation 9.1).

Usual investment asset tax value

7.141 All investment assets will have a tax value based on cost. For some investment assets, their tax value will be a modified cost (discussed further at paragraph 7.145 and following). For the remainder, their tax value will equal their cost [*subsection 10-40(1), item 6 in the table; subsection 78-20(1)j*]. The assets falling into that category will be:

- tangible assets that are not depreciating assets (e.g. land);
- rights that are neither depreciating assets nor financial assets (e.g shares, a perpetual easement over another's land); and
- acquired commercial secrets.

7.142 The tax value of those assets will not change in line with changes in their market value. Therefore, gains and losses that accrue because of fluctuations in their market value will be ignored until the asset (or some part of it) is realised. A gain or loss will be brought to account at that time because there will be a difference between the sale price and the asset's cost.

7.143 It is still possible for the tax value of these assets to change because an asset's cost increases every time an amount is spent to improve it. That increase in tax value will be matched by the amount spent, so it will have no immediate effect on taxable income.

Example 7.12 Increase in tax value of shares

Virginia acquires 10,000 partly paid shares in New Miner NL for 20 cents a share when the shares are floated, so the tax value of each of her shares is 20 cents. If New Miner later makes a 10 cent call on the shares, their tax value will increase to 30 cents each.

The \$1,000 increase in the tax value of Virginia's assets will be brought to account but will be matched by a \$1,000 payment. As a result the transaction will have no effect on her taxable income.

7.144 In the case of acquired commercial secrets, the only part of the asset that is *held* is the information acquired from someone else [*section 10-20, item 3 in the table*]. Therefore, expenditure improving the information would only be recognised in its tax value if the improvement was also from acquiring 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.¹⁰⁹

¹⁰⁹

But see footnote 94.

Goodwill

7.145 The tax value of an investment asset that is goodwill is the cost to acquire it from someone else [section 78-50]. 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 goodwill acquired will get a tax value equal to its cost at that time but any subsequent increases in its cost will not be added to its tax value. That preserves the treatment in the current law.

Shares in companies and interests in trusts

7.146 The tax value of a share in a company at a particular time is its cost at that time, reduced by any non-dividend parts of amounts received before then. [Subsection 78-100(1)]

7.147 A non-dividend part of an amount in respect of a share is an amount received from the company (other than for ceasing to hold the share), except to the extent that it is:

- a dividend; or
- a distribution, made by a liquidator in the course of winding up a company, that is deemed to be a dividend by the, as yet unwritten, equivalent of section 47 of the ITAA 1936.

[Subsection 78-100(2)]

Example 7.13 Decrease in tax value of shares

Haydn buys 1,000 shares in the Evanmead Motors Corporation for \$4,000 in Year 1. At the end of the year, the shares would have a tax value equal to their \$4,000 cost.

In Year 2, the board of Evanmead Motors decides that the company is over-capitalised and resolves to return \$1 per share to the shareholders. Haydn's portion is \$1,000. As this is paid to him neither as a dividend nor for ceasing to hold his shares, it is a non-dividend amount and reduces the tax value of his shares. At the end of Year 2, they have a tax value of \$3,000.

7.148 The non-dividend part of an amount does not include:

- any part that the shareholder repays; or
- compensation the shareholder pays that represents a repayment of any of the amount.

[Subsection 78-100(3)]

7.149 A similar tax value is proposed for interests in a trust but a rule for this has not yet been drafted.

Chapter 8

Liabilities and their tax value

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 12 and in Parts 2-5 and 2-10 of the prototype legislation.

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* loss or outgoing rather than a loss or outgoing that is no more than impending, threatened or expected.¹¹⁰ The idea of a presently existing loss or outgoing 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.¹¹¹

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

¹¹⁰ *New Zealand Flax Investments Ltd v FC of T* (1938) CLR 179 at page 207; *Nilsen Development Laboratories Pty Ltd v FC of T* (1981) 144 CLR 616 at pages 623-4, 627.

¹¹¹ 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.

70-15 of the ITAA 1997. It stops an outgoing incurred to acquire trading stock being recognised 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. CGT event A1 (the main CGT event) happens when a contract to dispose of an asset is entered into *but only if* the disposal actually occurs.¹¹² 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 timing inconsistencies in the recognition of gains and losses.

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 revenue expenditure can be ‘incurred’ but only qualify for a deduction to the extent that it is ‘properly referable’ to the income year in which it is put to profitable advantage (e.g. see *Coles Myer Finance Ltd v FC of T* (1993) 176 CLR 640 at pages 663 and 665-6); 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 prototype legislation defines *liability* for the whole law. That definition, which draws on the accounting meaning, will help to clarify the scheme of the income tax law, making it easier to comply with.

Summary of prototype legislation

8.10 The prototype legislation divides the rules about liabilities into 3 main places. Division 12 contains all the general rules:

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

¹¹² Section 104-10, ITAA 1997.

8.11 Parts 2-5 and 2-10 then have some further rules about each of those things. They sometimes modify the general rules and sometimes provide details about particular aspects of the general rules.

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

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

8.14 The value at which the prototype legislation recognises a liability (its *tax value*) at any particular time will be:

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

Comparison of key features of prototype legislation and current law

8.15 Chapter 2 compares the treatment of liabilities under the current law to the treatment proposed under TVM.

Detailed explanation of prototype legislation

8.16 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 6-55]

8.17 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?

8.18 A *liability* is one or more obligations to provide future economic benefits [subsection 12-15(1)]. This definition draws on the accounting world's understanding of a liability.

8.19 A company's paid up share capital is also a *liability* [subsection 12-15(2)]. There may be a need for a similar rule for trusts but this is not yet drafted in the prototype legislation.

8.20 There is some doubt in law about whether a lessor has an obligation to provide a lessee with future economic benefits during the lease term. That doubt led to a special rule in the current law's prepayment rules to make it clear that a prepayment under a lease is for the asset being made available during the lease period.¹¹³ The prototype legislation contains a similar rule that is intended to avoid the same doubt. It provides that a lessor has an obligation to provide the economic benefits embodied in the lessee's rights under the lease during the lease term. [Subsection 12-15(4)]

What is an obligation?

8.21 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.

8.22 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).

8.23 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 12-15(1)]

Example 8.1 Owing obligation to one entity but providing benefits to another

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.

¹¹³ See paragraph 82KZL(2)(b) of the ITAA 1936.

8.24 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 equitable¹¹⁴ obligations (see paragraph 8.31).

8.25 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

8.26 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. 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.

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

8.28 There are a few special rules about whether something is one or more liabilities. These are discussed later (starting at paragraph 8.53).

Who has a liability?

8.29 The change in the tax value of a liability affects the taxable income of the taxpayer who *has* it. [*Section 6-55, steps 5 and 6 of the method statement*]

General rules

8.30 In general, an entity *has* a liability if they owe a present legal or equitable obligation to provide future economic benefits [*section 12-20, item 1 in the table*]. Subject to the special rules (starting at paragraph 8.59), no one *has* any other liability [*section 12-20, item 2 in the table*].

What is a legal or equitable obligation?

8.31 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?

8.32 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

¹¹⁴ ‘Equitable’ here is used in the legal sense, not the sense that it is sometimes used by accountants (e.g. in paragraph 55 of SAC 4).

exists then. Therefore, a future obligation is not a liability anyone has for tax purposes, no matter how certain it is to arise.¹¹⁵

8.33 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.

8.34 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 prototype legislation reproduces the effect of the current law's 'incurred' test for deductibility.

Example 8.2 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.

Obligations with contingencies

8.35 This distinction is often relevant to contingent obligations. When an entity enters into a contract they may provide consideration in the form of an obligation that is subject to some contingency.¹¹⁶ Such an obligation is a present obligation as a matter of contract law (the contract exists), even though the nature or extent of the future economic benefits under the obligation may change when the contingency is met.¹¹⁷

8.36 Consider, for example, granting a call option over shares. The grantor's obligation is not initially to provide shares. Instead, it has variously been described as an obligation to keep open the offer to sell the shares¹¹⁸ or as a presently existing, but not yet binding, obligation to sell the shares.¹¹⁹ This means that the nature of the future economic benefits to be provided under the obligation will change from a promise to meet the

¹¹⁵ *FC of T v James Flood Pty Ltd* (1953) 88 CLR 492 at pages 506-8; *Nilsen Development Laboratories Pty Ltd v FC of T* (1981) 144 CLR 616 at pages 623-4; *Coles Myer Finance Ltd v FC of T* (1993) 176 CLR 640 at pages 660-663.

¹¹⁶ Note that the reasoning here is not limited to obligations arising under contract.

¹¹⁷ *Community Development Pty Ltd v Engwirda Construction Co* (1969) 120 CLR 455 per Kitto J at page 459; *FC of T v Gosstray* [1986] VR 876 at pages 878-879.

¹¹⁸ See *Goldsbrough Mort & Co Ltd v Quinn* (1910) 10 CLR 674 per Isaacs J at 691 and 696.

¹¹⁹ See *Goldsbrough Mort* per Griffith CJ at 678.

call *before* the contingency is met, to a promise to provide the shares *after* it is met.

8.37 The key point is that the obligation is a present obligation as soon as the option agreement is entered into, even though the nature of the benefits to be provided in the future will change if the contingency is satisfied.

8.38 It might be said that this reasoning is inconsistent with the way the courts have interpreted ‘incurred’ in the context of section 8-1 of the ITAA 1997.¹²⁰ However, that section refers to ‘incurred’ in a different context. Firstly, the current law’s general deduction test refers to a ‘loss or outgoing’ incurred, whereas TVM defines a liability as an obligation to provide ‘future economic benefits’. Also, the current law’s general deduction test is one-sided (i.e. it recognises the taxpayer’s outgoing, but not what the taxpayer gets in return). TVM, on the other hand, is 2-sided; it typically recognises both the outgoing (the present obligation to provide future economic benefits) and the incoming (money or other assets).

8.39 So, the grantor of the call option initially has a present obligation to meet the call, which will have a tax value equal to the amount received for granting the option.¹²¹ However, the grantor does *not* have a present obligation to provide the shares until the contingency is met by the grantee exercising the option.

Provisions

8.40 The intention under TVM is to preserve the taxation law’s current approach to the recognition of provisions for future outlays, rather than adopting the accounting approach.

Example 8.3 Provision for unreported insurance claims

In accordance with normal insurance industry practice, Kwikpay Insurance sets aside \$1.5m in its accounts for claims arising during the year that have not been reported by year’s end. This is its statistical estimate of the amount that will be paid in relation to those claims. Kwikpay wonders whether the \$1.5m is a liability it has at the end of the year.¹²²

Kwikpay can have obligations to provide future economic benefits (viz. the compensation due under the insurance contract) even though

¹²⁰ And its predecessor in the ITAA 1936, subsection 51(1).

¹²¹ A liability subject to a contingency (an ‘uncertain obligation’) will have a tax value equal to any amount actually received for assuming the liability. If money is not actually received, the tax value will be zero unless the taxpayer got an asset (other than just an unperformed obligation) for assuming the liability. In that case, the taxpayer will be taken to receive an amount reflecting the asset’s value. TVM’s contingency rules in Division 28, discussed in Chapter 10, explain how the tax value of an obligation is affected by the existence, and meeting, of a contingency.

¹²² Note: These are the facts in *RACV Insurance Pty Ltd v FC of T* 74 ATC 4169.

it is not yet aware of them. The case law seems clear that they can be present obligations even before they are reported.¹²³ 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 cannot yet be known with certainty, a reasonable estimate based on reliable statistical data will be enough. Therefore, Kwikpay *has* a \$1.5m liability at the end of the year.

8.41 The accounting approach recognises a liability when it is *more likely than not* to reflect a future outlay.¹²⁴ By contrast, the taxation approach has traditionally been jurisprudential rather than commercial.¹²⁵ 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.¹²⁶

8.42 It is anticipated that there would be a need to include special rules to preserve the existing law's policy of not recognising some provisions (such as provisions for employee entitlements). This could be done by giving a tax value of zero to those liabilities. The prototype legislation does not yet include these rules.¹²⁷

What is the tax value of a liability?

8.43 The prototype legislation contains rules for valuing liabilities. The values they provide are called *tax values* [section 12-40]. Initially, it may seem strange to think of a liability as having a 'value' because our natural assumption is that our 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.

8.44 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.

¹²³ *RACV Insurance Pty Ltd v FC of T* 74 ATC 4169; *Commercial Union Assurance Co of Australia Ltd v FC of T* (1977) 7 ATR 435; 14 ALR 651; *FC of T v Mercantile Mutual Insurance (Workers Compensation) Ltd & Anor* 99 ATC 4404.

¹²⁴ See SAC 4 at paras. 65-67.

¹²⁵ See, for example, *FC of T v James Flood Pty Ltd* (1953) 88 CLR 492 at page 506.

¹²⁶ See a convenient summary of this relationship in the judgment of Hill J in *FC of T v Citibank* 93 ATC 4691 at pages 4698-4700.

¹²⁷ Recommendation 4.21 in ATSR recommends that the provisions recognised for tax purposes should remain as those that are recognised as being 'incurred' under the current law.

Opening tax value

8.45 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 [section 6-85]. This is discussed in more detail in Chapter 6.

No negative tax values

8.46 The tax value of a liability can never be less than nil. If it would otherwise be reduced to less than nil, it is nil instead. This will be mostly relevant to depreciating liabilities and financial liabilities. [Subsection 12-40(2)]

Effects of particular tax values

8.47 In very broad terms, the *rules* about the tax values of liabilities after the start of a year can be categorised into 5 general *approaches*:

- proceeds of incurring (the liability equivalent of cost);
- nominal value;¹²⁸
- market value;
- estimated value; and
- nil.

Proceeds of incurring a liability

8.48 If a liability's tax value is set at the proceeds of incurring it, 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 incurring a liability in Chapter 9.

Market value

8.49 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 8.76 explains what the market value of a liability is.

8.50 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).

¹²⁸

See Chapter 14, about financial liabilities.

Estimated value

8.51 This approach spreads the expected gain or loss on a liability's value over time. It 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 liabilities whose value is expected to decline (e.g. rights that only last for a limited time). Expected increases will only be recognised for a limited range of *financial* liabilities.¹²⁹

Example 8.4 Tax value of depreciating liabilities

Terrific Promotions Pty Ltd wins the contract to handle the publicity for the Prior 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 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:

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

$$[20,000 - 0] + [0 - 0] - [12,000 - 0] = 8,000$$

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 the concept of a depreciating liability.

Nil value

8.52 Some liabilities are given a nil tax value for reasons of policy or to reduce the compliance costs otherwise involved in working out their tax value. The specific cases are discussed below (starting at paragraph 8.67).

Special rules for identifying liabilities

8.53 In general, the prototype legislation leaves it to common sense to determine whether or not something is one liability or a collection of them. However, there are a few cases where a specific outcome is required and rules are included in the prototype legislation to ensure that result.

¹²⁹ See Chapter 14.

Extension or renewal of a liability

8.54 When a liability is renewed or extended, the renewed or extended liability is treated as a continuation of the original liability rather than as a separate liability. [Section 22-125]

Insurance contracts

8.55 The obligations of an insurer under an insurance contract are treated as 2 separate types of liability. The first liability is the obligation to provide insurance against the risk. The second is the obligation to satisfy any claims. An obligation of that type arises each time an insured event occurs. It is contingent on that event (and sometimes also on a claim being received). This rule mirrors that applying to assets (see paragraph 7.85 of Chapter 7). [Subsection 22-130(1)]

8.56 The insurer's proceeds of incurring the liabilities (mostly the premiums) will be allocated fully to the obligation to provide insurance against risk [subsection 22-130(2)]. No part will be allocated to the contingent obligations but, if one of them becomes non-contingent, or certain, it will be taken into account as a liability of the insurer at its market value. How that happens is discussed in Chapter 10.

8.57 Consideration is being given to whether rules similar to those that apply to insurance contracts should apply in other cases (e.g. to warranties).

Other special rules

8.58 There will inevitably be some other special rules to distinguish between liabilities that are more appropriately located in another place because they relate to the other provisions there. All of those cases will be listed in an index table so that readers can find them easily. [Section 22-200]

Special rules about having liabilities

8.59 There are some special rules about who has a liability. They override the general rules. [Subsection 24-110(1)]

Share capital

8.60 A company *has* a liability for the amount of its paid up share capital [subsection 24-110(1), item 1 in the table]. There will be a similar rule for trusts but this is not yet drafted in the prototype legislation.

Partnership liabilities

8.61 The partnership *has* any liabilities that are partnership liabilities. None of the partners has those liabilities. [Subsection 24-110(1), item 3 in the table]

8.62 This is particularly important for real partnerships (as opposed to relationships that are merely 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 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 and the effect on the partnership's net income flows through to each partner in proportion to their interest in the partnership.

8.63 The partners do not have partnership liabilities for *any* purposes of the Act. [*Subsection 24-110(2)*]

Dealing with inconsistent liabilities

8.64 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.

8.65 The final special rule deals with such inconsistent obligations. No one has a liability to provide the economic benefits embodied in any asset that no one holds because of the equivalent special rules for assets. [*Subsection 24-110(1), item 4 in the table*]

Example 8.5 Excluding inconsistent liabilities

Clare takes a finance lease over a car from the Adequate Finance Corporation. The asset special rules tell us that Clare holds the car and Adequate Finance does not. In fact, Adequate has a liability to make the car available to Clare in accordance with the terms of the lease. However, it does not have that liability for tax purposes because it matches an asset of Clare's that paragraph 24-10(3)(a) says she does not hold.

Other special rules

8.66 There will inevitably be some other special 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 an index table so that readers can find them easily. [*Section 24-200*]

Special rules about tax values of liabilities

8.67 Apart from the rule that prevents a liability's tax value being less than nil (see paragraph 8.46), the general rules about the tax value of liabilities is just a table. The table provides the full rule for working out a liability's tax value in only 2 cases. In 2 others, it simply provides a cross-reference to the part of the prototype legislation that contains the detailed rules about those tax values. In the remaining 2 cases, the table does provide the tax value directly but the details about the types of assets that

it applies to are provided elsewhere and the table cross-references those places. [*Subsection 12-40(1)*]

Nil tax values

8.68 For policy or practical reasons, a small number of liabilities will be given a tax value of nil [*subsection 12-40(1), item 1 in 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 normal effect of reducing taxable income that a liability has 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.

8.69 The prototype legislation presently defines ***zero tax value liabilities*** as:

- routine liabilities; or
- liabilities of companies to pay dividends or return capital.

[*Subsection 68-10(2)*]

8.70 You can only have a routine liability if you also have a routine right (and vice versa). This issue was discussed earlier at the same time as routine assets (see paragraphs 7.118 and following in Chapter 7).

8.71 Zero-valuing liabilities of companies to pay dividends to their members preserves the treatment under the current law. There will probably be a similar rule for trusts but that is not yet included in the prototype legislation.

Depreciating liabilities

8.72 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.

8.73 The rules for working out the tax values of those liabilities are in Division 72 of the prototype legislation and discussed in Chapter 13. [*Subsection 12-40(1), item 2 in the table*]

Market value liabilities

8.74 Some liabilities will be able to have a tax value equal to their market value [*subsection 12-40(1), item 3 in the table*]. This tax value will be available for these liabilities at the *election* of the taxpayer.

8.75 The types of liabilities that can have a tax value equal to their market value will mostly be those financial liabilities 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). However, the full scope of the rules for when this method would be available has not yet been determined.

8.76 There is arguably no market for liabilities, so describing their tax value as equal to their market value is perhaps a misdescription. 'Market value' means, in the case of liabilities, the market value of the asset that someone else has because the liability is owed to them.¹³⁰ [*Subsection 995-1(1), paragraph (a) of the definition of 'market value'*]

Financial liabilities

8.77 Financial liabilities are obligations to pay money or to provide a financial asset (e.g. an obligation to issue or transfer a bill of exchange).

8.78 Unless the taxpayer who has them chooses to give them a tax value equal to their market value, they will take one of the several tax values provided by Division 76 based on whether or not they are short term debts, or debts that are due and payable immediately [*subsection 12-40(1), item 4 in the table*]. These issues are discussed in Chapter 14.

Paid up share capital

8.79 The amount of a company's paid up share capital will be a liability to the company [*subsection 12-40(1), item 5 in 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.¹³¹

8.80 As share capital is returned to shareholders, the amount of the 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.

8.81 A similar rule will be included for trusts but is not yet included in the prototype legislation.

¹³⁰ An alternative would be to make their market value equal the amount you would have to pay someone else to assume the liability.

¹³¹ Whether this mechanism is the best way to achieve this result will be considered further.

Other liabilities

8.82 Any other liability has a tax value equal to the proceeds of incurring it. Whether there are any liabilities that are not covered by one of the other categories may be doubted but, if there are, their tax value is provided for. [*Subsection 12-40(1), item 7 in the table*]

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 incurring a liability; and
- the cost of extinguishing a liability.

9.2 The cost of an asset and the proceeds of incurring 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.

9.3 The rules for working these things out are contained in Division 14 of the prototype legislation.

Context of Reform

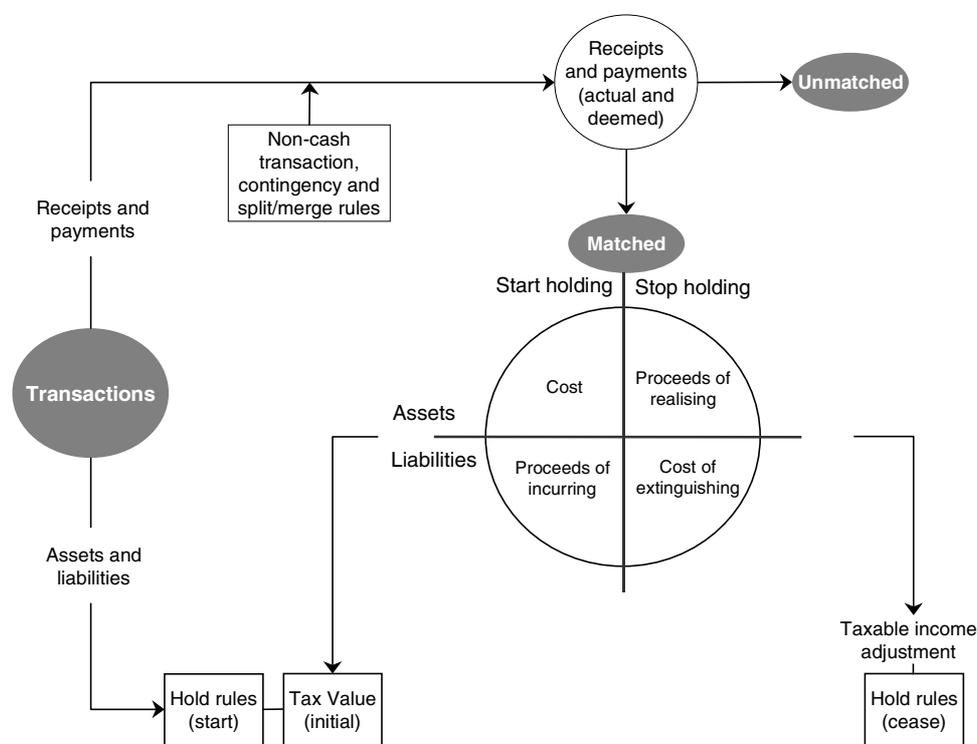
9.4 Working out the initial tax values of assets and liabilities is essential to calculating an entity's taxable income or tax loss. This is because the taxable income or tax loss of an entity depends upon their net income, and the calculation of net income uses a formula that takes into account the 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 TVM. The other essential components of this regime are the non-cash transaction and contingency rules, which are explained in Chapter 10, and the rules dealing with splitting and merging of assets and liabilities, which are explained in Chapter 11. We can describe these rules as a core valuation regime because the tax value of most assets starts at their cost, and the tax value of most liabilities starts at the proceeds of incurring them.

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 incurring 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 prototype legislation

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.

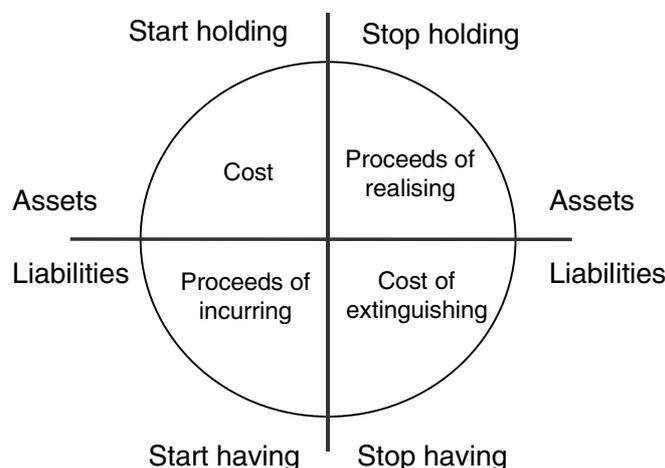
9.10 One of the most important features of the cost and proceeds regime is *symmetry*. This can be seen in the way that:

- 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 incurring 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 the proceeds of realisation of an asset for the creditor.

9.13 The prototype legislation 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), there is a split, merger or transformation of an asset or liability or a contingency is met. 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 condition and location from time to time;
- the *proceeds of realising* an asset are the amounts *received* because an asset ceases to be held;
- the *proceeds of incurring* a liability are the amounts *received* because the liability was assumed or increased;
- 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 TVM's core valuation regime, are explained in Chapter 10. The rules about uncertain obligations (also explained in Chapter 10), and splitting and merging of assets and liabilities (explained in Chapter 11) may also be relevant.

Comparison of key features of prototype legislation and current law

9.17 The prototype legislation 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 prototype legislation 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 prototype legislation and current law

<i>Prototype legislation</i>	<i>Current law</i>
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 <i>cost</i> 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 <i>proceeds of realising</i> 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 <i>proceeds of incurring</i> , and the <i>cost of extinguishing</i> , 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. Rules also exist to value liabilities for the purposes of the debt forgiveness rules.

Detailed explanation of prototype legislation

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

9.20 For most assets and liabilities, these rules are used to work out tax values. However, 2 important points should be noted:

- In general, the cost and proceeds rules assign *initial* tax values. So, while some assets always have a tax value of cost (e.g. land), other assets and liabilities have tax values which change over time (e.g. depreciating assets or liabilities).
- The cost and proceeds rules do 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 Division 68).

Cost of an asset

9.21 A crucial component of the net income calculation in sections 6-55 and 6-60 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.

9.22 The general definition of ‘cost’ adopts the unified concept of cost proposed in recommendation 4.18 of ATSR.

9.23 The *cost* of an asset at any particular time comprises 2 elements. That is, cost is made up of each amount which has been included in:

- the first element; and
- the second element.

[Subsection 14-20(1)]

9.24 An amount an entity pays is included in the *first element* or *second element* of cost only to the extent that the amount is reasonably attributable to the asset. *[Subsection 14-20(2)]*

What is the first element of cost?

9.25 The cost of an asset is determined by reference to payments. An amount an entity pays in order to start holding an asset is included in the first element of cost when the entity pays it, or when they start to hold the asset, if that happens later. *[Subsection 14-25(1)]*

9.26 It is important to note, however, that the concept of ‘pay’ includes both:

- actual (including constructive) payments; and
- deemed payments arising under a non-cash transaction, splitting or merging (Division 16), or the happening of a contingency (Division 28).

9.27 The rules for non-cash transactions are explained in Chapter 10. 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.

9.28 To illustrate:

- if an entity pays an amount for an asset, the asset's cost is the amount of money paid;
- 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;
- if an entity provides any other 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.

Example 9.1 Interaction between cost and non-cash transaction rules

On 30 June, Year 1, Odysseus buys a shipment of grain from Athene. Odysseus promises to pay \$100,000 for the grain by 30 July, Year 2. Even though Odysseus does not actually pay cash for the grain during Year 1, he is deemed to have paid \$100,000 for it under the non-cash transaction rules: section 16-15. The cost of the grain as at 30 June, Year 1 is therefore \$100,000.

Decreases in other asset tax values from starting to hold an asset

9.29 The first element of the cost of an asset includes the amount of a decrease in the total of the tax values of an entity's other assets that is attributable to the entity starting to hold the asset. This amount is included when the decrease happens, or when the entity starts to hold the asset, if that happens later. [*Subsection 14-25(2)*]

9.30 The most common situation in which this rule will apply is where an entity with a right to an asset gets that asset. When this occurs, their right to the asset is extinguished and replaced by the asset they had the right to get. If the right to get the asset is itself a separate asset, the first element of 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 (e.g. 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.

9.31 The effect of this is to 'roll over' the tax value of the right into the cost of the new asset.

Example 9.2 Decrease in other asset tax value from starting to hold an asset

As at 30 June Year 1, Artemis Ltd has the contractual right to a shipment of bauxite from Ajax Pty Ltd in Year 2. The tax value of this right is \$1 million.

When Artemis receives the bauxite in Year 2, the tax value of its assets would fall without the cost 'roll-over' rule, because Artemis' right to delivery would be discharged by performance.

However, under the roll-over rule the tax value of \$1 million previously assigned to Artemis' contractual right is 'rolled into' the cost of the bauxite. The cost of Artemis' bauxite would therefore be \$1 million.

Decreases in liability tax values from starting to hold an asset

9.32 Further, the first element of the cost of an asset is reduced by the amount of a decrease in the total of the tax values of an entity's liabilities that is attributable to the entity starting to hold the asset. The reduction is made when the decrease happens, or when the entity starts to hold the asset, if that happens later. [Subsection 14-25(3)]

Example 9.3 Decrease in liability tax value from starting to hold an asset

Artemis Ltd grants a put option to Ajax Pty Ltd over a shipment of bauxite. In return Artemis receives \$10,000. This is the proceeds of incurring Artemis' contingent liability to purchase the bauxite at a certain price, should Ajax exercise the option.

When Ajax exercises the option and sells the bauxite to Artemis for \$1 million, the tax value of Artemis' liabilities falls, because Artemis' obligation to purchase the bauxite would be discharged by performance.

Under the decrease in liabilities rule, the tax value of \$10,000 previously assigned to Artemis' contractual liability is deducted from the cost of the bauxite. The cost of Artemis' bauxite would therefore be \$990,000.

What is the second element of cost?

9.33 An amount an entity pays in order to bring an asset to its condition and location from time to time is included in the second element when the entity pays it. [Subsection 14-30(1)]

Example 9.4 Second element of cost

Telemachus adds a new tray and canopy to improve his ute. The materials that go into the addition contribute to the ute's condition. The payment he makes for those materials is included in the second element of the ute's cost.

9.34 Deemed payments can be included in the second element of cost. So, for example, if an entity gives one or more non-cash benefits in order to bring an asset to its condition and location, Division 16 treats the entity as paying an amount for this.

9.35 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 condition and/or location.

Example 9.5 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 condition and location of the harvester; each is unmatched and therefore ‘deductible’ in the year of payment.

9.36 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.

Decreases in tax values of other assets attributable to second element

9.37 The amount of any decrease in the tax value of an entity’s other assets that is attributable to bringing an asset to its condition and location from time to time is also included in the second element of cost, when the decrease occurs. [Subsection 14-30(2)]

9.38 The most common case where this rule will be relevant is where second cost elements are added by way of contract. In that case, actual or deemed payments will be allocated to the first element of cost of the contract rather than the second element of cost of the underlying asset. This rule ensures that payments an entity makes for its rights against the contractor are rolled into the tax value of the underlying asset as the contract is discharged.

Example 9.6 Second element of cost under contract

Telemachus pays Argus to add a new tray and canopy to improve his ute. The payment goes into the first element of the cost of Telemachus’ contractual rights against Argus.

When Argus does the work, the tax value of Telemachus’ right falls. That fall is ‘rolled into’ the second element of the cost of Telemachus’ truck.

Decreases in tax values of liabilities attributable to second element

9.39 Further, the amount of a decrease in the total of the tax values of an entity’s liabilities that is attributable to bringing the asset to its

condition and location from time to time reduces the second element when the decrease happens. [Subsection 14-30(3)]

Nexus between payments and asset

9.40 Inherent in the requirement that payments be made ‘in order to’ hold an asset, or bring it 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.

Example 9.7 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.

In doing so, Philip actually pays money, and also incurs liabilities to pay further amounts. His actual and deemed payments are added together in order to determine the cost of the cigarettes. In manufacturing the cigarettes, 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.

9.41 It is important to consider the *purpose* for which the payment is made.¹³² 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.

9.42 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

<i>Types of contracts</i>	<i>Expenses commonly incurred</i>
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.

¹³² *A-G v Sillem* (1864) 2 H&C 431 per Pollock CB at page 525.

<i>Types of contracts</i>	<i>Expenses commonly incurred</i>
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.

9.43 The current law would normally treat these expenses as revenue (and therefore deductible), although they would in some circumstances be treated as capital.¹³³ 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.

¹³³

See for instance (1958) 9 TBRD, Case J7, 32.

9.44 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.¹³⁴ 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.

9.45 Under TVM, 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.¹³⁵ 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.

No adjustments to cost to reproduce the current CGT ‘cost base’

9.46 The prototype legislation 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

9.47 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 prototype legislation 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).

Professional advice by non-recognised adviser

9.48 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 prototype legislation changes the cost rules applying to CGT assets, as expenditure of this

¹³⁴ *Taxation Ruling IT 2197.*

¹³⁵ 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.

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

9.49 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 prototype legislation 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.

Additional items included in second element for some private or domestic payments relating to land

9.50 Under TVM, amounts are also included in the second element of the cost of land when paid, to the extent that they are:

- reasonably attributable to land; and
- are of a private or domestic nature.

[Subsection 14-30(4)]

9.51 This provision would cover, for example, interest on money borrowed in order to purchase the land, rates and land tax.

9.52 This rule reflects ATSR recommendation 4.13(d)(i). Payments for land of a private or domestic nature are included in the land's cost because the gain on the land will be taxed;¹³⁶ it is therefore appropriate to allow tax relief for expenses directly attributable to the land.

9.53 The 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.

9.54 For each amount that subsection 14-30(4) includes in the cost of land, a loss reduction amount arises for the land *[subsection 14-30(5)]*. This is explained in Chapter 15.

Items excluded from cost of an asset

9.55 The cost of an asset does *not* include the following items:

- interest on money borrowed; or

¹³⁶ Subject, of course, to the main residence exemption.

- an amount to the extent that the entity has paid it in order to maintain, repair or insure the asset; or
- rates or land tax.

[Subsection 14-35(1)]

9.56 This rule ensures that those expenses reduce an entity's net income *immediately* (unless prepaid) rather than only doing so when the asset ceases to be held.

9.57 The list may 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 would be done if the prototype legislation is developed further.

9.58 However, the cost of land includes an item covered by subsection 14-35(1) to the extent provided by subsection 14-30(4). **[Subsection 14-35(2)]**

9.59 This means that 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 14-35 does not prevent these amounts from being added to the cost of the land. This ensures expenditure of this kind is given tax relief.

Special rules about cost

9.60 There are 4 special rules which are used to work out the cost of an asset in particular circumstances. These are set out in Division 26 of the prototype legislation.

Devolution under a deceased estate

9.61 Firstly, 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 26-20, item 1 in the table]**

9.62 This treatment 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.

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

Live stock

9.64 Secondly, live stock that an entity acquires by way of natural increase can be valued at a cost prescribed by regulation. This is consistent

with current law. 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 26-20, item 2 in the table]*

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

Minister's declaration – airports

9.66 Thirdly, where the Minister for Finance makes a determination as to cost, this determination applies to the exclusion of the cost under the general rules. *[Section 26-20, item 3 in the table]*

9.67 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.

Partner's asset becomes partnership asset

9.68 Finally, 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 26-20, item 4 in the table]*. This reflects the current treatment for capital allowances under Division 40 of the ITAA 1997.

9.69 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 asset.

Proceeds of realising an asset

9.70 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.

9.71 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 discountable investment asset 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.

What are the proceeds of realising an asset?

9.72 The ***proceeds of realising*** an asset are the total of:

- each amount an entity receives, before or at the time when they stop holding the asset, because they stopped holding it; and
- the amount of each decrease in the total of the tax values of an entity's liabilities that is attributable to them ceasing to hold the asset;

reduced by the amount of each decrease in the total of the tax values of the entity's other assets that are attributable to them ceasing to hold the asset.
[Section 14-40]

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

- actual (and constructive) receipts; and
- deemed receipts arising under a non-cash transaction, split or merge (Division 16), or the happening of a contingency (Division 28).

9.74 The rules for non-cash transactions are explained in Chapter 10. 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 realising 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 9.8 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 \$10,000. Even though Poseidon is actually receiving services, he is deemed, under the non-cash transaction rules, to have received \$10,000. \$10,000 is the proceeds of realising the car.

Nexus between receipt and ceasing to hold

9.75 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.

Special rules about proceeds of realisation

9.76 There are 2 special rules which are used to work out the proceeds of realising an asset in particular circumstances. These are set out in Division 26 of the prototype legislation.

Devolution under a deceased estate

9.77 Firstly, 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 26-40, item 1 in the table]

9.78 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

9.79 Secondly, 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 26-40, item 2 in the table]. This rule corresponds to the cost rule discussed at paragraphs 9.68 and 9.69.

Proceeds of incurring a liability

9.80 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.

9.81 The proceeds of incurring 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. TVM 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 an entity *pays* to start holding it, the proceeds of incurring a liability are what an entity *receives* to start owing it.

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

9.83 At a particular time, the *proceeds of incurring* a liability an entity has are the total of:

- each amount that has been included in the first element at or before that time (or nil if no amount was included); and
- each amount that has been included in the second element at or before that time (or nil if no amount was included).

[Subsection 14-75(1)]

9.84 An amount an entity receives is included in the *first element* or *second element* only to the extent that the amount is reasonably attributable to the liability. *[Subsection 14-75(2)]*

What is the first element of proceeds?

9.85 The proceeds of incurring a liability are determined by reference to receipts. A receipt falls within the first element of the proceeds of incurring a liability where:

- it causes the entity to start having the liability; or
- it was caused by the entity starting to have the liability.

[Subsection 14-80(1)]

9.86 Each amount is included in the first element when the entity receives it, or when it starts to have the liability, if that happens later.

9.87 The first and second elements of proceeds of incurring a liability comprise amounts the entity 'received'. This includes both:

- actual (and constructive) receipts; and
- deemed receipts arising under a non-cash transaction, splitting or merging (Division 16), or the happening of a contingency (Division 28).

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

Example 9.9 Assuming a liability

Odysseus arranges an overdraft facility for his business with his bank, Homer Ltd in Year 1. At the same time, he overdraws the account by \$1,000. \$1,000 is Odysseus' initial proceeds of incurring this liability.

In Year 2, 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 incurring Odysseus' 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.

Decreases in other liability tax values from starting to have a liability

9.89 The first element of the proceeds of incurring a liability includes the amount of a decrease in the total of the tax values of an entity's other liabilities that is attributable to them starting to have the liability. The amount is included when the decrease happens, or when the entity starts to have the liability, if that happens later. [Subsection 14-80(2)]

Example 9.10 Decrease in other liability tax values from starting to have a liability

In Year 1, the Artemis Board of Works agrees to assume a number of Ajax Pty Ltd's obligations under a debenture trust deed in Year 2. In return, Artemis is paid \$1 million. This is the proceeds of incurring Artemis' liability to assume another liability in the following year.

In Year 2, Artemis assumes the liability under the trust deed. As a result, its liability to do that is discharged by performance. The fall in tax value of Artemis' liability to Ajax at this time is 'rolled into' the tax value of its obligation to the debenture holders.

Decreases in asset tax values from starting to have a liability

9.90 Further, the first element of the proceeds of incurring a liability is reduced by the amount of a decrease in the total of the tax values of an entity's assets that is attributable to the entity starting to have the liability. The reduction is made when the decrease happens, or when the entity starts to have the liability, if that happens later. [Subsection 14-80(3)]

Example 9.11 Decrease in asset tax value from starting to have a liability

In Year 1, the Artemis Board of Works is granted a right to assume Ajax Pty Ltd's obligations under a debenture trust deed in Year 2 for \$1 million. For this it pays \$10,000. (Artemis believes that it can make a gain on this transaction, on the basis that the net present value of the payments it will have to make under the deed will be less than \$990,000).

The cost (and tax value) of Artemis' right is \$10,000. In Year 2, it will assume Ajax's liabilities. The tax value of its assets falls because Artemis' right to assume the liability would be discharged by performance.

Under the decrease in asset value rule, the tax value of \$10,000 previously assigned to Artemis' contractual right is deducted from the proceeds of incurring its liability under the deed. The proceeds of incurring this liability are therefore \$990,000.

What is the second element of proceeds of incurring a liability?

9.91 The proceeds of incurring a liability are determined by reference to receipts. A receipt falls within the second element of the proceeds of incurring a liability where:

- it causes the entity's liability to increase; or
- it was caused by the entity having an increased liability.

[Subsection 14-85(1)]

9.92 Each amount is included in the second element when the entity receives it, or at the time of the increase, if that happens later.

Example 9.12 Increasing a liability

Following from Example 9.9, in Year 2 Odysseus draws a cheque for \$500 against his overdraft account.

The \$500 goes into Odysseus' proceeds of incurring the liability he started to owe in Year 1. 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.

9.93 *Deemed* receipts can be included in the second element of the proceeds of incurring a liability. So, for example, if an entity gets one or more non-cash benefits as an augmentation of an existing liability, Division 16 treats the entity as receiving an amount for this.

Decreases in other liability tax values from increasing a liability

9.94 The amount of a decrease in the total of the tax values of an entity's other liabilities that is attributable to the liability increasing is included in the second element when the decrease happens, or when the liability increases, if that happens later *[subsection 14-85(2)]*.

Decrease in asset tax values from increasing a liability

9.95 Further, the amount of a decrease in the total of the tax values of an entity's assets that is attributable to the liability increasing reduces the

second element when the decrease happens, or when the liability increases, if that happens later. [*Subsection 14-85(3)*]

Nexus between receipt and liability

9.96 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.

Special rules about proceeds of incurring a liability

9.97 There are 2 special rules which are used to work out the proceeds of incurring a liability in particular circumstances. These are set out in Division 26 of the prototype legislation.

Devolution under a deceased estate

9.98 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 incurring the liability is equal to the tax value of the liability at the time of death. [*Section 26-75, item 1 in the table*]

9.99 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.¹³⁷

Partner’s liability becomes partnership liability

9.100 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 26-75, item 2 in the table*]

Cost of extinguishing a liability

9.101 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 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.

9.102 The cost of extinguishing a liability does not need to be separately calculated in most cases. Frequently, extinguishment costs will

¹³⁷ *Halsbury’s Laws of Australia* [395-4205] at page 736,877; *Norman v Baldry* (1834) 58 ER 726.

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.

What is the cost of extinguishing a liability?

9.103 The *cost of extinguishing* a liability is the total of:

- each amount an entity pays, before or at the time when they stop having a liability, in order to stop having it (to the extent that the amount is reasonably attributable to the liability); and
- the amount of each decrease in the total of the tax values of an entity's assets that is attributable to them ceasing to have the liability;

reduced by the amount of each decrease in the total of the tax values of the entity's other liabilities that is attributable to the entity ceasing to have the liability. [Section 14-90]

9.104 It is important to note, however, that the concept of 'pays' includes both:

- actual (including constructive) payments; and
- deemed payments arising under a non-cash transaction, split or merge (Division 16) or the happening of a contingency (Division 28).

Nexus between payment and ceasing to have

9.105 Inherent in the requirement that the entity pays 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.

Special rules about cost of extinguishing a liability

9.106 There are 2 special rules which are used to work out the cost of extinguishing a liability in particular circumstances. These are set out in Division 26 of the prototype legislation.

Devolution under a deceased estate

9.107 Firstly, 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 26-90, item 1 in the table*]

Partner's liability becomes partnership liability

9.108 Secondly, 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 26-90, item 2 in the table*]

Apportionment and allocation

9.109 As foreshadowed, the cost and proceeds rules allocate actual and deemed receipts and payments by reference to the extent to which those receipts and payments are 'reasonably attributable' to the asset or liability concerned.

9.110 The 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.

How much of an amount is reasonably attributable to something (such as an asset or liability)?

9.111 If some, but not all, of an amount is reasonably attributable to something (for example, an asset or liability), how much of the amount is ***reasonably attributable*** to that thing is worked out having regard to the relative market values, at the time when the amount is paid or received, of:

- that thing; and
- everything else to which any of the amount is reasonably attributable.

[Section 14-120]

9.112 Implicit in the 'reasonably attributable' requirement is that there will be a re-allocation of costs and proceeds for tax purposes where the allocation determined by the parties is unreasonable.

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

- received or paid for 2 or more different assets; or
- received or paid for one or more assets and one or more things which are not assets (e.g. services or a liability); or

- received as compensation for the assumption, or paid for the extinguishment, of 2 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 are not liabilities (e.g. services or an asset).

Apportionment and deemed cashflow

9.114 As previously mentioned, the non-cash transaction and splitting and merging rules in Division 16, and the contingency rules in Division 28, may deem an entity to have received and paid amounts in a non-cash transaction. Where this occurs, the deemed receipt and payment are apportioned across the assets and liabilities involved in the same way as an actual receipt or payment.

No double-counting

9.115 For the avoidance of doubt, the cost and proceeds rule have a number of rules which prevent double-counting of receipts and payments in the cost and proceeds of assets and liabilities.

Cost of assets

9.116 The cost of an asset does not include an amount, to the extent that the amount is included in:

- the cost of *another* asset (even if the tax value at a particular time of one or both of the assets is not worked out by reference to cost); or
- the entity's cost of extinguishing a liability.

[Paragraph 14-130(a)]

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

9.117 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 (compare to section 10-20, item 3 of the table). *[Section 10-20, items 3 and 4 in the table]*

9.118 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.

9.119 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 cost of the separate intellectual property assets that arise as a result of that information.

9.120 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;¹³⁸ 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.

9.121 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 9.13 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.¹³⁹

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 10-20, item 4 of the table; compare to: item 3). Further, the intellectual property (copyright) acquired by Argus is a 'listed zero tax value asset', because its subject matter is advertising material: paragraph 68-10(1)(f). This means that neither the information nor the copyright have any impact upon Argus' net income.

¹³⁸ 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.

¹³⁹ This may be affected by the project pool rules and those dealing with a 5-year statutory write-off for some expenditure (see footnote 135).

Example 9.14 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 10-20, item 4 of the table; compare to 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.¹⁴⁰

Example 9.15 Cost of extinguishing a liability vs cost

On 30 June, Year 1, Idomeneus purchases a palette of DVD players for his electrical store. He must pay \$10,000 for this by 30 July in Year 2. Under the non-cash transaction rules, Idomeneus is deemed to have paid \$10,000 for the DVD players in Year 1 and to have received the same amount for his liability to pay: section 16-15.

In Year 2, Idomeneus pays \$10,000 for the DVD players. This \$10,000 is *not* part of the cost of the DVD players. Rather, it is the cost of extinguishing his liability to pay.

Proceeds of realising an asset

9.122 The proceeds of realising an asset do not include an amount, to the extent that it is included in the proceeds of realising *another* asset.
[Paragraph 14-130(b)]

Proceeds of realising an asset

9.123 The proceeds of incurring a liability do not include an amount, to the extent that it is included in:

¹⁴⁰ This may be affected by the project pool rules and those dealing with a 5-year statutory write-off for some expenditure (see footnote 135).

- the proceeds of incurring *another* liability (even if the tax value at a particular time of one or both of the liabilities is not worked out by reference to the proceeds of incurring); or
- the proceeds of realising an asset

[Paragraph 14-130(c)]

Cost of extinguishing a liability

9.124 Finally, the cost of extinguishing a liability does not include an amount, to the extent that the amount is included in the cost of extinguishing *another* liability. *[Paragraph 14-130(d)]*

Chapter 10

Credit transactions, non-cash transactions and contingencies

Outline of Chapter

10.1 This Chapter explains the rules in Subdivisions 16-A to 16-D of the prototype legislation, which deal with arrangements involving non-cash benefits. These arrangements are:

- short-term trade credit transactions;
- 2-sided non-cash transactions (e.g. barter); and
- one-sided non-cash transactions.

10.2 This Chapter also explains the rules in Division 28, which address the treatment of non-cash benefits which are contingent in nature because they consist of or include one or more uncertain obligations.

Two important points about the non-cash transaction rules

10.3 There are 2 important points which need to be kept in mind in order to properly understand the scope and significance of the non-cash transaction rules in this prototype legislation.

Integral part of the TVM's core valuation regime

10.4 Firstly, the non-cash transaction rules are essentially a *mechanism* which allows taxpayers to work out the cost and proceeds of assets and liabilities. This regime operates by:

- using *deemed payments* (together with any 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 any actual receipts) to establish the proceeds of incurring 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

10.5 Secondly, the rules apply to any transaction other than one in which a non-cash benefit is exchanged for money only.

10.6 Consequently, the non-cash transaction rules cover what we conventionally understand to be a barter transaction. But they also extend beyond traditional notions of barter to include:

- cashless transactions of all kinds, including exchanges of rights, even if those rights ultimately result in cashflow (e.g. credit purchases and sales); and
- 2-way exchanges of non-cash benefits combined with amounts of cash.

Context of Reform

10.7 TVM 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 are essential.

Core valuation regime

10.8 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.

10.9 The non-cash transaction rules support TVM's core valuation regime for assets and liabilities: the cost and proceeds rules in Division 14, explained in Chapter 9.

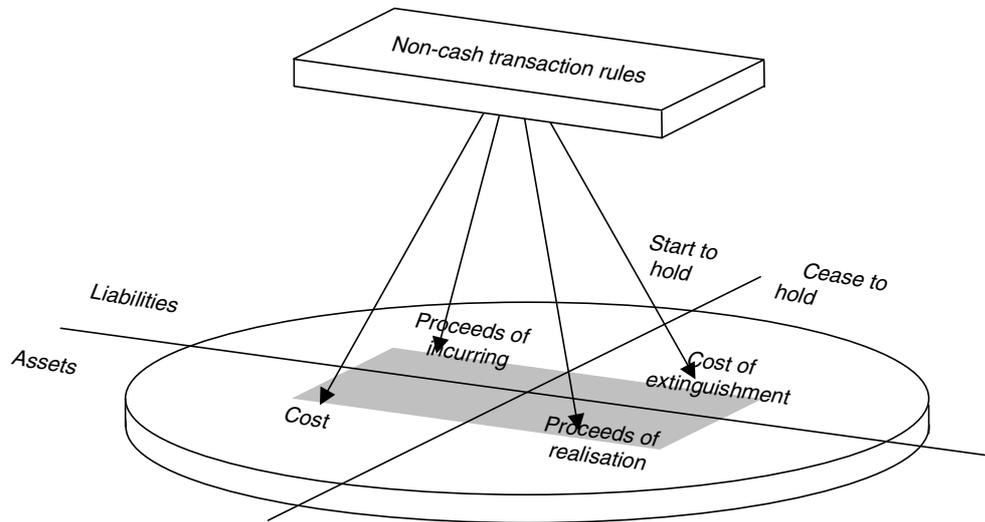
10.10 The non-cash transaction rules interact with the cost and proceeds rules by generating a series of deemed receipts and payments. This approach allows the tax system to recognise the value of a non-cash benefit as forming all or part of:

- the cost of an asset an entity acquires;
- the proceeds of realising an asset an entity ceases to hold;
- the proceeds of incurring a liability an entity starts to have; or

- the cost of extinguishing a liability an entity ceases to have.

10.11 This relationship is shown in the following diagram.

Diagram 10.1 Relationship between non-cash transaction and cost and proceeds rules



10.12 As the diagram shows, the non-cash transaction rules generate ‘inputs’ into the cost and proceeds rules.

Drafting economy and simpler law

10.13 This mechanism performs an important technical function. It simplifies the drafting of the prototype legislation by treating most things that tend to increase net income as receipts, and most things that that tend to reduce net income as payments.

10.14 The considerable simplification achieved by this approach is demonstrated in the following table.

Table 10.1 Simplification achieved by using ‘receive’ and ‘pay’ terminology

<i>Concept in prototype legislation</i>	<i>Economic concepts covered</i>
‘Receive x’.	<ul style="list-style-type: none"> • Receive money of x amount; • Receive right to money with market value of x; • Receive right to any other asset with a market value of x; • Receive any other asset with market value of x; • Receive services with market value of x; • Have liability of x extinguished or decreased by x; • Asset’s proceeds of realisation is x; • Asset’s proceeds of realisation is increased by x; • Liability’s proceeds of incurring is x; • Liability’s proceeds of incurring is increased by x.
‘Pay x’.	<ul style="list-style-type: none"> • Pay money of x amount; • Give right to money (assume liability to pay) with market value of x; • Give right to any other asset with a market value of x; • Give any other asset with market value of x; • Give services with market value of x; • Extinguish someone’s liability of x or decrease it by x; • Asset’s cost is x; • Asset’s cost is increased by x; • Liability’s cost of extinguishment is x; • Liability’s cost of extinguishment is increased by x.

Summary of prototype legislation

10.15 The common feature of the rules about credit transactions, non-cash transactions and contingencies is that they all use *deemed receipts and payments* as a mechanism for assigning initial tax values to the assets and liabilities involved in an arrangement.

When do the non-cash transaction rules apply?

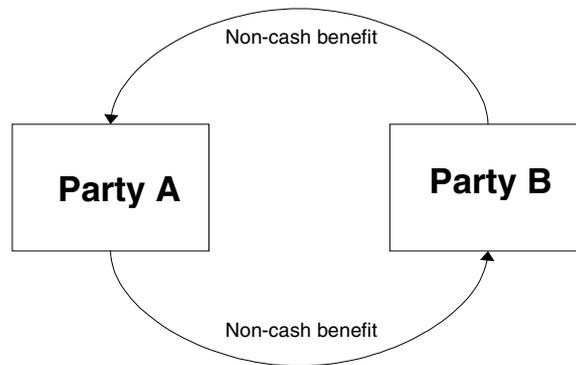
10.16 The non-cash transaction rules apply to any arrangement under which at least one entity gives one or more non-cash benefits for something other than just money. A non-cash benefit is essentially a service or any asset other than money.

10.17 There are 2 basic forms of non-cash transaction; 2-sided non-cash transactions and one-sided non-cash transactions.

Two-sided non-cash transactions

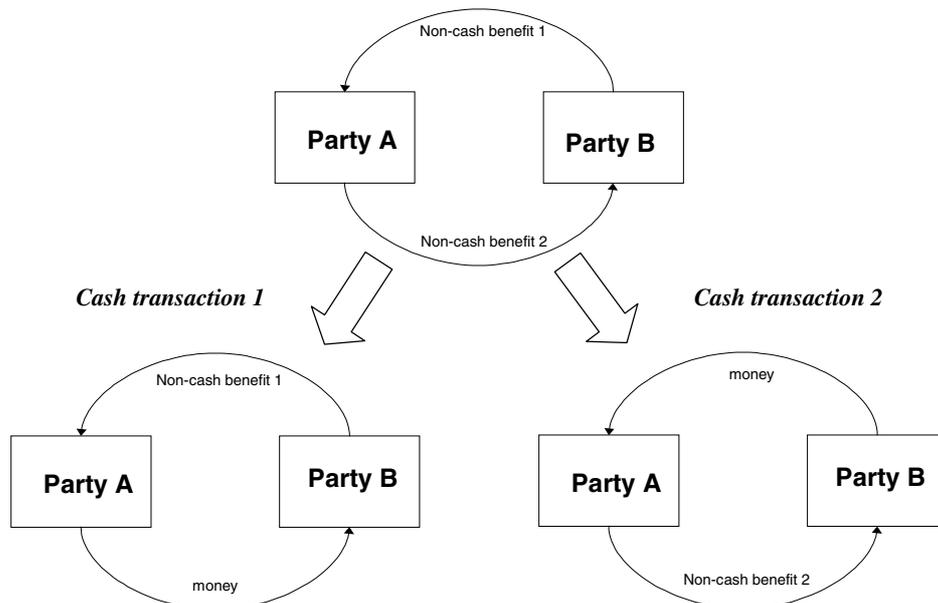
10.18 A 2-sided non-cash transaction involves an exchange of non-cash benefits between entities. This is illustrated in the following diagram.

Diagram 10.2 A 2-sided non-cash transaction



10.19 The effect of the 2-sided non-cash transaction rule is set out in the following diagram.

Diagram 10.3 Effect of the 2-sided non-cash transaction rule



10.20 As the diagram shows, the 2-sided non-cash transaction rules treat 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.

10.21 The *amount* of the deemed receipt and payment under a 2 sided non-cash transaction is worked out like this:

Table 10.2 Amount of deemed receipts and payments

<i>Type of transaction</i>	<i>The amount of the deemed receipt and payment is:</i>
Assume a liability to pay (or get a right to receive) money within 12 months after the liability comes into existence, in return for a non-cash benefit other than a financial asset. This is a short-term trade credit transaction.	The amount you are liable to pay (or receive).
Any other 2-sided non-cash transaction.	The market value of what you <i>get</i>

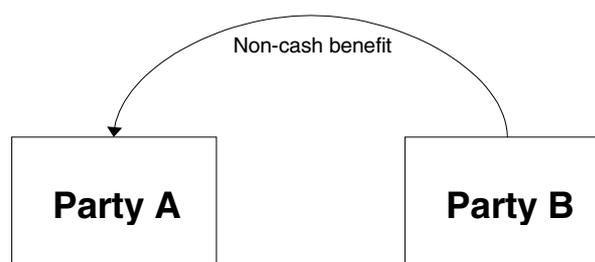
10.22 These deemed receipts and payments are taken to arise in addition to any *actual* receipts and payments that may flow between the parties at the time the transaction is entered into.

10.23 Because, in a non-private situation, 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. Their main effect, therefore, is to set the initial tax values and/or disposal proceeds of assets and/or liabilities of the entities involved in the arrangement.

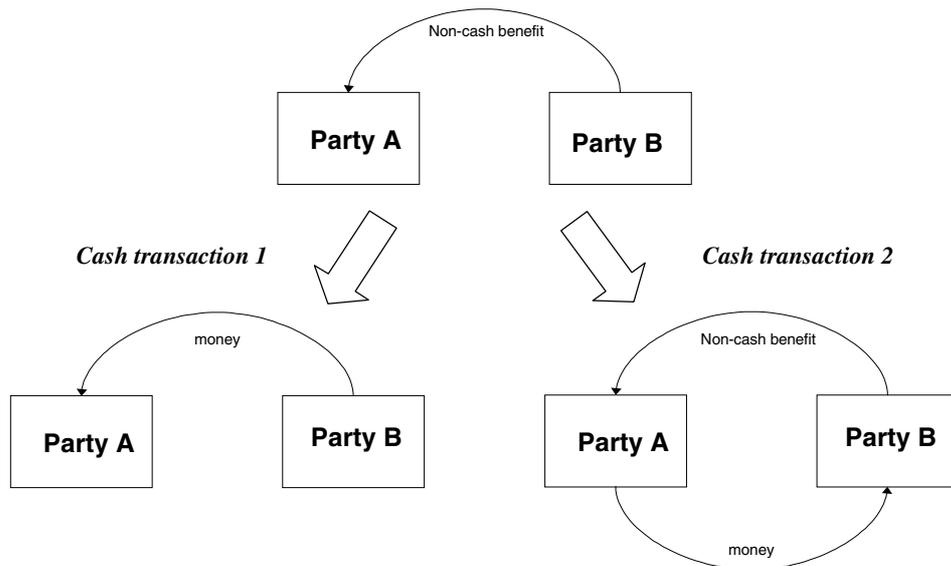
One-sided non-cash transactions

10.24 A one-sided non-cash transaction involves one entity giving (and another entity getting) a non-cash benefit without consideration. This is illustrated in the following diagram.

Diagram 10.4 A one-sided non-cash transaction



10.25 The effect of the one-sided non-cash transaction rule is set out in this diagram.

Diagram 10.5 Effect of the one-sided non-cash transaction rule

10.26 As the diagram shows, the rule treats the single transaction as if it comprised 2 separate transactions, each involving a money payment. 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.

10.27 The amount of each deemed receipt and payment is equal to the market value of the non-cash benefit given or received, as the case may be. 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.

10.28 Again, in a non-private situation, the deemed receipts and payments are equal, and therefore have no direct effect on the entity's net income. Their effect is to set initial tax values and/or disposal proceeds of assets and/or liabilities of the entities involved in the arrangement.

Effect of uncertain obligations on 2-sided non-cash transactions

10.29 An uncertain obligation can be a non-cash benefit. An uncertain obligation is essentially a presently existing obligation which nonetheless has a contingency that goes to whether or not the obligation will be fulfilled.

10.30 The general rule is that uncertain obligations an entity gives or gets are *disregarded* for the purposes of the non-cash transaction rules, except to the extent that they are given or received in return for at least one asset that is *not* an unperformed obligation. An unperformed obligation is a non-cash benefit consisting of a liability to provide non-cash benefits.

Uncertain obligations becoming certain

10.31 Finally, there are rules to address the situation when uncertain obligations become certain. In that case, rights and obligations which have become non-contingent are given full recognition by the tax system. This is done by deeming:

- a receipt to arise for an uncertain obligation becoming certain (offset by an equal payment); and
- a payment to arise for an uncertain right becoming certain (offset by an equal receipt).

10.32 The effect of this is to align the proceeds of incurring the newly-certain obligation and the cost of the newly-certain right with their market values. However, this rule does not apply in some cases, such as where an option over an asset is exercised.

Comparison of key features of prototype legislation and current law

10.33 There are 2 important points of comparison between the non-cash transaction rules in the prototype legislation and those in the current law.

Unified set of principles

10.34 Firstly, TVM's 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.

10.35 But the non-cash transaction rules go even further, by unifying the non-cash principles in the current law with the foundations of accruals tax accounting. They do this by providing a mechanism to assign tax values to financial assets and liabilities.

Overcoming potential double counting

10.36 Secondly, the non-cash transaction rules seek to overcome an anomaly which could potentially arise under the various cost rules in the current law. A duplication of taxing points can arise in non-cash transactions under the current law, which regards an exchange of assets as both a purchase and a sale; this difficulty is discussed in detail below in paragraphs 10.105 to 10.112. It does not often surface in practice, because we tend to assume that parties dealing at arm's length will exchange benefits of equal market value.

Comparison of key features

10.37 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.

Table 10.3 Comparison of key features of prototype legislation and current law

<i>Prototype legislation</i>	<i>Current law</i>
By providing a mechanism for determining the tax values of financial assets and liabilities, allows the timing of income recognition and tax relief to be determined on a principled, predictable and consistent basis.	Taxable income recognised according to judicial tax accounting concepts. <ul style="list-style-type: none"> • For income – amounts recognised where to do so would provide a ‘substantially correct reflex’¹⁴¹ of a taxpayer’s income. • For deductions – amounts recognised where ‘incurred’ and not of a capital nature; in some cases, the question of whether an expenditure is ‘properly referable’¹⁴² to a year of income is relevant.
Recognises the value of <i>all</i> 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.
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.
Deemed receipts and payments used to determine tax values of assets and liabilities across the income tax law.	Deemed receipts and payments used to determine cost and termination value of depreciating assets.
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.

¹⁴¹ *C of T (SA) v Executor Trustee & Agency Co of South Australia* (1938) 63 CLR 108.

¹⁴² *Coles Myer Finance Ltd v FC of T* 93 ATC 4214.

<i>Prototype legislation</i>	<i>Current law</i>
Where total income from non-cash business benefits does not exceed \$300, the first \$300 of such income will be exempt from income tax.	Where the total income derived from non-cash business benefits does not exceed \$300, the first \$300 of such income is exempt from income tax.
Provides a unified set of rules for dealing with contingent rights and liabilities.	Has many different contingency rules, scattered throughout the law. Examples include: <ul style="list-style-type: none"> • Judicial tests for determining when income is ‘derived’ or expenditure ‘incurred’; • The provisions relating to the distinction between debt and equity;¹⁴³ • Provisions relating to uncertain capital costs or proceeds.¹⁴⁴

Detailed explanation of prototype legislation

10.38 There are 3 main categories of arrangement dealt with under the non-cash transaction rules:

- short-term credit transactions;
- other 2-sided transactions, which include barter transactions; and
- one-sided transactions.

10.39 The intention of both these sets of rules is to treat non-cash benefits consistently and in accordance with their economic substance, and to support the rules, in Division 14, for working out the cost and proceeds of assets and liabilities. [*Section 16-5*]

10.40 It is important to note that the non-cash transaction rules do *not* apply to arrangements under which one or more of the parties immediately pays money. The rules can apply, however, where an entity promises to pay money in the future, or money is paid in addition to one or more non-cash benefits.

Short-term trade credit transactions

10.41 The most common situation in which the non-cash transaction rules will apply is where non-cash benefits are bought or sold on credit. This is addressed in Subdivision 16—B of the prototype legislation.

¹⁴³ Division 974 of the ITAA 1997.

¹⁴⁴ Paragraphs 112-20(1)(b) and 116-30(2)(a), and section 116-45 of the ITAA 1997.

When does the rule apply?

10.42 There are 4 requirements which must be satisfied in order for the short-term trade credit rules to apply.

10.43 Firstly, there must be an arrangement under which an entity ('the debtor') starts to have a financial liability to pay an amount ('the base amount') to another entity ('the creditor') [*paragraph 16-15(1)(a)*]. A financial liability is a liability consisting of an obligation to pay an amount or to provide a financial asset (see Chapter 14).

10.44 Secondly, the debtor's liability must be covered by item 2 of the table in section 76-115 [*paragraph 16-15(1)(b)*]. A liability of this kind is an obligation to pay money within 12 months after the day when the liability comes into existence, in return for a non-cash benefit *other than* a financial asset.

10.45 Thirdly, the debtor must get the one or more non-cash benefits which the base amount is for *and nothing else* under the arrangement [*paragraph 16-15(1)(c)*]. So, for example, if the debtor received money from the creditor, or a combination of non-cash benefits and money, the rule would not apply.

10.46 Finally, the creditor must get the financial asset corresponding to the debtor's financial liability *and nothing else*, other than any amounts the debtor actually pays, under the arrangement [*paragraph 16-15(1)(d)*]. So, for example, if the debtor promised to pay money and also provided a service in return for a non-cash benefit, the rule would not apply.

What are the consequences of the rule applying?

10.47 Where the rule applies, a deemed receipt and payment arises for both the debtor and the creditor [*subsection 16-15(2)*]. The effect of this is to generate inputs into the cost and proceeds rules in Division 14.

The debtor

10.48 In effect, the debtor is treated as if they had borrowed the base amount from the creditor and immediately paid it back in order to purchase the non-cash benefit from them. [*Subsection 16-15(4), item 1 in the table*]

10.49 The consequence of this is that the cost of the asset(s) (if any) acquired by the debtor will be equal to the base amount (see paragraph 14-20(1)(a) and subsection 14-25(1)).

Example 10.1 The effect of the short-term trade credit rule on the debtor

On 30 June in Year 1, Telemachus purchases an item of trading stock, on credit, for \$1,100. He promises to pay for the stock by 30 July in Year 2. In Year 1, Telemachus is deemed to receive \$1,100 and as a

result to start having a financial liability; the proceeds of incurring his liability are therefore \$1,100. He is also deemed to have paid \$1,100 for the stock; the cost of his stock is therefore \$1,100.

The creditor

10.50 In effect, the creditor is treated as if they had loaned the base amount to the debtor and immediately received that amount back as the purchase price of the non-cash benefit(s) given to them. [*Subsection 16-15(4), item 2 in the table*]

10.51 The consequence of this is that the proceeds of realising the non-cash benefits given to the debtor (to the extent that they are assets) will be equal to the base amount (see section 14-40).

Example 10.2 The effect of the short-term trade credit rule on the creditor

On 30 June in Year 1, Odysseus sells an item of trading stock, on credit, for \$1,100. The purchaser, Telemachus, promises to pay for the stock by 30 July in Year 2. In Year 1, Odysseus is deemed to receive \$1,100 (the base amount) for the trading stock he sold; the proceeds of realising his stock are therefore \$1,100. He is also deemed to have paid \$1,100 for his financial asset (comprising the right to payment); the cost of his right is therefore \$1,100.

Apportionment

10.52 If more than one non-cash benefit is given (or received) it will be necessary to apportion the amount taken to be received (or paid) between them. This apportionment is done under the core apportionment rule in section 14-120 (see paragraph 9.114 of Chapter 9).

Example 10.3 Apportionment under a short-term credit transaction

On 30 June in Year 1, Telemachus purchases 2 items of trading stock and a professional service from Odysseus, for \$1,100. He promises to pay for the stock and service by 30 July in Year 2. In Year 1, Telemachus is deemed to receive \$1,100 (the base amount) and as a result to start having a financial liability; the proceeds of incurring his liability are therefore \$1,100. He is also deemed to have paid \$1,100 for the stock and services.

Telemachus reasonably estimates, by reference to the relative market values of the things he has received from Odysseus, that 40% of the \$1,100 is for the first item of trading stock, 10% is for the second, and 50% is for the service. This means that the cost of the first item of stock is \$440 and the cost of the second is \$110. The services are not an asset, and do not therefore have a cost; Telemachus can therefore write-off the remaining \$550 of the deemed payment in Year 1.

How are actual payments of money treated?

10.53 The short-term credit rule can apply where the debtor pays money to the creditor as well as assuming a liability. Where that occurs, the payment is taken into account *in addition to* the deemed cash flows arising under the arrangement. [Section 16-10]

Example 10.4 Actual payment by the debtor

On 30 June in Year 1, Telemachus purchases an item of trading stock from Odysseus for \$1,100. He actually pays \$100, and promises to pay the remaining \$1,000 by 30 July in Year 2. In Year 1, Telemachus is deemed to receive \$1,000 (the base amount) and as a result to start having a financial liability; the proceeds of incurring his liability are therefore \$1,000. He is also deemed to have paid \$1,000 for the stock.

The *deemed* payment of \$1,000 is included in the cost of the stock. In addition, the *actual* payment of \$100 is included also. The cost of the stock in Year 1 is therefore \$1,100.

Meanwhile, Odysseus has exchanged a non-cash benefit (the stock) in return for \$100 and a financial asset comprising his right to \$1,000. He is deemed to receive \$1,000 for the stock. He also *actually* receives \$100. The proceeds of realising the stock are therefore \$1,100. Odysseus is deemed to have paid \$1,000 for his right to payment. The cost of that right is therefore \$1,000.

What are the consequences if the financial liability consists of or includes an uncertain obligation?

10.54 Subdivision 16-B contains a special rule to deal with increases in the amount payable under a short-term credit transaction arising because of the happening of a contingency.

10.55 Amounts are taken to be received and paid each time the tax value of the financial liability increases [subsection 16-15(3)]. The tax value of a financial liability in a short-term credit transaction is determined in accordance with section 76-115, and will therefore be the amount that must be paid. The amount to be paid would only increase if a contingency relating to the liability is satisfied.

10.56 Again, the consequences for both the debtor and the creditor are specified.

Consequences for the debtor

10.57 In effect, the debtor is treated as if they had borrowed the increase in the financial liability from the creditor and immediately paid it back as part of the purchase price of the non-cash benefits it got under the arrangement [subsection 16-15(4)]. The consequence of this is that the cost of the non-cash benefit increases by the amount of the increase in the liability.

Consequences for the creditor

10.58 In effect, the creditor is treated as if they had loaned the increase in the financial liability to the debtor and immediately received that amount back as part of the sale price of the non-cash benefits it gave under the arrangement [subsection 16-15(4)]. The consequence of this is that the proceeds of realising the non-cash benefit increase by the amount of the increase in the debtor's liability.

Example 10.5 Increased price caused by late payment

On 30 June Year 1, Apollo Pty Ltd sells coffee beans to Paris Pty Ltd for \$1,000. However, if Paris does not pay by 30 July Year 2, a penalty applies and the price of the coffee increases to \$1,100.

In Year 1, Paris is deemed to have received \$1,000 and to have started having a financial liability as a result. Paris is also deemed to have paid \$1,000 for the coffee. This means that, as at 30 June Year 1, the proceeds of incurring Paris' liability to pay for the coffee are \$1,000, and the cost of the coffee is \$1,000:

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

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

As it happens, Paris does not pay for the coffee until 1 August Year 2. At the expiry of 30 July Year 2, Paris' obligation to pay a further \$100 becomes certain. The tax value of this liability automatically increases by \$100 under section 76-115, item 2 of the table.

The base amount for the purposes of subsections 16-15(3) and (4) is \$100. Paris is deemed to receive \$100 for assuming the liability to pay the additional \$100, and to have paid an additional \$100 for the coffee. This means that the proceeds of incurring Paris' liability increases to \$1,100, as does the cost of the coffee.

$$[100 - 100] + [1,100 - 1,000] - [1,100 - 1,000] = \$0$$

Meanwhile, Apollo is treated in a symmetrical manner.

Compliance issues

10.59 It should be noted that, in practice, applying this rule is no different to applying the current law.

10.60 Under the current law, a value needs to be determined for assets acquired or liabilities incurred, even if payment has not yet occurred. The realisation proceeds of assets must also be determined, even if receipt has not yet occurred.

10.61 Although the legislative mechanism uses deemed receipts and payments to determine cost and proceeds, there is no need, in practice, to think of every transaction in those terms. The costs and proceeds generated by the deemed receipts and payments under these rules are the same as those obtained under the current law.

Two-sided non-cash transactions

10.62 Two-sided non-cash transactions (which include barter arrangements) are addressed in Subdivision 16-C of the prototype legislation.

10.63 The 2-sided non-cash transaction rules operate using the same mechanism as the short-term trade credit rules; cost and proceeds are established by generating deemed receipts and payments. However, the 2-sided non-cash transaction rules differ from the short-term credit rules in that receipts and payments are established by reference to the market value of the non-cash benefits an entity *gets* under the arrangement.

When does the rule apply?

10.64 The 2-sided non-cash transaction rules apply in cases that one would classically describe as barter; e.g. exchanging a tractor for a ute. However, they also apply to other cashless exchanges; e.g. promising to provide a stream of lease payments over 5 years in return for a right to possession.

10.65 Further, the 2-sided non-cash transaction rule applies to 2-way exchanges of non-cash benefits which also include money.

3 requirements

10.66 There are 3 requirements that must be satisfied in order for the 2-sided non-cash transaction rules to apply:

- Firstly, there must be an arrangement under which an entity *gives* at least one non-cash benefit [*Paragraph 16-25(1)(a)*].
- Secondly, the same entity must *get* at least one non-cash benefit under the same arrangement [*Paragraph 16-25(1)(b)*].
- Finally, the arrangement must *not* be one to which the short-term credit rule applies [*paragraph 16-25(1)(c)*]. The treatment of arrangements of this type is explained above at paragraphs 10.41 to 10.61.

What are the consequences of the rule applying?

10.67 Where the rule applies, a deemed receipt and deemed payment arises for the entities to which it applies. The amount of both the receipt

and the payment is worked out by reference to the market value of the non-cash benefits the entity *gets* in the transaction.

10.68 In effect, the entity is treated as if it had purchased the non-cash benefits it got for their market value and immediately received that purchase price back as sale proceeds of the non-cash benefits it gave.

The deemed receipt

10.69 Specifically, an entity is taken to receive an amount in return for all of the non-cash benefits its gives under the arrangement. That amount is equal to the sum of the market values of all of the non-cash benefits the entity *gets* under the arrangement, determined at the time when they get them [*subsection 16-25(2)*]. The deemed receipt arises at the time the entity gives the non-cash benefits [*subsection 16-25(4)*].

10.70 The consequence of this is that the amount of the receipt will form:

- the proceeds of realising the asset(s) (if any) the entity gives (see section 14-40); and/or
- the proceeds of incurring the liabilities (if any) the entity assumes (see paragraph 14-75(1)(a) and subsection 14-80(1)).

Example 10.6 Deemed receipt under a 2-sided non-cash transaction

Telemachus enters into a scrip-for-scrip transaction with Penelope. He gives Penelope 1,000 shares in Odysseus Pty Ltd (cost \$7,000 and market value, \$10,000),¹⁴⁵ and Penelope gives him 500 shares in Zeus Pty Ltd (market value, \$10,000).

Telemachus is deemed to have received, under subsection 16-25(2), \$10,000 for the Odysseus shares he gave. This is the proceeds of realising the Odysseus shares.

The deemed payment

10.71 The same amount that was deemed to be received is also deemed to be paid for the non-cash benefits the entity gets under the arrangement [*subsection 16-25(3)*]. The deemed payment arises at the time the entity gets the non-cash benefits [*subsection 16-25(4)*].

10.72 This deemed payment is then used by the cost and proceeds rules to determine:

- the cost of the asset(s) (if any) the entity gets (see paragraph 14-20(1)(a) and subsection 14-25(1)); and/or

¹⁴⁵ Note that where there is no 'general market' (e.g. 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 page 324.

- the cost of extinguishing pre-existing liabilities (if any) the entity had (see section 14-90).

Example 10.7 Deemed payment under a 2-sided non-cash transaction

Following on from the previous example, Telemachus is deemed to have paid \$10,000 for the shares he received, under subsection 16-25(3). The cost of the Zeus shares is therefore \$10,000.

So, under the net income formula, the result for Telemachus is:

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

$$[10,000 - 10,000] + [10,000 - 7,000] - [0 - 0] = \$3,000.$$

The gain Telemachus made under this transaction is recognised immediately, unless a roll-over applies. This gain will be reduced by the investment asset discount (via the taxable income adjustment rules) if the eligibility requirements for it are met.

Apportionment

10.73 An entity may exchange a number of separate assets, assume a number of liabilities, pay an amount, or do a combination of these things, under a single arrangement.

10.74 It is generally necessary to ascertain the cost of each asset acquired and the proceeds of incurring each liability assumed under a non-cash transaction. Further, it is sometimes necessary to work out the proceeds of realising each asset disposed of and the cost of extinguishing each liability that is discharged. This will generally be the case where the ‘gain’ or ‘loss’ on the transaction needs to be isolated for policy reasons; e.g. application of the investment asset discount.

10.75 The deemed receipts and payments generated by the 2-sided non-cash transaction rule are apportioned across assets and liabilities in accordance with the core apportionment rule in section 14-120. This apportionment is done on a reasonable basis, having regard to the relative market values of the assets and/or liabilities being exchanged.

Example 10.8 Apportionment of a deemed payment in a 2-sided non-cash 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, and to have paid the same amount. Athene’s deemed payments are worked out like this:

- Payment_{packing machine} = $9,000 \times \left(\frac{4,000}{9,000} \right) = \$4,000$
- Payment_{generator} = $9,000 \times \left(\frac{3,000}{9,000} \right) = \$3,000$
- Payment_{trolley} = $9,000 \times \left(\frac{2,000}{9,000} \right) = \$2,000$

These amounts represent the cost of each asset acquired.

How are actual payments of money treated?

10.76 The 2-sided non-cash transaction rule can apply where there is a 2-way exchange of non-cash benefits and one or more parties also pays cash. Where that occurs, the payment is taken into account *in addition to* the deemed cash flows arising under the arrangement. [Section 16-10]

10.77 An apportionment rule applies to modify the operation of subsections 16-25(2) and (3) in a 2-sided non-cash transaction that includes cash payments. Where the entity actually pays money under the arrangement, the deemed receipt and payment is worked out using the following formula [subsection 16-25(5)]:

$$\frac{\text{NCBs you give}}{(\text{NCBs you give} + \text{Payments})} \times \text{NCBs you get}$$

10.78 For the purposes of the formula in subsection 16-25(5):

- *NCBs you get* means the total of the market value, or the total of the market values, of the one or more non-cash benefits the entity gets under the arrangement.
- *NCBs you give* means the total of the market value, or the total of the market values, of the one or more non-cash benefits the entity gives under the arrangement.
- *Payments* means the total of the one or more amounts the entity *actually* pays under the arrangement.

[Subsection 16-25(6)]

Example 10.9 2-sided non-cash transaction – actual payment by a party

Telemachus enters into a scrip-for-scrip transaction with Penelope. Under the transaction, Telemachus gives Penelope shares in Odysseus Pty Ltd (cost \$7,000 and market value, \$10,000) and Penelope gives Telemachus shares in Zeus Ltd (cost \$5,000 and market value, \$3,000), \$6,000 in cash, and a promise to pay a further \$1,100 in cash in 8

months. This promise has a market value of \$1,000 at the date of the agreement, assuming an implicit interest rate of 15.39%.

Telemachus

Telemachus is deemed to receive \$4,000 for the Odysseus shares under subsection 16-25(2). 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 financial asset with a market value of \$1,000. Telemachus also *actually* receives \$6,000 for the shares. The proceeds of realising the Odysseus shares are therefore \$10,000.

Under subsection 16-25(3), Telemachus' total deemed payment of \$4,000 is allocated like this:

$$\text{Payment}_{\text{Zeus Shares}} = \$4,000 \times \left(\frac{3,000}{4,000} \right) = \$3,000$$

$$\text{Payment}_{\text{Promise}} = \$4,000 \times \left(\frac{1,000}{4,000} \right) = \$1,000$$

Note that under 16-25(3) the deemed payment is only apportioned across the non-cash benefits Telemachus gets, *not* the cash.

So, under the net income formula, the result for Telemachus is:

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

$$[10,000 - 4,000] + [4,000 - 7,000] - [0 - 0] = \$3,000$$

Telemachus makes a 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 investment asset discount (via the taxable income adjustment rules) if the eligibility requirements for it are met.

When Penelope pays off her liability in 8 months, the effect for Telemachus will be:

$$[1,100 - 0] + [3,000 - 4,000] - [0 - 0] = \$100$$

Telemachus is effectively assessed on the \$100 in implicit interest he receives under this arrangement.

Penelope

Since Penelope is *actually* paying money, subsections 16-25(5) and (6) apply. Using the apportionment formula in subsection 16-25(5), Penelope's deemed receipt is worked out like this:

$$\text{Receipt}_{\text{Zeus shares and promise}} = \left(\frac{4,000}{10,000} \right) \times 10,000 = \$4,000$$

This deemed receipt is apportioned under section 14-120 like this:

$$\text{Receipt}_{\text{Zeus shares}} = 4,000 \times \left(\frac{3,000}{4,000} \right) = \$3,000.$$

$$\text{Receipt}_{\text{Promise}} = 4,000 \times \left(\frac{1,000}{4,000} \right) = \$1,000.$$

This means that the proceeds of realising Penelope's Zeus shares are \$3,000, and the proceeds of incurring her liability to pay are \$1,000.

Penelope's deemed payments for the Odysseus shares are also \$4,000, under subsection 16-25(3). This is combined with her *actual* payment of \$6,000, to give a cost for the Odysseus shares she got of \$10,000. So, under the net income formula, the result for Penelope is:

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

$$[4,000 - 10,000] + [10,000 - 5,000] - [1,000 - 0] = -\$2,000.$$

This loss will be quarantined by way of an adjustment, to the extent that she has no investment asset 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):

$$[10,000 - 1,100] + [0 - 10,000] - [0 - 1,000] = -\$100.$$

Penelope is effectively able to 'deduct' the \$100 in implicit interest she paid under this arrangement.

Uncertain obligations

10.79 A special rule applies where a non-cash benefit provided in a 2-sided non-cash transaction consists of one or more uncertain obligations [sections 28-10 and 28-15]. This is discussed in detail below at paragraphs 10.122 to 10.157.

Compliance issues

10.80 Again, it should be noted that applying this rule is similar to applying the current law.

10.81 Under the current law, costs and proceeds need to be determined for virtually every non-private transaction, *even if it involves no cash*.¹⁴⁶ This involves determining the market values of what is given and received.

¹⁴⁶ e.g. sections 21 and 21A of the ITAA 1936, and paragraphs 40-185(1)(b), 40-305(1)(b), 70-45(1)(a), 110-25(2)(b) and 116-20(1)(b) of the ITAA 1997.

Where multiple assets or liabilities are involved, the current law also requires that market values be apportioned.

10.82 Although the legislative mechanism uses deemed receipts and payments to determine cost and proceeds, there is no need, in practice, to think of every transaction in those terms.

Setting off cash on both sides of a transaction

10.83 Subdivision 16-C contains a special rule for non-cash transactions involving 2-way exchanges of cash. It applies where entities *actually pay* and *actually receive* money [subsection 16-35(1)].¹⁴⁷ The rule effectively ‘bifurcates’ some non-cash transactions into a non-cash/partial cash component and a cash component.

Why the rules are needed

10.84 These rules are necessary to give the correct treatment to cash. In essence, the addition of cash to both sides of a transaction may provide a deferral effect on gains and a bringing forward of losses in some cases. Without this rule, money would be apportioned across money and non-cash benefits in proportion to their relative market values. This may cause distortionary effects by under or overstating the cost of assets or proceeds of incurring liabilities.

10.85 However, the setting off rules would be expected to apply rarely. They will only have an impact where there is a transaction with cash on both sides, in addition to non-cash benefits.

What are the consequences of the rule applying?

10.86 When the money paid is in excess of the money being received, it is first netted off against the money received, with the remainder allocated to the remaining non-cash benefits.

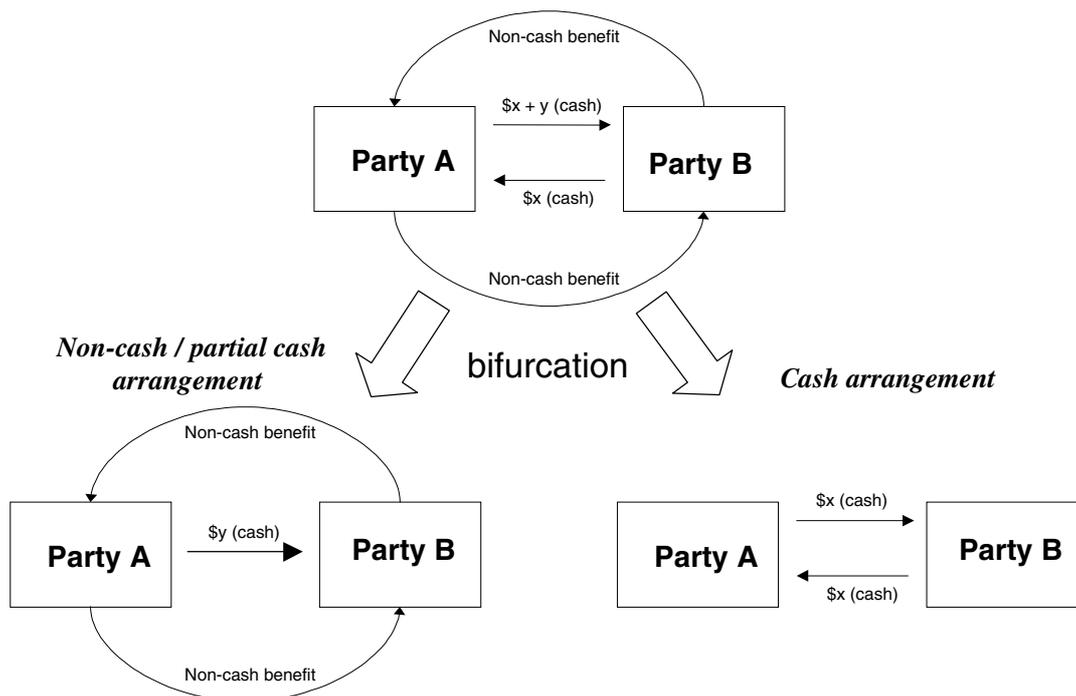
10.87 This approach has the effect of producing an ‘ordering rule’. Money is allocated to money first; any residue goes to the other non-cash benefits.

10.88 The amounts actually paid are set off against the amounts actually received. Subdivision 16-C applies as if, to the extent of the set-off, the amounts had been paid and received under a separate arrangement, instead of under the transaction involving the non-cash benefits. [Subsection 16-35(2)]

10.89 The effect of the rule is summarised in the following diagram.

¹⁴⁷ Note, however, that a mutual set-off would be sufficient to constitute an actual ‘payment’ (or ‘receipt’) for the purposes of these rules: *Re Harmony and Montague Tin and Copper Mining Company (Spargo’s Case)* (1873) LR 8 Ch App 407.

Diagram 10.6 Setting off cash on both sides of a transaction



10.90 As the diagram shows, the transaction is notionally split into a cash and a non-cash (or partial cash) transaction.

One-sided non-cash transactions

10.91 Not all transactions involve 2-way flows of economic benefits. When an entity receives an asset but pays nothing for it, it is still necessary to establish that asset's cost. Equally, an entity that gives an asset but receives nothing for it may need to establish the proceeds of realising that asset. Similar issues arise for liabilities.

When does the rule apply?

10.92 The one-sided rules apply to both recipients and givers of non-cash benefits.

The recipient

10.93 There are 2 requirements which must be satisfied for the one-sided non-cash transaction rule to apply to the *recipient* of a non-cash benefit under a one-sided transaction. [Section 16-55]

10.94 Firstly, the entity must get a non-cash benefit from another entity consisting of, or including, something other than an uncertain obligation that the other entity starts to have [paragraph 16-55(a)]. The meaning of 'uncertain obligation' is discussed in detail at paragraphs 10.128 to 10.136 below.

10.95 Secondly, the entity must pay nothing, and give no non-cash benefit, to any entity at any time for the non-cash benefit it gets. [*Paragraph 16-55(b)*]

The giver

10.96 The requirements for the *giver* of a non-cash benefit mirror those of the recipient. [*Section 16-60*]

10.97 Firstly, the entity must give a non-cash benefit to another entity consisting of, or including, something other than an uncertain obligation that the giver starts to have. [*Paragraph 16-60(a)*]

10.98 Secondly, the entity must receive no amount, and get no non-cash benefit, from any entity at any time for the non-cash benefit it gets. [*Paragraph 16-60(b)*]

What are the consequences of the rule applying?

10.99 Where these requirements are satisfied:

- the recipient is taken to receive, and the giver is taken to pay, an amount equal to the market value of the benefit [*paragraphs 16-55(c) and 16-60(d)*]; and
- the recipient is taken to pay, and the giver is taken to receive, the same amount for the benefit [*paragraphs 16-55(d) and 16-60(c)*].

10.100 In effect, the recipient in a one-sided non-cash transaction is treated as if they had received an amount of money from the giver and immediately used it to purchase the non-cash benefit from them. The consequence of this is that the cost of the asset acquired will be its market value.

10.101 The giver is, in effect, treated as if they had paid an amount of money to the recipient and immediately received the money back as sale proceeds from the asset they have disposed of. The consequence of this is that the proceeds of realising the asset will be its market value.

Example 10.10 Giving and getting something for nothing

In a bid to reduce its share capital, Hermes Software Ltd issues its shareholders with put options (total market value, \$1 million), entitling them to sell a certain number of their shares to Hermes at a fixed price.

Hermes has given the shareholders something for nothing. Under section 16-60, Hermes is deemed to pay \$1 million, and receive the same amount in return for the options. The proceeds of incurring its contingent liability under the options is therefore \$1 million.

The shareholders of Hermes have received something for nothing. Under section 16-55, they are (collectively speaking) taken to receive

\$1 million and to pay the same amount for the options. The collective cost of the options is therefore \$1 million. The shareholders are thereby assessable on the market value of the options. (This result is achieved under the current law, but requires a somewhat difficult inquiry into whether the options are assessable as ordinary income, or, alternatively, taxed under CGT event G1 or H2: Division 104 of the ITAA 1997).¹⁴⁸

Compliance issues

10.102 It should be noted that applying this rule is no different to applying the current law.

10.103 Under the current law, costs and proceeds need to be determined for virtually every non-private one-sided transaction, *even if it involves no cash*.¹⁴⁹

10.104 The costs and proceeds generated by the deemed receipts and payments under these rules are the same as those obtained under the current law. Although the legislative mechanism uses deemed receipts and payments to determine cost and proceeds, there is no need, in practice, to think of every transaction in those terms.

Why do the short-term credit and 2-sided non-cash transaction rules always give rise to *equal* receipts and payments?

10.105 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 10.113 to 10.118).

10.106 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 the entity got, and equate the cost of what they got with the market value of what they gave. Typically, this is the approach of the existing law.

Example 10.11 Two-sided non-cash transaction

Hector 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.

¹⁴⁸ See *Class Ruling* CR 2001/75.

¹⁴⁹ e.g. section 30-15, subsection 40-180(2), item 9 of the table, subsection 40-300(2), item 7 of the table, paragraph 112-20(1)(a), and subsection 116-30(1), ITAA 1997.

10.107 However this approach is flawed – it will involve double counting where, as in the example, the values don't match.

Example 10.12 Two-sided non-cash transaction

Following on from the previous example, the current law taxes Hector 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 Hector only \$20,000 better off, he is taxed on a total of \$40,000.

10.108 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.

10.109 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 the entity got.

10.110 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 10.13 Deemed sale of non-cash benefit at its market value

Following on from the previous example, Hector 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 10.14 Deemed sale of non-cash benefit at market value of consideration received for it

Following on from the previous example, Hector 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.

10.111 Both approaches are appropriate, depending upon the nature of what is given in the transaction. So, where an entity gives a short-term financial asset, the non-cash transaction rules look at the value of what they *give*. But where what the entity gives is another kind of non-cash benefit, the non-cash transaction rules look at the value of what the entity *gets*.

10.112 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.

Market value of a non-cash benefit

10.113 For the purposes of the non-cash transaction rules, the market value of a non-cash benefit is determined at the time that it is given or gotten. [*Section 16-65*]

10.114 'Market value' is a term that is used widely in the current 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.

10.115 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.

10.116 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 page 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".

10.117 '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. [*Subsection 995-1(1), definition of 'market value'*]

10.118 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.

The first \$300 of notional receipts under non-cash transactions are exempt

10.119 Consistent with the position under the current law, where total income from non-cash business benefits does not exceed \$300, the first \$300 of such income will be exempt from income tax.

10.120 This is not yet included in the prototype legislation, but would 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?

10.121 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 TVM legislation would need to ensure that the present treatment of these non-cash benefits is preserved.

Effect of uncertain obligations on 2-sided non-cash transactions

10.122 This part of the Chapter explains the rules under which receipts and payments are taken to have occurred under non-cash transactions involving one or more uncertain obligations.

10.123 In particular, this part of the Chapter discusses rules for determining the tax consequences when:

- a non-cash transaction occurs, under which an entity gives or gets a non-cash benefit that consists of an uncertain obligation; and
- the uncertain obligation, arising under such an arrangement, later becomes certain.

Overview

10.124 A right or obligation is not prevented from being an asset or liability merely because it is occasioned by some degree of uncertainty. For example, contingent liabilities arise from an 'existing obligation' which may or may not 'ripen' into a definite claim at some later time.¹⁵⁰ Contingent rights and liabilities can also be non-cash benefits.

10.125 Where a transaction involves the payment of money for an uncertain right, or the receipt of money for assuming an uncertain obligation, there is generally no difficulty in assigning a cost to the right or proceeds of incurrence to the liability, as the case may be.

¹⁵⁰ *Community Development Pty Ltd v Engwirda Construction Co* (1969) 120 CLR 455 per Kitto J at page 459; *FC of T v Gosstray* [1986] VR 876 at pages 878-879.

10.126 The situation is different, however, where there are no actual cash flows between the parties. In particular, it is usually not practical, nor appropriate, to recognise the tax value of a contingent right or obligation where what is given or received for it is an unperformed obligation (i.e. an obligation under an executory contract) or services. That is:

- Although an unperformed obligation is clearly an asset of the promisee and a liability of the promisor, it represents an intermediate or executory step in the process of gaining an ultimate non-cash benefit (i.e. an asset or service). Placing a tax value on this intermediate step when the amount given or received for it is contingent is often impractical and can lead to inappropriate results.
- Reflecting the current law, it would be inappropriate for a taxpayer to be taxed on income from services rendered while their right to be paid remains uncertain.

10.127 The rules about uncertain obligations address these issues by allowing non-cash benefits to be disregarded where they are consideration for unperformed obligations or services.

What are uncertain obligations?

10.128 An obligation to provide future economic benefits is a ***certain obligation*** only where the requirement to fulfil the obligation is not contingent (as determined under section 975-25). Otherwise, it is an ***uncertain obligation***. [Subsection 975-10(1)]

10.129 The obligation does *not* meet the condition in subsection 975-10(1) if the matter of whether *any future economic benefits at all* are to be provided under the obligation is contingent. [Subsection 975-10(2)]

Example 10.15 Uncertain obligation

Phoenix Pty Ltd acquires trading stock from Cassandra in exchange for a promise to pay her 10% of the profits, if any, that it makes in the next 5 years.

Under subsection 975-10(2), the obligation of Phoenix to pay for the stock is an uncertain obligation. Fulfilling the obligation is contingent upon profits existing in the following 5 years.

10.130 Certain obligations can arise, however, even though the *amount* of that obligation cannot be immediately determined.

10.131 A certain obligation is of certain amount only if the extent of the future economic benefits to be provided is non-contingent (as determined under section 975-25). Otherwise, it is of uncertain amount. [Subsection 975-15(1)]

10.132 Where an *obligation* is certain, but its *amount* is not, the extent of the future economic benefits to be provided is a reasonable estimate at the relevant time [*subsection 975-15(2)*]. The effect of this is to treat a certain obligation of uncertain amount in the same way as any other certain obligation.¹⁵¹

Example 10.16 Certain obligation of uncertain amount

PMA Ltd is in the business of writing employers' liability insurance. Each year, PMA estimates the dollar amount of claims which are likely to arise from events which have occurred during the year, but which have not yet been reported.

PMA has no way of knowing for certain how many insured events have occurred each year, or precisely what the dollar amount of the resulting claims will be. However, as it is virtually certain that insured events have occurred during the year, PMA's obligations in respect of them are non-contingent.

PMA has *certain obligations of uncertain amount*. The extent of the economic benefits to be provided in accordance with these obligations in a given year is a reasonable estimate. This would be the dollar amount of claims that are expected to arise from insured events estimated to have occurred within that year.

10.133 The basic inquiry used to work out whether the matters referred to in subsections 975-10(1) or 975-15(1) are contingent or not is whether, in substance or effect, they are contingent on any event, condition or situation, other than the ability or willingness of that entity to meet the obligation. A matter is contingent upon such an event, condition or situation where the happening of one or more of those things determines whether or not the obligation will be fulfilled. An event, condition or situation which is relevant includes the economic performance of the entity having the obligation. [*Paragraph 975-25(1)(a)*]

10.134 However, regard must also be had to:

- the artificiality, or the contrived nature, of any contingency on which the matter depends; and
- the pricing, terms and conditions of any scheme relating to the obligation; and
- anything else that is relevant.

[*Paragraph 975-25(1)(b)*]

10.135 The artificiality or the contrived nature of a contingency is one factor which may indicate that, in substance or effect, a matter is not contingent.

¹⁵¹

This could provide a basis for implementing recommendation 4.21 in ATSR.

Example 10.17 Artificial contingency

In Year 1, Phoenix Pty Ltd acquires trading stock in exchange for a binding promise to pay \$1 million on 1 July Year 2 if, but only if, the population of Australia exceeds 2,000 persons on that day.

The obligation of Phoenix to pay for the stock is a certain obligation. Having regard to the artificiality, substance and effect of the contingency, the liability of Phoenix to pay is non-contingent.

Example 10.18 Artificial contingency under a scheme

Phoenix Pty Ltd is under a liability to pay \$1,000 to Cassandra if a rainfall of 10 points is recorded at a particular place during a particular future period of time.

Phoenix undertakes *another* liability to pay \$1,000 to Cassandra if a rainfall of 10 points is *not* recorded at that place during that period.

Even though each liability is theoretically contingent, the scheme Phoenix has entered into indicates that its obligation to pay \$1,000 is a certain obligation.

10.136 A matter can be contingent, even if the entity having the obligation will suffer some detrimental practical or commercial consequences if it does not fulfil the obligation. [*Subsection 975-25(2)*]

When does the rule apply?

10.137 The rules about giving or getting uncertain obligations apply whenever an entity gives or gets a non-cash benefit consisting of or including one or more uncertain obligations. [*Subsections 28-10(1) and 28-15(1)*]

What are the consequences of the rule applying to an entity that gives an uncertain obligation?

10.138 The general rule is that non-cash benefits in the form of uncertain obligations are disregarded in a non-cash transaction. However, the general rule is subject to important exceptions.

10.139 Specifically, for the purposes of applying section 16-25, an entity must disregard a non-cash benefit it *gives*, to the extent that it consists of an uncertain obligation, unless the exception applies. [*Subsection 28-10(1)*]

When does the exception apply?

10.140 The exception applies where the only non-cash benefit(s) the entity *gets* under the arrangement consist of assets that are *not* unperformed obligations. [*Subsection 28-10(2)*]

10.141 An *unperformed obligation* is a non-cash benefit covered by item 2 or 3 of the table in subsection 960-50(1) [subsection 995-1(1), definition of 'unperformed obligation']. Non-cash benefits of this kind are liabilities, or increases in pre-existing liabilities owed by one entity to another [subsection 960-50(1), items 2 and 3 in the table]. They are generally obligations arising under an executory contract.

What are the consequences of the rule applying to an entity that gets an uncertain obligation?

10.142 Equally, an entity must disregard a non-cash benefit it *gets*, to the extent that it consists of an uncertain obligation, unless the exception applies. [Subsection 28-15(1)]

When does the exception apply?

10.143 In that case, the exception applies where the non-cash benefit(s) the entity *gives* under the arrangement consists only of assets that are not an unperformed obligations (see paragraph 10.141 above). [Subsection 28-15(2)]

What are the consequences of the exception applying?

10.144 Where what is given or received in return for an uncertain obligation is an asset other than an unperformed obligation *and nothing else*, the result is simple: the transaction is analysed like any other non-cash transaction under section 16-25.

Example 10.19 Applying the exception rule - *giving* an uncertain obligation in return for *getting* something certain

In Year 1, Athene gives Diomedes a right to 10% of the profits, if any, arising from her business in Year 3. In return, Diomedes gives Athene some shares in his company, Argos Pty Ltd.

The right to profits Athene gives consists of an uncertain obligation, because it is contingent upon profits existing in Year 3.

Thus, under subsection 28-10(1), what Athene gives is disregarded for the purposes of section 16-25 unless the non-cash benefit Athene gets is an asset other than an unperformed obligation.

In this case, the exception is satisfied. The shares Athene gets are an asset, and they are not an unperformed obligation. Therefore, the right to share in future profits she gives is *not* disregarded.

This outcome is appropriate, because Athene needs to give her shares a cost. She would be deemed to receive the market value of the shares in return for her promise to provide a profit share, and to have paid the same amount for the Argos shares she received.¹⁵²

¹⁵²

This replicates the cost that would arise under the current law: see paragraph 110-25(2)(b) of the ITAA 1997.

Example 10.20 Applying the exception rule – *getting* an uncertain obligation in return for *giving* something certain

To continue the previous example, the right to profits Diomedes gets consists of an uncertain obligation, because it is contingent upon profits existing in Year 3.

Thus, under subsection 28-15(1), what Diomedes gets is disregarded for the purposes of section 16-25 unless the non-cash benefit Diomedes gives is an asset other than an unperformed obligation.

In this case, the exception is satisfied. The shares Diomedes gives are an asset, and they are not an unperformed obligation. Therefore, the right to share in future profits he gets is *not* disregarded.

This outcome is appropriate, because Diomedes may need to need to give his shares a proceeds of realisation (e.g. because he needs to isolate the ‘gain’ from disposing of the shares in order to apply the investment asset discount). He would be deemed to receive the market value of the promise to provide a profit share for the shares he disposed of, and to have paid the same amount for the profit share right he received.

Assuming the parties are dealing at arm’s length, this would be equal to the market value of the shares he gave.

What if the entity gets assets other than unperformed obligations and something else?

10.145 An apportionment rule applies where what is *received* in return for an uncertain obligation *includes* an asset other than an unperformed obligation, but *also* consists of other non-cash benefits (e.g. unperformed obligations or services). The rule is involved but the transactions to which it applies would not commonly arise in practice.

10.146 The amount taken to be received or paid for the non-cash benefit(s) given or gotten in these situations is worked out using the following formula [subsection 28-10(3)]:

$$\text{Unreduced amount} \times \frac{\text{MV Assets}}{\text{Total MV}}$$

10.147 ‘Unreduced amount’ refers to the amount that, apart from section 28-10, the entity would be taken to receive for the non-cash benefit it gives to the extent that it consists of the uncertain obligation [subsection 28-10(4)]. This deemed receipt will have arisen under the non-cash transaction rules in Division 16.

10.148 ‘MV Assets’ means the total of the market value of each non-cash benefit the entity gets under the arrangement that falls under the exception; i.e. that is an asset and is not an unperformed obligation. [Subsection 28-10(4)]

10.149 Finally, 'Total MV' means the market value, or the total of the market values, of the non-cash benefits the entity gets under the arrangement. [Subsection 28-10(4)]

10.150 If subsection 28-10(3) applies, the amount the entity is taken to pay under subsection 16-25(3) is reduced; a consequence of the fact that the operation of subsection 16-25(2) has been altered by applying the formula. [Paragraph 28-10(5)(a)]

10.151 However, the deemed payment generated by subsection 16-25(3) is allocated *only* to the non-cash benefits the entity gets which consists of assets other than unperformed obligations [paragraph 28-10(5)(b)]. If the entity gets a number of assets other than unperformed obligations, the deemed payment is then allocated between them in accordance with the core apportionment rule in section 14-120.

10.152 The uncertain obligation rule does not operate autonomously; rather, it operates by changing the operation of Division 16. This means that, once the consequences of Division 16 are determined, these are fed into section 16-25 in order to determine the final tax outcome.

Example 10.21 'Uncertain obligation' rule – giving an uncertain obligation in return for an unperformed obligation and another asset.

In Year 1, Athene gives Diomedes a right to share in profits, if any, arising from her business in Year 3. The market value of this entitlement is \$5,000. In return, Diomedes gives Athene some shares in his company Argos Pty Ltd (market value, \$3,000), and a right to further Argos shares (market value, \$2,000).

The right to profits Athene gives is an uncertain obligation, because it is contingent upon profits existing in Year 3.

However, subsection 28-10(3) is satisfied because the shares are an asset, and they are not an unperformed obligation. Therefore, the right to share in future profits Athene gives is *not* disregarded.

Athene's deemed receipt arising under subsection 16-25(2) is modified by the operation of subsection 28-10(3). Athene's deemed receipt for the right to profits given is $5,000 \times (3,000/5,000) = \$3,000$.

Under subsection 16-25(2), Athene is deemed to receive \$3,000 for the contingent profit share she gave. This means that the deemed payment under subsection 16-25(3) for the shares and rights she got will also be \$3,000. However, this is *not* allocated between the shares and the right to the shares; under paragraph 28-10(5)(b), it is taken to be for the shares only. The cost of the shares is therefore \$3,000 and the cost of the right is nil.

What if the entity gives assets other than unperformed obligations and something else?

10.153 An apportionment rule also applies where what is *given* in return for receiving an uncertain obligation *includes* an asset other than an unperformed obligation, but *also* consists of other non-cash benefits (e.g. unperformed obligations or services) [*subsections 28-15(3), (4) and (5)*].

10.154 This rule uses the same apportionment mechanism as that used in section 28-10 (about arrangements under which an entity gives an uncertain obligation); see paragraphs 10.145 to 10.152 above.

Example 10.22 ‘Uncertain obligation’ rule – giving an uncertain obligation and another asset in return for an unperformed obligation and another asset.

To continue on from the previous example, the right to profits Diomedes gets corresponds to an uncertain obligation, because it is contingent upon profits existing in Year 3.

However, subsection 28-15(3) is satisfied because the shares Diomedes gives are an asset, and they are not an unperformed obligation. Therefore, the right to share in future profits Diomedes gets is *not* disregarded.

Diomedes’ deemed receipt arising under subsection 16-25(2) is modified by the operation of subsection 28-15(3). Under subsection 28-15(3), Diomedes’ deemed receipt for the right to profits he gives is $5,000 \times (3,000/5,000) = \$3,000$. Under subsection 16-25(2), Diomedes is therefore deemed to receive \$3,000 for the shares he gave.

Diomedes’ deemed payment arising under subsection 16-25(3) is modified by the operation of subsection 28-15(5). That payment is the deemed payment that *would* arise, if section 28-15 did not apply, *reduced* by the difference between:

- the amount (apart from section 28-15) that Diomedes would have been taken to receive; and
- the amount worked out under subsections 28-15(3) and (4).

Thus, the deemed payment will be \$3,000 ($5,000 - 2,000$). The cost of Diomedes’ right to profits will therefore be \$3,000.

What does the exception do, and why?

10.155 The exception rule in subsections 28-10(3) and 28-15(3) allow a tax value to be assigned to an uncertain obligation to the extent that what is given or received for it consists of an asset other than an unperformed obligation.

10.156 As a result, in a non-cash transaction, uncertain costs and proceeds are only recognised to the extent that what is given or received in return is a tangible asset or non-executory entitlement.¹⁵³

10.157 The reason for this approach is simple. In general, it is preferable to delay tax recognition for assets and liabilities which are uncertain; the tax system waits until these economic benefits 'come home'. However, where tangible assets or non-executory entitlements are being exchanged, it is necessary, as it is under the current law, for them to be given a cost (and sometimes a proceeds of realisation), even if what is given or received in return is uncertain.

Uncertain obligations becoming certain

10.158 It has been explained how the uncertain obligation rule causes some assets and liabilities to be disregarded while a state of uncertainty exists. A corollary of this approach is that rules are needed to determine appropriate tax values for those assets and liabilities when that state of uncertainty comes to an end.

10.159 This is done by the rules about uncertain obligations becoming certain in Subdivision 28-B of the prototype legislation (referred to as the 'becoming certain rule' in this Chapter).

10.160 It should be noted, however, that the application Subdivision 28-B is not limited to non-cash transactions. It can apply, for example, when an entity purchases insurance for cash.

10.161 There are 2 rules: one that applies to the entity to whom the obligation is owed, and a mirror rule that applies to the entity that owes the obligation.

What transactions are excluded from this rule?

10.162 Subdivision 28-B does not apply to an uncertain obligation under an arrangement covered by the short-term credit rules in section 16-15 [*subsection 28-50(1)*]. The rules relating to contingencies arising in these transactions were explained above at paragraphs 10.54 to 10.58.

10.163 Secondly, Subdivision 28-B does not apply to an uncertain obligation to:

- provide an asset other than money; or
- accept an asset other than money.

¹⁵³ That is, an asset which is intangible, but which does not depend upon performance by another entity; e.g. a membership interest in a company or trust.

unless the asset is a replacement asset provided under an insurance contract or a warranty.

[Subsection 28-50(2)]

10.164 An uncertain obligation to *provide* an asset arises, for example, for the grantor of a call option over an asset. They may have to sell the asset to the grantee, but only if the grantee exercises the option to purchase.

10.165 An uncertain obligation to *accept* an asset arises, for example, for the grantor of a put option over an asset. They may have to purchase the asset to the grantee, but only if the grantee exercises the option to sell.

Why have this exclusion?

10.166 The reason for excluding transactions such as options from the ‘becoming certain’ rule is simple. Applying the rule to such a transaction would trigger a taxing point when an uncertain obligation becomes certain. For example, any gain or loss arising upon exercise of the option would have to be brought to account in the year of exercise. In cases other than warranties and insurance, this outcome is generally not appropriate.

When does the rule apply to the entity to whom the obligation is owed?

10.167 Assuming that the exclusions described above do not apply, the entity to whom the obligation is owed must satisfy 2 requirements before the uncertain ‘obligation becoming certain’ rule applies.

10.168 Firstly, there must either be:

- an uncertain obligation owed to the entity which becomes certain *[paragraph 28-55(a)]*; or
- an increase in the extent of the future economic benefits to be provided under the uncertain obligation owed to the entity, either because the entity increases their reasonable estimate under subsection 975-15(2), or because the certain obligation becomes one of certain amount. *[Paragraph 28-55(b)]*

10.169 Secondly, the previously uncertain obligation’s market value at the time must exceed what would be:

- the tax value of the asset the entity holds consisting of the obligation *[paragraph 28-55(c)]*; or
- the tax value of an asset the entity holds to the extent that it includes the obligation and the tax value is attributable to the obligation. *[Paragraph 28-55(d)]*

What are the consequences of the rule applying to the entity to whom the obligation is owed?

10.170 Where the ‘uncertain becoming certain’ rule applies, the entity to whom the obligation is owed is taken:

- to pay for the obligation at the time an amount equal to the excess of the obligation’s market value over its tax value [paragraph 28-55(e)]. The consequence of this is that the cost of the entity’s right will be increased by that amount; and
- to receive the same amount, and to receive it for each thing (if any) that the entity gave in return for the obligation or in return for it becoming certain [paragraph 28-55(f)]. The consequence of this is that the proceeds of realising the assets given, or proceeds of incurring the liabilities assumed, under the arrangement, will be increased by that amount.

10.171 The effect of this is to align the cost of the entity’s newly-certain right with its market value.

Example 10.23 Professional work-in-progress and the ‘uncertain becoming certain’ rule

Accountant Henderson agrees to perform accounting services for client Coughlan. Henderson gives Coughlan a non-contingent right to services. In return, Coughlan gives Henderson a contingent right to payment. This right consists of an uncertain obligation, because Henderson’s right to payment is dependent upon Henderson doing the work, determining which items are properly billable, and issuing a bill.¹⁵⁴

Henderson disregards his right to payment under subsection 28-15(1). The exception in subsection 28-15(2) does not apply, because all Henderson is giving Coughlan is an unperformed obligation, which will later become services. Because what Henderson is getting is disregarded, section 16-25 has no application. (Section 16-60 does not apply either, because Henderson is still getting a non-cash benefit for the purposes of that provision). The result is that there are no costs or proceeds so that Henderson’s right to payment, and obligation to provide services, have tax value of nil and can be disregarded.

Eventually, Henderson does the work, decides which items can be properly billed for, and issues the bill for \$10,000 to Coughlan. At this point, both Henderson’s right to receive payment and Coughlan’s obligation to pay become certain.

Under section 28-55, Henderson is taken to have paid \$10,000 for his right to payment and to have received \$10,000 for his services. The cost of his right to payment is therefore \$10,000. At this point, Henderson’s right to money becomes income:

¹⁵⁴ *Henderson v FC of T* 70 ATC 4016; 1 ATR 596.

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

$$= [10,000 - 10,000] + [10,000 - 0] - [0 - 0] = \$10,000$$

When does the rule apply to the entity that owes the obligation?

10.172 The requirements and consequences of the ‘uncertain becoming certain’ rule which apply to an *entity which owes the obligation* mirror those for the entity to whom the obligation is owed. [Section 28-60]

Example 10.24 Professional work-in-progress and the ‘uncertain becoming certain’ rule

To continue on from the previous example, Coughlan would disregard his obligation to make payment under subsection 28-10(1). The exception in subsection 28-10(2) does not apply, because all Coughlan is giving Henderson is an unperformed obligation. Because what Coughlan is giving is disregarded, section 16-25 has no application. (Section 16-55 does not apply either, because Coughlan is still giving a non-cash benefit for the purposes of that provision). The result is that there are no costs or proceeds so that Coughlan’s right to services, and obligation to pay, have tax value of nil and can be disregarded.

Eventually, Henderson does the work, decides which items can be properly billed for, and issues the bill for \$10,000 to Coughlan. At this point, both Henderson’s right to receive payment and Coughlan’s obligation to pay would become certain.

Under section 28-60, Coughlan would be taken to have received \$10,000 for assuming his liability to pay Henderson, and paid \$10,000 for Henderson’s services. The proceeds of incurring his liability to pay would therefore be \$10,000. At this point, Coughlan’s liability to pay would be given tax relief.

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

$$[10,000 - 10,000] + [0 - 0] - [10,000 - 0] = -\$10,000$$

Application of the ‘uncertain becoming certain’ rule to insurance contracts.

10.173 The rights of an insured under an insurance contract are treated as comprising 2 separate assets: the ‘protection against risk’ asset, and ‘insurer’s uncertain obligation’ asset (see further, Chapter 7, paragraphs 7.85 and 7.86). Similarly, the liabilities of an insurer are treated as comprising 2 separate obligations: the ‘insurance against the risk’ liability and the ‘uncertain obligation’ liability (see further paragraphs 8.55 and 8.56 of Chapter 8).

10.174 A consequence of this approach is that the tax value of an insured's uncertain right to have a claim satisfied, and of an insurer's uncertain obligation to meet the claims, will be nil.

10.175 However, a definite liability to make an insurance claim pay-out arises as a result of, and at the time when, the event insured against happens.¹⁵⁵ Upon the occurrence of an insured event, the insurer's uncertain obligation will become certain for the purposes of sections 28-55 and 28-60. Those provisions will therefore automatically assign a cost to the insured's right and proceeds of incurrence to the insurer's liability.

Example 10.25 Applying the 'uncertain becoming certain' rule to a contract of insurance

PMA Ltd enters into a contract of insurance with Trojan Pty Ltd. Under this contract, PMA agrees to insure Trojan against claims for compensation made against it for personal injury or damage to property caused by an occurrence connected with Trojan's business.

The tax value of PMA's uncertain obligation to meet a claim by Trojan is nil. The tax value of Trojan's uncertain right to the payment of money under a claim is also nil.

Shortly after, a customer is injured by a Trojan product and sues Trojan. Trojan makes a claim for \$500,000 under its insurance contract.¹⁵⁶ At this time, PMA's uncertain obligation to make a payment and Trojan's uncertain right to the payment becomes certain.

Assuming the obligation's market value is approximately \$500,000, Trojan would be deemed to pay \$500,000 for the right to compensation; the cost of that right is therefore \$500,000: paragraph 28-55(e). It would also be deemed to receive \$500,000: paragraph 28-55(f).

Meanwhile, PMA Ltd would be deemed to receive \$500,000 in return for starting to have the liability to pay compensation; the proceeds of incurring that liability is therefore \$500,000: paragraphs 28-60(c) and (d). It would also be deemed to pay \$500,000: paragraph 28-60(e).

¹⁵⁵ e.g. *FC of T v Mercantile Mutual Insurance (Workers Compensation) Ltd & Anor* 99 ATC 4404 per Hill J at page 4413.

¹⁵⁶ Note that, consistently with the current law, a claim need not be reported to be recognised as a liability of the insurer under TVM; see Example 10.16.

Chapter 11

Splitting and merging assets and liabilities

Outline of Chapter

11.1 This Chapter explains the rules for splitting, merging, transforming and substituting assets and liabilities. These rules are usually referred to as the ‘splitting and merging rules’.

11.2 The rules are contained in Subdivision 16-E of the prototype legislation.

Context of Reform

11.3 The tax values of assets and liabilities are essential elements of the net income formula used to work out an entity’s taxable income.

11.4 An asset can be a collection of smaller elements that could be seen as embodying economic benefits in themselves (think of a car, which is an asset but is also a collection of parts that could be separate assets, and probably once were). The same is also true of a liability, which may comprise a number of separately identifiable obligations. It follows that there is scope for an asset or a liability to be split into several separate assets or liabilities and for separate assets and liabilities to be merged into a single asset or liability.

11.5 In those circumstances, rules are needed to deal with the old assets or liabilities no longer being there and with the new assets or liabilities being there instead. In particular, rules are needed to establish the cost of the new assets and the proceeds of incurring the new liabilities.

11.6 Similar issues arise when an asset or liability is transformed into a different asset or liability and where one asset or liability is substituted for another.

11.7 Broadly, the intention behind the splitting and merging rules is to assign tax values to assets and liabilities in such a way that no taxing point is triggered by a split, merge or other change. This recognises the general proposition that taxing points should not be triggered when an entity merely re-arranges the configuration of its economic benefits, as opposed to realising a change in its overall economic position.

Summary of prototype legislation

11.8 Subdivision 16-E treats each:

- split;
- merger;
- change in nature ('transformation'); or
- substitution;

of an asset as a disposal of the original asset for a receipt equal to its tax value and an acquisition of the new assets for an equal payment.¹⁵⁷

11.9 Similar rules apply to liabilities, with similar results.

11.10 These rules rely upon the same legislative mechanism used by the non-cash transaction rules (explained in Chapter 10). The key difference between the non-cash transaction rules and the rules explained in this Chapter is that the splitting and merging rules generate a 'tax value roll-over' to the split, merged, transformed or substituted assets and/or liabilities.

11.11 Because the deemed receipt and payment generated by the splitting and merging rules are always equal, they offset each other exactly. This means that they have no direct effect on an entity's net income. Their effect, however, is to set the cost and proceeds of the assets and liabilities involved in the arrangement.

Comparison of key features of prototype legislation and current law

11.12 This table compares the key features of the splitting and merging rules in the prototype legislation with the treatment under the current law.

Table 11.1 Comparison of key features of the prototype legislation and the current law

<i>Prototype legislation</i>	<i>Current law</i>
Has a rule for splitting, merging and transforming <i>all assets</i> .	Has rules for splitting, merging and changing CGT assets and splitting and merging depreciating assets. ¹⁵⁸
Has a rule for splitting, merging and transforming <i>liabilities</i> .	Has rules in the debt forgiveness area for partially extinguishing debts. ¹⁵⁹

¹⁵⁷ These rules will *not* change the pre-CGT status of the assets involved.
¹⁵⁸ Sections 40-115, 40-125, 40-205, 40-210, 112-25 of the ITAA 1997.

<i>Prototype legislation</i>	<i>Current law</i>
Has rules for substituting one or more rights or liabilities for one or more other rights or liabilities covering the same benefits.	Has rules for replacement spectrum licences. ¹⁶⁰

Detailed explanation of prototype legislation

11.13 For a system built on assets and liabilities like TVM, a key question is what happens when an asset or liability is split, merged or changed in some other way.

11.14 Is the original asset or liability still there or has it been so changed that it is gone? If it is gone, was anything realised for it and how much? What are the costs and proceeds associated with the old and new assets and/or liabilities? The splitting and merging rules answer these sorts of questions.

Rule for splitting, merging and transforming assets

11.15 One rule covers splitting, merging and transforming assets.

What are the consequences of a split, merge or transformation of an asset?

11.16 If one or more assets (the ‘original assets’) are split, merged or transformed into one or more other assets (the ‘new assets’), the entity that held the original assets is taken to have stopped holding them and started holding the new assets. [*Paragraphs 16-80(2)(a) and (b)*]

11.17 This is the mechanism that ensures that the original assets are no longer held. It leaves no room for arguing that any of the original assets carries on ‘minus a bit’.

Example 11.1 What happens to original and new assets?

Aphrodite buys some land for \$250,000. Later, she subdivides it into 5 blocks. When the new titles are issued, the splitting rule will mean that Aphrodite ceases to hold the original land and starts to hold the new blocks.

11.18 The entity is taken to have received the original assets’ tax value for ceasing to hold them [*paragraph 16-80(2)(c)*]. The consequence of this is that the proceeds of realising the original assets will be equal to that amount: section 14-40.

¹⁵⁹ Schedule 2C of the ITAA 1936.

¹⁶⁰ Section 40-120 of the ITAA 1997.

Example 11.2 Proceeds of realising the original assets

Continuing the previous example, Aphrodite will be taken to have received \$250,000 for her original parcel of land because that was its cost (i.e. its tax value). The market value is not relevant.

11.19 The entity is also taken to have paid the same amount for the new assets as it was deemed to have received for the original assets [*paragraph 16-80(2)(d)*]. The consequence of this is that the cost the new assets will be equal to that amount: paragraph 14-20(1)(a) and subsection 14-25(1).

Example 11.3 Cost of the new assets

Continuing the previous example, Aphrodite will be taken to have paid \$250,000 for her new blocks because that is what she ‘received’ for the original asset. That amount would be divided between the new blocks under the core apportionment rule in section 14-120.

11.20 Setting the amount received for ceasing to hold the original assets at their tax value ensures that the split, merge or transformation does not create a taxing point. There is no taxing point because the decline in the tax value of assets is exactly matched by the deemed receipt. Any gain or loss the asset has accrued will not be picked up in net income because of the split, merge or transformation.

11.21 Similarly, there will be no taxing point in the acquisition of the new assets because the payment will match their tax value. Setting the deemed payment at the same amount as the original assets’ tax value also ensures that any gain or loss the original assets have accrued will be transferred into the new assets. That gain or loss will be recognised only when the new assets are realised.

Example 11.4 How an accrued gain is ‘rolled over’ under a split, merge or transformation

Continuing the previous example, if Aphrodite’s land had a market value of \$400,000 when the split happened, it would have an accrued gain of \$150,000. Because the original land is taken to have been sold for its *tax value*, that accrued gain is not realised by the split. Because the new blocks are taken to have been bought for \$250,000, the \$150,000 accrued gain will be transferred into the new blocks (assuming the market value does not change). A part of that gain will be brought to account when each of the new blocks is sold.

Rule for splitting, merging and transforming liabilities

11.22 One rule covers splitting, merging and transforming liabilities.

What are the consequences of split, merge or transformation of a liability?

11.23 The rules about splitting, merging or transforming liabilities exactly mirror those for splitting an asset:

- The entity that has the original liabilities is taken to have stopped having them and to have started having the new liabilities. [*Paragraphs 16-85(2)(a) and (b)*]
- The entity is deemed to have paid (just before the split, merge or transformation) an amount equal to the tax value of the original liabilities to stop having them [*paragraph 16-85(2)(c)*]. The consequence of this is that the cost of extinguishing the original liabilities will be equal to that amount: section 14-90; and
- The entity is deemed to have received the same amount to assume the new liabilities [*paragraph 16-85(2)(d)*]. The consequence of this is that the proceeds of incurring the new liabilities will be equal to that amount: paragraph 14-75(1)(a) and subsection 14-80(1).

Explanation of splitting

11.24 It is possible to ‘split’ both composite assets - assets made up of a number of separately identifiable components embodying economic benefits - and non-composite assets (other kinds of assets).

11.25 Whether a particular composite item is itself an asset or whether its components are separate assets is a question of fact and degree to be determined in the light of all the circumstances of the particular case.

11.26 A composite asset can be a collection of smaller components that could be seen as embodying economic benefits in themselves (think of a car, which is an asset but is also a collection of parts that could be separate assets, and probably once were). The same is also true of a liability, which may comprise a number of separately identifiable obligations.

11.27 The fact that composite assets contain a number of elements, in themselves embodying economic benefits implies that it may be possible, in some cases, to split them into a number of separate assets.

11.28 The same possibility can arise even for a non-composite asset, such as a block of land. It is not difficult to imagine subdividing the land, so creating one or more new separate assets. Although less common, liabilities can also be split.

What is a split?

11.29 The splitting rule only applies if an asset or liability is ‘split’ into 2 or more assets or liabilities. ‘Split’ is not defined, so it has its ordinary meaning. The key to understanding what a split is, is understanding what an asset or liability is. This is discussed in detail in Chapters 7 and 8. When you can identify as separate assets (or liabilities) things that used to be a single asset (or liability), a split is likely to have occurred.

11.30 But a split must also be an independently discernible event; it is not enough for a taxpayer to change their mind about whether a collection of economic benefits or obligations is a single asset or liability.

Example 11.5 Split requires a discernible event

You would commonly view the collection of parts that make up a car as a single asset. You could remove the seats from the car and that would be a split. But it would not be a split if you simply started thinking of the seats as separate from the rest of the car.

11.31 A split can only occur in the hands of the same entity.¹⁶¹ This is because the splitting rule is intended to cope with how one entity deals with an asset that becomes many assets. The only role the splitting rule has in transfers of an asset from one entity to another is where the transfer is only partial, so can be seen as a split followed by a transfer of some of the new assets. This case is discussed further in paragraphs 11.33 to 11.35.

Example 11.6 What is a split?

Continuing the previous example, if you sold the car to a spare parts dealer who thought of it as a collection of assets rather than a single asset, that would not be a split. Instead, it would be the sale by you of a single asset and the purchase by the dealer of multiple assets.

Timing

11.32 Usually, the timing of a split will not matter. In some cases however, a splitting process might span 2 income years (or even more in rare cases) and, in such instances, working out when the split happens will be important. A split can only happen when the splitting process is finished.

Example 11.7 When does a split occur?

Penelope purchases a country estate and decides to subdivide it into 10 blocks and develop them for sale. She lodges an application to subdivide the estate with the local council. Once it is satisfied that all the legal requirements have been met, the council approves the

¹⁶¹ Note that if you start to hold an asset on trust for someone else, that is a transfer to another entity for tax purposes because each capacity in which you act is treated as a different entity (see existing subsection 960-100(3) of the ITAA 1997).

subdivision. Penelope applies to the Land Titles Registrar for the subdivision to be registered and, in due course, the Registrar revokes the original title and issues 10 new titles. The estate is not split when Penelope decides to subdivide, not when she applies to the council, not when the council approves the subdivision, not even when Penelope lodges her application with the Registrar. It is only 'split' when the process is finished and that is when the Registrar issues the new titles.

What are the consequences of ceasing to hold part of an asset?

11.33 A special rule applies if there is a 'splitting off'; that is, if the entity ceases to hold part of an asset. In that case, the prototype legislation applies as if, just before the entity stopped holding that part, the original asset was split into the part it stopped holding and the rest of the original asset. [Subsection 16-80(3)]

11.34 This rule clarifies what happens in cases where only part of an asset stops being held. In some of those cases, there will be an obvious split that happens first (e.g. if you remove the canopy from your ute before selling it). In other cases, there will not be any obvious split occurring first (e.g. if you sell a half interest in your business). The rule is primarily aimed at dealing with those less obvious cases.

11.35 It does not matter that the law would not recognise someone as owning both parts of a split asset. Because the transaction is treated as a split, subsection 16-80(3) will deem the new assets to be held prior to the disposal of one or more of them.

Example 11.8 Part disposal

Hermes, a partner in a law firm, assigns half of his interest in the partnership to his wife, Helen. Hermes has stopped holding part of his partnership interest so, immediately before that happened, the splitting off rule would treat him as having split his partnership interest into 2 halves.

It does not matter that the general law would not recognise Hermes as ever owning his partnership interest as 2 separate assets. Hermes is *deemed* to hold both halves under subsection 16-80(3).

Depreciation

11.36 Ceasing to hold part of an asset could be confused with depreciation because both things involve a loss of economic benefits from a particular asset. A rule is provided to remove any doubt that depreciation and splitting are different things. It says that merely using an asset is not the same thing as ceasing to hold part of it. That means that the splitting rule will not apply just because you consume an asset's economic benefits. [Subsection 16-80(4)]

11.37 The key distinction between a split and depreciation is that, in a split, the original asset becomes several new assets while a depreciating asset is still recognisably the same asset even as it is used up.

11.38 The distinction between depreciation and splitting might be relevant in the context of rights to get a limited quantity of things. As the things are received, there will be fewer left to get but you do not stop holding part of the right each time you get something. Instead, the right depreciates as you consume its benefits (see Chapter 12).

Example 11.9 Depreciation v splitting

Iliad Snake Oil Pty Ltd buys 2,000 snakes from the Hyperion reptile farm. Iliad takes 200 snakes in the first carload, leaving a right to take a further 1,800. If the year ended then, the right would have depreciated to reflect the consumption of a tenth of the benefits. The right to take the snakes would *not* be split into a right to 200 snakes and a right to 1,800 snakes because Iliad has not stopped holding part of its original right; it has merely consumed some of the benefits.

However, if Iliad assigned to someone else a right to take 1,000 of the remaining snakes, the split rules would apply because Iliad would have stopped holding part of its right.

What are the consequences of ceasing to have part of a liability?

11.39 If an entity stops having only part of a liability, the liability is treated as having been split, just beforehand, into the part it stopped having and the rest [*subsection 16-85(3)*]. This is the mirror of the equivalent rule for assets.

11.40 Finally, as with depreciating assets, partially satisfying a depreciating liability is not the same thing as ceasing to have part of that liability, so the splitting rule does not automatically apply in such cases. [*Subsection 16-85(4)*]

Example 11.10 Splitting a liability

Melanthus owes Athene \$10,000, but is unable to pay back the full amount of the debt. After becoming aware of Melanthius' predicament, Athene decides to forgive \$2,000 of the debt.

The splitting rule will mean that Melanthius ceases to have the original liability of \$10,000. He will be taken to have paid \$10,000 to extinguish that liability and to have received \$10,000 as the proceeds of incurring 2 new liabilities. That amount would be divided between the new liabilities under the core apportionment rule in section 14-120. Immediately prior to the forgiveness, Melanthius would be deemed to have two new liabilities; one with a tax value of \$8,000, and another with a tax value of \$2,000. The second liability would disappear because of the forgiveness.

It does not matter that the general law would not recognise Melanthius as ever owing \$10,000 as 2 separate debts. Melanthius is *deemed* to have both liabilities under subsection 16-85(3).

Explanation of merging

11.41 Merging is the opposite of splitting. Instead of one asset or liability being split into several, several assets or liabilities are merged into one or at least fewer than you started with.

What is a merge?

11.42 Again, as with splitting, understanding when assets or liabilities merge requires understanding what an asset or liability is. When economic benefits or obligations are combined in such a way that you can identify fewer assets or liabilities than you started with, a merger is likely to have occurred. However, there must also be an independently discernible event; a mere change of mind about grouping is not enough.

11.43 The merging rule only applies to assets or liabilities that are held by a single entity. It does not cover mergers of assets or liabilities held by different entities.

Timing

11.44 As with splitting, a merger takes place only when the merging process is finished.

Example 11.11 Merging assets

Cyclops has a block of land that he purchased some years previously for \$10 million. Because he needs more space to develop his business, he purchases an adjacent block for \$8 million. At this time, Cyclops has 2 assets with tax values (costs) of \$10 million and \$8 million respectively. On the advice of his lawyers, Cyclops consolidates the 2 parcels into a single title before developing the newly-purchased block.

The merging rule would treat Cyclops as ceasing to hold the original parcels of land for \$18 million. The proceeds of realising the 2 blocks would therefore be \$18 million. The merging rule would also treat Cyclops as paying \$18 million for starting to hold the newly merged property. The cost of the new property would therefore be \$18 million.

Example 11.12 Merging liabilities

In Year 1, wholesaler Eurycleia enters into an advance purchase order with retailer Odysseus, under which she is to supply Odysseus with 1.8 million bullets per month between 1 July and 30 September, in Year 2. Towards the end of Year 1, Odysseus realises that he will need more stock than this. He therefore supplies another purchase order for a further 0.2 million bullets between 1 January to 31 March, Year 3.

In January Year 2, Odysseus wins a new supply contract and realises that he will need even more stock between 1 July and 30 September, Year 2. Rather than enter a separate purchase order, it is agreed to amend the second purchase order so that it effects a contractual variation¹⁶² of the first. In effect, Eurycleia then has to supply 2 million bullets between 1 July and 30 September Year 2, and 0.2 million bullets between the 1 January to 31 March, Year 3.

The merging rule would treat Eurycleia as ceasing to have her liabilities to supply bullets under the first and second agreements, to have started having her liability under the amended agreement (a combination of the amended first and second orders). She would be taken to have paid the tax value of her original liabilities in order to stop having them, and to have received the same amount for incurring her liability under the amended agreement. This would be the proceeds of incurring the new liability.

Note that, because the tax values are merely rolled between the agreements, the operation of the merging rule can be ignored for practical purposes. The rule supplies legislative support to allow Eurycleia to consolidate liabilities if that is administratively convenient.

Multiple merged assets or liabilities

11.45 Sometimes it is possible for assets or liabilities to be merged into more than one final asset or liability. You could start with a collection of aeroplane parts, for instance, and merge them into 2 aircraft. You could analyse this as a series of mergers, each resulting in only one asset but it is more convenient to consider simultaneous mergers as a single event and the rules are drafted accordingly.

Distinction between merging and improving

11.46 Merging 2 assets together often looks like improving one of them. If it were an improvement, the improved asset would continue to be held but its cost would be increased. In a merger, both original assets would cease to be held and a new (merged) asset would start to be held.

11.47 The test is whether the same entity holds both assets before they are merged. If it does, this will be a merger. If it does not, then the entity is improving its own asset by adding someone else's asset to it.

Example 11.13 Merger v improvement

Eumaeus owns a 4-wheel drive vehicle. He buys an air conditioner and installs it himself on his vehicle. Because he held both the vehicle and the air conditioner before he merged them, the merger rules would apply.

¹⁶² The common law recognises a distinction between (a) variation of an existing contract by a later one; and (b) rescission of a contract followed by the creation of a new one: *Tallerman Pty Ltd v Nathan's Merchandise (Vic) Pty Ltd* (1957) 98 CLR 93.

Contrast that with Laertes, who is less mechanically inclined. He takes his 4-wheel drive to a dealer to have an air conditioner installed. Because Laertes did not hold the air conditioner before it was merged with his vehicle, this would be an improvement of his vehicle. Of course, for all practical purposes, the results are the same in both cases.

Explanation of transformation ('change in nature')

11.48 As well as splitting one asset or liability into several and merging several assets or liabilities into fewer, it is possible for an asset or liability to be changed into a different sort of asset or liability. Such a change in nature is referred to in this Chapter as a 'transformation'.

11.49 The reference to a change in nature exists to make it clear that the transformation of an asset or liability is not a taxing point (i.e., it provides legislative support to ignore the transformation for tax purposes). Again, this is achieved by 'rolling over' the tax value of the transformed asset or liability.

What is a transformation (change in nature)?

11.50 The transformation of an asset or liability involves starting and ending with only one asset or liability but changing its nature (in whole or in part) in the process.

11.51 A mere change in how an asset or liability is characterised is not enough to be a transformation [*subsections 16-80(5) and 16-85(5)*]. There must be something fundamentally different in the asset's or liability's nature for the transformation rule to apply, not just a change in its use or in the way it is described, categorised or accounted for.

Example 11.14 Something that is *not* a transformation

Sheep grazier Nestor takes sheep from his stock and slaughters them for the consumption of his family. As each sheep is taken from the paddock, it ceases to be Nestor's trading stock for the purposes of the tax law.¹⁶³ This does *not* mean, however, that the sheep have been transformed into new assets of Nestor.

Timing

11.52 In contrast to a split or merge, it is possible for a transformation to occur, even though the total transformation process is not complete. For instance, it could be transformed into something on its way to becoming a third thing. In theory, this means that the transformation rule could apply to an asset several times during a transformation process. In practice though, it need only apply when the process is complete.

¹⁶³ See section 222-60 of the prototype legislation.

Substitution rule

Why have substitution rules?

11.53 Substitution cases would mostly be covered by the rules about splitting or merging. However, those rules do not apply when the substitution can only be done by someone else. For those cases, a special rule is needed.

When does the substitution rule apply?

11.54 The substitution rule applies if an entity stops holding one or more rights or liabilities and starts holding one or more other rights or liabilities, without any overall change in the economic benefits involved. *[Paragraphs 16-90(1)(a), (b), (c) and (d) and 16-95(1)(a), (b) and (c)]*

Example 11.15 Substitution of shares

As a result of market pressure, Demodocus Pty Ltd decides to replace each of its ordinary shares with one voting share and one share that entitles the holder to dividends and also contains all other shareholder rights. The shareholders would apply the substitution rule to this case.

11.55 In effect, a new grouping of rights or liabilities is substituted for the original grouping of rights or liabilities. The important thing to remember is that the economic benefits do not change; only the way they are grouped is altered.

11.56 It is also important to note that the substitution rule does not apply to tangible assets. For example, if you swapped one table for another, the rule would not apply.

Consequences of applying the substitution rule

11.57 When it stops holding the original assets, an entity is taken to have received an amount for that equal to the total of the original assets' tax values *[paragraph 16-90(2)(a)]*. The consequence of this is that the proceeds of realising the original assets will be that amount: section 14-40.

11.58 The entity is also taken to have paid the same amount for the new assets when it starts to hold them *[paragraph 16-90(2)(b)]*. The consequence of this is that the cost of the new assets will be that amount: paragraph 14-20(1)(a) and subsection 14-25(1).

Example 11.16 Substitution of shares

Continuing the previous example, Demodocus' shareholders would be taken to have received the original shares' tax value (usually cost) to stop holding them and to have paid the same amount to start holding

the substituted shares.¹⁶⁴ The relative costs of the voting shares and the dividend shares would be worked out by the core apportionment rules in section 9-120.

11.59 Similarly, when it stops having the original liabilities, an entity is taken to have paid an amount equal to their total tax value to stop having them [*paragraph 16-95(2)(a)*]. The consequence of this is that the cost of extinguishing the new liabilities will be that amount: section 14-90.

11.60 The entity is also taken to have received the same amount for incurring the new liabilities when it starts to have them [*paragraph 16-95(2)(b)*]. The consequence of this is that the proceeds of incurring the new liabilities will be that amount: paragraph 14-75(1)(a); subsection 14-80(1)

Actual, and other deemed, receipts and payments

11.61 The splitting, merging, transformation and substitution rules all deem amounts to have been paid and received by an entity. That does not mean that they deem those to be the only relevant payments and receipts. In many cases, there will also be actual receipts or payments, or other deemed payments (e.g. from the non-cash transactions rules in Subdivisions 16-B to 16-D), that need to be taken into account. [*Section 16-10*]

Example 11.17 Payment for splitting

Agamemnon pays Argus, a master cabinet maker, \$3,000 to divide the settee in her hotel's foyer into 2 lounge chairs. The settee has a depreciated tax value of \$4,000. The splitting rule would treat Agamemnon as receiving \$4,000 to stop holding his settee and as paying \$4,000 to start holding the new lounge chairs. In addition, he has *actually* paid \$3,000. The total amount paid for the lounge chairs would be \$7,000 (presumably \$3,500 each). That amount would be the chairs' cost and they would depreciate from that.

Apportionment rules

11.62 The core apportionment rule provides that an amount relates to an asset or liability to the extent that it is reasonably attributable to that asset or liability. They will generally apply when one amount is paid or received for several things. The receipt or payment must be apportioned between the various things to establish the cost or proceeds of each. [*Section 14-120*]

¹⁶⁴

Note that this would not apply when shares in one company were substituted for shares in another (as often happens in a corporate takeover). The economic benefits before and after the substitution must be *identical*, which isn't the case if the new shares are in a different company.

11.63 In making the apportionment, regard must be had to the relative market values of the things for which the amount is received or paid at the time of the receipt or payment. [Section 14-120]

Example 11.18 Apportionment in a split

Livia, a builder, decides to sell her ute's tray and canopy. She advertises, and sells them for \$1,200. This activates the splitting rule. The ute originally had a depreciated *tax value* of \$3,000 and, after the split, the ute (without tray and canopy) had a *market value* of \$3,800 and the tray and canopy \$1,200. The \$3,000 she is taken to have paid to get the new assets (tray and canopy + ute) is apportioned between them like this:

$$ute = 3,000 \times \frac{3,800}{(3,800 + 1,200)} = 2,280$$

$$tray / canopy = 3,000 \times \frac{1,200}{(3,800 + 1,200)} = 720$$

The tray and canopy will have a tax value of \$720 but were sold for \$1,200, so a \$480 gain will be brought to account.

Chapter 12

Depreciating assets

Outline of Chapter

12.1 Division 72 of the prototype legislation contains the rules for writing off the cost of a depreciating asset for the purpose of working out the taxable income of the entity which holds that asset.

12.2 This Chapter explains:

- what a depreciating asset is;
- what its tax value is; and
- how to work out the decline in its tax value.

Context of Reform

12.3 The uniform capital allowances regime (Division 40 of the ITAA 1997) was introduced to simplify the law by establishing common principles for writing off most tangible depreciating assets and some intangibles.

12.4 Despite these recent improvements, the current law remains a complex mixture of ordinary income tax concepts and specific statutory rules. This means both law and administration are complex, providing inconsistent and inappropriate treatment through different outcomes for broadly similar transactions. For instance, lump sum payments made for some rights are recognised only as a capital loss at the end of the right (such as franchise fees, lease premiums and restrictive covenants) whereas others are spread over the period of the right (such as prepayments for services). These outcomes distort the choice of particular forms of business arrangement, so that tax considerations unduly interfere with the way in which investment funds are allocated.

12.5 The inadequate framework of the current law means that a number of specific rules are needed to address particular circumstances that the present structure of the tax law could not otherwise deal with. For instance, the current law does not recognise the conceptual similarity between rights created when a prepayment is made and other assets with a limited effective life. Instead a discrete area of the law deals with prepayments, using a similar, though different, mechanism to spread such expenditure than it uses to spread the cost of other assets with a limited

effective life. The duplication of logically identical concepts and mechanisms adds legislative and administrative complexity.

12.6 In addition, the current law's treatment of rights often does not mirror the treatment of the corresponding liabilities. The lack of symmetry in the rules that govern the timing and characterisation of transactions creates anomalies in the tax treatment of the different parties to an arrangement. For instance, lump sum payments for the granting of some rights are taxed immediately on receipt, but are not deductible to the grantee except as a capital loss on the termination of the right.

12.7 Division 72 of the prototype legislation addresses the inconsistent and distortionary nature of the current law through:

- a comprehensive structure that offers *common rules* for the treatment of *all* depreciating assets — that is, broadly all tangible and intangible assets with a limited effective life will be written-off according to the rules in Division 72; and
- a *symmetrical treatment* of both sides of a transaction — that is, through asset rules that mirror those about liabilities, the law will generally recognise the same amounts at the same times for each party to a transaction.

12.8 Thus, as well as covering the ground covered by the current uniform capital allowance and prepayment rules, TVM's depreciating asset rules are designed to implement the ATSR recommendations on rights (including prepayments).¹⁶⁵ So far, Division 72 deals with the core recommendations (4.6(b), 10.1 and 10.3) that set the default position for rights and liabilities. However, it should be noted that some other recommendations are yet to be considered.

Summary of prototype legislation

12.9 Division 72 establishes what a depreciating asset is, what is its tax value and how to work out the decline in its tax value.

12.10 A ***depreciating asset*** is an asset that can be used for only a limited period. Typically, this will mean that such an asset will fall in value over time and will be held for only a finite period.

12.11 The tax value of a depreciating asset will initially be its cost, which starts to decline when it is first used or (for tangibles) installed ready for use. The decline in tax value will be:

¹⁶⁵ See sections 4 and 10 of ATSR.

- for tangible depreciating assets, IRUs, and mining rights (and co-ownership interests in any of these) — based on the entity’s choice between:
 - the straight-line method; and
 - the diminishing value method.
- for other depreciating assets — based on:
 - the straight-line method – where the economic benefits are expected to be received evenly;
 - the proportion of total economic benefits received – where the economic benefits are expected to be received unevenly; or
 - the market value of economic benefits received – where the total economic benefits to be received are inestimable.

Comparison of key features of the prototype legislation and current law

Tangible depreciating assets

12.12 The comparison between the treatment of tangible depreciating assets under Division 72 of the prototype legislation and the corresponding provisions in the current law is set out in the following table:

Table 12.1 Comparison of key features of the prototype legislation and the current law

<i>Prototype legislation</i>	<i>Current law</i>
<i>Assets under Division 40 of the ITAA 1997 (Capital Allowances)</i>	
The prototype legislation will allow the holder of a tangible depreciating asset to write-off the cost according to its effective life, using either the ‘diminishing value’ method or the ‘straight-line’ method ¹⁶⁶ .	Broadly, Division 40 of the ITAA 1997 recognises the cost of most tangible depreciating assets. These rules allow the holder of such assets to write-off the cost by reference to its effective life, using either the ‘diminishing value’ method or the ‘prime cost’ method.

¹⁶⁶ Note: The ‘straight-line’ method is equivalent to the ‘prime cost’ method under the current law — see paragraphs 12.83 to 12.85.

<i>Prototype legislation</i>	<i>Current law</i>
<i>Buildings and structures</i>	
The appropriate treatment for buildings and structures is a matter for further consultation (see Treasurer's Press Release No. 74, 11 November 1999).	Under Division 43 of the ITAA 1997, a building or structure can be written off over either 40 or 25 years, irrespective of its actual effective life.

Intangible depreciating assets — rights

12.13 Broadly, the prototype legislation recognises the cost of *all* intangible depreciating assets (non-perpetual rights) as the economic benefits are received.

12.14 In general terms, the coverage of Division 72 of the prototype legislation is much broader than Division 40 of the ITAA 1997. In particular, the prototype legislation encompasses many intangible assets (rights) that are not dealt with by the depreciation provisions of the current law. Therefore, the prototype legislation represents a significant policy shift in the treatment of such rights. The comparison between the treatment of some of these rights under Division 72 of the prototype legislation and the corresponding provisions in the current law is set out in the following table:

<i>Prototype legislation</i>	<i>Current law</i>
<i>Intangible assets covered by Division 40 of the ITAA 1997</i>	
The prototype legislation applies generally to intangible assets with a limited effective life, including those specified under Division 40 of the ITAA 1997. The prototype legislation maintains the current treatment of those specified intangibles by prescribing the same effective life and write-off methods as under the ITAA 1997.	Under Division 40 of the ITAA 1997, a specified list of intangibles are depreciating assets. These assets have a prescribed effective life and most may only be written-off according to the 'prime-cost' method.
<i>Rights generated when prepayments are made</i>	
The rights created under a prepayment will be written-off according to the way in which the economic benefits are received. Often, the economic benefits will be received evenly throughout a period. In such a case, the right would be written-off on a straight-line basis ¹⁶⁷ .	Certain prepayments are deductible on a straight-line basis over the period the right to receive services exists (Subdivision H of Division 3 of Part III of the ITAA 1936).

¹⁶⁷ Note: Exceptions to the prepayment rules in the current law are yet to be replicated.

<i>Prototype legislation</i>	<i>Current law</i>
<i>Rights like restrictive covenants, profits à prendre and easements</i>	
<p>The cost of a right, for example one created under:</p> <ul style="list-style-type: none"> • a profit à prendre; • a restrictive covenant; or • an easement; <p>will be written-off according to the way in which the economic benefits are received.</p>	<p>The cost of a right created under:</p> <ul style="list-style-type: none"> • a profit à prendre; • a restrictive covenant; or • an easement; <p>is generally recognised as a capital loss when the right ends (CGT event C2, section 104-25 of the ITAA 1997).</p>

Changes in terminology

12.15 In a number of instances the prototype legislation introduces new terminology for concepts that appear in the current law. For instance, the current law concept of ‘adjustable value’ is subsumed within the term ‘tax value’ in the prototype legislation. This change reflects the standardised set of core rules that are a key feature of TVM. Other changes to terminology reflect the wider class of assets to which TVM depreciating asset provisions apply.

12.16 Wherever possible the terminology of the current law has been retained to assist users of the law to accustom themselves with the prototype legislation. For instance, the concept of ‘effective life’ serves the same role under TVM as under the current law, and so the prototype legislation continues with the use of this term.

Detailed explanation of prototype legislation

Link to higher level rules

Taxable income and net income

12.17 Under Division 6 of the prototype legislation an entity must work out net income for an income year in order to work out taxable income. A key component of net income is the change in the tax value of assets. This is the difference between the tax value at the start of the income year (the opening tax value) and the tax value at the end of the income year (the closing tax value) of each asset.

12.18 Subdivision 72-B contains the core provisions for working out the decline in tax value of depreciating assets (the ‘write-off’). Generally a depreciating asset’s opening tax value for the year is reduced by the decline in tax value [*subsection 72-35(1)*]. The result is the closing tax value for the income year. The closing tax value at the end of the year is the opening tax value for the next [*section 6-85*].

Private, domestic or exempt purposes

12.19 Division 72 does not itself contain any explicit adjustment when a depreciating asset is used to any extent for a private, domestic or exempt purpose. Adjustments are made to cancel the part of the decline in the asset's tax value relating to that use under Division 222 (private or domestic) or Division 130 (exempt).¹⁶⁸

'Holding' an 'asset'

12.20 The question as to whether an entity 'holds' a depreciating asset, and therefore is entitled to write-off its decline in tax value depends on the broad notions of 'asset' and 'hold', which are contained in Division 10. Generally, the legal owner will be the holder. In a limited number of cases an economic owner, who is not a legal owner, may hold the asset instead. Economic owners are the entities that are able to access the economic benefits to the exclusion of other entities.

Balancing adjustment on ceasing to 'hold' an asset

12.21 Division 72 does not contain a specific rule to adjust net income when a depreciating asset is disposed of for an amount greater or less than its tax value. That is because, under the general rules for calculating net income in Division 6, the proceeds of realising the asset are brought to account as receipts while the asset itself would no longer be reflected in the closing tax value of assets. This provides an automatic balancing adjustment on disposal of a depreciating asset (subject to adjustment for any private or domestic or exempt use of the asset).

12.22 In other words, based on the effective life of an asset, the statutory methods under Division 72 produce a decline in tax value from time to time. This statutory decline in tax value is not necessarily correlated to the actual (or expected) decline in the market value and any difference between the statutory decline and the actual fall in value will be reconciled when the entity stops holding the asset.

Example 12.1 Automatic 'balancing adjustment' on ceasing to hold a depreciating asset

Mike sells a depreciating asset for \$10,000 at the beginning of an income year. His asset's opening tax value for that year was \$8,000 (the asset's cost less its statutory decline in tax value to that time). His net income for the year will be:

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

$$[\$10,000 - 0] + [0 - \$8,000] - [0 - 0] = \$2,000$$

¹⁶⁸ Division 130 is yet to be drafted.

That is, the general application of the TVM mechanism includes in his net income the excess of the proceeds from the sale over the depreciated value of the asset.

What is a depreciating asset?

12.23 A *depreciating asset* is defined as an asset that can be used only for a limited period. [Subsection 72-30(1)]

12.24 Generally, land is not considered to have a limited effective life and so will not meet the definition of a depreciating asset. However, at common law assets that become fixtures to land, or are improvements on land are regarded as part of the land. Under the prototype legislation, such improvements or fixtures are treated as separate from the land and so may still qualify as depreciating assets, regardless of whether they can in fact be removed from the land or are permanently attached. [Section 22-20]

12.25 Some assets are specifically excluded from the definition of depreciating asset, such as trading stock, shares, financial assets and private collectables. [Subsection 72-30(3); section 234-40]

What is the 'limited period' for which a depreciating asset can be used?

12.26 A depreciating asset is one that can be used only for a limited period. This period is the 'effective life' of the asset (discussed in greater detail at paragraphs 12.109 to 12.132). Essentially, 'effective life' is the period of time that an asset can be used *by any entity* [section 72-100]. This means that an asset will have a limited effective life, and therefore will be a depreciating asset, if at some point in the future the asset will embody no further future economic benefits.¹⁶⁹

12.27 A depreciating asset includes physical assets of a wasting nature that decline in value because of deterioration or obsolescence and assets of an intangible kind such as patents and rights to get goods or services that have a limited lifetime due to statutory or contractual limitations.

Example 12.2 A right to future services as a depreciating asset

Fred agrees to provide Ginger with fortnightly tango lessons over a period of 3 years in exchange for a lump sum payment. She holds an asset, being the right to get the lessons under the contract. This is a depreciating asset as it is a right that will cease to exist when she receives all the services.

12.28 The definition does not limit depreciating assets to things that lose value *steadily* over their effective lives. Nor are depreciating assets limited to things that *only* decline in value. Depreciating assets may maintain their value for a time, or even increase it for a time. However, a depreciating asset will lose its value overall (or down to no more than

¹⁶⁹

At this time the asset would cease to exist.

scrap value) by the end of its effective life. In particular it covers assets that do not generally *decline in value over the course of their effective life*. In this way, the prototype legislation addresses things like options, which have a limited effective life but lose all (or substantially all) of their value when they cease to exist.

What does ‘use an asset’ mean?

12.29 ‘Use an asset’ is defined to mean consume or receive the economic benefits embodied in the asset [*subsection 72-30(2)*]. The concept of the economic benefits ‘embodied’ in an asset is discussed below at paragraphs 12.40 to 12.43. When an asset is ‘used’, these economic benefits are realised and the asset declines in value as the future economic benefits diminish. That is, ‘use’ includes any purpose or application the asset is put to, from which the holder of the asset receives or consumes the economic benefits embodied in the asset.

12.30 The defined meaning of ‘use’ accords with the term’s broad ordinary meaning. That is, ‘use’ will include the general notions of:

- ‘employing’, ‘exercising’, or ‘exploiting’ an asset; or
- diminishing the ability or opportunity to do any of those things.

12.31 At the broadest level, the concept of ‘use’ means the way in which any advantage is obtained because of the manner and purpose in which an asset is held. Under a narrower interpretation, the concept can mean the physical application of an asset for the purpose that it was intended to be applied (e.g. ‘use’ of a lawnmower can simply mean employing it to cut grass). In the prototype legislation, the term ‘use’ should be read in its broadest ordinary meaning. That is, the term is not limited by any concept of the physical utilisation of a tangible object. Indeed, the concept of ‘use’ is applicable to both tangible and intangible depreciating assets.

12.32 The concept of ‘use’ is central to the depreciating asset provisions. In addition to the definition of ‘depreciating asset’ the concept is also relevant to determining:

- when an asset starts to decline in tax value;
- what its effective life is; and
- what method to apply to work out its decline in tax value.

Using tangible assets

12.33 As mentioned above, the most obvious use of a tangible asset is to physically employ it for a specific task. However, the concept of ‘use’

should be read more widely than that to include passive kinds of use. For instance, an entity can ‘use’ an asset by having it ‘installed ready for use’ because the entity benefits from the ability to put the asset to work at any time. In other words, the entity derives an advantage from having the capacity to employ the asset should it be required. That advantage is an economic benefit that is embodied in the asset, the ability to physically use it.

12.34 In addition, a tangible asset may be ‘used’ by leasing it to another entity (who may put it to a physical use). This is a form of use because the lessor is realising the ability of the asset to be put to a physical use by assigning that right to physically use it.

Example 12.3 ‘Using’ a tangible depreciating asset

Greg holds a plough (a tangible depreciating asset). His ‘use’ of the asset includes receiving or consuming economic benefits by:

- storing it in his shed for future use — i.e. installed ready for use;
- ploughing his fields with it — i.e. physical use; or
- leasing it to someone else — i.e. assigning the right to physical use.

Using intangible assets – rights

12.35 Intangible depreciating assets (i.e. rights) may be ‘used’ either when economic benefits are consumed or received because the right is:

- *exercised*; or
- *held*, rather than exercised.

12.36 In order to establish which of these is true for a particular right, an entity must look at which of those factors can be determinative of the asset’s effective life. In other words, if the effective life of the right *can* be determined by the time and way in which it is exercised, it is ‘used’ when it is exercised. If, instead the effective life of the right *cannot* be limited by its exercise, it is ‘used’ when it is merely held. These ideas are explained in more detail below.

‘Use’ by exercising the right

12.37 For some rights, economic benefits will be received only when the right is exercised. These are the rights that either have an effective life that:

- *is* determined by the way it is expected to be exercised; or

- *could have been* determined by its exercise, if it was expected to be exercised in a different way.

12.38 In other words, this covers all rights except those whose effective life *cannot* be determined by its exercise, but instead can be limited only by the period until it expires.

Example 12.4 Effective life is determined by expected exercise

Melissa has a right to remove a total of 10 tonnes of gravel from a pit. She can exercise this right at any time she chooses as there is no specified time limit for her right. The effective life of her right therefore depends only on when she reasonably expects she will remove the 10 tonnes of gravel. Therefore, she will only receive economic benefits, and so ‘use’ the right, as the gravel is removed from the pit. No economic benefits are received if time passes and she takes no gravel.

Example 12.5 Effective life is determined by expected exercise

Melissa has a right to remove a total of 10 tonnes of gravel from a pit within 10 years. When she enters the agreement she expects to take 2 tonnes of gravel in each year. Based on this expectation, she reasonably estimates that the effective life of her right will be 5 years (as the right is exhausted by her exercise of it in this period). That is, the effective life of the asset is determined by the expected exercise of that right and so she ‘uses’ that asset as she exercises it.

Example 12.6 Effective life *could have been* determined by expected exercise

In contrast to example 12.5, Melissa instead expects she will only remove half a tonne of gravel per year. Based on this expectation, she reasonably estimates that the effective life of her right will be 10 years (as the right will not be exhausted by her exercise of it before it expires). Although the effective life of the asset is not determined by her expected exercise of that right, it could have been if her expected exercise was different (i.e. along the lines of example 12.5). Therefore, she ‘uses’ her right by exercising it.

‘Use’ by holding the right, rather than exercising it

12.39 Some rights are ‘used’ by merely holding them. This means that the economic benefits embodied in those rights are consumed or received because of the passage of time irrespective of their exercise, and that their effective life is a function of time alone. That is, there is no possibility that the time and way in which a right is exercised can influence its effective life. Common examples of these kinds of assets are the rights held under an easement, or a contract of insurance. For these kinds of assets, economic benefits are received because the entity gains an advantage from holding the right, regardless of whether they actually exercise that right. For instance, under an easement the party that has the right to pass across

land receives economic benefits whether or not they exercise that right by actually passing across the land. Typically, the value of the right will fall irrespective of how often it is exercised or whether it is exercised at all. That is, economic benefits flow as a natural consequence of holding the asset and its effective life will ultimately be a defined period of time.

Example 12.7 ‘Use’ by holding rights under an insurance policy

Andrea insures the contents of her home against loss from fire for one year. Throughout the year of the agreement she receives economic benefits in the form of a protection against risk.¹⁷⁰ The protection is her right to claim compensation from the insurer in the event of a fire that causes damage. Regardless of whether such damage occurs or not, she ‘uses’ her right at every point in time she holds the policy since the economic benefits (the protection) are received as time goes by.

What economic benefits are ‘embodied’ in an asset?

12.40 It is important to remember that the relevant economic benefits are those that are *embodied* in the asset, and therefore diminish or are exhausted as they are consumed or received when the asset is used. In contrast, an entity may receive economic benefits that relate to an asset but which do not deplete the economic benefits embodied in it. The latter will *not* constitute the ‘use’ of an asset. In other words, there is a distinction to be made between the economic benefits:

- that are received *from* the store of value in asset — that is, they are economic benefits that were *embodied* in the asset but have been realised, thereby reducing the store of economic benefits embodied in the asset; and those
- that are received *because* the asset has worth as a store of value — that is, they are economic benefits that are received because the asset has value, but do not reduce the store of value that is embodied in the asset.

12.41 The ‘use’ of a depreciating asset refers to the consumption or receipt of economic benefits that come from the asset. A corollary of this is that the stock of economic benefits embodied in an asset diminishes as it is used. Therefore a distinction is to be made between the ‘use’ of an asset and the economic benefits consumed or received because the asset has value *as a store* of economic benefits. For instance, offering a depreciating asset as security for a loan is not to be considered a use of the asset. This is because the economic benefits that are received are not those that were embodied in the asset. Instead the economic advantage is derived from the fact that the depreciating asset is a store of value that can be traded.

¹⁷⁰

See section 22-30, explained at paragraphs 7.85 and 7.86 of Chapter 7.

Example 12.8 Economic benefits received because asset is a store of value

Martin buys a motorcycle, which is to be shipped from abroad. Before it is delivered he offers it as security over a personal loan he takes out. He receives economic benefits as a consequence of offering the motorcycle as security, however these are not economic benefits that were embodied in it. Instead these are economic benefits that he receives as a consequence of assuming the liability to repay the loan. Therefore, this is not considered to be a 'use' of the motorcycle.

12.42 In other cases, in addition to the economic benefits embodied in the asset there are further economic benefits that can be received from using the asset in a particular way (e.g. to produce income). Only the economic benefits that are embodied in the asset are relevant for working out whether an asset is a depreciating asset, what its tax value is and what its decline in tax value is.

12.43 For instance, a car may be used as a taxi, from which the entity receives the economic benefits embodied in the car. However, this particular type of use will also give rise to financial rewards for economic benefits that were not embodied in the car. In particular, the fares a taxi-driver earns relate to the provision of her labour, the fuel consumed by the car and other expenses. That is, the rewards are not simply a return of the economic benefits embodied in the asset but are earned as consideration for the provision of other economic benefits that do not relate solely to the asset (i.e. the rewards often also relate to the provision of labour and/or materials).

Is every depreciating asset covered by Subdivision 72-B?

12.44 A number of assets that would generally meet the definition of a depreciating asset are, for policy reasons, 'listed zero tax value assets'. This means that they are given a closing tax value of zero, and therefore payments made to hold them will be recognised immediately rather than over a period of time. Therefore, listed zero tax value assets are not covered by the rules in Subdivision 72-B. These assets are listed in Division 68.

12.45 Some other depreciating assets are given special write-off treatment under the current law. Further legislation will be drafted to ensure that these assets maintain their special treatment. For example, special rules are to be developed relating to landcare and other primary production assets to produce the same outcomes as the current law¹⁷¹.

¹⁷¹ Special rules will also be required to give taxpayers an 'immediate deduction' for depreciating assets costing \$300 or less that are used predominantly for the purpose of producing assessable income that is not from carrying on a business.

What is the ‘tax value’ of a depreciating asset?

12.46 The *tax value* of a depreciating asset broadly represents so much of the cost of the asset, as is not yet written-off at a particular time. ‘Tax value’ therefore provides the starting point for calculating further decline and net income.

12.47 An entity will need to know the ‘tax value’ of an asset:

- at the end of the income year;
- when it is split or merged; or
- when they stop holding it and an adjustment is required (e.g. because there was some private use of the asset).

Tax value at the end of an income year

12.48 For the first income year in which the decline in tax value is being worked out, the ‘tax value’ is determined in the following way:

$$\text{tax value} = \text{asset's cost} - \text{asset's decline in tax value for the income year}$$

[Paragraphs 72-35(1)(a) and (2)(a)]

12.49 Where an entity continues to hold the depreciating asset at the end of that first year, the closing tax value will be carried forward to the start of the following income year as the *opening tax value*. [Section 6-85]

12.50 The tax value of a depreciating asset at a particular time in a later income year is:

$$\begin{array}{rcccl} \text{opening tax} & & \text{any amounts added to} & & \text{the decline in} \\ \text{value at the} & & \text{cost during the year up} & & \text{tax value up to} \\ \text{start of that} & \textit{plus} & \text{until that particular time} & \textit{less} & \text{that particular} \\ \text{income year} & & & & \text{time} \end{array}$$

[Paragraphs 72-35(1)(a) and (2)(b)]

Example 12.9 Calculating tax value

Renee’s tractor has an opening tax value of \$60,000. The decline in tax value (as worked out under Division 72) for that income year is \$10,000. The tax value at the end of the income year is:

$$\$60,000 - \$10,000 = \$50,000$$

The amount of \$50,000 will be carried forward as the ‘opening tax value’ for the next income year.

Tax value during the income year

12.51 When an asset is split, merged or disposed of *during* an income year, an entity may need to establish what its tax value was at that time. To do so the entity should treat this date during the income year as if it were instead the end of an income year [subsection 72-35(5)]. This means that the tax value at the time during the income year would be the opening tax value and additional costs *to that date* less the decline in tax value *to that date*. This rule is necessary because tax value is otherwise calculated at the end of an income year based on the decline in tax value over the *entire* year.

Example 12.10 Calculating the tax value of a split depreciating asset

On 1 August Sandra splits her depreciating asset into 2 new assets. The tax value of the original asset on 1 August will be relevant to determine the cost of the new assets (see Chapters 9 and 11). The tax value of the original asset immediately before the split will be:

Opening tax value of original asset	<i>plus</i>	Amounts added to cost of original asset	<i>less</i>	Decline in tax value from 1 July to 1 August
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When does tax value start to decline?

12.52 The decline in tax value of a depreciating asset starts at the earlier of when:

- for any depreciating asset — it is first used;¹⁷² or
- for a *tangible* depreciating asset — is first installed ready for use.

[Subsection 72-35(3)]

Installed ready for use

12.53 The prototype legislation restates the definition of ‘installed ready for use’ that appears in the current law. By its nature, the phrase applies only to *tangible* depreciating assets. For these assets, the decline in tax value begins when they are first installed ready for use or first used. These times may coincide since when a tangible asset begins to be used it usually must be installed ready for use.

¹⁷² A detailed discussion of the concept of ‘using’ a depreciating asset appears above at paragraphs 12.29 to 12.39.

Asset held by an entity that previously held the same asset

12.54 In the event that an entity has previously held the same depreciating asset, the decline in tax value begins at the earliest relevant event after they *most recently* started to hold the asset. [*Subsection 72-35(3)*]

Example 12.11 Asset held by an entity that previously held the same asset

Suppose Rupert buys a depreciating asset on 1 July 2005 and uses it from that time until selling it on 1 July 2006. He reacquires it on 1 July 2007 and uses it from this time. For the later period he holds the asset, it starts to decline in tax value on 1 July 2007 and *not* 1 July 2005.

What is the decline in tax value?

12.55 The decline in tax value will be worked out:

- for tangible depreciating assets, IRUs and mining rights (and co-ownership interests in any of them) — based on the choice between:
 - the straight-line method; and
 - the diminishing value method.
- for other depreciating assets — based on either:
 - the straight-line method, if economic benefits are expected to be received evenly; or, if not
 - the proportion of total economic benefits received, if it can be reasonably estimated; or, if not
 - the market value of economic benefits received.

Decline in tax value of tangible depreciating assets IRUs and mining rights (and co-ownership interests in them)***Choice of methods***

12.56 For each tangible depreciating asset, IRU, or mining right an entity holds they must decide whether to apply the straight-line or diminishing value method for working out the decline in tax value of those assets. [*Subsection 72-65(1)*]

12.57 In addition, a co-ownership interest in a tangible asset, an IRU or a mining right can be written-off according to the either the straight-line or diminishing value method [*subsection 72-40(1), item 1 in the table*]. As explained in paragraph 7.95 of Chapter 7, assets that would otherwise be

held by 2 or more entities are held by neither of them. Instead each joint holder is treated as if they only held their co-ownership interest [*subsection 24-10(1), item 4 in the table*]. In those cases the co-ownership interest in an asset may be written-off according to any method that the underlying asset could be, were it owned outright. This treatment is designed to accord the treatment of the co-ownership interest with that of the underlying asset.

Example 12.12 Co-ownership interests in a tangible asset

Ben and Clare each own a half share in a stagecoach (the underlying depreciating asset). The co-ownership interest that each holds is an intangible depreciating asset. Nevertheless, the same write-off methods are available for that intangible asset as for the underlying tangible asset. That is, the write-off options are the same for Ben and Clare as if they held the underlying asset, rather than a co-ownership interest in it.

12.58 Both the straight-line and the diminishing value formulas rely on the effective life of the asset, and generate a decline in tax value regardless of changes in its actual market value.

Restrictions on the choice of methods

12.59 There are some restrictions on the general choice between the diminishing value and straight-line methods. These restrictions reflect the current law and are designed to ensure that entities cannot exploit the characteristics of the 2 methods to accelerate the decline in tax value. Such exploitation would occur if an entity could choose the diminishing value method in the early years of an asset's effective life, and the straight-line method in the later years.

General restriction: One method of decline in tax value per asset

12.60 An entity must continue to calculate the decline in tax value of a particular depreciating asset for later income years in accordance with whichever of the straight-line or diminishing value methods they chose to apply for the first income year. [*Subsection 72-130(2)*]

12.61 That is, an entity is not permitted to change from one method of decline in tax value to another in respect of the same depreciating asset. This does not prevent an entity from using different methods for different assets.

Associate and same end-user restriction

12.62 In order to ensure that the intent of the general restriction is not circumvented by artificial or contrived changes in who holds the asset, the general restriction is extended in cases where:

- the asset is passed between associates [*subsection 72-65(2)*]; or

- despite changes in who holds the asset, the end user is the same [subsection 72-65(4)].

12.63 That is, where an entity becomes the holder of an asset that was held by an associate, the entity must use the same method as the associate had applied. [Subsection 72-65(2)]

12.64 Also, entities must use the same method that the previous holder of the depreciating asset was using if the *end-user* of the depreciating asset does not change. For example this could occur by a lessee purchasing an asset after the lease of the asset has ended. [Subsection 72-65(4)]

12.65 Special rules assist an entity to obtain that information from the associate or former holder (see paragraphs 12.137 to 12.141). However if the entity cannot find out which method the associate or former holder had chosen, either because it is impractical to find out or because the associate or former holder had not yet chosen a method, the holder of a depreciating asset must use the diminishing value method. This limitation reduces potential for exploitation by preventing an entity moving from the diminishing value method to the straight-line method. [Subsections 72-65(3) and (5)]

Diminishing value method

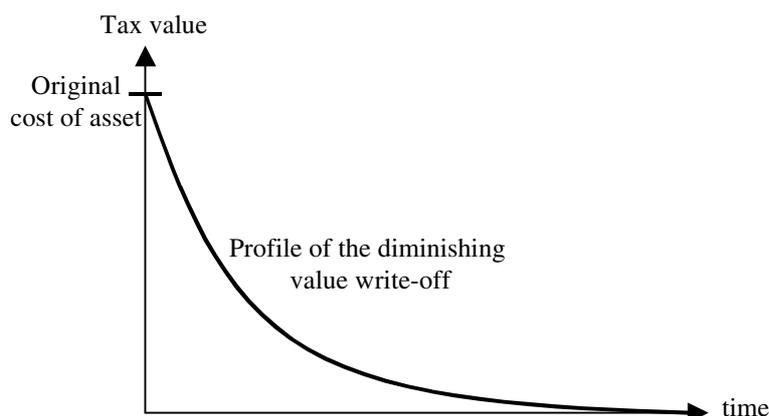
12.66 The diminishing value method that appears in the prototype legislation replicates the current law, and is expressed in the following formula:

$$\text{Base value} \times \frac{\text{Days}}{365} \times \frac{150\%}{\text{Effective life}}$$

[Section 72-70]

12.67 In contrast to the straight-line alternative, the diminishing value method produces a decline each year that is a constant proportion of the asset's remaining tax value. It therefore produces a progressively smaller decline in tax value as the balance falls. The constant rate of decline is based on 1½ times the straight-line rate of decline, giving a larger decline early in the asset's life, and a smaller decline late in the asset's life, as compared to the straight-line method. The profile of the write-off under the diminishing value method is illustrated below.

Diagram 12.1 The diminishing value write-off



12.68 The diminishing value formula has 3 elements:

- ‘base value’;
- ‘days’; and
- ‘effective life’.

Base value

12.69 The base value represents the tax value of the asset that remains to be written off.

12.70 For the first income year in which the decline in tax value occurs, the base value is the asset’s cost at the end of that income year. This amount includes any payments in that year that are either first or second elements of cost. [*Paragraph 72-35(2)(a)*]

12.71 For later years, the base value is the opening tax value for the income year and any amounts added to cost for the year [*paragraph 72-35(2)(b)*]. That is, payments for any improvements to a depreciating asset that are made during an income year are taken into account when calculating the decline in tax value for that year. Because these amounts are simply added to base value, they are (in effect) given the benefit of a whole year’s decline rather than being apportioned in any way. This simplifies the calculation formulas substantially, and increases the decline in tax value.

Days

12.72 The ‘days’ component of the formulas refers to the number of days during the income year that the entity ‘held’ the depreciating asset while it was declining in tax value. The days for which there is no decline in tax value are ignored, they are:

- days before the asset started to decline in tax value; and

- days a tangible asset was not used or installed ready for use (by its holder or any co-owner of it).¹⁷³

[Section 72-70]

12.73 This component ensures that the write-off for an income year is reduced where, for example, the asset is disposed of during the year. A disposal ends the decline in tax value, because no economic benefits are received when the entity no longer holds the asset.

12.74 For the year in which the asset starts to decline in tax value, the 'days' component is calculated from that time, which may not necessarily coincide with the time the entity actually started to hold the asset (such as when an entity holds a tangible asset for a time before it is installed ready for use). The time when a depreciating asset starts to decline in tax value was discussed above at paragraph 12.52.

12.75 For a later year, the number of days that an entity held a depreciating asset is worked out from the start of the income year for which the decline in tax value is being calculated.

Effective life

12.76 The term *effective life* describes the length of time over which any entity could reasonably expect to use the particular asset.

12.77 The estimated effective life of an asset is expressed in years. Part years are expressed as a fraction, and are *not* rounded to the nearest whole year. For instance, if the effective life of a particular asset were estimated to be 4 years and 6 months, its effective life would be expressed as 4½ years. Of course, in many cases the actual effective life will be estimated to be a whole number of years.

12.78 For the income year in which an asset starts to decline in tax value, the effective life component represents the effective life of the asset calculated as from the time it started to decline in tax value.

12.79 Under the diminishing value method, the effective life for a later income year will be the asset's *whole* effective life. This will be the same effective life used in calculating the initial decline in tax value, unless that effective life has been recalculated since that first year. That is, if the entity recalculates the effective life of a depreciating asset the most recent recalculated life must be used (see paragraph 12.126).

12.80 The rules for working out the effective life are discussed in paragraphs 12.109 to 12.132.

¹⁷³

IRUs and mining rights are 'used' by merely holding them (see paragraph 12.39).

Example 12.13: Diminishing value method

Sonia is a tourist operator who organises sailing expeditions around the Whitsunday Islands. She decides to expand her operations and acquires a new yacht on 13 August at a cost of \$200,000. Sonia self-assesses the effective life of the yacht to be 12 years and decides to work out its decline in value under the diminishing value formula. Assuming that the yacht is first ready for use on 5 September in the same year, its decline in tax value for Year 1 and Year 2 is calculated in the following way:

Year 1

$$\begin{aligned} \text{Decline in tax value} &= \$200,000 \times \frac{365 - 66}{365} \times \frac{150\%}{12} \\ &= \$20,479 \end{aligned}$$

$$\begin{aligned} \text{Closing tax value} &= \$200,000 - \$20,479 \\ &= \$179,521 \end{aligned}$$

The 'tax value' of \$179,521 is carried forward to the start of income Year 2 to become the 'opening tax value'.

Year 2

$$\begin{aligned} \text{Decline in tax value} &= \$179,521 \times \frac{365}{365} \times \frac{150\%}{12} \\ &= \$22,440 \end{aligned}$$

$$\begin{aligned} \text{Closing tax value} &= \$179,521 - 22,440 \\ &= \$157,081 \end{aligned}$$

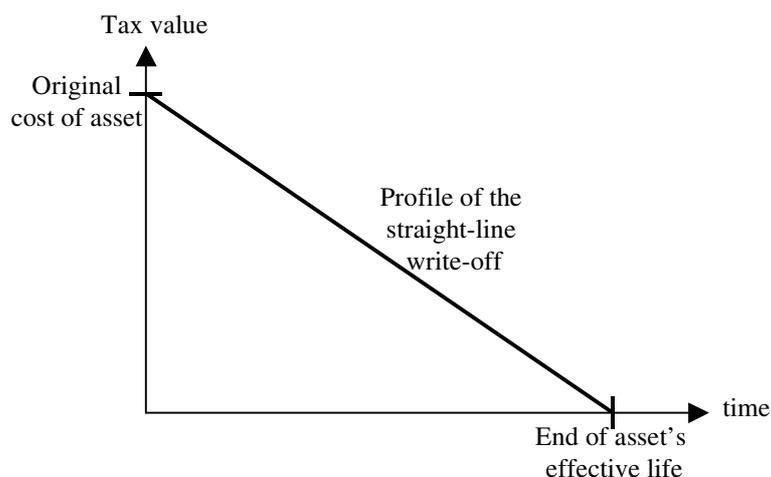
Straight-line method

12.81 The straight-line method appears in the following formula:

$$\text{Base value} \times \frac{\text{Days}}{365} \times \frac{100\%}{\text{Remaining effective life}}$$

[Section 72-75]

12.82 Under the straight-line method, the tax value of an asset decreases uniformly over its effective life. The decline from time to time therefore allocates the remaining cost over the remaining effective life, and produces a 'straight-line' write-off. The profile of the write-off under the straight-line method is illustrated below.

Diagram 12.2 The straight-line write-off

12.83 The 'straight-line formula' proposed in the prototype legislation is an alternative expression of the 'prime-cost' formula used in the current law (section 40-75 of the ITAA 1997). This change in expression (and in name) reflects the broader scope and application of this write-off method under TVM (i.e. it applies to rights (including prepayments) and liabilities). Despite these differences, the results achieved under the 'straight-line' formula are identical to those under the current 'prime-cost' formula. That is, both methods give the same write-off over the effective life.

12.84 However, the drafting of the 'straight-line' formula is a more efficient expression of the concept. It streamlines the rules (by reducing the number of provisions and generally simplifying their expression) and directly contemplates the inclusion of second element costs in a way that the 'prime cost' formula does not. This change in expression will not change the record-keeping or systems requirements of entities.

12.85 In summary, the 'straight-line' formula:

- improves the drafting of the law, because retaining the 'prime cost' formula requires complex adjustments if there are any second elements of cost in an income year;
- is mathematically identical to the 'prime cost' formula;
- applies not only to tangible depreciating assets and a limited class of intangibles (as in the current law), but generally to all depreciating assets (including intangible assets) and depreciating liabilities.¹⁷⁴

12.86 The straight-line method shares the 'base value' and 'days' components of the diminishing value method (see paragraphs 12.69 to

¹⁷⁴

See Chapter 13.

12.75). However, the final component of the straight-line method is 'remaining effective life' rather than simply 'effective life'. [Subsection 72-75(1)]

Remaining effective life

12.87 Under the straight-line method, the **remaining effective life** is a component of the formula. At any particular moment it represents the period of effective life that is yet to elapse as from the later of:

- when the asset starts to decline in tax value; or
- the start of the income year.

[Subsection 72-75(2)]

12.88 The rules for working out the effective life are discussed in paragraphs 12.109 to 12.132.

Example 12.14 Straight-line method

Luke purchases a piece of machinery for use in his landscaping business for \$65,000. He estimates its effective life to be 8 years. The machinery is first installed ready for use on 22 October in that year. Using the straight-line method, the decline in tax value of the asset is calculated in the following way:

Year 1

$$\begin{aligned} \text{Decline in tax value} &= \$65,000 \times \frac{365 - 113}{365} \times \frac{100\%}{8} \\ &= \$5,609 \\ \text{Closing tax value} &= \$65,000 - 5,609 \\ &= \$59,391 \end{aligned}$$

The 'tax value' of \$59,391 is carried forward to the start of income Year 2 to become the 'opening tax value'.

Year 2

The *remaining effective life* as at the start of income Year 2 is 7.31 years (i.e. 8 years less the 252 days it was used in Year 1). Therefore, the decline in tax value for Year 2 is:

$$\begin{aligned} \text{Decline in tax value} &= \$59,391 \times \frac{365}{365} \times \frac{100\%}{7.31} \\ &= \$8,125 \end{aligned}$$

$$\begin{aligned} \text{Closing tax value} &= \$59,391 - 8,125 \\ &= \$51,266 \end{aligned}$$

Year 3

The *remaining* effective life as at the start of income Year 3 is 6.31 years. Therefore, the decline in tax value for Year 3 is:

$$\begin{aligned} \text{Decline in tax value} &= \$51,266 \times \frac{365}{365} \times \frac{100\%}{6.31} \\ &= \$8,125 \end{aligned}$$

$$\begin{aligned} \text{Closing tax value} &= \$51,266 - 8,125 \\ &= \$43,141 \end{aligned}$$

Decline in tax value of other depreciating assets

12.89 Intangible depreciating assets (other than mining rights, IRUs and co-ownership interests in them or a tangible depreciating asset) *cannot* be written off using the diminishing value method. They *can* be written off according to:

- where economic benefits are expected to be received *evenly* throughout the life of the asset — the straight-line method; or
- where economic benefits are expected to be received *unevenly* and the proportion of total economic benefits received *can* be reasonably estimated — the proportion of total economic benefits received in an income year; or
- where economic benefits are expected to be received *unevenly* and the proportion of total economic benefits received *cannot* be reasonably estimated — the market value of economic benefits received in an income year.

[Subsection 72-40(1), items 2, 3 and 5 in the table]

Straight-line method – economic benefits received evenly

12.90 An entity must use the straight-line method to work out the decline in tax value where they know or can reasonably estimate that the economic benefits they will receive in each year they will hold the asset will be the same in extent [subsection 72-40(1), item 2 in the table]. The straight-line method is discussed in detail in paragraphs 12.81 to 12.88.

12.91 The straight-line method applies only to assets that inherently give rise to an even flow of economic benefits. These include rights from

which economic benefits are received (that is, they are used) by merely holding the right, rather than exercising it (see paragraph 12.39). The following rights are examples of where the economic benefits may commonly be realised evenly over a period:

- a right to use a tangible asset or land for a period;
- a right to use a statutory right or information for a period;
- a right to carry on an activity for a period, such as a franchise;
- a right of insurance against risk for a period;
- a right to have another entity not do something for a period (a restrictive covenant).

Example 12.15 Economic benefits received evenly under a restrictive covenant

Andrew sells his home-brewing supplies store to Elaine. As part of the agreement, he promises not to open a similar store in the local area for 3 years. Her right to be free of competition from Andrew is a depreciating asset.

The tax value of this right will decline evenly as time passes. Elaine must write-off her asset using the straight-line method.

12.92 In addition to the rights that *inherently* provide an even flow of economic benefits there are other assets that provide economic benefits in the same extent in each year by reason of circumstance. An example is a right to a regular receipt of non-cash benefits of similar economic value. Another example is a profit à prendre under which the economic benefits are to be received evenly. If the holder of the right reasonably expects that they will receive the same extent of benefits from that right in each income year that they will hold the right, then the decline in its tax value will be worked out under the straight-line method.

Reasonable estimates

12.93 What is a ‘reasonable estimate’ will depend on the circumstances in which the entity is to receive economic benefits from the asset.

Example 12.16 Estimating the economic benefits to be received

Phil makes a prepayment for which he has a right to receive cleaning services for 3 years (a depreciating asset). Under the terms of the contract the same services are to be received weekly. The terms of the contract form the basis on which Phil can reasonably expect that he will receive the same extent of economic benefits in each year in which he holds the right. Therefore, he must use the straight-line method to calculate the decline in the tax value of his asset.

Same in extent

12.94 Because an *economic* benefit is a favourable circumstance or advantage that can be measured in money terms, the flow of these benefits can be compared on the basis of that money value (for more discussion on the meaning of economic benefits see paragraph 7.32 and following of Chapter 7). However, usually this will not require any estimate of the market values of the expected economic benefits but simply a comparison of the proportion of total economic benefits to be received in each year. That is, if the economic benefits to be received from year to year are of the same or a similar kind, they may be compared directly without reference to their estimated market value.

Example 12.17 Comparing economic benefits directly, without estimating market values

Ben, a professional tennis player, has a right to receive 2 years of tennis coaching starting on 1 July. The same classes are given in each year. Since the economic benefits under the right (the lessons) are homogenous, the proportion received in each year can be established by direct comparison of the right in each year, without reference to the market values. Therefore, the proportion of the economic benefits received under the right is 50% in Year 1 and 50% in Year 2 so Ben must write-off the right using the straight-line method.

12.95 On the other hand, when the economic benefits to be received in each year are of a fundamentally different nature so that they cannot be compared directly, a reasonable estimate of the market values would be an appropriate way to compare the extent of benefits to be received. In these cases, the relevant market value is the estimated market value of each of the economic benefits as if they had been received when the entity started to hold the asset (instead of when they are actually received) [*subsection 72-40(2)*]. That is, fluctuations in the estimated market value of the asset after the time when an entity starts to hold it do not affect the write-off. This means that any unrealised gains or losses that are reasonably estimated will not be taken into account in the calculation of the write-off.

Example 12.18 Comparing economic benefits by reasonably estimating the market values

In contrast to example 12.17, Colleen, a professional tennis player, has a right to receive tennis lessons in a group clinic in Year 1, and one-on-one advanced tuition in Year 2. The different entitlements she has under the contract are regarded as a single depreciating asset (according to the facts of this particular case). Since the economic benefits under the right (the beginner's and advanced lessons) are *not* homogenous, the proportion received in each year *cannot* be established by direct comparison of the number of lessons received in each year. Instead a comparison could be made between what she reasonably estimates is the market value of the beginner's lessons and the advanced lessons. The market values to be compared are her

reasonable estimates of the market values as if she received all the lessons when she started to hold the right, not when she actually receives them.

The economic benefits expected in the second year exceed those to be received in the first year. Therefore, she does not expect to receive the same extent of economic benefits in each year, and so it is inappropriate to use the straight-line method to calculate the decline in tax value of her right.

Economic benefits received for only part of a year

12.96 When an entity compares the economic benefits it estimates it will receive in an income year it has to account for the fact that the effective life may continue only for part of that year. That is, the estimate of economic benefits to be received in each income year is made assuming that:

- the entity held the asset for the rest of its effective life [*subsection 72-40(1), item 2 in the table*]; and
- if the effective life starts or ends part way through an income year, the economic benefits received in those years are scaled-up as though they were full years [*subsection 72-40(3)*].

12.97 Taken together, these assumptions compare income years as if the economic benefits were received over the course of the *entire* income year in question.

Assume the asset is held throughout its effective life

12.98 The first assumption is that the entity will hold the asset throughout its remaining effective life. This assumption is necessary so that the possibility of an early realisation of the asset (e.g. through sale) will not affect the write-off method. [*Subsection 72-40(1), item 2 in the table*]

Example 12.19 Stop holding an asset before its effective life ends

On 1 July, Michele is granted an easement across another entity's land for a period of 2 years. She assigns her right under the easement during the second income year (i.e. before the easement expires). Nevertheless, she must compare the economic benefits she receives from holding the asset in year 2, as if she had continued to hold it until 30 June.

Scaling-up economic benefits when effective life starts or ends during the income year

12.99 In addition, if the effective life starts or ends part way through an income year, the economic benefits received in those years are, for the purposes of the estimate, scaled-up as though they were full years. This is achieved by adjusting the value of the economic benefits received to

account for the number of days for which the effective life did not continue. The adjustment ‘grosses-up’ the economic benefits relative to the number of days they are received, according to this formula:

$$\text{Extent of economic benefits received} = \frac{365}{\text{Number of days of the effective life in the income year} + 1} \times \text{Economic benefits received}$$

[Subsection 72-40(3)]¹⁷⁵

Example 12.20 Effective life starts during income year

Glenn has a right to receive services over a period of 21 months, ending on 30 June in Year 2. The right starts to decline in tax value when services are first received, on 1 October in Year 1. He reasonably estimates that he receives \$374 of the services in Year 1 and \$500 in Year 2 (based on the market value of those services as at 1 October in Year 1). He must compare the extent of benefits received in Year 1 by applying the gross-up formula:

$$\text{Extent of economic benefits received in income year 1} = \frac{365}{\text{Number of days after the asset started to decline in tax value} + 1} \times \text{Economic benefits received}$$

$$\$500 = \frac{365}{273} \times \$374$$

Therefore, Glenn can reasonably estimate that the extent of the economic benefits he receives in each income year is the same. He then must use the straight-line method to work out the decline in tax value.

Example 12.21 Effective life ends during income year

Amanda has a right to receive services over a period of 15 months, beginning on 1 July in Year 1. The effective life of the right ends when the last services are received, on 30 September in Year 2. She reasonably estimates that she receives \$1,000 of the services in Year 1 and \$400 in Year 2. She must compare the extent of benefits received in Year 2 by applying the gross-up formula:

$$\text{Extent of economic benefits received in income year 2} = \frac{365}{\text{Number of days after start of income year that effective life ends} + 1} \times \text{Economic benefits received}$$

$$\$1,587 = \frac{365}{92} \times \$400$$

Under the assumption, Amanda can reasonably estimate that the extent of the economic benefits she receives in each income year is *not* the

¹⁷⁵ This provision is being considered further to ensure that it operates correctly in the kind of cases discussed in paragraph 12.92.

same. She then must *not* use the straight-line method to work out the decline in tax value. Instead, the decline in tax should be worked out under the method described below.

Proportion of total economic benefits – economic benefits to be received unevenly

12.100 Where the economic benefits expected to be received from a depreciating asset are *not* in the same extent in each income year the straight-line method will not be appropriate. Instead, the decline in tax value may be based on the ‘proportion of total economic benefits received’. [*Subsection 72-40(1), item 3 in the table*]

12.101 As under the straight-line method, a reasonable estimate of the market value of the economic benefits received in each year would be an appropriate basis for a comparison. In these cases, again the relevant market value is the estimated market value of each of the economic benefits as if they had been received at the time the entity started to hold the asset (instead of the later time when they are actually received) [*subsection 72-40(2)*]. That is, fluctuations in the estimated market value of the asset after the time when an entity starts to hold it do not affect the write-off. This means that estimated unrealised gains or losses will not be taken into account in the calculation of the write-off.

12.102 In these circumstances the decline in tax value may be worked out by estimating the proportion of total economic benefits received in an income year. When it can be estimated, that proportion of the asset’s base value will be the decline in tax value for the income year (see paragraph 12.69 to 12.71 for a discussion of base value). That is, the decline in tax value is:

$$\text{Decline in tax value} = \frac{\text{Current-year economic benefits}}{\text{Current-year economic benefits plus future-year economic benefits}} \times \text{Base value}$$

Current-year economic benefits

12.103 ‘Current-year economic benefits’ are those economic benefits that have been received from an asset, in the income year for which the decline in tax value is being worked out.

Future-year economic benefits

12.104 ‘Future-year economic benefits’ are the economic benefits that it is estimated will be received from the asset after the current year.

12.105 This total includes any economic benefits an entity would receive if they held the asset until the end of its effective life. That is, the proportion is based on the economic benefits an entity receives in the current year as a proportion of all future economic benefits embodied in the asset. This means that even if an entity expects to sell an asset before

the end of its effective life, the ‘future-year economic benefits’ include any economic benefits that can be received from the asset by any entity after that disposal.

Example 12.22 Economic benefits received unevenly

Martin buys a right to receive cleaning services from 1 July in Year 1 to 30 June in Year 2 for \$1,000. The contract stipulates that the economic benefits are not to be received evenly, but \$750 worth of cleaning services will be received in Year 1, and \$250 worth in the Year 2. The asset starts to decline in tax value in Year 1, so its base value is the cost, \$1,000.

The decline in tax value of the right in Year 1 will be:

$$\frac{\text{Year 1 economic benefits}}{\text{Year 1 economic benefits plus Year 2 economic benefits}} \times \text{Base value in Year 1}$$

$$\$750 = \frac{\$750}{\$1,000} \times \$1,000$$

The closing tax value at the end of Year 1 is \$250.

The decline in tax value of the right in year 2 will be:

$$\frac{\text{Year 2 economic benefits}}{\text{Year 2 economic benefits}} \times \text{Base value in Year 2}$$

$$\$250 = \frac{\$250}{\$250} \times \$250$$

Market value of economic benefits – economic benefits to be received are inestimable

12.106 Where the proportion of total economic benefits received from a depreciating asset in an income year *cannot* be reasonably estimated, the decline in tax value is the market value of economic benefits actually received in an income year. That is, when neither the ‘straight-line’ nor the ‘proportion of total economic benefits’ decline methods are applicable, the decline in tax value is the market value of economic benefits received.
[Subsection 72-40(1), item 5 in the table]

12.107 In contrast to the decline in tax value methods set out above, the relevant market value is the market value *at the time* the economic benefits are actually received.

Example 12.23 Economic benefits received inestimable

Rebecca has a right under a profit à prendre to remove an unspecified quantity of sand from another person's land over a 2 year period. She may be unable to estimate the proportion of the sand she takes in Year 1 as a percentage of the total right because the reserves of the land are unknown or she is unsure how much she will want to extract in Year 2. In either case the right must be written off according to the market value of the sand as she takes it.

Other tax value decline methods being considered

12.108 Other methods for measuring the annual decline in tax value are being considered (e.g. to deal with the proper treatment of long-term leases and rights).

Working out effective life

12.109 For the income year in which a depreciating asset starts to decline in tax value, the entity that holds it will generally need to choose whether to work out that asset's effective life by:

- adopting the Commissioner's determination of effective life applicable to that depreciating asset (if there is such a determination); or
- self-assessing the asset's effective life.

[Subsections 72-95(1) and (2)]

12.110 However, this choice of effective life is not available where:

- the 'associate' or 'same end-user' restriction applies; or
- there is a statutory effective life prescribed (in the case of an intangible asset).

Associate and same end-user restriction

12.111 An entity has no choice of effective life when they acquired the asset from an associate, or despite the change in holder there is no change in the end user of the asset (see paragraphs 12.62 to 12.65). In these cases the effective life is that which the associate or former holder was using.

[Subsection 72-95(4)]

12.112 Special rules assist an entity in obtaining that information from the associate or former holder (see paragraphs 12.137 to 12.141). If it is not possible to obtain such information the entity should use the Commissioner's determination (if any) of effective life. Only if no such determination exists can the entity then self-assess the recalculated effective life *[subsection 72-95(5)]*.

Statutory effective life of certain intangibles

12.113 The choice of effective life is not available for certain intangible assets that currently qualify for write-off under Division 40 of the ITAA 1997. For those assets, the law prescribes a minimum period for their effective life. This is the same statutory effective life as under the existing law. [*Subsection 72-95(6)*]

Commissioner's determination of effective life

12.114 The power of the Commissioner to make a written determination of the effective life of a depreciating asset provides an alternative to self-assessing the effective life of an asset [*subsection 72-125(1)*]. The Commissioner's 'safe harbour' determinations are *not binding* on entities, who generally have the choice of self-assessing effective life for themselves.

12.115 In making a determination, the Commissioner estimates the period such a depreciating asset can be used by any entity for any purpose [*subsection 72-125(4)*]. For the determination of the effective life of a *tangible* depreciating asset, the estimate will be made:

- assuming it will be subject to wear and tear at a rate that it is reasonable for the Commissioner to assume; and
- assuming it will be maintained in reasonably good order and condition; and
- having regard to the likelihood of the asset being scrapped, sold for scrap or abandoned (as the effective life ends when these events occur).

[*Subsection 72-125(6)*]

Applicable determinations

12.116 A determination may specify its date of effect [*subsection 72-125(2)*]. It may apply retrospectively to a date, but only where there is no applicable determination for that date, or the new determination specifies a shorter effective life [*subsection 72-125(3)*].

12.117 To establish the effective life of a depreciating asset, the Commissioner's determination must be in force when:

- the entity starts to hold the asset; or
- the entity enters into a contract to start to hold the asset; or
- the entity begins construction of the asset;

provided that the asset starts to decline in tax value within 5 years of the relevant time. Otherwise the appropriate determination is the one in force at the time the asset starts to decline in tax value. This rule ensures that an entity can rely on a determination only once they are committed to the asset for which the determination would apply. [*Paragraph 72-95(3)(a)*]

12.118 However, where the depreciating asset is *plant* that the entity:

- enters into a contract to start to hold; or
- starts to hold; or
- starts to construct;

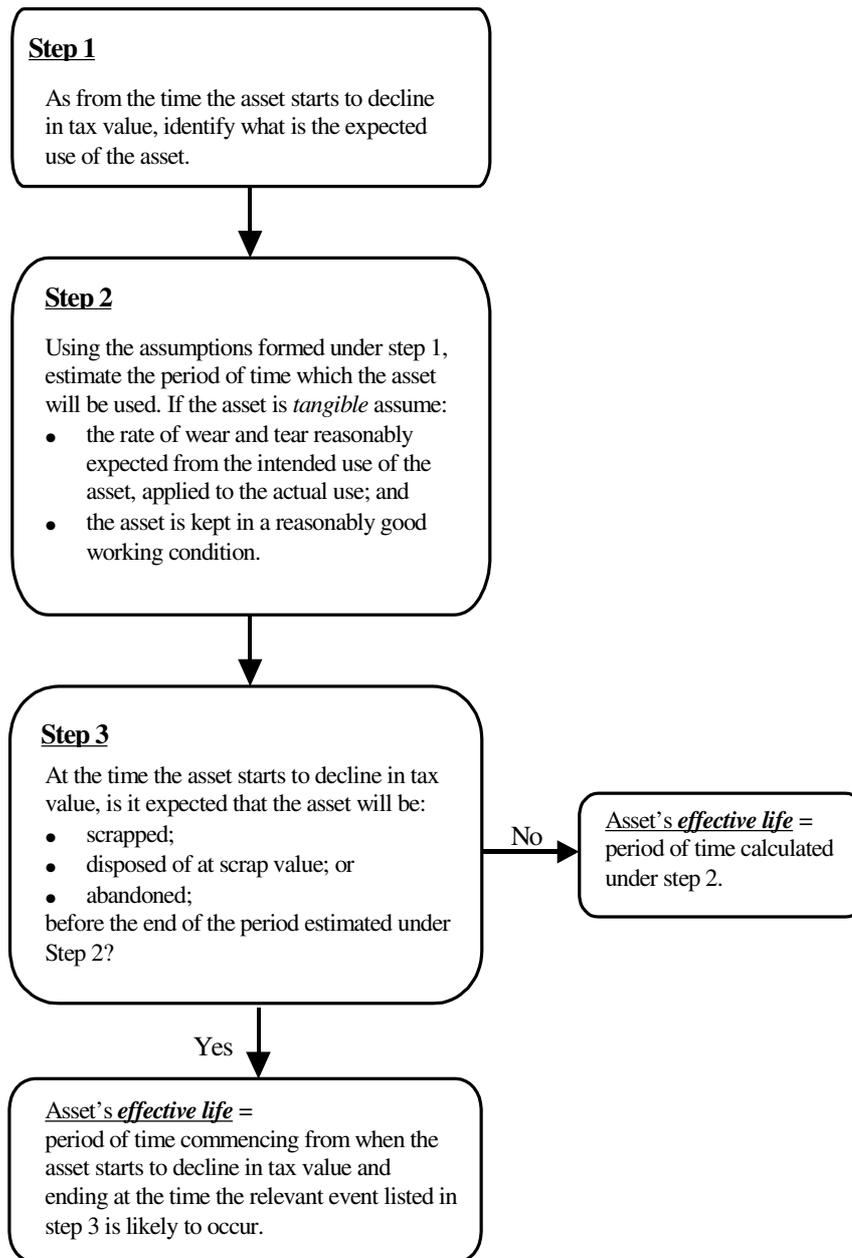
before 11.45 am, by legal time in the Australian Capital Territory on 21 September 1999, the applicable determination is that which was in force at the earliest of those times. There is no restriction on the period within which this plant must be used. [*Paragraph 72-95(3)(b)*]

Self-assessing effective life of a depreciating asset

12.119 Entities that hold a depreciating asset usually have the option to self-assess the asset's effective life as an alternative to relying on a Commissioner's determination. The estimate of effective life must be worked out as a period from the time the decline in tax value began. However, the choice need not be made *at* that time. The choice only needs to be made for the *income year* in which the decline in tax value began. [*Subsection 72-100(1)*]

12.120 Diagram 12.3 outlines how an entity may self-assess the effective life of a depreciating asset.

Diagram 12.3 Self-assessing the effective life of a depreciating asset



[Section 72-100]

Maintenance and wear and tear of a tangible asset

12.121 For tangible depreciating assets, a ‘reasonableness test’ applies when estimating the wear and tear of the asset and the condition in which the asset will be maintained. A reasonable estimate will depend on the circumstances in which the asset is to be used by the entity (or any other expected user). [Subsection 72-100(2)]

Example 12.24 Self-assessing the effective life of an asset

Andre runs a tennis-coaching clinic. During the income year, he purchases a new ball-launching machine for use during training sessions. According to the machine's specifications, the maximum number of tennis balls that can be launched from the machine is 1 million. From previous coaching experience, Andre estimates that the machine will be used to fire an average of 10,000 tennis balls per month. The effective life of the machine, based on his anticipated level of usage, is therefore 8 1/3 years.

Effective life of co-ownership interests in depreciating assets

12.122 Where there is more than one owner of a depreciating asset, those owners each have a right which is a proprietary interest in the underlying asset, a *co-ownership interest*. As under the current law, the cost of a co-ownership interest in a depreciating asset is written-off in the same way as the cost of the underlying asset would be if it were only owned by one entity.

12.123 This means that the effective life of the co-ownership interest is the same as the underlying asset, taking into account the relevant factors discussed above. However, because each co-owner's interest is a separate asset, changes to one owner's interest do not necessarily affect another owner's interest. For example, if there are 3 joint owners of an asset, and one sells all or part of an interest in the underlying asset to a new co-owner, the other 2 original co-owners have no change to their assets. Joint ventures that are not partnerships are a common case where this rule will apply, as they are joint owners who each hold a separate asset. Partners do not illustrate the point, as partnership assets are held only by the partnership (and not by the partners) for income tax purposes.

Effective life of IRUs

12.124 Similarly, the effective life of an IRU is the same as the effective life of the international telecommunications submarine cable over which the IRU is granted. [*Subsection 72-95(6), item 9 in the table*]

Renewals and extensions of rights

12.125 As a renewal or extension of a right is treated as a continuation of the original right the effective life of a right includes any such extension or renewal. [*Section 22-25*]

Recalculating effective life of a depreciating asset

12.126 An entity may choose, and in some cases is required, to recalculate the effective life of a depreciating asset. The methodology used for recalculating the effective life is based on the same principles that apply when originally self-assessing the effective life of that depreciating asset. [*Subsection 72-105(4)*]

When must an entity recalculate?

12.127 For each income year in which significant second element costs have been paid for a depreciating asset an entity must consider the effect of these additions on the effective life. This ensures an appropriate allocation of the cost of these additions over the remaining effective life. Therefore, an entity must recalculate the effective life of an asset when its cost has increased by at least 10% in that year and:

- the entity has self assessed the effective life; or
- the entity uses the Commissioner's determination of effective life, and uses the straight-line method; or
- the entity is required to use the same effective life as an associate or former holder (see paragraphs 12.111 and 12.112).

[Subsection 72-105(2) and (3)]

12.128 Of course, in some circumstances despite these additions to the cost of an asset the recalculated effective life may be no different from the original self-assessment.

When may an entity recalculate?

12.129 An entity may choose to calculate a new effective life for a depreciating asset where the effective life it has been applying is no longer accurate because of changes to the way the asset is used, or other circumstances relating to the nature of its use. *[Subsection 72-105(1)]*

12.130 Reassessment is limited to cases where the basis for estimating the effective life has *changed*. It does not apply in situations where the basis of the original effective life estimate is incorrect due to a mistake of fact or error made by the entity. In these cases, the entity may apply to the Commissioner for an amendment of prior assessments.

12.131 The ability to reassess applies regardless of whether the entity has previously:

- chosen to self-assess effective life;
- reassessed effective life;
- been required to use the effective life of an associate or former holder; or
- adopted the Commissioner's determination of effective life.

12.132 Some examples of changes in circumstances that may mean that the effective life an entity has been applying is no longer accurate are:

- the use of an asset turns out to be more or less intensive than expected (or was anticipated by the Commissioner's determination);
 - e.g. a treadmill in a gymnasium that was expected to be used for 100 kilometres a day, is actually used for 200 kilometres a day.
- the nature of the use of the asset changes;
 - e.g. a tractor was initially intended to be used for ploughing fields, but instead is used in tractor-pulling competitions.
- there is a downturn in demand for the goods and services the asset is used to produce that will result in the asset being scrapped earlier than was initially expected;
 - e.g. reduced demand for yo-yos means that production is stopped and the string weaving machine is scrapped.
- legislation prevents the asset's continued use;
 - e.g. Commonwealth legislation makes the rights under certain restrictive covenants void.
- changes in technology make the asset redundant;
 - e.g. new technology outdates the subject of a registered design.

Choices

12.133 Division 72 allows entities to make certain choices, such as:

- whether to use the Commissioner's determination, or to self-assess the effective life of an asset;
- for certain assets, whether to use the straight-line or diminishing value method to work out the decline in tax value.

Choice must be made before income tax return is lodged

12.134 Generally, any choice about a depreciating asset must be made by an entity on or before the day the entity lodges their income tax return for the income year to which the choice relates. In certain circumstances, the Commissioner may allow a choice to be made within a further time.

[Subsection 72-130(1)]

Choices are irrevocable

12.135 Generally, a choice made in relation to a depreciating asset applies to that income year and to all later income years. This means that choices are generally irrevocable, and once made bind the entity in respect of that depreciating asset into the future. [*Subsection 72-130(2)*]

12.136 An important exception to this general rule is that the choice of an effective life is essentially revoked when the effective life chosen is no longer accurate because of changed circumstances (see paragraph 12.129). [*Subsection 72-130(3)*]

Getting tax information from associates

12.137 There are specific rules that may require an entity that holds a depreciating asset to apply the same effective life, or the same decline in tax value method, as an associate (see paragraphs 12.62 and 12.112). To comply with these requirements, an entity must obtain information from the associate. An entity will obtain such information by notifying the associate in writing of the information required [*subsection 72-140(1)*]. The entity can provide only one such notice in relation to the one depreciating asset [*subsection 72-140(6)*].

12.138 The notice must be given by the entity to the associate within 60 days after the entity starts to hold the depreciating asset. The notice should specify a period of 60 days within which the associate must provide the information to the new holder. [*Subsection 72-140(2)*]

12.139 A penalty will be imposed if the associate intentionally refuses or fails to comply with the notice. The penalty is 10 penalty units. [*Subsection 72-140(3)*]

12.140 Where the associate of a new holder is a partnership, the obligation of the new holder will be satisfied if they give the notice to any of the partners. The obligation to comply with the notice is imposed on each of the partners personally, rather than on the partnership itself. That obligation may be satisfied by any of those partners, and once satisfied by any partner no obligation exists for any of them. [*Subsection 72-140(4)*]

12.141 If a partner refuses or fails to comply with the obligation under the notice they will each be penalised, unless another partner has satisfied the obligation. The penalty is 10 penalty units each. [*Subsection 72-140(5)*]

Chapter 13

Depreciating liabilities

Outline of Chapter

13.1 Division 72 of the prototype legislation contains the rules for bringing to account the proceeds of incurring a depreciating liability for the purpose of working out the taxable income of the entity that has the liability.

13.2 This Chapter explains:

- what a depreciating liability is;
- what its tax value is; and
- how to work out the decline in its tax value.

Context of Reform

13.3 As was noted in Chapter 8, the current law has no consistent or comprehensive liability regime. Sometimes deductions are allowed for liabilities from the moment the entity becomes subject to them, sometimes from that moment but only if they are eventually satisfied, and sometimes not at all. This demonstrates that the current law has no consistent timing rule for recognising gains and losses.

13.4 In addition, the current law treatment of liabilities often does not mirror the treatment of the corresponding rights. The lack of symmetry in the rules that govern the timing and characterisation of transactions creates anomalies in the tax treatment of the different parties to an arrangement. For instance, lump sum payments for the granting of some rights are taxed immediately on receipt, but are not deductible to the grantee except as a capital loss on the termination of the right.

13.5 These inadequacies of the current law distort the choice of particular forms of business arrangement, so that tax considerations interfere with the way in which investment funds are allocated.

13.6 The deficient framework of the current law has also added legislative and administrative complexity since specific rules are needed to address circumstances that cannot be dealt with under the structure of the current law.

13.7 In addition, there is a range of case law that supplements the legislation. Often these decisions distil the principles and conceptual bases of the income tax base, highlighting the deficiencies of the current legislation. For instance, the ‘derived’ principle is supported by the decision in *Arthur Murray (NSW) Pty Ltd v FCT*¹⁷⁶. In that case, a dancing school was paid in advance for 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 nature and values of both the receipt and the obligations comprising the transaction. Under TVM, this transaction is *overtly* split into the 2 constituent parts; 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 depreciating liability.

13.8 In this way Division 72 of the prototype legislation builds upon the core rules of the prototype legislation to provide one of the key income recognition mechanisms of TVM. That is, the proceeds of incurring a liability are brought to account as income as the economic benefits owed under it are provided.

13.9 Broadly, Division 72 addresses the inconsistent and distortionary nature of the current law through:

- a comprehensive structure that offers *common rules* for the treatment of *all* depreciating liabilities — that is, broadly all liabilities that correspond to a depreciating right will be written-off according to the rules in Division 72;
- a *symmetrical treatment* of both sides of transactions — that is, through asset rules that mirror those about liabilities, the law will generally recognise the same amounts at the same times for each party to a transaction.

13.10 Thus, as well as covering the ground covered by the current law (e.g. under the *Arthur Murray* principle), TVM’s depreciating liability rules are designed to implement the ATSR recommendations on rights (including prepayments).¹⁷⁷ So far, Division 72 deals with the core recommendations (4.6(b), 10.1 and 10.3) that set the default position for rights. However, it should be noted that some other recommendations are yet to be considered. These include recommendation 10.4, which recommends a different treatment from the default for the grantors of some rights, like restrictive covenants and franchises.

¹⁷⁶ (1965) 114 CLR 314.

¹⁷⁷ See sections 4 and 10 of ATSR.

Summary of prototype legislation

13.11 Division 72 establishes what is a depreciating liability, what is its tax value and how to work out the decline in its tax value.

13.12 A *depreciating liability* is a liability under which economic benefits will be provided for only a limited period.

13.13 The tax value of a depreciating liability will initially be the amount received in order to take on the obligation, called the 'proceeds of incurring' the liability. That tax value declines as economic benefits are provided by the entity that has the liability, beginning when it first provides those economic benefits.

13.14 The decline in tax value will be worked out using:

- the straight-line method – where the economic benefits are expected to be provided evenly; or
- the proportion of total economic benefits provided – where the economic benefits are expected to be provided unevenly; or
- the market value of economic benefits provided – where the economic benefits that are to be provided are inestimable.

Comparison of key features of the prototype legislation and current law

13.15 Broadly, the tax law will bring to account the proceeds of incurring a depreciating liability as the economic benefits owed are provided. The comparison between the treatment of some of these liabilities under Division 72 of the prototype legislation and the corresponding provisions in the current law is set out in the following table.

Table 13.1 Comparison of key features of the prototype legislation and the current law

<i>Prototype legislation</i>	<i>Current law</i>
<p>The proceeds of incurring a liability will be brought to account according to the way in which the economic benefits are provided. For example, the amount received in return for a liability to provide goods or services over a period of time will be brought to account as the goods or services are provided.</p> <p>Often, the economic benefits will be provided evenly throughout a period, and so, the proceeds would be brought to account on a straight-line basis.¹⁷⁸</p>	<p>If the proceeds of incurring the liability are ordinary income, it is derived when the benefits (e.g. services) are actually provided, since this ends the potential for a refund of the prepayment (see <i>Arthur Murray (NSW) Pty Ltd v FCT</i>¹⁷⁹).</p> <p>In other cases the proceeds of incurring a liability are often recognised as a capital gain when the liability arises (CGT event D1, section 104-35 of the ITAA 1997).</p>

Detailed explanation of prototype legislation

Link to higher level rules

Taxable income and net income

13.16 Under Division 6 an entity must work out net income for an income year in order to work out taxable income. A key component of net income is the change in the tax value of liabilities. This is the difference between the tax value at the start of the income year (the opening tax value) and the tax value at the end of the income year (the closing tax value) of each liability.

13.17 An ‘unmatched’ increase in the tax value of an entity’s liability will reduce their net income.¹⁸⁰ An ‘unmatched’ decrease in the tax value of an asset will reduce net income.¹⁸¹

13.18 Subdivision 72-B contains the core provisions for working out the decline in tax value of depreciating liabilities. Generally, a depreciating liability’s opening tax value for the year is reduced by the decline in tax value [subsection 72-50(1)]. The result is the closing tax value for the income year. The closing tax value at the end of the year is the opening tax value for the next [section 6-85].

¹⁷⁸ Note, however, that ATSR recommendation 10.4 would, if implemented, provide a different treatment in some cases (see paragraph 13.10).

¹⁷⁹ (1965) 114 CLR 314.

¹⁸⁰ That is, when it is not ‘matched’ by a receipt, or an increase in the tax value of an asset, or the decrease in the tax value of another liability.

¹⁸¹ That is, when it is not ‘matched’ by a payment, or a decrease in the tax value of an asset, or the increase in the tax value of another liability.

Private, domestic or exempt purposes

13.19 Division 72 does not itself contain any explicit adjustment when economic benefits are provided under a depreciating liability that is, to any extent, for a private, domestic or exempt purpose. Adjustments will be made to cancel the part of the decline in the liability's tax value relating to that purpose under Division 222 (private or domestic) or Division 130 (exempt).¹⁸²

'Having' a 'liability'

13.20 The question whether an entity 'has' a depreciating liability depends on the broad notions of 'liability' and 'have', which are contained in Division 12. The entity which *has* a depreciating liability is required to bring to account the proceeds of incurring that liability. In broad terms, the entity that bears the obligation under the liability will *have* it (see paragraphs 8.30 and following of Chapter 8).

Balancing adjustment on ceasing to 'have' a liability

13.21 Division 72 does not contain a specific rule to adjust net income when a depreciating liability is extinguished for an amount greater or less than its tax value. That is because, under the general rules for calculating net income in Division 6, the costs of extinguishment are brought to account as payments while the liability itself would no longer be reflected in the closing tax value of liabilities. This provides an automatic balancing adjustment on extinguishment of a depreciating liability.¹⁸³

What is a depreciating liability?

13.22 Mirroring the definition of 'depreciating asset', a ***depreciating liability*** is a liability under which economic benefits will be provided for only a limited period [section 72-45]. A liability will exist for only a limited period because the obligation is satisfied when the economic benefits that are owed, are provided.

Example 13.1 What is a depreciating liability

Colleen agrees to provide Ben with fortnightly tennis lessons over a period of 3 years in exchange for a lump sum payment. She has a liability, being the obligation to provide the lessons under the contract. This is a *depreciating* liability, as it will no longer exist when she has provided all of those services.

¹⁸² Division 130 is yet to be drafted.

¹⁸³ This may be subject to further adjustment for any private or domestic or exempt purpose of the liability.

13.23 Some liabilities are specifically excluded from the definition of depreciating liabilities, such as financial liabilities and the amount of a company's paid up share capital.¹⁸⁴ [Subsection 72-45(2)]

What is the 'limited period' for which economic benefits are provided?

13.24 A depreciating liability is one under which economic benefits will be provided only for a limited period. This period is the *effective life* of the liability (discussed in greater detail at paragraphs 13.70 to 13.83) [section 72-115]. This means that a liability will have a limited effective life, and therefore be a depreciating liability, if at some point in the future there will be no economic benefits to be provided under the liability and so it will cease to exist.

13.25 Generally a depreciating liability consists of the obligations of an entity that correspond to the non-perpetual rights of another, such as the obligations of a grantor under:

- an agreement to supply goods or services;
- a restrictive covenant;
- an easement;
- a profit à prendre; or
- an option.

Example 13.2 Limited period during which economic benefits provided

Kelly plays football for the Lockingtree Football Club. He agrees to play for the club for 8 weeks in return for a payment in advance of his match fees. Kelly has a liability, being the obligation to play for the club for 8 weeks. This is a *depreciating* liability, as it will cease to exist when the period elapses.

13.26 The definition does not limit depreciating liabilities to obligations to provide economic benefits *evenly* over a period. Nor are depreciating liabilities limited to obligations to provide a decreasing quantity of economic benefits. The economic benefits owed under a depreciating liability may be constant for a time, or even increase for a time. A depreciating liability is simply an obligation, for which all the economic benefits owed will be provided over a period, called the effective life.

Example 13.3 Variations in economic benefits provided

Rebecca agrees to supply Jenny with 10 tonnes of grapes, plus a further tonne for each year that the liability exists, up to 5 years.

¹⁸⁴ Further exclusions may need to be added.

Rebecca provides no grapes in Year 1 and so at the start of Year 2 she has a liability to provide 11 tonnes. Her liability has increased. Nevertheless, the liability is a depreciating liability, as all the economic benefits will be provided within 5 years.

13.27 From that effective life, the statutory methods produce a decline in tax value. This statutory decline in tax value is not necessarily correlated to an expected decline in the actual market value. To the extent that the statutory decline differs from the actual fall in value, this will be reconciled when the entity no longer has the liability.

When are economic benefits provided?

13.28 An *economic* benefit is a favourable circumstance or advantage that can be measured in money terms (for more discussion on the meaning of economic benefits see paragraph 7.32 and following of Chapter 7). Depreciating liabilities have a limited effective life (i.e. economic benefits will be provided for only a limited period) since:

- economic benefits are provided because of *having* the liability, rather than actively satisfying it; or
- economic benefits are provided because of *actively servicing* the liability, rather than simply having it.

Economic benefits provided by having the liability

13.29 Economic benefits are provided because of merely having the liability when the effective life is a function of time alone (e.g. restrictive covenants, insurance). For these kinds of liabilities, economic benefits are provided because the entity to which they are owed receives economic benefits from merely holding their corresponding right, regardless of whether they actually exercise that right (for further discussion on this corresponding right see paragraph 12.39 of Chapter 12). That is, economic benefits flow as a natural consequence of the liability existing and its term will ultimately be defined by time.

Example 13.4 Economic benefits provided by having a liability

Glenyce grants an easement over her land for a period of 8 years. The easement is a depreciating liability that she has, an obligation to provide economic benefits (the right of way across land). At every point in time that the easement exists, she is providing the right of way (the economic benefits) to the grantee.

Economic benefits provided by actively servicing the liability

13.30 Economic benefits will be provided other than because of merely having the liability when the effective life is a function of the way the liability is serviced, and not simply of time. This does not mean that the liability is perpetual, only that its effective life is not defined at the outset.

In these cases, the effective life will be the expectation of how long the obligation will exist, based on how the economic benefits will be provided. That is, the holder of a corresponding right will receive economic benefits based on an actual exercise of the right, rather than merely holding it (for further discussion on this corresponding right see paragraphs 12.37 and 12.38 of Chapter 12).

13.31 In other words, such a liability cannot be satisfied by the mere passage of time. For instance, a right to take something off another person's land (a *profit à prendre*) will usually only be exhausted when that thing is actually taken from the land.

What are the economic benefits provided under the liability?

13.32 A liability is an obligation to provide future economic benefits [*subsection 12-15(1)*]. It follows that the economic benefits provided *under* a liability are defined by the terms of the liability itself. That is, ordinarily a liability will be satisfied by the provision of the economic benefits as agreed in the arrangement itself. For instance, a liability to provide cleaning services is generally fulfilled by providing *those* services.

13.33 However, in certain circumstances a liability can be satisfied through the provision of economic benefits *other* than those originally agreed. Whether this change would constitute a discharge of the original liability and the creation of a new one is a legal question. For instance, under the law of contract there may be the discharge of one contract in return for another contractual promise. This is known as 'accord and satisfaction'. It brings the original liability to an end and creates a new one (on different terms) in its place. The new arrangement is reached by agreement (the accord) and is in fulfilment of the obligations under the original contract (the satisfaction). This is in contrast with the 'variation' or 'waiver' of terms under a contract that results in changes to the obligations of the parties but preserves the existence of the original contract.

13.34 A depreciating liability corresponds to the depreciating asset held by another entity. It follows then that the idea of the 'economic benefits provided under' a liability mirrors the notion of 'using' a depreciating asset. That is, a depreciating right is 'used' when the economic benefits owed under the corresponding liability are given. In other words, the economic benefits provided under a liability are those which were future benefits embodied in the corresponding right that are consumed or received by the holder of that right. Accordingly, a receipt of economic benefits that does not constitute the 'use' of an asset also does not represent the provision of economic benefits under the corresponding liability. (Paragraphs 12.35 to 12.39 of Chapter 12 explain what is the 'use' of a depreciating right).

Example 13.5 When economic benefits are not provided

Juanita grants an easement over her land to Lucas. He offers this right as security over a personal loan he has taken out. The economic benefits that he receives from acquiring the loan do not come from 'using' the asset (see paragraph 12.41). Therefore, Juanita does not provide those economic benefits under her corresponding liability.

Is every depreciating liability covered by Subdivision 72-B?

13.35 There are a number of liabilities that would generally meet the definition of a depreciating liability which, for policy reasons, are **listed zero tax value liabilities**. This means that they are given a closing tax value of zero, and receipts for starting to 'have' them will be recognised immediately rather than over a period of time. Therefore, listed zero tax value liabilities are not covered by the rules in Subdivision 72-B. These liabilities are listed in subsection 68-10(2).

What is the 'tax value' of a depreciating liability?

13.36 The **tax value** of a depreciating liability broadly represents so much of the proceeds of incurring the liability, as is not yet written-off at a particular time. It therefore provides the starting point for calculating further decline and net income.

13.37 An entity will need to know the 'tax value' of a liability:

- at the end of the income year;
- when it is split or merged; or
- when it stops having the liability and an adjustment is required (e.g. because the liability was partly private).

Tax value at the end of an income year

13.38 At the end of the first income year in which the decline in tax value is being worked out, the 'closing tax value' is:

$$\begin{array}{rcl} \text{closing tax} & & \text{proceeds of} \\ \text{value} & = & \text{incurring the} \\ & & \text{liability} \end{array} \quad - \quad \begin{array}{l} \text{liability's decline in tax} \\ \text{value for the income year} \end{array}$$

[Paragraphs 72-50(1)(a) and (2)(a)]

13.39 Where an entity continues to have the depreciating liability at the end of that first year, the closing tax value will be carried forward to the start of the following income year as the **opening tax value**. *[Section 6-85]*

Example 13.6 Calculating tax value

Phil receives a \$10,000 prepayment for services he will provide over 4 years. The \$10,000 is the proceeds of incurring the depreciating liability to provide the services. The decline in tax value, as calculated under Division 72 is \$2,500. The tax value at the end of the income year is:

$$\$10,000 - \$2,500 = \$7,500$$

The amount of \$7,500 will be carried forward as the 'opening tax value' for the next income year.

13.40 The tax value of a depreciating liability at the end of a later income year is:

opening tax value at the start of that income year	<i>plus</i>	any amounts added to the proceeds of incurring the liability during the year	<i>less</i>	the decline in tax value
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[Paragraphs 72-50(1)(a) and (2)(b)]

Example 13.7 Calculating tax value

Following the facts in example 13.6, Phil receives a further \$6,000 in exchange for increasing the services he will provide over the remaining 3 years of the contract. The liability declines in tax value by \$4,500. The tax value at the end of the income year is:

$$\$7,500 + \$6,000 - \$4,500 = \$9,000$$

The amount of \$9,000 will be carried forward as the 'opening tax value' for the next income year.

Tax value during the income year

13.42 When a liability is split, merged or disposed of *during* an income year, an entity may need to establish what its tax value was at that time. To do so the entity should treat this date during the income year as if it were instead the end of an income year [subsection 72-50(5)]. This means that the tax value at the time during the income year would be the opening tax value and proceeds added *to that date* less the decline in tax value *to that date*. This rule is necessary because tax value is otherwise calculated at the end of an income year based on the decline in tax value *over the entire year*.

When does tax value start to decline?

13.43 The decline in tax value commences when the economic benefits are first provided under the depreciating liability. [Subsection 72-50(3)]

What is the decline in tax value?

13.44 The decline in tax value of a depreciating liability will be worked out based on either:

- the straight-line method, if economic benefits are expected to be provided evenly; or, if not
- the proportion of total economic benefits provided, when it can be reasonably estimated; or, if not
- the market value of economic benefits provided.

Straight-line method – economic benefits provided evenly

13.45 An entity must use the straight-line method to work out the decline in tax value where they know or can reasonably estimate that the economic benefits they will provide in each year they will have the liability will be the same in extent. [*Subsection 72-55(1), item 1 in the table*]

13.46 The following liabilities are examples of where the economic benefits may commonly be provided evenly:

- an obligation to provide a tangible asset (including land) for a period;
- an obligation to allow someone else to carry on an activity for a period, such as under a franchise;
- an obligation to insure another against risk for a period;
- an obligation to provide non-cash benefits of similar economic value at regular intervals.

Example 13.7 Economic benefits provided evenly

Camille grants Phil an easement across her land for 5 years. She has an obligation to allow Phil to pass through her property for the term of the easement. This obligation is a depreciating liability.

The economic benefits are provided evenly as time passes. Therefore, Camille must bring to account the proceeds of incurring her liability using the straight-line method.¹⁸⁵

Reasonable estimates

13.47 What is a reasonable estimate will depend on the circumstances in which the entity is to provide economic benefits under the liability.

¹⁸⁵

But note that recommendation 10.4 in ATSR is yet to be considered.

Example 13.8 Estimating the economic benefits to be provided

Paul receives a prepayment for which he has a liability to provide cleaning services for a period of 3 years (a depreciating liability). Under the terms of the contract the same services are to be provided weekly. The contract forms the basis on which Paul can reasonably expect that he will provide the same extent of economic benefits in each year in which he has the liability. Therefore, he must use the straight-line method to calculate the decline in tax value of his liability.

Same in extent

13.48 If the proportion of economic benefits provided is the same in each year then the economic benefits are taken to have flowed to the *same extent*. This does not mean that the same benefits should be provided by the entity that has the liability in each day they have a liability, only that they should provide the same proportion in each year. That is, the timing of economic benefits provided *within* the year is irrelevant because the comparison is between economic benefits received in each year. [Subsection 72-55(1), item 1 in the table]

Example 13.9 Timing of benefits *within* income year is irrelevant

Andrew has a depreciating liability to provide catering services for an annual convention, over 2 income years. The economic benefits provided in respect of each convention are the same. In income Year 1, the convention is held in July. In the next income year, the convention is held in October. Although he provides the services at different times in the respective years, the same extent of economic benefits are provided over the whole of each of the income years. Therefore, he must use the straight-line method to calculate the decline in tax value of his liability.

13.49 Because an *economic* benefit is a favourable circumstance or advantage that can be measured in money terms, the flow of these benefits can be compared on the basis of that money value (for more discussion on the meaning of economic benefits see paragraph 7.32 and following of Chapter 7). However, this will not mean that a market valuation of the expected economic benefits is required but simply that the proportion of total economic benefits to be provided in each year is estimated. That is, if the economic benefits to be provided from year to year are of the same or a similar kind, they may be compared directly without reference to their market value.

Example 13.10 Comparing economic benefits directly, without estimating market values

Jimmy-Jack's Pet Care has a liability to provide 2 years of cat grooming services. The same services are given in each year. Since the economic benefits under the liability are homogenous, the proportion provided in each year can be established by direct comparison of the obligation in each year, without reference to the market values.

Therefore, the proportion of the economic benefits provided under the liability is 50% in Year 1 and 50% in Year 2 so Jimmy-Jack's must write-off the liability using the straight-line method.

13.50 On the other hand, when the economic benefits to be provided in each year are of a fundamentally different nature so that they cannot be compared directly, a reasonable estimation of the market values would be an appropriate way to work out the extent of benefits to complete the comparison. In these cases, the relevant market value is the market value of each of the economic benefits as if they had been provided at the time that the entity started to have the liability (instead of the later time when they are actually provided). That is, fluctuations in the market value of the economic benefits to be provided under the liability, after the time when an entity starts to have it, do not affect the way it is brought to account. This means that unrealised gains or losses from market fluctuations will not be brought to account. *[Subsection 72-55(2)]*

Example 13.11 Comparing economic benefits by reasonably estimating the market values

In contrast to example 13.10, Jimmy-Jack's instead has a liability to provide dog walking services in Year 1, and obedience training in Year 2. Since the economic benefits under the liability are *not* homogenous, the proportion provided in each year *cannot* be established by direct comparison of the number of consultations provided in each year. Instead a comparison could be made between the market value of the walking services and the training. The market values to be compared are the market values at the time Jimmy-Jack's starts to have the liability, not when the services are provided.

On this basis, they do not expect to provide the same extent of economic benefits in each year and so it is inappropriate to use the straight-line method to calculate the decline in tax value of this liability.

Economic benefits provided for only part of a year

13.51 The comparison of economic benefits an entity estimates it will provide in an income year has to account for the fact that the economic benefits may actually be provided for only part of that year. That is, the estimate of economic benefits to be provided in each income year is made assuming that:

- the entity had the liability for the rest of its effective life *[subsection 72-55(1), item 1 in the table]*; and
- if the effective life starts or ends part way through an income year, the economic benefits provided in those years are scaled-up as though those years were full years *[subsection 72-55(3)]*.

13.52 Taken together, these assumptions compare income years as if the economic benefits were provided over the course of the *entire* income year in question.

Assume the entity has the liability throughout its effective life

13.53 The first assumption is that the entity will have the liability throughout its remaining effective life. This assumption is necessary so that the possibility of an early extinguishment of the liability (e.g. through discharge) will not affect the method of the decline in tax value. [*Subsection 72-55(1), item 1 in the table*]

Example 13.12 Stop having a liability before its effective life ends

On 1 July, Anne grants a lease over her land for 2 years. At the time she must choose the appropriate decline method, she expects that she will sell her interest in that land (subject to the lease) *during* the second income year (i.e. before the lease expires). Nevertheless, Anne must compare the economic benefits she expects to provide in Year 2, as if she had continued to have the liability until 30 June.

Scaling-up economic benefits when effective life starts or ends during the income year

13.54 In addition, if the effective life starts or ends part way through an income year, the economic benefits provided in those years are scaled-up as though those years were full years. This is achieved by adjusting the value of the economic benefits provided to account for the number of days for which the effective life did not continue. The adjustment ‘grosses-up’ the economic benefits relative to the number of days they are provided, according to this formula:

$$\text{Extent of economic benefits provided} = \frac{365}{\text{Number of days of the effective life in the income year} + 1} \times \text{Economic benefits provided}$$

[*Subsection 72-55(3)*]

Example 13.13 Effective life starts during income year

On 1 January Greg agrees to provide pool cleaning services, for a period of 18 months (ending 30 June in Year 2) for \$1,500. His liability starts to decline in tax value when the services are first provided. He reasonably estimates that he provides \$499 of the services in Year 1 and \$1,001 in Year 2. Greg must compare the extent of benefits provided in Year 1 by applying the gross-up formula:

$$\text{Extent of economic benefits provided in income year 1} = \frac{365}{\text{Number of days after the liability started to decline in tax value} + 1} \times \text{Economic benefits provided}$$

$$\$1,001 = \frac{365}{182} \times \$499$$

Therefore, Greg can reasonably estimate that the extent of the economic benefits he provides in each income year is the same. He then must use the straight-line method to work out the decline in tax value.

What is the straight-line method?

13.55 The straight-line method appears in the following formula:

$$\text{Base value} \times \frac{\text{Days}}{365} \times \frac{100\%}{\text{Remaining effective life}}$$

[Subsection 72-75(1)]

13.56 The components of the formula are summarised below. They are discussed in more detail in paragraphs 12.81 to 12.88.

'Base value'

13.57 For the first income year in which the decline in tax value occurs, the base value is the proceeds of incurring the liability at the end of that income year. This amount includes any receipts in that year that are either first or second elements. *[Paragraph 72-50(2)(a)]*

13.58 For later years, the base value is the opening tax value for the income year and any amounts added to the proceeds of incurring the liability for the year. *[Paragraph 72-50(2)(b)]*

'Days'

13.59 The 'days' component of the formulas refers to the number of days during the income year that the entity 'had' the depreciating liability while it was declining in tax value. The days before the liability started to decline in tax value are ignored. *[Subsection 72-75(1)]*

'Remaining effective life'

13.60 At any particular moment the *remaining effective life* is the period of time from the beginning of that income year, or the time when the liability's decline started (if that is later), until the liability's effective life ends. *[Subsection 72-75(2)]*

Example 13.14 Straight-line method

On 1 July Juanita receives \$150,000 as the proceeds of incurring a liability to provide professional services *evenly* over 3 years. Therefore, she estimates its effective life to be 3 years. Using the straight-line method, the decline in tax value of her liability is calculated in the following way:

Year 1

$$\begin{aligned} \text{Decline in tax value} &= \$150,000 \times \frac{365}{365} \times \frac{100\%}{3} \\ &= \$50,000 \end{aligned}$$

$$\begin{aligned} \text{Closing tax value} &= \$150,000 - 50,000 \\ &= \$100,000 \end{aligned}$$

The 'tax value' of \$100,000 is carried forward to the start of income Year 2 to become that year's 'opening tax value'.

Year 2

The *remaining* effective life as at the start of Year 2 is 2 years. Therefore, the decline in tax value for Year 2 is:

$$\begin{aligned} \text{Decline in tax value} &= \$100,000 \times \frac{365}{365} \times \frac{100\%}{2} \\ &= \$50,000 \end{aligned}$$

$$\begin{aligned} \text{Closing tax value} &= \$100,000 - \$50,000 \\ &= \$50,000 \end{aligned}$$

Proportion of total economic benefits – economic benefits to be provided unevenly

13.61 Where the economic benefits expected to be provided for a depreciating liability are *not* in the same extent in each income year the straight-line method will not be appropriate. Instead, the decline in tax value may be based on the 'proportion of total economic benefits provided'. [Subsection 72-55(1), item 2 in the table]

13.62 As under the straight-line method, the market value of the economic benefits provided in each year would be an appropriate basis for a comparison. However, market values will often *not* be necessary. If the economic benefits to be provided under the liability are the same in nature (e.g. goods of a particular kind), the proportion can simply be worked out on the basis of the number provided. Where market value is relevant, it is the market value of each of the economic benefits as if they had been provided at the time that the entity started to have the liability (instead of the later time when they are actually provided). [Subsection 72-55(2)]

13.63 In these circumstances the decline in tax value may be worked out by estimating the proportion of total economic benefits provided in an income year. When it can be estimated, that proportion of the liability's base value will be the decline in tax value for the income year (see paragraphs 13.57 and 13.58 for a discussion of base value). That is, the decline in tax value is:

$$\text{Decline in tax value} = \frac{\text{Current-year economic benefits}}{\text{Current-year economic benefits plus future-year economic benefits}} \times \text{Base value}$$

Current-year economic benefits

13.64 ‘Current-year economic benefits’ are those economic benefits that have been provided under the liability, in the income year for which the decline in tax value is being worked out.

Future-year economic benefits

13.65 ‘Future-year economic benefits’ are the economic benefits that it is estimated will be provided under the liability after the current year.

13.66 This total includes any economic benefits an entity would provide if they had the liability until the end of its effective life. That is, the proportion is based on the economic benefits an entity provides in the current year as a proportion of all future economic benefits owed under the liability. This means that even if an entity expects to be discharged from the liability before the end of its effective life, the ‘future-year economic benefits’ include any economic benefits that are to be provided under the liability.

Example 13.15 Uneven provision of services

Paul receives \$1,000 for agreeing to provide services from 1 July in Year 1 to 30 June in Year 2. The contract stipulates that the economic benefits are not to be provided evenly, but \$750 worth of services will be provided in Year 1, and \$250 worth in the Year 2. The liability to provide the services starts to decline in tax value in Year 1, so its base value is the proceeds of incurring it, \$1,000.

The decline in tax value of the liability in Year 1 will be:

$$\frac{\text{Year 1 economic benefits}}{\text{Year 1 economic benefits plus Year 2 economic benefits}} \times \text{Base value in Year 1}$$

$$\$750 = \frac{\$750}{\$1,000} \times \$1,000$$

The closing tax value at the end of Year 1 is \$250.

The decline in tax value of the liability in Year 2 will be:

$$\frac{\text{Year 2 economic benefits}}{\text{Year 2 economic benefits}} \times \text{Base value in Year 2}$$

$$\$250 = \frac{\$250}{\$250} \times \$250$$

Market value of economic benefits – economic benefits to be provided are inestimable

13.67 Where the proportion of total economic benefits provided for a depreciating liability in an income year *cannot* be reasonably estimated the decline in tax value is the market value of economic benefits actually provided in an income year. That is, when neither the ‘straight-line’ nor the ‘proportion of total economic benefits’ decline methods are applicable, the decline in tax value is the market value of economic benefits provided. [Subsection 72-55(1), item 4 in the table]

13.68 In contrast to the decline in tax value methods set out above, the relevant market value is the market value *at the time* the economic benefits are actually provided.

Example 13.16 Inestimable quantity provided under a liability

Cassandra grants a profit à prendre to remove an unspecified quantity of gravel from her land over a 2 year period. She may be unable to estimate the proportion of the gravel taken in Year 1 as a percentage of the total liability because the gravel reserves are unknown or she is unsure how much the grantee will want to extract. In either case the liability must be written off according to the market value of the gravel as it is taken.

However, even if the market value of gravel taken exceeds the liabilities tax value at that time, the tax value cannot decline below nil (see subsection 12-40(2)).

Other tax value decline methods being considered

13.69 Other methods for measuring the annual decline in tax value are being considered (e.g. to deal with the proper treatment of long term liabilities).

Working out the effective life of a depreciating liability

13.70 For the income year in which a depreciating liability starts to decline in tax value, the entity that has it will generally need to decide whether to work out that liability’s effective life by:

- adopting the Commissioner’s determination of effective life applicable to that depreciating liability (if there is such a determination); or
- self-assessing the liability’s effective life.

[Subsection 72-110(1)]

Commissioner's determination of effective life

13.71 The prototype legislation establishes the Commissioner's powers to make a written determination of the effective life of a depreciating liability [subsection 72-125(1)]. The Commissioner's 'safe harbour' determinations are *not binding* on entities, who have the choice of self-assessing effective life for themselves.

13.72 In making a determination, the Commissioner estimates the period during which economic benefits can be provided under such a depreciating liability.

Applicable determinations

13.73 That determination may specify its date of effect [subsection 72-125(2)]. It may apply retrospectively to that date, but only where there is no applicable determination for that date, or the new determination specifies a shorter effective life [subsection 72-125(3)].

13.74 To establish the effective life of a depreciating liability, the Commissioner's determination must be in force when:

- the entity starts to have the liability; or
- the entity enters into a contract to start to have the liability;

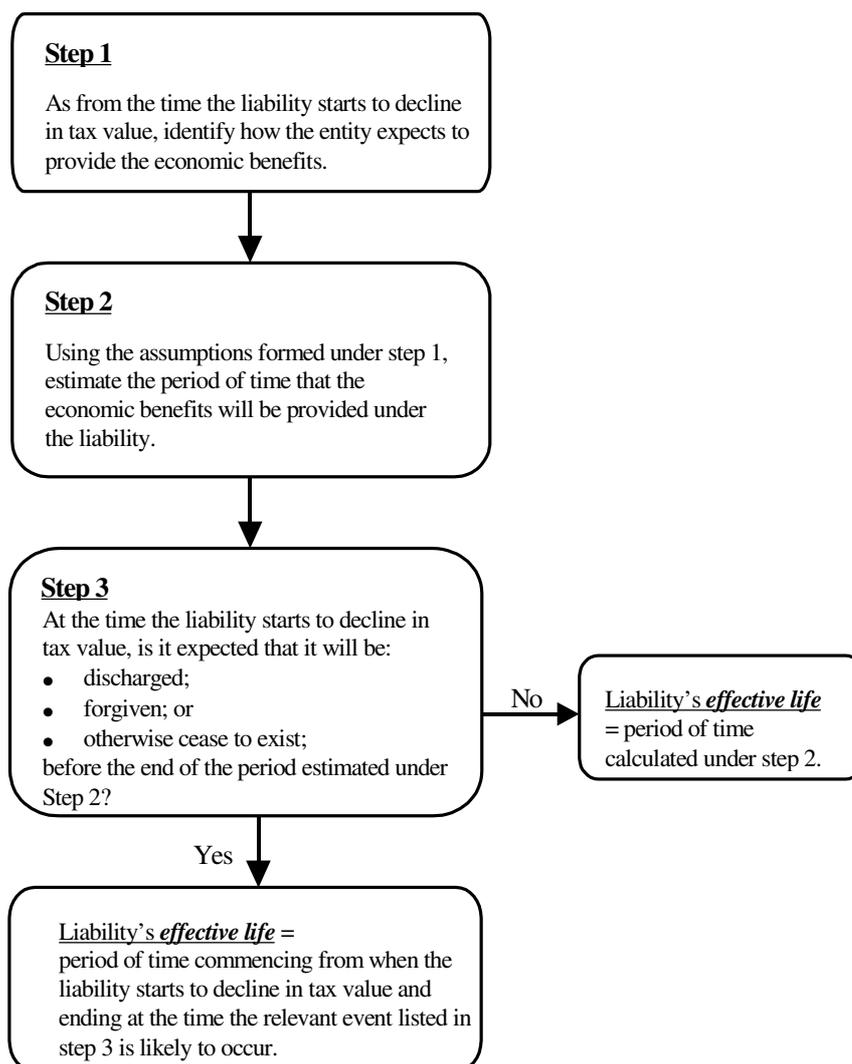
provided that the liability starts to decline in tax value within 5 years of the relevant time. Otherwise the appropriate determination is the one in force at the time the liability starts to decline in tax value. [Subsection 72-110(3)]

Self-assessing effective life

13.75 Entities that have a depreciating liability have the option to self-assess the liability's effective life as an alternative to relying on a Commissioner's determination. The initial estimate of effective life must be worked out as a period from the time the decline in tax value began. However, the choice need not be made *at* that time. The choice only needs to be made for the *income year* in which the decline in tax value began. [Subsection 72-110(2)]

13.76 Diagram 13.1 outlines how an entity may self-assess the effective life of a depreciating liability.

Diagram 13.1 Self-assessing effective life of a depreciating liability



Example 13.17 Effective life of a depreciating liability

Lorna receives a lump sum payment to endorse a product. The contract provides that the period of endorsement commences on 1 February of Year 1 and ends on 30 October of Year 2. The effective life of the liability is 1.75 years.

Renewals and extensions of a liability

13.77 As a renewal or extension of a liability is treated as a continuation of the original liability, the effective life of a liability includes any such extension or renewal. [Section 22-125]

Recalculating the effective life of a depreciating liability

13.78 An entity may choose, and in some cases is required, to recalculate the effective life of a depreciating liability. The methodology

used for recalculating the effective life is based on the same principles that apply when originally self-assessing the effective life of that depreciating liability [subsection 72-120(3)]. This means that the new effective life is an estimate of the period from the time when the liability starts to decline in tax value until it ceases to exist (for more detail on remaining effective life see paragraph 13.60).

When must an entity recalculate?

13.79 For each income year in which significant second elements of the proceeds of incurring the liability have been received, an entity must consider the effect of these additions on the effective life. This ensures an appropriate allocation of the additional proceeds over the remaining effective life. Therefore, an entity must recalculate the effective life of a liability when the proceeds of incurring it has increased by at least 10% in that year and:

- the entity has self assessed the effective life; or
- the entity uses the Commissioner's determination of effective life *and* uses the straight-line method.

[Subsection 72-120(2)]

When may an entity recalculate?

13.80 An entity may choose to determine a new effective life for a depreciating liability where the effective life the entity is using is no longer accurate because of changes to the way economic benefits are provided under the liability, or other circumstances have changed.

[Subsection 72-120(1)]

13.81 For instance, an entity may recalculate the effective life of a depreciating liability if the term of the liability is extended, renewed or shortened. This could be the case, for example, if a contractual obligation to provide services is extended.

13.82 Recalculation is limited to cases where the basis for estimating the effective life has *changed*. It does not extend to situations where the basis of the effective life estimate used in the calculations is incorrect due to a mistake of fact or error made by the entity. In these cases, the entity may apply to the Commissioner for an amendment of prior assessments.

13.83 The ability to recalculate applies regardless of whether the entity has previously:

- chosen to self-assess effective life;
- recalculate effective life; or
- adopted the Commissioner's determination of effective life.

Choices

When choice must be made

13.84 Division 72 allows entities to choose whether to use the Commissioner's determination, or to self-assess the effective life of a liability. This choice must be made by an entity on or before the day the entity lodges their income tax return for the income year to which it relates. The Commissioner may allow a choice to be made within a further time. [*Subsection 72-130(1)*]

Choices are irrevocable

13.85 Generally, a choice made in relation to a depreciating liability applies to that income year and to all later income years. This means that choices are generally irrevocable and, once made, bind the entity in respect of that depreciating liability into the future. [*Subsection 72-130(2)*]

13.86 An important exception to this general rule is that the choice of an effective life is essentially revoked when the entity chooses to recalculate effective life because the original one is no longer accurate because of changed circumstances (see paragraph 13.80). [*Subsection 72-130(3)*]

Chapter 14

Financial assets and financial liabilities

Outline of Chapter

14.1 This chapter explains how to work out the tax value of a financial asset or a financial liability.

14.2 The rules are contained in Division 76 of the prototype legislation.

Context of Reform

14.3 Under the current law, gains and losses from financial assets and liabilities may be brought to account for income tax purposes under a number of provisions. These include the general income and deduction provisions (section 6-5 and 8-1 and the ITAA 1997) as well as specific provisions (including sections 26BB and 70B and Divisions 3B and 16E of Part III of the ITAA 1936). These gains and losses are generally brought to account on realisation. In some cases, however, accrual taxation applies.

14.4 The RBT considered that the current system was characterised by uncertainty and incoherence. The Review also stated that increased financial innovation over recent decades exposed weaknesses – including the ability to delay gains and bring forward losses and the non-neutral treatment of risk bearing activities – inherent in the realisation based system of taxing the gains and losses from financial assets and liabilities.¹⁸⁶

14.5 ATSR proposed that except where there was a mark-to-market election, or where the future gains and losses are ‘uncertain’, gains and losses from financial assets and liabilities should be accrued: see recommendations 9.2 and 9.3.

Summary of prototype legislation

14.6 The tax value of a financial asset or financial liability will be determined by one of the following:

¹⁸⁶ Chapter 5, Review of Business Taxation, *A Platform for Consultation*, February 1999.

- the market value of the asset or liability;
- the cost of the asset or liability;
- the amount which the taxpayer has a right to receive (in the case of an asset) or the obligation to pay (in the case of a liability); or
- the accrual rules, which will spread gains and losses over the term of the asset or liability, reflecting the time value of money.

14.7 A financial asset or liability will only have its tax value calculated on a market value basis if the taxpayer has chosen to under Division 74.¹⁸⁷

14.8 Where a taxpayer has not chosen to have the tax value of a financial asset or liability calculated on a market value basis, the tax value will be determined under Division 76, that is, by reference to the asset's cost, to the amount receivable or payable, or under the accrual rules. The table in section 76-15 contains a list of types of financial assets and the basis on which their tax value will be calculated.

14.9 Similarly, section 76-115 contains a list of types of financial liabilities and the basis on which their tax value will be calculated. The rules for liabilities mirror those for assets.

14.10 Subdivisions 76-C and 76-D contain the rules for calculating the tax value of financial assets and liabilities subject to accruals.

Comparison of key features of prototype legislation and current law

Table 14.1 Comparison of key features of prototype legislation and current law

<i>Prototype legislation</i>	<i>Current law</i>
Provides a clear and coherent framework for determining whether gains and losses from financial assets and liabilities are brought to account over the period of time to which they relate (accruals) or at the time of payment or receipt (realisation).	There is no coherent system for determining when gains and losses are brought to account for tax purposes.

¹⁸⁷ The rules for the market value election are not yet included in the prototype legislation.

<i>Prototype legislation</i>	<i>Current law</i>
Gains that are certain and arise from financial assets are systematically brought to account for tax purposes as they accrue.	Gains (not including periodic interest) to the holder of particular securities issued with deferred returns are brought to account as they accrue. Interest derived by financial institutions are brought to account as it accrues.
Losses that are certain and arise from financial liabilities are brought to account as they accrue.	Losses (not including periodic interest) to the issuer of securities issued with deferred returns are brought to account as they accrue. Interest incurred by financial institutions brought to account as it accrues. Discount expense on some short term discounted instruments brought to account as it accrues.
Other gains and losses brought to account when they are realised.	Gains and losses not brought to account on an accruals basis brought to account on realisation.
Individuals and STS taxpayers specifically excluded from accrual rules except for deferral arrangements.	No explicit exclusion for individuals or STS taxpayers from accrual treatment.

Detailed explanation of prototype legislation

14.11 The first part of this Chapter discusses the definitions of ‘financial asset’ and ‘financial liability’ and the framework under which their tax values are worked out. It then goes on to discuss the rules for calculating the tax value of those assets and liabilities subject to accruals treatment.

What is a financial asset?

14.12 A *financial asset* is an asset that consists only of one or more of the following things:

- a right to receive an amount (whether denominated in Australian currency or foreign currency);
- a right to receive:
 - another financial asset; or
 - part of such an asset;

- foreign currency (other than where that currency is a collectable – See Chapter 18).

[Section 76-10]

14.13 Examples of things which are financial assets include:

- a lender's rights under a loan;
- a trade creditor's rights to money owing from the sale of goods or services on credit;
- a promisee's rights under a promissory note;
- a bearer's/payee's rights under a bill of exchange; and
- a customer's rights against a bank, represented by their bank account.

A financial asset must be an asset

14.14 The first element of the definition of 'financial asset' requires that an asset can be identified. An asset is anything that embodies future economic benefits. In most cases, it will be obvious whether or not an asset exists; this is discussed further in Chapter 7.

A financial asset must consist of a right to receive an amount or at least part of another financial asset

14.15 The second element of the definition requires a financial asset to consist of a right to money or a right to another financial asset (or part of one). In most cases, it will be clear whether or not such a right exists. However, in some cases it is necessary to consider the distinction between:

- an entitlement which is really a definite 'right to' something; and
- an entitlement which, contingently, gives rise to such a right in certain circumstances (e.g. upon an entity making a profit).

14.16 To some degree, this distinction reflects the dichotomy between debt and equity recognised in the current law (see Division 974 of the ITAA 1997). Further consideration of the interaction between this Division and the prototype legislation is necessary.

Example 14.1 What is *not* a right to money

Eddie subscribes for an ordinary share in Showbox Ltd. It entitles him to vote at General Meetings, and to share in a distribution of company profits, in the event that profits arise and an ordinary dividend is

declared. The share also allows Eddie to participate in any capital distributions that are made upon a winding up.

The share represents a right to a specified amount of the share capital of Showbox. It carries certain rights and liabilities while Showbox is a going concern and in its winding up. However, it *does not* represent a right to money. Eddie's right to a dividend or a payment upon winding-up is, at best, contingent upon profits arising and a dividend being declared, or upon Showbox being wound up. Accordingly, the share *is not* a financial asset of Eddie.

Where profits *do* arise and a dividend is declared, Eddie's right to the dividend becomes a debt (assuming that Showbox's constitution provides for the declaration of dividends).¹⁸⁸ This right *is* a financial asset.

14.17 Additional rules would be needed for financial assets that involve foreign currency if the prototype legislation is developed further.

What is the tax value of a financial asset?

14.18 The tax value of a financial asset is determined by reference to 5 distinct classes of entitlement. These are:

- rights to receive amounts that are due and payable;
- short-term rights to receive an amount in return for giving a non-cash benefit other than a financial asset;
- some financial assets held by individuals and STS taxpayers;
- financial assets that have a certain gain; and
- a residual category – comprising any other kind of financial asset.

Amounts due and payable

14.19 The tax value of a financial asset consisting of a right to receive an amount which is due and payable, other than one receivable in return for a non-cash benefit (other than a financial asset), is the amount the entity has the right to receive. [*Section 76-15, item 1 in the table*]

14.20 An amount is 'due and payable' when the time for payment has arrived. [*Subsection 995-1(1), definition of 'due and payable'*]

¹⁸⁸ See section 254V of the *Corporations Act 2001*.

Example 14.2 Amounts due and payable

On 30 June, Year 1, Off-Ramp Entertainment Pty Ltd sells some staging equipment to a nightclub for \$10,000. The nightclub must pay Off-Ramp for this by 30 July, Year 2.

Off-Ramp's right to payment does *not* fall within item 1 of section 76-15 during Year 1, because payment is not due until Year 2.

Short-term rights to receive an amount in return for giving a non-cash benefit other than a financial asset

14.21 This class of financial asset comprises rights to receive an amount which is:

- in return for giving a non-cash benefit other than a financial asset; and
- requires payment within 12 months after the day the right began (or would, assuming any uncertain obligations to pay were certain).

Example 14.3 Amounts due and payable

To continue on from the previous example, Off-Ramp's right to payment *would* fall within item 2 of section 76-15 during Year 1. Although payment is not due until Year 2, payment is for a non-cash benefit (the staging equipment) and will occur within 12 months of the sale.

When the time for payment arrives, the right to payment *then* falls within item 1 of section 76-15.

14.22 The tax value of these kinds of assets is the amount (if any) that the entity *actually* has the right to receive [*section 76-15, item 2 in the table*]. This means that contingent rights to receive additional amounts, arising if certain events occur in the future, are not counted.

14.23 For the purposes of identifying this class of financial asset, however, a contingent right, which corresponds to an *uncertain obligation*, is treated as if it corresponded to a *certain obligation*. The meaning of uncertain and certain obligations is discussed in detail in Chapter 10 (see paragraphs 10.128 to 10.136).

Example 14.4 Contingent short-term right to payment for a non-cash benefit

On 30 June, Year 1, the Mariners Trading Trust sells a shipment of clam chowder to Rainier Pty Ltd for \$5,000. Under the supply contract, Rainier must pay for this by 30 July of Year 2. However, in the event that Rainier pays late, it will have to pay an additional \$500 (i.e.

\$5,500 in total). Mariners has an uncertain right to receive \$500, because receipt of this amount is contingent upon late payment.

However, this does not mean that item 2 of the table in section 76-15 is not satisfied. This item applies, because the payment is for a non-cash benefit, and, ignoring the uncertain obligation, it must be made within 12 months. However, the right's tax value will only be \$5,000. This is because the uncertain obligation to pay \$500 to Mariners is not taken into account for the purposes of working out the tax value.

If Rainier does *not* pay on time, the tax value of Mariner's right would then rise to \$5,500.

14.24 Setting the tax value of these kinds of assets at their face value is a compliance-cost-saving measure. This approach avoids requiring an entity to calculate the cost of short-term trade debts. As a result, any difference between the cost of the asset and the amount receivable is brought to account at the time the asset is acquired.

14.25 This class of financial asset does *not* include short-term debts arising from the provision of a financial asset. Generally the same compliance cost issues do not arise with the provision of finance.

Some financial assets held by individuals and STS taxpayers

14.26 This class of financial asset comprises the rights of an individual or STS taxpayer to receive an amount which:

- has a return consisting only of interest payable within 12 months after the day it accrues¹⁸⁹ (providing the account does not have a 'stepped interest rate'¹⁹⁰);
- has an annual rate of return, not including interest which is payable within 12 months of it accruing, of no more than 1% of the right's cost when the taxpayer began to hold it; or
- has a remaining term (measured from when holding began) of 12 months or less.

14.27 The tax value of these kinds of assets is the cost of the asset at that time, reduced by the total of each amount the taxpayer receives in respect of it, at or before then, to the extent that the amount represents a repayment of that cost. [*Section 76-15, item 3 in the table*]

14.28 The *cost* of a financial asset is worked out under sections 14-20, 14-25, and 14-30 (see further, Chapter 9). It is essentially the amounts the

¹⁸⁹ This is a reference to the time from which the interest accrues *economically*, as opposed to when it might be regarded as accruing legally.

¹⁹⁰ That is, an interest rate that will, under the terms applicable to the asset, change otherwise than in accordance with market fluctuations.

taxpayer paid (or is deemed to have paid under Division 16) in order to hold the right.

14.29 Repayments of cost are those amounts the taxpayer receives in respect of the asset which represent, economically, a return *of* capital as opposed to a return *on* capital (e.g. interest).

Example 14.5 An STS taxpayer's bank account

Kurt runs a small brasserie, trading as Coffee Nirvana Pty Ltd. Coffee Nirvana is an STS taxpayer. Each day, Kurt takes the Coffee Nirvana's takings to the bank and deposits them in a business account. The business account calculates interest daily and pays it quarterly.

As the bank account gives Coffee Nirvana a right to money, it is a financial asset. However, the only return on this bank account is the interest, which accrues daily at the prevailing bank deposit rate and is payable within 12 months of that accrual.

Thus, the tax value of Coffee Nirvana's bank account begins at cost. The first element of cost will be equal to the amount of the first deposit: see subsection 14-25(1). Each subsequent deposit (including deposits of interest credited by the bank) will be included in the second element of the account's cost: see subsection 14-30(1).

Kurt does not need to worry about accruing the value of Coffee Nirvana's bank account. Its tax value simply grows as he makes deposits, and falls as he makes withdrawals. Coffee Nirvana is taxed on interest as it is received.

Financial assets that have a certain gain

14.30 This class of financial asset comprises those rights to money or financial assets which have a 'certain gain'. The meaning of certain gain is discussed in detail below at paragraph 14.60.

14.31 The tax value of these kinds of assets is the amount worked out under Subdivision 76-C [*section 76-15, item 4 in the table*]. For this class of financial asset, the 'certain gain' is accrued in accordance with the asset's internal rate of return.

Residual category – comprising any other kind of financial asset.

14.32 This class of financial asset comprises those rights to money or financial assets which do not fall within any of the previous categories.

14.33 The tax value of these kinds of assets is the cost of the asset at that time, reduced by the total of each amount the taxpayer receives in respect of it, at or before then, to the extent that the amount represents a repayment of that cost. [*Section 76-15, item 5 in the table*]

14.34 An asset falling into this category would typically be a right that has an ‘uncertain’ gain because of some contingency affecting receipts under it. An example is a right under a contract to sell a predetermined number of units of one currency for a predetermined number of units of another currency at a predetermined future date (that is, a forward foreign currency contract). The contingency in this case is the forward exchange rate.

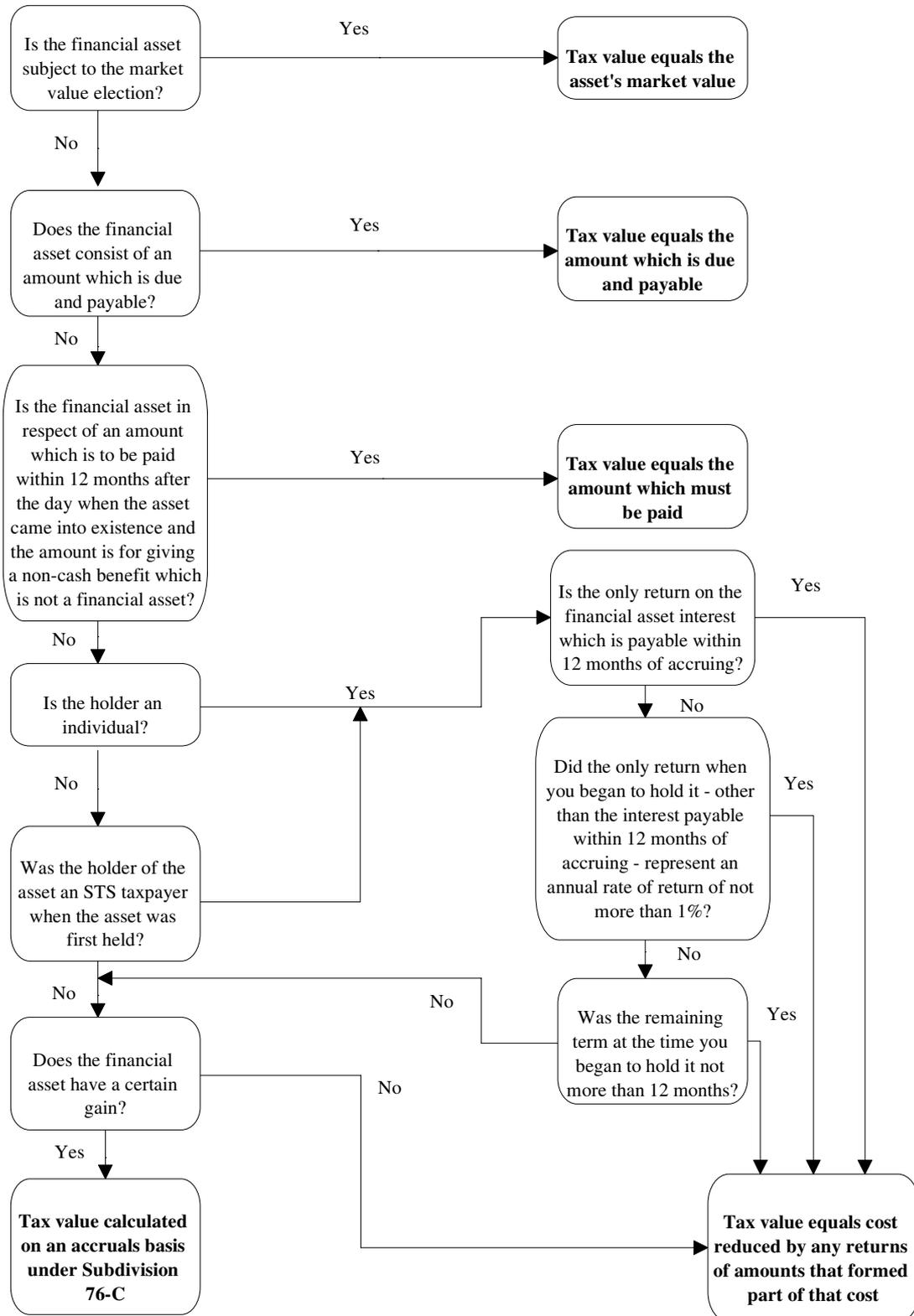
Summary – tax value of financial assets

14.35 Generally speaking, the results of the tax value rules applicable to financial assets and liabilities not subject to the market value election will be:

- for individuals and STS taxpayers – realisation, except for deferral transactions with a term of more than 12 months;
- for other taxpayers – accruals for debt instruments such as promissory notes and loans, and for interest rate swaps; and realisation for other financial instruments such as forwards and options, as well as short term trade credit arrangements.

14.36 The flow chart on the next page illustrates how to determine the tax value of financial assets.

Diagram 14.1 Tax value of financial assets



What is a financial liability?

14.37 A **financial liability** is a liability that consists only of one or more of the following things:

- an obligation to pay an amount (whether denominated in Australian currency or foreign currency);
- an obligation to provide a financial asset.

[Section 76-110]

14.38 Examples of things which are financial liabilities include:

- a borrower's obligation under a loan;
- a trade debtor's obligations representing money owing from the purchase of goods or services on credit;
- a promisor's obligation under a promissory note;
- a drawer's obligation under a bill of exchange; and
- a bank's obligation represented by a customer's account.

A financial liability must be a liability

14.39 The first element of the definition of 'financial liability' requires that a liability can be identified. A liability is something that consists of one or more obligations to provide future economic benefits. In most cases, it will be obvious whether or not a liability exists; this is discussed further in Chapter 8.

A financial liability must consist of an obligation to pay an amount or provide a financial asset

14.40 The second element of the definition requires a financial liability to consist of an obligation to pay money or provide a financial asset. In most cases, it will be clear whether or not such an obligation exists. However, in some cases it is necessary to consider the distinction between:

- a liability which is really a definite 'obligation to' pay or provide something; and
- an obligation which, contingently, gives rise to such a liability in certain circumstances (e.g. upon an entity making a profit).

14.41 To some degree, this distinction reflects the dichotomy between debt and equity recognised in the current law. See Division 974 of the

ITAA 1997. Further consideration of the interaction between this Division and the prototype legislation is necessary.

Example 14.6 What is *not* an obligation to pay an amount

To continue on from Example 14.1, Showbox Ltd would have received subscription money from Eddie in return for issuing a share to him. This money is included in Showbox's paid-up capital, and is therefore a liability it has: subsection 12-15(2).

Even so, the subscription money is *not* a financial liability of Showbox. Showbox is under no obligation to pay the money back to Eddie. Further, the fact that Showbox may have to pay Eddie an amount if it makes a profit and declares a dividend, or winds itself up, does not mean that it has a financial liability to Eddie either.

Where profits *do* arise and a dividend is declared, Showbox's obligation to pay the dividend *does* become a financial liability, however.¹⁹¹

14.42 Additional rules would be needed for financial liabilities that involve foreign currency if the prototype legislation is developed further.

What is the tax value of a financial liability?

14.43 The rules for working out the tax value of a financial liability mirror those for financial assets; see paragraphs 14.18 to 14.36 above. That is, the classes of liability are:

- obligations to pay amounts that are due and payable;
- short-term liabilities to pay an amount in return for getting a non-cash benefit other than a financial asset;
- certain financial liabilities of individuals and STS taxpayers;
- financial liabilities that have a certain loss; and
- a residual category – comprising any other kind of financial liability.

Amounts due and payable

14.44 The tax value of a financial liability consisting of an obligation to pay an amount which is due and payable, other than one which is payable for a non-cash benefit (other than a financial asset), is the amount the entity is liable to pay. [*Section 76-115, item 1 in the table*]

14.45 As mentioned, an amount is 'due and payable' when the time for payment has arrived (see paragraph 14.20).

¹⁹¹ Note that this would have a tax value of nil: paragraph 68-10(2)(b).

Short-term liabilities to pay an amount in return for a non-cash benefit other than a financial asset

14.46 This class of financial liability comprises obligations to pay an amount which is:

- in return for a non-cash benefit other than a financial asset; and
- requires payment within 12 months after the day the right began (or would, assuming any uncertain obligations to pay were certain).

14.47 The tax value of these kinds of liabilities is the amount (if any) that the entity is *actually* liable to pay [*section 76-115, item 2 in the table*]. This means that contingent liabilities to pay additional amounts, arising if certain events occur in the future, are not counted.

14.48 For the purposes of identifying this class of financial liability, however, an *uncertain obligation* is treated as if it is a *certain obligation*. The meaning of uncertain and certain obligations is discussed in detail in Chapter 10 (see paragraphs 10.128 to 10.136).

14.49 Again, setting the tax value of these kinds of assets at their face value is a compliance-cost-saving measure.

14.50 This class of financial liabilities does *not* include short-term debts arising from obtaining a financial asset.

Some financial liabilities of individuals and STS taxpayers;

14.51 This class of financial liability comprises the obligations of an individual or STS taxpayer to pay an amount which:

- has a return consisting only of interest payable within 12 months after the day it accrues¹⁹² (providing the account does not have a ‘stepped interest rate’¹⁹³);
- has an annual rate of return, not including interest which is payable within 12 months of it accruing, of no more than 1% of the right’s cost when the taxpayer began to hold it; or
- has a remaining term (measured from when having began) of 12 months or less.

14.52 The tax value of these kinds of liabilities is the proceeds of incurring the liability at that time, reduced by the total of each amount the taxpayer pays in respect of it, at or before then, to the extent that the

¹⁹² See footnote 189 above.

¹⁹³ See footnote 190 above.

amount represents a repayment of those proceeds. [*Section 76-115, item 3 in the table*]

14.53 The *proceeds of incurring* a financial liability are worked out under sections 14-75, 14-80, and 14-85 (see further, Chapter 9). It is essentially the amounts the taxpayer received (or is deemed to have received under Division 16) which caused it to have the liability.

14.54 Repayments of proceeds are those amounts the taxpayer pays in respect of the liability which represent, economically, a return *of* capital as opposed to a return *on* capital (e.g. interest).

Financial liabilities that have a certain loss

14.55 This class of financial liability comprises those obligations to pay money or provide financial assets which have a ‘certain loss’. The meaning of certain loss is discussed in detail below at paragraph 14.92.

14.56 The tax value of these kinds of liabilities is the amount worked out under Subdivision 76-D [*section 76-115, item 4 in the table*]. For this class of financial liability, the ‘certain loss’ is accrued in accordance with its internal rate of return.

Residual category – comprising any other kind of financial liability

14.57 This class of financial liability comprises those obligations to pay money or provide financial assets which do not fall within any of the previous categories.

14.58 The tax value of these kinds of liabilities is the proceeds of incurring the liability at that time, reduced by the total of each amount the entity pays in respect of it, at or before then, to the extent that the amount represents a repayment of those proceeds. [*Section 76-115, item 5 in the table*]

14.59 An example of a liability falling into this category would typically be a liability that has an ‘uncertain’ loss because of some contingency affecting payments under it.

Financial assets with a tax value determined on an accruals basis

When will a financial asset have a certain gain?

14.60 A financial asset will have a certain gain at a particular point in time if it is substantially more likely than not that the sum of the following will exceed the cost of the asset [*section 76-40*]:

- all amounts which have been received in respect of the asset and were certain receipts prior to becoming due and payable; and
- any future certain receipts.

Where this is the case, the asset will have its tax value calculated under the accrual rules contained in subdivision 76-C [section 76-15, item 4 of table]. The components of this test are explained in more detail below.

14.61 Strictly, the determination as to whether a financial asset has a certain gain is made continuously over the life of the asset. This is because a financial asset can start out not having a certain gain but, for example, can embody a contingency that is settled with the result that it thereafter has a certain gain. However, for practical purposes, the determination of whether there is a certain gain will typically only have to be made at the time the asset is acquired.

14.62 In determining whether a financial asset has a certain gain, all the certain receipts are taken into account, including interest payments. This is unlike Division 16E of the ITAA 1936 which ignores periodic interest payments in determining whether an amount should be subject to accruals taxation.

14.63 If all the future receipts are not known, those receipts do not necessarily have to be estimated in determining whether it is substantially more likely than not that the receipts will exceed the cost. What is required is a consideration of the likelihood that the sum of the receipts will exceed the cost. *Substantially more likely than not* means that the likelihood of the sum of the certain receipts exceeding the cost of the asset, has to be more than merely *more likely than not*. This does not, however, mean that it has to be *highly likely* that the sum of the certain receipts will exceed the amount invested.

14.64 The ‘substantially more likely than not’ test establishes one of the basic principles for distinguishing between accruals and realisation treatment for a wide range of financial assets. At the same time, to provide some assistance in determining whether a particular asset has a certain gain or not, the prototype legislation provides for the making of regulations. These regulations can prescribe the amounts, the basis for determining the amounts, and methods for working out the amounts that are unknown [subsection 76-80(1)]. The regulations could also treat a receipt, which might otherwise be a certain receipt, as an uncertain receipt [subsection 76-80(2)].

14.65 Regulations will allow guidance to be provided on the types of cashflows and the situations that would or would not give rise to accruals treatment for financial assets. For example, the regulations could be used to make it clear that a financial instrument which embodied rights to payments solely calculated by reference to a share price or particular commodity price would not be subject to accruals treatment. This procedure enables the prototype legislation to reduce the uncertainty which currently exists in relation to the scope of Division 16E of the ITAA 1936.

14.66 Further, the regulations could be used to prescribe a method for calculating an unknown amount that is to be calculated by reference to a stable variable or a variable which generally increases from one period to the next (for example the consumer price index). Thus the regulations could, where appropriate, be used to give clear and explicit guidance on accruals treatment for instruments such as CPI-linked bonds.

14.67 This use of the regulations to clarify the treatment of particular cash flows in determining whether a financial asset has a certain gain or not reflects ATSR recommendation 9.3. The discussion following that recommendation proposed that a general principle be used to determine whether payments are certain or uncertain. This principle would be supported by a list of variables and instruments which will not be subject to accruals treatment.

14.68 The listing of the variables in regulations is also intended to allow the addition of other variables in the future where it is considered the treatment of payments calculated by reference to such variables should be made clearer.

14.69 Not listing a particular variable in the regulations by itself does not mean that a financial asset, the payments on which are calculated by reference to that variable, would necessarily have a certain gain. It would remain to be determined whether or not it was substantially more likely than not that the certain receipts exceeded the cost.

14.70 If a receipt is treated as an uncertain receipt only because the variable by which the amount is to be calculated is listed in the regulations, but there is a minimum amount payable irrespective of the value of the variable, the minimum amount is a certain receipt. For example, a taxpayer is entitled to a future payment equal to the minimum of \$100 or an amount calculated by reference to the future changes in value of a particular variable. The \$100 would be treated as a certain receipt even if the variable is listed in the regulations as not giving rise to a certain receipt [*subsection 76-80(4)*]. Also see example 14.11.

What is a certain receipt?

14.71 A certain receipt is an amount to be received in respect of a financial asset if an entity has a certain obligation to pay the amount. A future payment can be a certain receipt even if the amount of the future payment is not known or cannot be worked out. [*Section 76-70*]

14.72 An amount is not a certain receipt if the amount is not known and it will be calculated by reference to the future value or level of a variable or the future change in the value or level of a variable and that variable is prescribed in the regulations. [*Subsection 76-80(2)*]

14.73 A special rule applies to a financial asset consisting of a right to get another financial asset, where the obligation of the other party to

supply that asset is a 'certain obligation'. This rule deems the right to get the other asset to be a certain receipt:

- to be received at the latest time when that other asset can be provided under the right; and
- of an amount equal to what it is reasonable to expect the market value of the other asset to be at that latest time.

[Section 76-90]

Certain obligation

14.74 An obligation is certain if the requirement to fulfil the obligation is, in substance of effect, non-contingent *[section 975-10]*. See paragraph 10.128 and following in Chapter 10.

How to calculate the tax value of a financial asset on an accruals basis

14.75 A financial asset that has a certain gain will have its tax value calculated under a formula contained in the prototype legislation.

[Subsection 76-210(3)]

14.76 The formula, in effect adjusts the previous tax value of the financial asset (last tax value) by reference to the internal rate of return of the financial asset (Rate) and any amounts paid or received at that time (Reset amounts). The formula is:

$[\text{Last tax value} \times (1 + \text{Rate})] - \text{Reset amounts}$

The components of the formula are explained below.

14.77 It should be noted that this formula provides for compounding accruals methods which, as noted below at paragraph 14.80, permit any compounding period, as long as it is not more than 12 months. Under this approach, the daily internal rate of return does not have to be calculated. Further work on the accruals rules would involve development of the circumstances in which straight-line accruals can be used, for example:

- when the remaining term of the financial asset is no more than 12 months;
- when any discount or premium for the remaining term represents an annual rate of return of no more than a certain percentage of a reference rate, and the balance of the return is paid out each year.

What is the 'last tax value'?

14.78 The last tax value of a financial asset is defined as its tax value when it last had to be calculated, namely when one of the following events occurred:

- when it was first held by you;
- when it started to have a certain gain;
- when you received an amount that was a certain receipt;
- an income year ended;
- a certain receipt become receivable;
- an amount already receivable in respect of the asset became a certain receipt;
- a certain receipt stopped being a receivable in respect of the asset;
- an amount receivable in respect of the asset stopped being a certain receipt;
- the amount of a certain receipt receivable in respect of the asset changed;
- the cost of the asset changed.

[Section 76-220]

What is the Rate?

14.79 The Rate is used in the accruals formula. It represents the internal rate of return of the asset at a particular point of time. This is calculated by working out the rate at which the present value of all certain receipts would equal the tax value at the previous test time *[subsection 76-230(1)]*. Any receipts which are already due and payable are ignored in performing this calculation.

14.80 In working out this rate any compounding period can be used as long as it is not more than 12 months. *[Subsection 76-230(2)]*

14.81 This figure, calculated under subsection 76-230(1), is used as the Rate in the accruals formula if the number of days in the compounding period is the same as the number of days in between the test time and the previous test time.

Example 14.7 Calculating the Rate for the accruals formula

Daisy acquires a bond with a term of 2 years for \$950. Interest of \$60 is payable at the end of Years 1 and 2. The face value of the bond of \$1,000 is repayable at the end of Year 2.

If Daisy chose to calculate the Rate on a 12 month compounding basis it would be 8.84% (rounded to 2 decimal places).

Alternatively, if Daisy chose to calculate the Rate on a 6 monthly basis the rate would be 4.32% (rounded to 2 decimal places).

14.82 If the number of days in the period between the test time and the last test time is different to the number of days in the compounding period the Rate is adjusted to reflect the different length of time. The Rate is adjusted by applying the following formula:

$$[(1 + \text{Base rate})^{(\text{Days} \div \text{Compounding period})}] - 1$$

[Subsection 76-230(3)]

14.83 The 'Base rate' is the rate which is calculated under subsection 76-230(1). The 'Days' are the number of days between the previous and current test times.

Example 14.8 Calculating the Rate for the accruals formula

If, in the example above, Daisy had acquired the bond on the 31 May of Year 1 she would be required to calculate the tax value of the bond at 30 June of Year 1.¹⁹⁴ However, as the period between the time the bond was acquired (31 May) and the end of the year (30 June) is less than the compounding period the Rate calculated in the earlier example could not be used to calculate the tax value. Daisy would have to adjust the Rate by using the formula in subsection 76-230(3).

Assuming that Daisy had chosen to calculate the Rate on a 12 monthly compounding basis the Rate for the period from 31 May to 30 June would be:

$$\begin{aligned} & [(1 + 0.0884)^{(30 \div 365)}] - 1 \\ & = 0.70\% \text{ (rounded to 2 decimal places)} \end{aligned}$$

14.84 In calculating the Rate it must be assumed that:

- that the taxpayer who currently holds the financial asset or financial liability will continue to hold it for the rest of its life; and

¹⁹⁴

Assuming 30 June is the end of Daisy's income year.

- that each amount that will be received in respect of the financial asset will be received when it becomes due and payable.

[Section 76-20]

Reset amounts

14.85 Reset amounts are any amounts you received at the test time in respect of the asset and which were certain receipts for some period before becoming due and payable, and any increase in the cost of the asset at the test time. *[Section 76-240]*

Estimating future receipts for calculation purposes

14.86 A financial asset may have a certain gain even though all the future certain receipts have not been quantified. In such cases the calculation of the tax value and specifically the Rate will be determined by reference to estimated amounts. The basis of estimating these amounts is contained in Subdivision 76-E.

14.87 Broadly the estimates are to be made in accordance with the value of the variable when it was most recently used for the purposes of calculating a payment under the asset.

14.88 If an amount is to be calculated by reference to a future value or level of a variable for the purpose of estimating the future amount it is assumed that the value or level of the variable will be the same as was last used in calculating an amount payable under the security. If no amount has been calculated by reference to the value or level of the variable then it is assumed that the variable will be the same as it was at the end of the last financial year security. *[Paragraph 76-380(1)(a)]*.

14.89 Where a future amount is to be calculated by reference to a change in the value or level of a variable, it is to be assumed that the rate of change will be the same as occurred over a similar period ending at the time when an amount was calculated using the change in the variable under the asset *[paragraph 76-380(2)(a)]*. If no amount has been calculated then at the end of the last financial year. *[Paragraph 76-380(2)(b)]*

Examples of how tax value is worked out on an accruals basis

14.90 The following examples illustrate the application of the accruals rules discussed above.

Example 14.9 Determining whether an asset has a certain gain

Hannah Ltd acquires a bond on issue with a term of 3 years. The cost of the bond was \$10,000. The bond pays annual interest of \$650. The face value is payable on maturity.

At the time the bond is first held the sum of the amounts that have been received in respect of the bond is zero (as there has been no amount which has been received). The sum of the certain receipts to be received is \$11,950 (3 interest payments of \$650 each plus the repayment of the face value of \$10,000). As the sum of the amounts which have been received (zero) and the sum of the certain receipts (\$11,950) is greater than the cost, the bond has a certain gain.

Immediately after the first interest payment has been received the bond, as expected, would still have a certain gain. At that time the sum of the amounts which have been received and were certain receipts before becoming due and payable is \$650. The sum of the certain receipts to be received is \$11,300 (2 interest payments of \$650 plus the repayment of the face value of \$10,000). The sum of all of the receipts (\$11,950) is greater than the cost of \$10,000.

Example 14.10 Determining whether an asset has a certain gain

Adam Ltd invests in an instrument under which it is entitled to annual payments of \$1,000 for the next 2 years. It will be entitled to further payments of \$1,000 a year for the following 3 years (that is, in Years 3, 4 and 5) if the price of gold exceeds \$300 per ounce at the end of Year 2. The cost of the instrument is \$3,500.

At the time the asset is acquired the asset does not have a certain gain. The certain receipts of \$2,000 do not exceed the cost of \$3,500.

The asset does not have a certain gain prior to the end of Year 2.

At the end of Year 2 the price of gold is \$327. Therefore Adam is entitled to receive 3 further payments of \$1,000 each. Those payments as at the end of Year 2 are certain receipts.

At the end of Year 2 the sum of the amounts that have been received in respect of the asset are \$2,000 (\$1,000 at the end of Years 1 and 2). The sum of the certain receipts to be received is \$3,000 (\$1,000 at the end of Years 3, 4 and 5). As the total of these amounts, that is \$5,000, exceeds the cost of the asset, the asset will have a certain gain as from the end of Year 2.

Example 14.11 SPI linked bond with minimum payments

On 30 June Year 1, a taxpayer acquires a financial asset with a term of 3 years for a cost of \$1,000. The taxpayer is entitled to annual payments calculated by reference to the face value of the asset and the change in a share price index (SPI) over the 12 months ending the day prior to payment date. The annual payments are subject to a floor of 1% of the face value. The face value of \$1,000 is payable on maturity. The taxpayer does not make a market value election in respect of the asset.

As a result of the changes in the SPI the taxpayer receives the following payments:

30 June Year 2: \$55

30 June Year 3: \$48

30 June Year 4: \$52 (plus the \$1,000 repayment of the face value)

The asset's tax value will be calculated on an accruals basis, as the asset has a certain gain. In determining that the financial asset has a certain gain and in calculating the Rate, the following are taken into account:

- the cost;
- the guaranteed annual payments of 1%; and
- the repayment of the face value.

The Rate is 1% (compounded on an annual basis).

The tax value at:

Year 1

The closing tax value is \$1,000 as that is the cost of the bond.

Net income for Year 1:

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

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

$$= 0$$

Year 2

The tax value is:

$$[\text{Last tax value} \times (1 + \text{Rate})] - \text{Reset amounts}$$

$$1,000 \times (1.01) - 10 = 1,000$$

Net income for Year 2:

$$[55 - 0] + [1,000 - 1,000] - [0 - 0]$$

$$= \$55$$

Year 3

The tax value is:

$$1,000 \times (1.01) - 10 = 1,000$$

Net income for Year 3:

$$[48 - 0] - [1,000 - 1,000] - [0 - 0]$$

$$= \$48$$

Year 4

The asset is not held at the end of the year.

Net Income for Year 4:

$$[1,052 - 0] + [0 - 1,000] - [0 - 0]$$

$$= \$52$$

In calculating the reset amount, only the certain receipt is taken into account. That is the \$10, rather than the total cash flows of \$55 in Year 2 and \$48 in 30 Year 3.

However, the total cash flows, that is the uncertain *and* certain parts, are taken into account in the net income formula.

Example 14.12 Contingent bond: cash flows contingent when acquired: contingency settled during the term of the arrangement

On 1 June in Year 1, Michare Pty Ltd purchases a bond for \$1,000 which will make six monthly payments provided gold prices reach \$410 an ounce on 30 September Year 2. If this event occurs, the instrument will pay \$50 every six months from 31 October in Year 2 until 31 October in Year 4. The principal is repaid only if gold prices reach the specified level.

Michare Pty Ltd has a financial year ending 30 June.

On 1 September of Year 2, gold prices reach \$435 an ounce.

The bond is not subject to the market value election.

At the time the bond is acquired the obligation of the issuer to pay the amount is contingent on the price of gold reaching \$410. The bond does not have a certain gain as there are no certain receipts (section 76-40). Therefore at that time the tax value of the asset is its cost (section 76-15, item 5), that is \$1,000.

Year 1

On 30 June in Year 1, the tax value remains at the cost.

Net income for Year 1:

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

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

$$= 0$$

Year 2

On 1 October in Year 2, the taxpayer has a certain gain as gold prices have reached the specified level. The tax value at that time remains \$1,000 in accordance with subsection 76-210(2).

On 31 October in Year 2, the tax value is calculated in accordance with subsection 76-210(3):

$$[\text{Last tax value} \times (1 + \text{Rate})] - \text{Reset amounts}$$

The Rate, calculated on a 12 monthly compounded basis, is 12.6896%.

However as the period between the last test time and the test time is less than 12 months, the Rate has to be adjusted to reflect the difference in the length of the periods. This Rate apportioned in accordance with subsection 76-230(3) is

$$[(1 + 0.126896)^{(30/365)}] - 1$$

$$= 0.99\% \text{ (correct to 2 decimal places)}$$

31 October Year 2:

The tax value is:

$$1,000 \times 1.0099 - 50$$

$$= 960$$

30 April, Year 2:

Apportionment of Rate:

$$[(1 + 0.126896)^{(181/365)}] - 1$$

$$6.10\%$$

The tax value is:

$$[960 \times (1 + 0.061)] - 50$$

$$= 968$$

30 June, Year 2:

Apportionment of Rate:

$$[(1 + 0.126896)^{(61/365)}] - 1$$

$$= 2.02\%$$

The tax value is:

$$\begin{aligned} & 968 \times [(1 + 0.0202)] - 0 \\ & = 987 \end{aligned}$$

Net income for Year 2:

$$\begin{aligned} & [100 - 0] + [968 - 1,000] - [0 - 0] \\ & = \$68 \end{aligned}$$

Year 3

30 October, Year 3:

Apportionment of Rate:

$$\begin{aligned} & [(1 + 0.126896)^{(123/365)}] - 1] \\ & = 4.11\% \end{aligned}$$

The tax value is:

$$\begin{aligned} & [987.98 \times (1 + 0.04108)] - 50 \\ & = 978 \end{aligned}$$

30 April Year 3:

Apportionment of Rate:

$$\begin{aligned} & [(1 + 0.126896)^{(182/365)}] \\ & = 6.14\% \end{aligned}$$

The tax value is:

$$\begin{aligned} & [978.57 \times (1 + 0.0614)] - 50 \\ & = 988 \end{aligned}$$

30 June Year 3:

Apportionment of Rate:

$$\begin{aligned} & [(1 + 0.126896)^{(61/365)}] \\ & = 2.02\% \end{aligned}$$

The tax value is:

$$\begin{aligned} & 988.63 \times [(1 + 0.0202)] - 0 \\ & = 1,008 \end{aligned}$$

Net income for Year 3:

$$\begin{aligned} & [100 - 0] + [1,008 - 987] - [0 - 0] \\ & = \$121 \end{aligned}$$

Year 4

Net income for Year 4:

$$\begin{aligned} & [1,050 - 0] + [0 - 1,008] - [0 - 0] \\ & = \$42 \end{aligned}$$

Example 14.13 Interest bearing bond acquired at a discount

Prudent Ltd acquires a bond with a remaining term of 2 years and a face value of \$10,000 on 1 July for \$9,820. Under the bond, interest payments of \$625 are payable on 30 June in each of the following 2 years.

Prudent Ltd has not chosen to calculate the tax value of any of its financial assets or liabilities on a market value basis.

As the sum of the amounts Prudent Ltd will receive as a result of holding the bond will exceed the cost of the bond the tax value is calculated under the accruals basis (Subdivision 76-C)

The tax value of the bond at the time it is acquired is its cost, that is \$9,820 (section 76-210).

Year 1

As the tax value is calculated under the accruals basis and as there are no test times prior to the end of the year of income, the tax value is worked out as follows:

$$[\text{Last tax value} \times (1 + \text{Rate})] - \text{Reset amounts}$$

Last tax value is the tax value at the time the bond was first held which is \$9,820.

The Rate is 7.25%

The Reset amount is \$625

The tax value is

$$\begin{aligned} & [9,820 \times (1 + 0.0725)] - 625 \\ & = 9,906 \end{aligned}$$

The net income is:

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

$$[625 - 9,820] + [9,906 - 0] - [0 - 0]$$

$$= \$711$$

Year2

The bond is not held at the year-end. Therefore the closing value of the asset is nil. The net income is

$$[10,625 - 0] + [0 - 9,906] - [0 - 0]$$

$$= \$719$$

Example 14.14 Interest rate swap agreement

Elliott Bay Ltd entered into an interest rate swap with Puget Sound Ltd on 1 January, Year 1. The swap has a term of 3 years, ceasing on 1 January, Year 4. Amounts payable under the agreement are based upon a notional principal amount of \$100 million.

Under the agreement, Elliott Bay must pay Puget Sound a fixed amount of \$6 million each year (i.e. at a fixed leg rate of 6%). In return, Puget Sound undertakes to make a yearly payment to Elliott Bay, determined by reference to the floating Bank Bill Swap Rate ('BBSW') prevailing 12 months prior to the payment date. As at 1 January, Year 1, the BBSW rate is 6.1%.

At the time of the agreement, Elliott Bay reasonably estimates that the floating leg rate will be approximately equal to its current level of 6.1% for the duration of the agreement. On this basis, it estimates that the market value of its right to payments over the coming 3 years is approximately \$16,275,252.14 (i.e. 3 receipts of \$6,100,000.00, discounted at a rate of 6.1%). Under section 16-25, Elliott Bay is deemed to receive \$16,275,252.14 for assuming its liabilities under the swap, and to have paid the same amount for its rights under the swap. The cost of its right, and the proceeds of incurring its liability, are therefore both equal to \$16,275,252.14.

The amounts Elliott Bay receives under the floating security are certain receipts for the purposes of section 76-70. Although Elliott Bay cannot say for sure what the *amount* of the receipts will be, Puget Sound has a certain obligation to make payments. The amount of Elliott Bay's certain receipts will be calculated by reference to the rate at which the amount payable on 1 January Year 2 is calculated: subsection 76-380(1).

The tax value of Elliott Bay's right under the floating security is accrued under the formula in subsection 76-210(3). Over time, *actual*

movements in the BBSW can be observed; these movements will therefore be factored into the 'rate' used by Elliott Bay under section 76-230. This means that the rate used to accrue Elliott Bay's floating security will change over time, as the BBSW, and consequently Elliott Bay's certain receipts, fluctuate.

Meanwhile, the tax value of Elliott Bay's liability under the fixed security will accrue under the formula in subsection 76-310(3). This will simply involve accruing the financial liability at a rate of 6%.

Assuming that the actual BBSW rates are 6.1% in Year 1, 7.0% in Year 2 and 5.8% in Year 3, this will be the result:

Year 1

1 January Year 1:

The tax value of the asset is:

\$16,275,252 (that is the cost of the asset)

The tax value of the liability is:

\$16,275,252 (that is the proceeds from incurring the liability)

30 June Year 1:

Tax values for both the asset and the liability at later times will be calculated under the accruals formula

Last tax value \times (1 + Rate) – Reset amounts

The Rate for the liability on a 12-month compounding basis is 5.21%

The Rate for the asset on 12 monthly compounding basis is:

- 6.1% in Year 1
- 16.49% in Year 2
- -3.48% in Year 3

In order to work out the tax value under the accrual rules the Rate must be adjusted where the days between the test time and the previous test time is not the same as the days in the compounding period.

Liability

30 June Year 1:

The Rate for the liability is:

$[(1 + \text{Base rate})^{(\text{Days} + \text{Compounding period})}]$

$[(1 + 0.0521)^{(180 + 365)}] - 1$

$$= 2.54\%$$

The tax value of the liability is:

$$[\text{Last tax value} \times (1 + \text{Rate})] - \text{Reset amounts}$$

$$[16,275,252 \times (1 + 0.0254)] - 0$$

$$= 16,688,643$$

Asset

30 June Year 1:

The Rate for the asset is:

$$[(1 + \text{Base rate})^{(\text{Days} + \text{Compounding period})}]$$

$$[(1 + 0.0610)^{(180+365)}] - 1$$

$$= 2.96\%$$

The tax value of the asset is:

$$\text{Last tax value} \times (1 + \text{Rate}) - \text{Reset amounts}$$

$$[16,275,252 \times (1 + 0.0296)] - 0$$

$$= 16,756,999$$

Net income for Year 1:

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

$$[16,275,252 - 16,275,252] + [16,756,999 - 0] - [16,688,643 - 0]$$

$$= \$68,356$$

Year 2

Liability

1 January Year 2:

The Rate for the liability is:

$$[(1 + 0.0521)^{(185+365)}] - 1$$

$$= 2.61\%$$

The tax value for the liability is:

$$[16,688,643 \times (1 + 0.0261)] - 6,000,000$$

$$= 11,124,217$$

30 June Year 2:

The Rate for the liability is:

$$[(1 + 0.0521)^{(180+365)}] - 1$$

$$= 2.54\%$$

The tax value of the liability is:

$$[11,124,217 \times (1 + 0.0254)] - 0$$

$$= 11,406,772$$

Asset

1 January Year 2:

The Rate for the asset is:

$$[(1 + 0.061)^{(185+365)}] - 1$$

$$= 3.05\%$$

The tax value for the asset is:

$$[16,756,999 \times (1 + 0.0305)] - 6,100,000$$

$$= 11,168,087$$

30 June Year 2:

The Rate for the asset is:

$$[(1 + 0.1649)^{(180+365)}] - 1$$

$$= 7.82\%$$

The tax value of the asset is:

$$[11,168,087 \times (1 + 0.0782)] - 0$$

$$= 12,041,431$$

Net Income for Year 2:

$$[6,100,000 - 6,000,000] + [12,041,431 - 16,756,999] - [11,406,772 - 16,688,643]$$

$$= \$666,303$$

Year 3

Liability

1 January Year 3:

The Rate for the liability is:

$$\begin{aligned} & [(1 + 0.0521)^{(185+365)}] - 1 \\ & = 2.61\% \end{aligned}$$

The tax value for the liability is:

$$\begin{aligned} & [11,406,772 \times (1 + 0.0261)] - 6,000,000 \\ & = 5,704,489 \end{aligned}$$

30 June Year 3:

The Rate for the liability is:

$$\begin{aligned} & [(1 + 0.0521)^{(180+365)}] - 1 \\ & = 2.54\% \end{aligned}$$

The tax value of the liability is:

$$\begin{aligned} & [5,704,489 \times (1 + 0.0254)] - 0 \\ & = 5,849,383 \end{aligned}$$

Asset

1 January Year 3:

The Rate for the asset is:

$$\begin{aligned} & [(1 + 0.1649)^{(185+365)}] - 1 \\ & = 8.04\% \end{aligned}$$

The tax value for the asset is:

$$\begin{aligned} & [12,041,431 \times (1 + 0.0804)] - 7,000,000 \\ & = 6,009,562 \end{aligned}$$

30 June Year 3:

The Rate for the asset is:

$$\begin{aligned} & [(1 - 0.0348)^{(180+365)}] - 1 \\ & = -1.73\% \end{aligned}$$

The tax value of the asset is:

$$[6,009,562 \times (1 - 0.0173)] - 0$$

$$= 5,905,597$$

Net Income for Year 3

$$[7,000,000 - 6,000,000] + [5,905,597 - 12,441,431] - [5,849,383 - 11,406,772]$$

$$= \$421,555$$

Year 4

Net income for Year 4:

$$[5,800,000 - 6,000,000] + [0 - 5,905,597] - [0 - 5,849,383]$$

$$= -\$256,214$$

Summary of yearly outcomes

Date	Receipts	Payments	Closing Assets	Opening Assets	Closing Liabilities	Opening Liabilities	Net income change	Yearly net income
1/1 Y1	16,275,252	16,275,252	16,275,252		16,275,252			
30/6 Y1			16,756,999	16,275,252	16,688,643	16,275,252	68,356	68,356
1/6 Y2	6,100,000	6,000,000	11,168,087	16,756,999	11,124,217	16,688,643	75,514	
30/6 Y2			12,041,431	11,168,087	11,406,772	11,124,217	590,789	666,303
1/1 Y3	7,000,000	6,000,000	6,009,562	12,041,431	5,704,489	11,406,772	670,414	
30/6 Y3			5,905,597	6,009,562	5,849,383	5,704,489	-248,859	421,555
1/1 Y4	5,800,000	6,000,000	0	5,905,597	0	5,849,383	-256,214	
30/6 Y4								-256,214

Financial liabilities with a tax value determined on an accruals basis

14.91 The rules dealing with working out the tax value of liabilities subject to accruals treatment (Subdivision 76-D) exactly mirror those applying to assets subject to accruals treatment.

14.92 Whereas assets with ‘certain gains’ are accrued, liabilities with ‘certain losses’ are accrued. A ‘certain loss’ is worked out on the same basis as a certain gain, except that a liability’s ‘certain payments’ must exceed the proceeds of incurring that liability (see discussion at paragraph 14.60 and following). *[Section 76-140]*

14.93 The concept of ‘certain payments’ is symmetrical to the concept of ‘certain receipts’ used for assets (see discussion at paragraphs 14.71 and following). Regulations will be relevant to determining which payments are certain for this purpose, in the same manner as they are

relevant to determining which receipts are certain. [*Sections 76-170, 76-180 and 76-190*]

14.94 The formula used to work out the tax value of a financial liability with a certain loss is essentially the same as that which applies to assets with a certain gain (see discussion at paragraphs 14.75 and following). [*Sections 76-120, 76-305, 76-310, 76-320, 76-330 and 76-340*]

14.95 The rules for estimating certain receipts that apply to assets, are also applicable for estimating certain payments (see discussion at paragraph 14.86 and following). These rules are relevant in calculating the tax value of a liability with a certain loss where the payments are not known but are determined by reference to the value, or change in value, of a variable. [*Sections 76-370 and 76-380*]

Chapter 15

Investment asset treatment (currently capital gains tax regime)

Outline of Chapter

15.1 This Chapter explains how the investment asset rules will operate under TVM. The proposed operation of the investment asset rules is compared to the current capital gains tax (CGT) regime. These rules are contained in Divisions 100 and 101 of the prototype legislation.

Context of Reform

15.2 Under the current law, capital gains do not form part of ordinary income. Accordingly, the income tax law requires special statutory income rules,¹⁹⁵ for assets acquired after 19 September 1985, to include capital gains in assessable income after any capital losses have been offset against them.

15.3 TVM will, however, as a matter of principle and structure automatically include such gains and losses in net income. This is because, under TVM, net income includes gains or losses on the realisation of assets.

15.4 Of course, gains and losses from pre-CGT assets¹⁹⁶ will be excluded from net income. This will be done using the same kind of mechanism proposed to be used under TVM to exclude gains or losses from private assets.¹⁹⁷

15.5 Under TVM, the capital gains tax regime is known as investment asset treatment. The language of ‘capital gains tax’ under the current law reflects that, without the special rules in that regime, many of the gains or losses to which the CGT regime applies would not be included in the income calculation of a taxpayer. In contrast, the term ‘investment asset treatment’ reflects that no special rules are necessary to include gains or losses in working out net income. Instead assets covered by this regime are simply another group of assets (like depreciating assets and trading stock) that will get specific treatment under the law. In the case of most investment assets, concessional and quarantining treatment applies.

¹⁹⁵ Parts 3-1 and 3-3 of the ITAA 1997.

¹⁹⁶ As defined in the current law, which covers CGT assets acquired before 20 September 1985.

¹⁹⁷ See Chapter 17.

15.6 The investment asset rules under TVM do not separately include investment asset gains and losses in net income.¹⁹⁸ Rather the investment asset rules identify investment asset gains and losses included in net income and provide for the following treatment:

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

15.7 In contrast, the purpose of the current capital gains tax rules is both to include any net capital gains in assessable income *and* to provide discount treatment and loss quarantining.

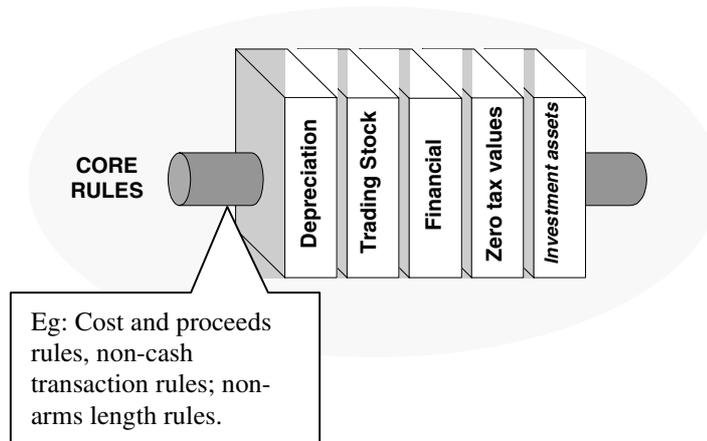
Use of common core rules

15.8 Currently the CGT regime contains a range of special rules that deal with, amongst other things, 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 regimes.

15.9 In contrast, the investment asset provisions apply to gains and losses that are already included in net income under the TVM core rules. TVM contains cost and proceeds rules that apply to all assets, regardless of the type of asset. 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 are also proposed under TVM.¹⁹⁹ Therefore separate provisions are not needed in the TVM investment asset rules to deal with such transactions. The following diagram illustrates this:

¹⁹⁸ The net income formula applies generally to all assets and liabilities, including investment assets, to include gains and losses from disposal.

¹⁹⁹ ATSR recommendation 6.17.

Diagram 15.1 Use of common core rules

Investment asset events

15.10 A capital gain (or loss) can only occur under the current law if a CGT event happens. There are 40 different CGT events.

15.11 Under TVM 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 TVM's core rules automatically bring to account gains or losses in net income from ceasing to hold an asset. Therefore under TVM many of the existing CGT events will not be needed (see Chapter 16) because their only function is to include amounts in taxable income. This job will be done by the net income formula under TVM.²⁰⁰

Investment asset

15.12 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. Similarly, the CGT regime requires special rules to prevent expenditure that can be deducted from forming part of the cost base of a CGT asset.

15.13 For example, if a taxpayer's ordinary income includes a profit from the sale of an asset bought with a profit making intention²⁰¹ then the taxpayer's capital gain will be reduced by the amount of that ordinary income.

15.14 An important design feature of TVM is that the assets getting investment asset treatment are more narrowly defined than is currently the

²⁰⁰ See Chapter 6.

²⁰¹ The asset is not trading stock.

case. This implements recommendation 4.10 of ATSR and ensures that no overlap between provisions occurs.

15.15 The current CGT regime requires special rules to prevent deductible expenditure from being included in the cost base of a CGT asset.

15.16 By contrast under the TVM's core rules expenditure will *either* directly reduce net income in the year that the taxpayer has the liability or alternatively it will increase the tax value of an asset. Accordingly, special rules to prevent expenditure *both* directly reducing net income in the year that the taxpayer has the liability and also increasing the tax value of an asset are not needed.

Summary of prototype legislation

15.17 The TVM 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.

15.18 The TVM investment asset rules identify the amount of investment asset gains or losses that are included in net income under the TVM core rules. This allows any investment asset discounting and loss quarantining to be applied to these investment asset gains and losses as a taxable income adjustment.

15.19 The effect of the current CGT rules dealing with roll-overs, exemptions and small business concessions will be retained under TVM for investment assets. 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?

15.20 Ceasing to hold an investment asset is the main circumstance in which the amount of an investment asset gain or loss is identified to enable investment asset treatment (concessional treatment or loss quarantining) to apply.²⁰² However, a limited number of other investment asset events that apply to investment assets in other situations will be needed under TVM to identify the investment asset gains or losses that do not arise from ceasing to hold the asset. [*Subsection 100-25(3)*]

15.21 The prototype legislation includes 2 further investment asset events.²⁰³

²⁰² Investment asset treatment is provided in the form of a taxable income adjustment.

²⁰³ 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

- capital return by company event;²⁰⁴ and
- trust capital distribution event.²⁰⁵

[Subdivision 100-D]

15.22 Chapter 16 examines the treatment of transactions under TVM to which the existing CGT events apply.

Working out the taxable income adjustments to apply investment asset treatment

15.23 Gains or losses included in net income from investment assets may be fully or partially offset by upward and downward adjustments to provide for investment asset treatment. Taxable income adjustments will.²⁰⁶

- apply the discount to discountable gains (paragraphs 15.82 to 15.86 explain how indexation frozen at 21 September 1999 will be applied); and
- quarantine carry forward investment asset losses.

15.24 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:

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. See Chapter 20 also.

²⁰⁴ This is the current CGT event G1.

²⁰⁵ This is the current CGT event E4.

²⁰⁶ There will also be rules to deal with small business concessions (see Chapter 22) also, roll-over relief and exemptions for investment asset gains or losses (such as the main residence exemption). These rules will not be part of Division 100 of the prototype legislation.

- if the investment asset losses for the income year exceed the investment asset gains for the year there is 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?

15.25 An investment asset will be defined as an asset whose tax value is worked out under item 6 of the table in subsection 10-40(1) of the prototype legislation. So, it will not include a listed zero tax value asset, trading stock, a depreciating asset,²⁰⁷ a market value asset or a financial asset. Investment assets include a narrower range of assets than the current CGT asset definition. Some transitional matters will also need to be dealt with by the definition. *[Section 78-10]*

Treatment of collectables

15.26 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 TVM, collectables will be dealt separately from the investment asset rules. The main effect of the rules on collectables will be to quarantine investment asset losses from certain collectables so that they can only be offset against investment asset gains from those collectables (see Chapter 18). *[Division 234]*

²⁰⁷ With the exception of some buildings and structures.

Comparison of key features of prototype legislation and current law

Comparison of core provisions

15.27 The following table sets out how some key concepts apply in the prototype legislation compared to the existing CGT provisions.

Table 15.1 Comparison of key features of the prototype legislation and the current law

<i>Prototype Legislation</i>	<i>Current law</i>
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 40 CGT events under the current law.
Investment Assets	
Investment assets are broadly all assets other than depreciating assets, trading stock, market value assets and financial assets.	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 are reflected 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

15.28 The following table compares the key terms used in the TVM investment asset rules with the corresponding terms in the existing CGT provisions.

Table 15.2 Comparison of key terms in the prototype legislation with those in the current law

<i>Prototype Legislation</i>	<i>Current Law</i>
Investment asset	CGT asset
Investment asset event	CGT event
Investment asset gain	Capital gain
Discountable gain	Discount capital gain
Investment asset loss	Capital loss

<i>Prototype Legislation</i>	<i>Current Law</i>
Carry forward investment asset loss	Net capital loss
[No equivalent needed]	Net capital gain

Comparison of Divisions in current law to treatment under TVM

15.29 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 TVM. Part 3-3 is not covered because it has not yet been fully examined.

Table 15.3 Comparison of provisions in the prototype legislation with those in the current law

<i>Prototype Legislation</i>	<i>Current Law</i>
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 78-10 by reference to the items in the asset tax value table (subsection 10-40(1)) (see paragraphs 15.37 to 15.43).	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).

<i>Prototype Legislation</i>	<i>Current Law</i>
Investment asset events	
Section 100-25 sets out the main investment asset event – ceasing to hold an asset. Subdivision 100-D sets out the other investment asset events. They are the non-dividend payment for shares event and the trust capital distribution event. As indicated at paragraph 15.47 up to 5 further events may be required.	Division 104 sets out 40 CGT events that result in capital gains or losses being recognised.
Discountable gains	
Subdivision 100-E provides for certain investment asset gains, referred to as 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 TVM core rules contain non-cash transaction rules (Division 11 of the prototype legislation) 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 10 of the ITAA 1997 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 TVM core rules deal with starting and ceasing to hold an asset (Division 10 of the prototype legislation).	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 TVM core rules (Division 10 of the prototype legislation) deal with the tax value of assets. Subsection 101-65(3) and section 101-10, item 3 of the prototype legislation creates a loss reduction amount to replicate the effect of the reduced cost base rules.	Subdivision 110-A provides the cost base rules and Subdivision 110-B provides the reduced cost base rules.

<i>Prototype Legislation</i>	<i>Current Law</i>
Modification to cost base and reduced cost base rules	
The TVM general rules will deal with changes to tax values.	Subdivision 112-A provides general modifications to cost base and reduced cost base rules.
The TVM 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 TVM 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	
Subsection 101-65(1) of the prototype legislation and item 1 of section 101-10 of the prototype legislation contain gain reduction rules that replicate frozen indexation that applies under the current law.	Division 114 provides for indexing the cost base of an asset.
Proceeds of realisation	
These rules will be dealt with by the TVM core rules (see cost and proceeds rules in Division 14 of the prototype legislation).	Division 116 sets out how to work out the capital proceeds from a CGT event.
Exemptions	
Similar rules to some of those in Division 118 of the ITAA 1997 will be needed. See chapter 18 for an explanation of collectables. General anti-overlap rules and specific overlap rules for plant, film copyright and trading stock will not be required.	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.

Detailed explanation of new law

What is investment asset treatment?

15.30 Investment asset treatment under TVM consists of:

- investment asset discounts (currently CGT discounts) on discountable investment asset gains;

- gain or loss reduction amounts for assets:
 - held prior to 11.45am legal time in ACT on 21 September 1999 to provide for indexation up to that time; and
 - to apply the reduced cost base for assets held prior to the commencement of the TVM; and
- quarantining of investment asset losses.

How is investment asset treatment provided under TVM?

15.31 Under TVM investment asset treatment is provided by taxable income adjustments that alter the impact that investment asset transactions would otherwise have on taxable income.

15.32 This is achieved by:

- downward adjustments to apply:
 - the investment asset discount;
 - the gain reduction amount to replicate frozen indexation; and
 - carry-forward investment asset losses; and
- upward adjustments to apply:
 - loss quarantining; and
 - the loss reduction amount to replicate the effect of the reduced cost base applying prior to the commencement of the TVM.

Relationship between TVM investment asset rules and the TVM net income formula

15.33 Under TVM net income is determined as:

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

15.34 This formula includes in net income all realised gains and losses for assets including investment assets. Therefore investment asset treatment does not separately *include* investment asset gains in net income. Rather investment asset treatment, unlike the current CGT regime only provides concessional and quarantining treatment.

When are gains and losses on investment assets recognised under TVM?

15.35 Generally, gains and losses are recognised at the time investment assets cease to be held.²⁰⁸ The investment asset provisions identify any gains and losses that arise from investment assets and apply investment asset treatment to those gains and losses. [*Subsection 100-45(1), section 100-85 and section 100-95*]

15.36 In the main, investment assets attract a tax value of cost and therefore any change in the market value of the asset will only be recognised when the asset ceases to be held. [*Subsection 10-40(1), item 6 in the table and subsection 78-20(1)*]

What is an investment asset?

15.37 The tax value table in the prototype legislation sets out the tax value of different categories of asset. Investment assets receive special treatment under the investment asset rules. Investment assets are, broadly, any assets that are not listed zero tax value assets, trading stock, depreciating assets, market value assets and financial assets.²⁰⁹ [*Section 78-10*]

15.38 Examples of assets that will get investment asset treatment are:

- goodwill;
- membership interests such as shares in a company or an interest in a trust estate;
- perpetual²¹⁰ options and rights (e.g. a perpetual easement upon land) and perpetual licences;
- land;
- buildings covered by the equivalent of Division 43 of the ITAA 1997;
- high-cost private-use collectables (see Chapter 18); and
- tangible assets that do not have a limited effective life such as gold coins or bullion.

²⁰⁸ For shares in a company (similar provisions for interest in a trust), subsection 78-100(1) of the Prototype legislation provides that any non-dividend part of an amount received from a company reduces the tax value of the interest held in the shares. Accordingly, if the amount of the non-dividend part exceeds the tax value of the shares then an amount will be included in net income even though the shares are still held (see paragraphs 7.146 to 7.149).

²⁰⁹ See discussion in Chapter 7.

²¹⁰ Options and rights with a limited effective life are depreciating assets.

15.39 Further consideration will be given to which long-term rights (such as a 99 year lease of land) will be treated as investment assets and get investment asset treatment.

Capital works that get investment asset treatment

15.40 Capital works such as (broadly) buildings, structural improvements and earthworks to which the current Division 43 of the ITAA 1997 applies are depreciating assets. However, they also receive investment asset treatment under Division 100 of the prototype legislation. *[Section 100-20]*

15.41 This will replicate the current outcome under the law under which capital works receive write-off under Division 43 and also capital gains tax treatment.

15.42 Certain buildings and structural improvements will not qualify for investment asset treatment. These include greenhouses and certain buildings and structural improvements for primary producers and mining and quarrying businesses to which the current uniform capital allowances regime applies. This mirrors how the current law applies.

15.43 The implications of the uniform capital allowances system for buildings and structures will be subject to further consultation: see Treasurer’s Press Release No. 74 dated 11 November 1999.

What investment assets do not receive investment asset treatment?

15.44 A number of investment assets do not receive investment asset treatment. The following table sets out the assets that are excluded in this way. *[Section 100-15]*

Table 15.4 Investment assets excluded from investment asset treatment

<i>Assets excluded from investment asset treatment</i>	<i>Reason for exclusion</i>
Purchased information that is not generally available.	<p>Purchased information that is not generally available is not property or a legal or equitable right. Accordingly, it is not a CGT asset under the current law. CGT event D1 applies to treat the receipt of capital proceeds from the sale of such information less related costs as a capital gain. However, no CGT discount applies.</p> <p>Accordingly, the exclusion of this asset from investment asset treatment, generally, replicates the current treatment under the tax law.²¹¹</p>

²¹¹ That is, that the net amount is included in taxable income without any discount applying.

Pre-CGT assets (broadly assets last held before 20 September 1985).	This replicates the current law and recognises that gains and losses arising from CGT assets acquired prior to 20 September 1985 are not generally taxed. ²¹²
Private assets held by an individual, or by a partnership (other than a limited partnership) if at any time when the asset was held, an individual was a member of the partnership (see Chapter 17).	This implements recommendation 4.13 of ATSR in which gains and losses generally from disposing of investment assets used privately, other than certain collectables are not brought to account.
Australian currency except a collectable.	This recognises that investment asset treatment should not apply to Australian currency other than to assets that are collectables such as very old bank notes.

When do the investment asset rules apply?

15.45 Investment asset events are the mechanism that triggers investment asset treatment.

15.46 The prototype legislation contains 3 investment asset events:

- ceasing to hold an investment asset;
- non-dividend payment for shares event; and
- trust capital distribution event.

15.47 It is expected that up to another 5 events may be required. Chapter 16 examines transactions to which the current CGT events apply and identifies how it is expected that TVM will apply to these.

Investment asset event – ceasing to hold an investment asset

15.48 Ceasing to hold an investment asset is the main investment asset event that will apply in the majority of cases. This event will occur at the time that a taxpayer ceases to hold an investment asset.

15.49 The amount of an investment asset gain or loss that arises from this event is worked out as follows:

Step 1

Work out the proceeds of realising the investment asset (broadly, the amounts received for ceasing to hold the asset). [Section 14-40]

²¹² The existing transitional rules that stop assets being pre-CGT assets would continue to apply.

Step 2

Subtract:

- the asset’s tax value immediately before it stops being held; and
- any amounts paid to cease holding the asset²¹³ that are not included in the tax value above.

15.50 Depending on the result of step 2, there may be an investment asset gain, an investment asset loss or no gain or loss.

Table 15.5 The effect of the result of step 2:

<i>Result</i>	<i>Impact</i>
Positive amount	Investment asset gain
Nil amount	Neither a gain or loss
Negative amount	Investment asset loss

Example 15.1 Working out an investment asset gain

Camille buys a block of land for \$100,000 in Year 1 intending to build an office on it. Instead she sells it for \$110,000 in Year 2 with no building having been constructed. The land is held for less than 12 months.

Under subsection 78-20(1), the asset has a tax value of cost (i.e. \$100,000).

When the land is sold in Year 2 the net income formula applies as follows:

$$\begin{aligned}
 & \left[\text{Receipts} - \text{Payments} \right] + \left[\begin{array}{c} \text{Closing} \\ \text{tax value} \\ \text{of assets} \end{array} - \begin{array}{c} \text{Opening} \\ \text{tax value} \\ \text{of assets} \end{array} \right] - \left[\begin{array}{c} \text{Closing} \\ \text{tax value} \\ \text{of liabilities} \end{array} - \begin{array}{c} \text{Opening} \\ \text{tax value} \\ \text{of liabilities} \end{array} \right] \\
 & = [110,000 - 0] + [0 - 100,000] - [0 - 0] \\
 & = 10,000.
 \end{aligned}$$

Accordingly, Camille’s taxable income includes the \$10,000.

Work out the investment asset gain or loss

²¹³ The method statement deducts amounts paid to cease to hold an asset that are not included in the tax value of an asset in order to broadly replicate the second element of cost of the cost base of a CGT asset under the current law (subsection 110-25(3) of the ITAA 1997). Under TVM these amounts reduce net income when the liability for them arises, but they need to be separately identified in the method statement to ensure that the amount of investment asset gain or losses are broadly equivalent to amounts worked out under the current law.

$$\begin{array}{r}
 \text{Proceeds of} \\
 \text{realising the asset} \quad - \quad \text{Asset's tax value} \quad - \quad \text{Incidental costs of} \\
 \text{ceasing to hold} \\
 \\
 110,000 - 100,000 - 0 \\
 \\
 = \$10,000
 \end{array}$$

The \$10,000 gain is an investment asset gain.

Example 15.2 The treatment of selling costs of an asset

On 23 June Year 1 Joseph contracts to sell a block of land to Mary for \$10,000 that he acquired after 19 September 1985. The land originally cost \$9,000. Settlement occurs in Year 2. Legal and professional costs of \$500 are paid on 23 June Year 1. Joseph has no other transactions in Year 1 or Year 2.

Incidental costs relating to ceasing to hold the asset do not form part of the land's first or second elements of cost because they are not costs for starting to hold the asset or that relate to its condition or location. Accordingly, the incidental costs reduce net income in the Year 2.

Year 1

$$\begin{array}{r}
 \left[\begin{array}{c} \text{Receipts} \\ \text{--} \\ \text{Payments} \end{array} \right] + \left[\begin{array}{c} \text{Closing} \\ \text{tax value} \\ \text{of assets} \end{array} \right] - \left[\begin{array}{c} \text{Opening} \\ \text{tax value} \\ \text{of assets} \end{array} \right] - \left[\begin{array}{c} \text{Closing} \\ \text{tax value} \\ \text{of liabilities} \end{array} \right] - \left[\begin{array}{c} \text{Opening} \\ \text{tax value} \\ \text{of liabilities} \end{array} \right] \\
 \\
 [0 - 500] - [9,000 - 9,000] - [0 - 0] \\
 \\
 = -\$500
 \end{array}$$

Joseph has a loss of \$500 in the Year 1.

Year 2

$$\begin{array}{r}
 [10,000 - 0] - [0 - 9,000] - [0 - 0] \\
 \\
 = \$1,000
 \end{array}$$

Work out the investment asset gain or loss

$$\begin{array}{r}
 \text{Proceeds of} \\
 \text{realising the asset} \quad - \quad \text{Asset's tax value} \quad - \quad \text{Incidental costs of} \\
 \text{ceasing to hold} \\
 \\
 10,000 - 9,000 - 500 \\
 \\
 = \$500
 \end{array}$$

The \$500 gain is an investment asset gain.

The gain of \$500 qualifies for an investment asset discount of $\$500 \times 50\% = \250 .

Taxable income = net income +/- taxable income adjustments – unused tax losses

= $\$500 - \$250 - 0$

= \$250

Investment asset event – non-dividend payment for shares event

15.51 The non-dividend payment for shares event²¹⁴ is triggered if:

- a taxpayer receives certain payments (referred to as non-dividend parts) (see paragraph 7.147) from a company;
- the payments are not for ceasing to hold the shares²¹⁵; and
- the payments are more than the share's tax value immediately before the payment.

[section 100-85]

15.52 The event applies at the time the non-dividend part is received.

15.53 The investment asset gain is equal to the difference between the payment and the share's tax value immediately before the payment. An investment asset loss cannot be made from the transaction. ***[Subsection 100-85(2)]***

15.54 Chapter 7 explains how the tax value of a share in a company is worked out, including working out non-dividend parts of company distributions (see paragraphs 7.146 to 7.148).

Investment asset event – trust capital distribution event

15.55 It is proposed that the trust capital distribution event will apply in a similar way to the non-dividend payment for shares event. ***[Section 100-95]***

Applying investment asset concessions and quarantining

15.56 Where investment asset gains or losses arise under the investment asset events:

- firstly, each gain or loss is reduced by adjustments for exemptions, roll-overs and gain and loss reduction amounts that apply to the gains or losses ***[section 100-65]***;

²¹⁴ This is equivalent to the current CGT event G1.

²¹⁵ The main investment asset event will apply in such cases.

- then, if the total of the remaining investment asset gains exceed investment asset losses then any investment asset discounts are applied [*subsection 100-75(2)*];
- finally, if the total of investment asset losses exceed the total of investment asset gains then quarantining of the losses occurs [*subsection 100-75(3)*].

Applying exemptions, roll-overs and gain and loss reduction amounts to investment asset gains and losses

15.57 Exemptions, roll-overs and gain and loss reduction amounts are all specific to particular investment asset gains and losses. Accordingly, the amount of an investment asset gain is reduced by any exemptions, roll-overs and gain reduction amounts that apply to it. Gains cannot be reduced below zero. [*Subsection 100-65(1)*]

15.58 Similarly, any investment asset losses are reduced by any exemptions, roll-overs and loss reduction amounts that apply. These amounts apply only to the extent of the loss, so the loss can be reduced to zero but cannot become a gain. [*Subsection 100-65(2)*]

Working out the investment asset discount and investment asset loss quarantining that applies to investment asset gains

15.59 There are 3 steps that apply in working out the investment asset discount and the amount of investment asset loss quarantining.

1: Comparing investment asset gains with investment asset losses

15.60 Firstly, investment asset gains that remain after applying adjustments such as exemptions etc. are reduced by the investment asset losses. The gains can be reduced in any order.

2: Gains exceed current year losses

a. offset gains against current year losses

15.61 Secondly, if the investment asset gains exceed current year investment asset losses then the losses can be offset against the gains in any order. Accordingly, if some gains qualify for the investment asset discount and others do not, then the losses can first be offset against the gains that do not qualify for the discount, thereby maximising the amount of discountable gains remaining. [*Subsection 100-75(2), step 1 of the method statement*]

b. offset gains against unapplied carried forward losses

15.62 Next, remaining investment asset gains are offset in any order against unapplied carried forward investment asset losses. Similarly, if

some remaining gains qualify for the investment asset discount and others do not, then the carried forward losses can first be offset against the gains that do not qualify for the discount.

15.63 A **downward adjustment** applies to the extent that unapplied carried forward investment asset losses are offset. This reflects that, unlike where current year investment asset losses are offset against investment asset gains, the carried forward losses have not been included in the net income formula for the year because they relate to transactions that occurred in prior years. The taxable income adjustment ensures that taxable income is reduced to reflect the application of the prior year losses. This adjustment effectively reverses the earlier adjustment that occurred when the investment asset losses were quarantined in a prior year. *[Subsection 100-75(2), step 2 of the method statement]*

c. applying the investment asset discount

15.64 The investment asset discount is then applied for each remaining investment asset gain that qualifies for the discount (discountable gains (see paragraphs 15.69 to 15.81)).

15.65 The discount is worked out by multiplying the discount percentage by each remaining gain. The discount percentage is:

- 50% for gains of individuals and trusts (other than complying superannuation funds); and
- 33¹/₃% for gains of complying superannuation entities and life insurance companies from an investment asset that is a virtual PST asset.

[Subsection 100-75(2), step 3 of the method statement; section 100-80]

3. Losses exceed current year gains

15.66 Thirdly, if the current year investment asset losses exceed the current year investment asset gains there is a **carry forward investment asset loss** for the income year. There is an **upward adjustment** equal to the amount of that loss. *[Subsection 100-75(3)]*

Example 15.3 Applying investment asset losses

Max has investment asset gains of \$1,000 in Year 1 and investment asset losses of \$2,500 for the same year. Accordingly, Max has a net investment asset loss of \$1,500 for Year 1 and an upward taxable income adjustment of \$1,500 which quarantines the loss.

$$\begin{aligned}\text{taxable income} &= \text{net income} +/\text{- taxable income adjustment} - \text{losses} \\ &= -\$1,500 + \$1,500 - 0 \\ &= 0\end{aligned}$$

Year 2

In Year 2 Max has investment asset gains of \$500 and no investment asset losses. Accordingly, \$500 of the carried forward investment asset loss is applied. The loss is applied via a downward taxable income adjustment with the remaining \$1,000 continuing to carry forward to later income years. The downward adjustment partially reverses the effect in Year 1 of quarantining the investment asset loss.

$$\begin{aligned}\text{taxable income} &= \text{net income} +/\text{- taxable income adjustment} - \text{losses} \\ &= \$500 - \$500 - 0 \\ &= 0\end{aligned}$$

Example 15.4 Applying exemptions and prior year losses

George owns shares in a pooled development fund that he bought for \$10,000 in Year 2. He decides to sell them in Year 3 for \$15,000. An exemption applies to the disposal. He also sells shares in a company for \$6,000 in Year 3 that he bought for \$5,000 in Year 2. George also has unused prior year investment asset losses of \$500.

The investment asset provisions apply as follows:

1. Work out the investment asset gain or loss

Gain on the sale of shares in pooled development fund = \$5,000
(\$15,000 – \$10,000). Gain on sale of shares in company = \$1,000
(\$6,000 – \$5,000)

2. Apply specific adjustments to gains and losses

A downward adjustment of \$5,000 (for the exemption) to the PDF gain on the sale of the shares reduces the gain to nil.

Investment asset gain of \$1,000 remains.

3. Apply current year investment asset losses against gains

There were no investment asset losses made in the year. Therefore investment asset gains of \$1,000 remain.

4. Gains exceed losses – offset carry forward investment asset losses

Investment asset gains – carry forward investment asset losses

$$\$1,000 - \$500 = \$500$$

5. Work out investment asset discount

$$50\% \times \$500 = \$250$$

The net income formula for Year 3 is as follows:

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

$$= [21,000 - 0] + [0 - 15,000] - [0 - 0]$$

$$= \$6,000$$

Taxable income = net income +/- taxable income adjustments – unused tax losses

$$= \$6,000 + [-\$5,000^{216} - \$250^{217} - \$500^{218}] - 0$$

$$= \$250$$

Taxing point of gains and losses under TVM

15.67 Implicit in the operation of the existing CGT regime is that a capital gain or loss generally²¹⁹ only arises in one year of income even though there may be receipts in more than one income year relating to the one CGT asset.

15.68 Similarly, under TVM a gain will generally²²⁰ only be recognised in one year when the asset ceases to be held. This is because if you cease to hold an asset any instalments of the purchase price received in a year before the asset stops being held will be matched by a liability to provide the asset or a decline in the tax value of a right to receive amounts that include the instalment.

Example 15.5 Taxing points

Eloise enters into a contract to sell a surplus block of vacant land at the end of Year 1 for \$100,000. She bought the land for \$50,000 earlier in Year 1 as part of her manufacturing business. She receives the purchase price in 2 equal instalments:

- the first is received upon signing the contract of sale; and
- the second is received at the start of Year 2, upon settlement.

The land has been held for less than 1 year.

At the time of entering into the contract, a non-cash transaction will occur under which Eloise gets a right to money (a financial asset) and gives a non-cash benefit (liability to transfer title in the land). Under

²¹⁶ Taxable income adjustment to exempt the sale of the PDF gain.

²¹⁷ Taxable income adjustment to apply the investment asset discount.

²¹⁸ Taxable income adjustment to apply the unused carry forward investment asset losses.

²¹⁹ An exception to this rule is CGT event G1, for example in which a number of capital gains may arise in one or more income years if capital payments by the company exceed the cost base of the shares. Event E4 applies to trust interests in a similar way.

²²⁰ Like the current law a number of investment asset gains could arise in one or more years under the non-dividend payment by a company event or the trust capital distribution event.

section 16-15, Eloise is taken to receive the amount she has a right to receive (\$50,000) for the land, and to pay the same amount for that right. For practical purposes the deemed receipt and payment of \$50,000 can be ignored. In addition, Eloise also receives \$50,000 in cash.

Year 1

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

$$[100,000^{221} - 100,000^{222}] + [100,000^{223} - 0^{224}] - [100,000^{225} - 0]$$

$$= \$0$$

Year 2

$$[50,000^{226} - 0] + [0^{227} - 10,000] - [0^{228} - 100,000]$$

$$= \$50,000$$

Investment asset discount

15.69 The investment asset discount will apply in the same way as the CGT discount applies under the current law.

Qualifying conditions

15.70 A taxpayer will be able to choose to apply the investment asset discount to investment asset gains if the taxpayer:

- is in a class of entities that qualify; and
- has held the asset for the required minimum period.

15.71 However, an investment asset gain from an investment asset will not qualify as a discountable gain if frozen indexation is applied (i.e., a downward adjustment is applied for a gain reduction amount (see paragraphs 15.82 to 15.86). [*Subsection 101-65(2)*]

²²¹ Equals actual receipt (\$50,000) and deemed receipt of \$50,000 under short-term credit rule: section 16-15.

²²² Equals Eloise's deemed payment (\$50,000) under short-term credit rule in section 16-15 and the purchase price of the land (\$50,000).

²²³ Equals the tax value of financial asset (\$50,000) and tax value of land (\$50,000).

²²⁴ Note that the land was not held at the end of Year 1.

²²⁵ Proceeds of incurring the liability (\$100,000) to transfer the land under the sale contract.

²²⁶ Receipt of remaining \$50,000 in cash.

²²⁷ Neither the land, nor right to payment are held at the end of Year 3.

²²⁸ Eloise's liability to transfer the land is discharged during Year 3.

Entities that are entitled to the investment asset discount

15.72 The following entities qualify for the investment asset discount:

- individuals;
- complying superannuation entities;
- trusts;
- life insurance companies but only for discountable gains arising from investment assets that are virtual PST assets. [Section 100-160]

The 12 month holding requirement

15.73 To qualify for the investment asset discount, an investment asset must have been held by the taxpayer for at least 12 months at the time of the investment asset event happening. [Section 100-185(1)]

15.74 If a taxpayer makes an investment asset gain from an investment asset event happening to an asset held by the taxpayer for more than 12 months before the investment asset event, under an agreement entered into within that 12 month period, the investment asset gain does not qualify for the discount. [Section 100-185(2)]

15.75 This rule will prevent taxpayers inappropriately taking advantage of the investment asset discount by seeking to artificially extend the period of ownership of the asset that produces the investment asset gain.

Qualifying conditions for entities with newly acquired assets

15.76 The investment asset discount will not apply to investment asset gains arising from investment asset events happening to equity interests in a company or trust if more than half of the assets of the underlying company or trust were acquired within the 12 month period before the sale of the equity interests in the company or trust. The sum of the tax values of assets acquired by the company or trust within 12 months of the investment asset event happening to the equity interest are compared to the total of the tax values of the assets of the company or trust at the time of the investment asset event. [Section 100-205]

15.77 However, the investment asset discount *will* apply to investment asset gains from investment asset events happening to:

- shares in a company with at least 300 members; or
- interests in a *fixed trust* with at least 300 beneficiaries;

unless the concentrated ownership rules apply (refer to paragraphs 15.78 and 15.79). [Section 100-210]

15.78 A company or trust satisfies the concentrated ownership rules if less than 21 individuals own, directly or indirectly:

- shares with fixed entitlements to at least 75% of the income or capital, or at least 75% of the voting rights in the company; or
- interests in the trust with fixed entitlements to at least 75% of the income or capital, or at least 75% of the voting rights in the trust (if any).

[Subsections 100-210(3) and (4)]

15.79 For the purposes of these tests, one individual together with associates, and any nominees of the individual or their associates will be counted as one individual. *[Subsection 100-210(5)]*

15.80 In addition, the investment asset discount may not be available for investment asset gains where there is any *potential* for rights attaching to the shares or interests in the trust to be varied or abrogated. It does not matter whether or not the rights attaching to any of the shares or interests are actually varied or abrogated. *[Subsections 100-210(6) and (7)]*

Discountable gain from trust capital distribution event

15.81 It is proposed that there will be a rule that ensures that investment asset gains from the trust return of capital event can potentially qualify as a discountable gain.

Gain and loss reduction amounts (currently indexation/reduced cost base)

Gain reduction amounts

15.82 The gain reduction amount is a transitional mechanism under TVM that effectively applies frozen indexation available under the current law. It may also be used in the future as a mechanism to reduce gains where that is required.

15.83 In order to continue to allow taxpayers to effectively apply indexation to assets held on or before 11.45am on 21 September 1999, a taxpayer may choose to apply a gain reduction amount. This is an alternative to applying an investment asset discount (see paragraphs 15.69 to 15.81).

15.84 The gain reduction amount arises for investment assets held on or before 11.45am on 21 September 1999. The gain reduction amount is equal to the indexation component of an investment asset's cost base *[Subsection 101-65(1)]*. The gain reduction amount exists for as long as you hold the asset *[section 101-60]*.

15.85 The gain reduction amount gives rise to a downward taxable income adjustment when an investment asset event happens to the investment asset to which it relates if:

- an investment asset gain has been made; and
- the taxpayer chooses to apply the adjustment.

[Subsection 101-65(2)]

15.86 The amount of the taxable income adjustment is equal to the lesser of the investment asset gain and the gain reduction amount for the investment asset *[section 101-10, item 1 in the table]*. Because the adjustment cannot exceed the investment asset gain, this ensures that, like the current law, the application of the indexation component cannot result in a loss.

Example 15.6 Gain reduction amounts

Tom acquired shares in ABC Co Ltd in December 1997 for \$10,000 (Year 1). He sells that interest in Year 10 for \$10,500. He elects to apply a gain reduction amount.

The indexed cost base of the shares at the end of the September quarter of 1999 is:

$$\begin{aligned} &\text{cost} \times \frac{\text{Quarterly CPI September 99}}{\text{Quarterly CPI December 97}} \\ &= 10,000 \times \frac{123.4}{120} \\ &= 10,280 \end{aligned}$$

Accordingly, the gain reduction amount is \$280 (the indexation component of the cost base). Tom has a downward adjustment equal to the lesser of the gain reduction amount and the investment asset gain of \$500, i.e. \$280.

Tom’s taxable income in Year 10 is as follows:

Net income

$$\begin{aligned} &\left[\text{Receipts} - \text{Payments} \right] + \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of assets} & \text{of assets} \end{array} \right] - \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of liabilities} & \text{of liabilities} \end{array} \right] \\ &= [10,500 - 0] + [0 - 10,000] - [0 - 0] \\ &= \$500 \end{aligned}$$

Work out the investment asset gain or loss

Proceeds of realising the asset — Asset's tax value — Incidental costs of ceasing to hold

10,500 – 10,000 – 0

= \$500

The \$500 gain is an investment asset gain.

Taxable income

= net income +/- taxable income adjustments – unused tax losses

= \$500 – \$280 – 0

= \$220

Loss reduction amount

15.87 The loss reduction amount replicates the effect of the reduced cost base in the existing CGT provisions.

15.88 A taxpayer's loss reduction amount for an asset will be set at the start of the first income year that TVM would apply. The loss reduction amount arises for investment assets held immediately before the start of that first income year equal to the excess of the cost base of the asset without indexation over the reduced cost base of the asset [*subsection 100-65(3)*]. This will replicate the effect of the reduced cost base up until immediately before the income year in which the TVM would commence. The loss reduction amount exists for so long as you hold the asset [*section 101-60*].

15.89 The loss reduction amount gives rise to an upward taxable income adjustment if:

- there is an investment asset loss; and
- that loss is for an asset with a loss reduction amount.

[*Section 101-10, item 3 in the table*]

15.90 The amount of the taxable income adjustment is equal to the lesser of the investment asset loss or the loss reduction amount for the investment asset.

15.91 The only element of reduced cost base that will need to be replicated after the commencement of TVM is the exclusion of holding and other costs that relate to land that are of a private or domestic nature. This is currently the third element of the cost base (subsection 110-25(4) of the ITAA 1997).

TVM benefits – reduced cost base

15.92 The existing reduced cost base rules ensure that expenditure is not included in the reduced cost base if it is deductible or has been deducted. Such a rule is not necessary under TVM because if expenditure forms part of the tax value then it is only recognised when an investment asset event occurs. Similarly, the existing reduced cost base rules include in the reduced cost base an amount included in assessable income under a balancing adjustment. This rule is not necessary under TVM because gains and losses for assets are worked out under the net income formula and no overlap arises between different regimes.

Example 15.7 Loss reduction amounts – reduced cost base

Rose acquired a block of land to keep her horse on in Year 1 for \$50,000. She sells that land in Year 2 for \$48,000. The first year of income in which TVM applies is Year 2. Rose pays rates of \$500 in Year 1.

Accordingly, her cost base for the asset immediately before the start of TVM is \$50,000 plus the amounts of rates paid is \$50,000 + \$500 = \$50,500. Her reduced cost base at the same time (which excludes the rates) is \$50,000.

At the start of TVM in Year 2, the land has a tax value of \$50,500 (i.e. its cost base immediately before TVM commenced).

Rose has a taxable income in Year 2 as follows:

Net income

$$\begin{aligned}
 & \left[\text{Receipts} - \text{Payments} \right] + \left[\begin{array}{l} \text{Closing} \\ \text{tax value} \\ \text{of assets} \end{array} - \begin{array}{l} \text{Opening} \\ \text{tax value} \\ \text{of assets} \end{array} \right] - \left[\begin{array}{l} \text{Closing} \\ \text{tax value} \\ \text{of liabilities} \end{array} - \begin{array}{l} \text{Opening} \\ \text{tax value} \\ \text{of liabilities} \end{array} \right] \\
 & = [48,000 - 0] + [0 - 50,500^{229}] - [0 - 0] \\
 & = -\$2,500
 \end{aligned}$$

Work out the investment asset gain or loss

$$\begin{aligned}
 & \begin{array}{l} \text{Proceeds of} \\ \text{realising the asset} \end{array} - \begin{array}{l} \text{Asset's tax value} \end{array} - \begin{array}{l} \text{Incidental costs of} \\ \text{ceasing to hold} \end{array} \\
 & = \$48,000 - \$50,500 - 0 \\
 & = -\$2,500
 \end{aligned}$$

²²⁹ Investment assets held by a taxpayer immediately prior to the commencement of TVM have an opening tax value equal to the cost base of the investment asset at that time without indexation.

Her loss reduction amount is \$500 (ie. the unindexed cost base less the reduced cost base). Rose has an upward adjustment equal to the lesser of the loss reduction amount of \$500 and the investment asset loss of \$2,500, i.e. \$500.

Her investment asset loss is reduced by the amount upward adjustments that apply to the loss ie., the \$500 upward adjustment for the loss reduction amount.

The remaining investment asset loss is \$2,000 ($-\$2,500 + \500). She has an upward adjustment of \$2,000 to quarantine the investment asset loss.

Rose has a carry forward investment asset loss of \$2,000.

Taxable income

$$\begin{aligned} &= \text{net income +/- taxable income adjustments} - \text{unused tax losses} \\ &= -\$2,500 + \$2500 - 0 \\ &= \$0 \end{aligned}$$

Loss reduction amounts for land

15.93 Under TVM, land cannot be a private asset. However, any amounts paid that are reasonably attributable to land that are of private or domestic nature would be excluded from the calculation of taxable income, but for subsection 14-30(4) of the prototype legislation. This section includes these amounts in the tax value of the land (second element) in a similar way in which the third element of the CGT cost base currently applies (see subsection 110-25(4) of the ITAA 1997).

15.94 Such amounts will also give rise to a loss reduction amount. The purpose of the loss reduction amount is to ensure that where an investment asset loss arises from the disposal of the land that, like the current law,²³⁰ certain private outgoings are not taken into account in working out that loss. Such private outgoings include interest, insurance, rates and taxes. *[Subsection 14-30(5)]*

Example 15.8 Loss reduction amounts – land

Colin acquired a block of land in Year 1 for \$200,000 to build a beach house to use on the weekends. He pays rates and interest totalling \$10,000 in Year 1. He changes his mind and sells the land for \$170,000 at the start of Year 2.

The tax value of the land is equal to the cost of the land (first element of cost subsection 14-25(1) of the prototype legislation) and payments that are private and domestic in nature that relate to the land (second element of cost subsection 14-30(4) of the prototype legislation).

²³⁰ Subsection 110-55(2) of the ITAA 1997.

$$= \$200,000 + \$10,000 = \$210,000$$

Colin has a loss reduction amount of \$10,000 equal to the amount of interest and rates paid (under subsection 14-30(5) of the prototype legislation).

Colin's taxable income in Year 2 is as follows:

Net income

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

$$= [170,000 - 0] + [0 - 210,000] - [0 - 0]$$

$$= -\$40,000$$

Work out the investment asset gain or loss

$$\begin{array}{ccc} \text{Proceeds of} & & \text{Incidental costs of} \\ \text{realising the asset} & - & \text{ceasing to hold} \\ & & \text{Asset's tax value} \end{array}$$

$$= \$170,000 - \$210,000 - 0$$

$$= -\$40,000$$

As Colin has made an investment asset loss, he has an upward adjustment equal to the lesser of the loss reduction amount of \$10,000 and the investment asset loss of \$40,000 ie. \$10,000.

This investment asset loss is reduced by the amount of upward adjustments that apply to the loss ie., the \$10,000 upward adjustment for the loss reduction amount.

The remaining investment asset loss = $-\$40,000 + \$10,000 = -\$30,000$. He has an upward adjustment of \$30,000 to quarantine the investment asset loss.

Colin has a carry forward investment asset loss of \$30,000.

Taxable income

$$= \text{net income} \pm \text{taxable income adjustments} - \text{unused tax losses}$$

$$= -\$40,000 + \$40,000 - 0$$

$$= \$0$$

Chapter 16

TVM treatment of current CGT events

Outline of Chapter

- 16.1 This Chapter examines:
- how transactions covered by some of the more commonly applied CGT events will be treated under TVM; and
 - outlines how the remaining CGT events are proposed to be dealt with under TVM.

Context of Reform

16.2 Under the current law capital gains do not form part of ordinary income, and so the law contains special statutory income rules to include certain capital gains in taxable income and allow certain capital losses to be offset against such capital gains.

16.3 The current CGT regime achieves this outcome through the use of CGT events. These events apply to work out the amount of a capital gain or capital loss and determine the time at which the gain or loss arises.

16.4 CGT events are needed to apply to a range of different transactions involving CGT assets. Additional CGT events are also needed because the CGT regime applies not only in circumstances in which a disposal of a CGT asset occurs, but also in some cases where capital proceeds are received that do not relate to the disposal of a CGT asset.

16.5 There are currently 40 separate CGT events. This reflects the lack of a core structure that applies to assets and liabilities in the current tax system.

16.6 In contrast to the current CGT provisions, the investment asset provisions in the TVM *do not* trigger taxing points. The investment asset provisions only provide for investment asset discounts and loss quarantining. The core rules of the TVM automatically trigger a taxing point in situations in which assets cease to be held. Further, the core rules, together with other TVM provisions (e.g. section 78-100 of the prototype legislation for the tax value of shares), apply to other situations in which capital proceeds are received (see Chapter 15).

Summary of prototype legislation

16.7 The core rules of the TVM will generally apply to transactions for which CGT events are currently required. The gain or loss from such transactions will be brought to account without the need for an equivalent mechanism.

16.8 Investment asset events are only needed to apply investment asset treatment to those gains or losses. There are three investment asset events in TVM under which the amount of an investment asset gain or loss is identified. Ceasing to hold an asset will be the main case. The other 2 investment asset events are the non-dividend payment for shares event and the trust capital distribution event (the equivalents of CGT events G1 and E4 in the ITAA 1997) – see paragraphs 15.51 to 15.55.

16.9 The application of some of the more commonly applied CGT events has been considered in detail. The events considered are CGT events A1, B1, C1, C2, C3, D1, D2, E4, G1, H1, H2 and K5.

16.10 Analysis of the remaining CGT events indicates that another 5 investment asset events may be required. These would be equivalent to CGT events E3, J1, K2, K4 and K7 (refer to table 16.2 for further details).

Comparison of key features of prototype legislation and current law

16.11 The following table compares the treatment of selected CGT events under the current law with the way in which the transactions will be treated under TVM.

Table 16.1 Comparison of key features of the prototype legislation and the current law

<i>Current law</i>	<i>Prototype legislation</i>
CGT event A1 – disposal of a CGT asset	
CGT event A1 happens if you dispose of a CGT asset.	TVM's core rules will bring to account gains or losses covered by CGT event A1. TVM's core rules recognise these gains or losses when assets cease to be held (usually when legal ownership changes).

<i>Current law</i>	<i>Prototype legislation</i>
CGT event B1 – use and enjoyment before title passes	
CGT Event B1 happens if an entity enters into an agreement with another entity under which use and enjoyment of the asset passes between entities where title will or may pass between the entities when the agreement ends.	TVM's core rules will bring to account gains or losses covered by CGT event B1. Under the operation of the hold rules, (item 1 in the table in section 24-10 of the prototype legislation) you cease to hold an asset when an immediate right to possess and use the property exists and title will or may pass at the end of the arrangement.
CGT event C1 – loss or destruction of a CGT asset	
CGT event C1 happens when a CGT asset is lost or destroyed.	TVM's core rules will bring to account gains or losses covered by CGT event C1. The asset ceases to be held when the loss or destruction of the asset occurs. Any loss will be recognised at this time. However, any right to receive compensation will offset the loss.
CGT event C2 – cancellation, surrender and similar endings	
CGT event C2 happens if your ownership of an intangible CGT asset ends by the asset being redeemed, cancelled, released, discharged, satisfied, expired, abandoned, surrendered, forfeited or other similar ending.	The TVM core rules will bring to account gains or losses covered by CGT event C2. Under TVM an asset (such as the right to exercise an option) matches the payment made to acquire the asset. A gain or loss is brought to account when the option ceases to be held.
CGT event C3 – end of option to acquire shares etc	
CGT event C3 happens if an option a company or a trustee of a unit trust granted to an entity to acquire shares, units or debentures in the company or unit trust ends because it is not exercised, is cancelled, released or abandoned.	The TVM core rules bring to account gains or losses covered by CGT event C3. Under TVM, the company's receipt of the money for the option is offset by a liability to allow the exercise of the option (valued as the proceeds of incurring the liability). If the option is not exercised or expires, the liability is extinguished and the company or trust is assessed on the gain. Any expenditure incurred in bringing the option into existence is expensed in the year incurred.

<i>Current law</i>	<i>Prototype legislation</i>
CGT event D1 – creating contractual or other rights	
CGT event D1 happens if you create a contractual right or other legal or equitable right in another entity.	The TVM core rules bring to account gains or losses covered by CGT event D1. Under TVM, the receipt of the money for the creation of the contractual right or other legal or equitable right is offset by the liability created (valued as the proceeds of incurring the liability). As the tax value of the liability declines, the gain is brought to account.
CGT event D2 – granting an option	
CGT event D2 happens if you grant an entity an option. The event happens when the option is granted.	The TVM core rules bring to account gains or losses covered by CGT event D2. Under TVM, the receipt of the money for the option is offset by a liability to allow the exercise of the option (valued as the proceeds of incurring the liability). If the option is not exercised or expires, the liability is extinguished and the gain assessed. Any expenditure made to bring the option into existence is expensed in the year paid.
CGT Event E4 – Capital payment for trust interest	
CGT Event E4 happens when a trustee makes a capital payment for a trust interest.	Section 100-95 sets out the trust capital distribution event. The timing and amount of the gain is the same as under the current law (see paragraph 15.55).
CGT Event G1 – Capital payment for shares	
CGT Event G1 happens when a company pays a non-assessable amount.	Section 100-85 sets out the non-dividend payment for shares event. The timing and amount of the gain is the same as under the current law (see paragraph 15.51 to 15.55).
CGT event H1 – forfeiture of a deposit	
CGT event H1 happens when a deposit paid to you is forfeited because a prospective sale or other transaction does not proceed.	The TVM core rules bring to account gains or losses covered by CGT event H1. The gain or loss is brought to account when the forfeiture occurs, and the liability incurred upon receiving the deposit falls away.
CGT event H2 – receipt for event relating to a CGT asset	
CGT event H2 happens if an act, transaction or event occurs in relation to a CGT asset that you own and no adjustment is made to the asset's cost base or reduced cost base.	The TVM core rules bring to account gains or losses covered by CGT event H2. The gain or loss is brought to account when the act, transaction or event occurs because the receipt is recognised by the net income formula.

<i>Current law</i>	<i>Prototype legislation</i>
CGT event K5 – special capital loss from collectable that has fallen in market value	
CGT event K5 happens when CGT event A1, C2 or E8 happens to a share in a company, or an interest in a trust that owns a collectable.	Section 234-70 replaces CGT event K5 (see paragraph 18.48).

Detailed explanation of prototype legislation

16.12 The current CGT regime provides that if a CGT event happens to a CGT asset then a capital gain or loss is realised in one income year only. Broadly, under TVM this outcome also applies.

16.13 An exception to the single taxing point approach under TVM is proposed where an investment asset gain or loss is expected and is brought to account under the TVM net income formula but because of events in a later income year the transaction does not proceed and is terminated. In these circumstances it is not anticipated that any gain or loss realised in a prior year would be adjusted. Instead TVM could ‘unwind’ the transaction in the year that it becomes known that the transaction will not proceed.²³¹

16.14 The following section examines how transactions covered by some of the most commonly applied CGT events will be treated under TVM.

CGT Event A1

16.15 The TVM core rules will bring to account gains or losses covered by CGT event A1.²³² The ceasing to hold an investment asset event will apply to isolate the gains or losses and give them investment asset treatment (see paragraph 15.48 of Chapter 15).

Example 16.1 How TVM applies to a sale of a property where the contract is entered into and settlement occurs in the same financial year

Bec purchases a unit for \$200,000 in Year 1. She enters into a contract for the sale of the unit in Year 2 for \$210,000. Settlement occurs in Year 2. The asset had been held for less than 12 months when settlement occurs.

At settlement, Bec ceases to hold the asset. Item 1 in the table in section 10-20 of the prototype legislation provides that where an asset is any kind of property, the asset is held by the owner of the asset.

²³¹ See paragraph 16.44.

²³² Section 104-10 of the ITAA 1997.

Where there is both a legal and an equitable owner, the holder of the asset is the legal owner. Therefore, Bec is the holder of the unit until settlement in Year 2.

Year 1

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

$$[0 - 200,000] + [200,000 - 0] - [0 - 0] = 0$$

The net effect on taxable income in Year 1 is nil.

Year 2

In Year 2 there is a receipt of \$210,000 and the closing tax value assets is \$0 (because the unit is no longer held).

$$[210,000 - 0] + [0 - \$200,000] - [0 - 0]$$

$$= \$10,000.$$

A gain of \$10,000 is included in net income in Year 2. Because the investment asset discount cannot apply in this case, Bec has no carry forward investment asset losses and no other investment asset events have happened during the year, there is no need to work out the investment asset gain or loss from the transaction.

Example 16.2 How TVM applies to a sale of an investment asset where settlement deferred to year following payment of deposit

Katie purchases a unit for \$200,000 in Year 1. She enters into a contract for the sale of the unit later in Year 1, for \$210,000. At the time of entering into the contract, Katie receives a deposit of \$21,000. Settlement will not occur until Year 2.

As at 30 June, Year 1, Katie continues to hold the unit, because settlement has not yet occurred (see Example 16.1 above). Katie's right to receive the sale proceeds is a financial asset. At the same time, Katie's has a liability to provide the unit to the purchaser in Year 2.

Year 1

Upon entering into the sale contract, a short-term credit transaction occurs under which Katie gives the purchaser a non-cash benefit (her obligation to convey the property), in return for money (\$21,000) and a financial asset (her right to receive the remaining \$189,000). She will be deemed to receive \$189,000, in return for assuming her obligation, and to have paid the same amount for her right to further payment in Year 2.

So, as at 30 June Year 1:

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

$$[210,000^{233} - 389,000^{234}] + [389,000^{235} - 0^{236}] - [210,000^{237} - 0]$$

$$= \$0$$

Of course, part of the liability offsets the corresponding right to be paid \$189,000, so for practical purposes that part of the liability and the right can be ignored, along with the matching deemed receipts and payments.

Year 2

In Year 2, there is a receipt of \$189,000. The closing tax value of Katie's assets is nil, as Katie will have ceased to hold the unit and her right to the balance of the sale proceeds. Her liability to transfer the unit will also have been extinguished. So, as at 30 June Year 2:

$$[189,000 - 0] + [0 - 389,000] - [0 - 210,000]$$

$$= \$10,000.$$

This gain is included in net income when Katie ceases to hold the asset; i.e. in the income year of settlement. Because the investment asset discount cannot apply in this case, there are no carry forward investment asset losses, and no other investment asset events have happened during the year, there is no need to work out the investment asset gain or loss from this transaction.

See also Example 16.10 for the result when the transaction does not proceed after the deposit is paid.

16.16 If title to the asset passes later than when the contract for disposal of the asset is entered into, the TVM core rules bring to account the asset gains or losses when holding ceases (usually when legal ownership changes). These rules apply for all types of assets including investment assets. This differs from the existing CGT treatment under which the taxing point occurs when the contract is entered into.

16.17 Although consideration may have been received when the contract is entered into, it is matched by the liability that the vendor has to transfer the asset (see Example 15.5 in Chapter 15). This liability is only

²³³ = Actual receipt (\$21,000) + deemed receipt of \$189,000 under short-term credit rule: section 16-15.
²³⁴ = Deemed payment (\$189,000) under short-term credit rule in section 16-15 + payment to purchase land (\$200,000).
²³⁵ = Tax value of financial asset (\$189,000) + tax value of land (\$200,000).
²³⁶ Note that the land was not held at the end of Year 0.
²³⁷ = Deemed receipt (\$189,000) under short-term credit rule in section 16-15 + actual receipt (\$21,000).

met when settlement occurs. TVM recognises this liability whereas the current CGT rules do not.

16.18 The TVM core rules generally bring to account the gain or loss later than CGT event A1.²³⁸

CGT Event B1

16.19 CGT event B1²³⁹ applies if use and enjoyment of a CGT asset is obtained before title passes. CGT event B1 happens if the right to use and enjoyment of a CGT asset passes between entities where title may or will pass between the entities at the end of the agreement. For instance, A and B may enter into an agreement under which A gives B the right to use and enjoyment of land. At the end of the agreement, A may or will transfer the land to B. This is a B1 event. The most common transaction that event B1 applies to is a hire purchase agreement.

16.20 The TVM core rules will bring to account gains or losses covered by CGT Event B1. The gain or loss is brought to account at the same time as the existing CGT treatment.

Example 16.3 How TVM applies to a sale of a property where use and enjoyment of property passes prior to title passing

Natarsha enters into an agreement in Year 1 with Rachael for the use and enjoyment of Rachael's Farm for 5 years, with the title to the farm to pass to Natarsha at the expiration of the 5 years for a sum of \$250,000, paid in 5 equal annual instalments. The tax value of the farm is \$200,000. The prevailing interest rate is 4%.

Under TVM the investment asset gain is recognised in the year that the asset ceases to be held. Under the operation of the hold rules, (item 1 in the table in subsection 24-10(1) of the prototype legislation) where use and enjoyment passes prior to legal ownership, you cease to hold an asset when an immediate right to possess and use the property exists and title will or may pass at the end of the arrangement. In the example this is in Year 1.

Year 1

In Year 1 Rachael has a receipt of \$50,000 and a closing tax value of \$0 for the asset that ceases to be held. A right to receive the remaining \$200,000 is created. Under the accruals rules in Division 76, this right has a tax value of \$181,495.76.²⁴⁰ This right will diminish over the

²³⁸ This reflects the asset 'holding' rule in the prototype legislation, which generally says that you hold an asset while you are its owner. This, in turn, means that holding ceases when ownership ceases. This generally reflects the position under the current law for trading stock and depreciating assets, but, as explained here, is different to the current treatment under CGT event A1. An alternative general holding rule for assets under TVM could provide that holding ceases when a contract for sale is entered into.

²³⁹ Section 104-15 of the ITAA 1997.

²⁴⁰ See Division 76 of the prototype legislation and Chapter 14.

years. As Natarsha is already treated as holding the farm, Rachael's liability to make it available is not recognised.²⁴¹

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

$$[50,000 - 0] + [181,494.76 - 200,000] - [0 - 0]$$

$$= \$31,494.76.$$

Work out the investment asset gain or loss

$$\begin{array}{r} \text{Proceeds of} \\ \text{realising the asset} \end{array} - \begin{array}{r} \text{Asset's tax value} \end{array} - \begin{array}{r} \text{Incidental costs of} \\ \text{ceasing to hold} \end{array}$$

$$231,494.76 - 200,000 - 0$$

$$= \$31,494.76$$

The \$31,494.76 gain is an investment asset gain. This amount would need to be worked out if Rachael is eligible for the 50% investment asset discount, or if Rachael has carry forward investment asset losses or other investment asset events have happened to her during the year.

Year 2

In Year 2 Rachael has a receipt of \$50,000 and reduction in the closing tax value of assets by \$42,740.21.

$$[50,000 - 0] + [138,754.55 - 181,494.76] - [0 - 0]$$

$$= \$7,259.79$$

Year 3

In Year 3 Rachael has a receipt of \$50,000 and reduction in the closing tax value of assets by \$44,449.82.

$$[50,000 - 0] + [94,304.73 - 138,754.55] - [0 - 0]$$

$$= \$5,550.18$$

Year 4

In Year 4 Rachael has a receipt of \$50,000 and reduction in the closing tax value of assets by \$46,227.81.

²⁴¹

This treatment is achieved by item 4 of the table in subsection 24-110(1) of the prototype legislation. If a liability is recognised where the asset has already ceased to be held then the net income formula will not achieve the correct result. Accordingly, the rule ensures that no liability is recognised when an asset ceases to be held despite legal ownership being retained until a later time.

$$[50,000 - 0] + [48,076.92 - 94,304.73] - [0 - 0]$$
$$= \$3,772.19$$

Year 5

In Year 5, the last year of the agreement, Rachael has a receipt of \$50,000 and reduction in the closing tax value of assets by \$48,076.92.

$$[50,000 - 0] + [0 - 48,076.92] - [0 - 0]$$
$$= \$1,923.08$$

16.21 The TVM outcome results in the same total amount being assessed over the total length of the agreement. However, as a result of the accruals rules in Division 76, rather than recognising the entire amount of the gain in the year the asset is disposed of, the investment asset gain is taxed immediately, while the interest component is spread over the life of the agreement.

CGT Event C1

16.22 CGT event C1²⁴² applies if there is a loss or destruction of an asset. If you will get compensation for the loss or destruction (e.g. under an insurance policy) the event applies at the time you get the compensation. Otherwise the event applies when the loss or destruction happens.

16.23 The TVM core rules will bring to account gains or losses covered by CGT event C1. The asset ceases to be held when the loss or destruction of the asset occurs. Any loss will be recognised at this time. This reflects the economic position of the entity that suffers the loss of the asset.

16.24 If there is a right to compensation for the loss of the asset, the taxpayer is treated as having received an amount equal to the market value of the right and to have paid the same amount when the loss arose [sections 22-30 and 28-55].²⁴³ Accordingly, the tax value of that right will offset the loss that arises. If the right's tax value exceeds the tax value of the lost asset, a gain arises; if it is less, there is a loss.

Example 16.4 How TVM applies to the loss or destruction of an asset where no right to be paid compensation exists.

Phil builds an office building on land he owns for \$100,000 in Year 1. In Year 2 a fire destroys the property. Phil does not hold a right to compensation. TVM results in the loss being recognised in the year that the destruction occurs.

Year 2

²⁴² Section 104-20 of the ITAA 1997

²⁴³ See Chapter 10.

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

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

$$= - \$100,000$$

Work out the investment asset gain or loss

$$\begin{array}{ccc} \text{Proceeds of} & - & \text{Asset's tax value} & - & \text{Incidental costs of} \\ \text{realising the asset} & & & & \text{ceasing to hold} \end{array}$$

$$0 - 100,000 - 0$$

$$= - \$100,000$$

The \$100,000 loss is an investment asset loss that is quarantined under the investment asset rules²⁴⁴.

Example 16.5 How TVM applies to the loss or destruction of an asset where a right to be paid compensation exists.

Contrasting the above example, assume that Phil's property is insured. The policy provides that compensation equal to the market value of the property is receivable. Phil holds a legal right to compensation. Phil estimates that the current market value of the property is \$130,000. He receives an insurance payment for the property of \$130,000 in Year 3 being the market value as determined by the insurer.

TVM treatment

When the loss occurs Phil ceases to hold the asset. Phil holds a right under his insurance policy to compensation for the loss of the asset. The rights under the insurance policy to compensation for the loss are valued at the market value of the property.²⁴⁵

Year 2

Phil is deemed to have paid and received \$130,000 under section 28-55 of the prototype legislation.

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

$$[130,000 - 130,000] + [130,000^{246} - 100,000] - [0 - 0]$$

$$= \$30,000$$

²⁴⁴ See Chapter 15.

²⁴⁵ This would reflect the market value of the right to compensation.

²⁴⁶ The asset is represented by the right to receive the insurance compensation.

Year 3

$$[130,000 - 0] + [0 - 130,000] - [0 - 0]$$

$$= 0$$

16.25 The TVM recognises the loss or destruction of an asset at the time the loss or destruction happens. Under CGT event C1, if compensation is received then the gain or loss is recognised at the time of receipt of the compensation. If there is no amount received then the loss is recognised at the time that the loss occurs.

CGT event C2

16.26 CGT event C2²⁴⁷ happens if your ownership of an intangible CGT asset ends by the asset being redeemed, cancelled, released, discharged, satisfied, expired, abandoned, surrendered, forfeited or other similar ending. The time of the event is when you enter into the contract that results in the asset ending, or if there is no contract, when the asset ends.

16.27 The TVM core rules will bring to account gains or losses covered by CGT event C2. Many of the assets covered by this event are depreciating assets under TVM. They will not receive investment asset treatment but are otherwise taxed in the same way as the current law.

Example 16.6 How TVM applies to the cancellation of an intangible asset

In Year 1 Naomi acquired options to purchase 1,000 shares in Dodds Palace & Co Pty Ltd for \$35 per share. The options cost \$20,000 with an exercise date in Year 2. At the exercise date Naomi does not exercise her right to acquire the shares. At that time, the shares had a market value of \$50.

Year 1

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

$$[0 - 20,000] + [20,000 - 0] - [0 - 0]$$

$$= 0$$

Under TVM the asset (the right to exercise an option) matches the payment made to acquire the asset.

Year 2

²⁴⁷

Section 104-25 of the ITAA 1997.

$$\begin{aligned}
 & [0 - 0] + [0 - 20,000] - [0 - 0] \\
 & = -\$20,000
 \end{aligned}$$

The loss is brought to account when the option expires. This is not an investment asset loss, as the option is a depreciating asset, not an investment asset.

16.28 Under TVM, the gain or loss is brought to account at the same time as the current law.

CGT Event C3

16.29 CGT event C3²⁴⁸ happens if an option a company or a trustee of a unit trust granted to an entity to acquire shares, units or debentures in the company or unit trust ends because it is not exercised, is cancelled, released or abandoned. The time of the event is when you enter into the contract that results in the asset ending, or if there is no contract, when the asset ends.

16.30 The TVM core rules bring to account gains or losses covered by CGT Event C3. Under TVM a liability to make good on the option is recognised when the option is granted. The liability is extinguished when the option ends.

Example 16.7 How TVM applies to the end of an option to acquire shares.

Venus & Co Pty Ltd issued options to purchase its shares to Miffy in Year 1 for \$20,000. The options have an exercise date in Year 2. The options cost \$1,000 to issue. At the exercise date Miffy does not exercise her right to acquire the shares.

Year 1

Venus & Co's net income is worked out as:

$$\begin{aligned}
 & \left[\begin{array}{c} \text{Receipts} \\ - \\ \text{Payments} \end{array} \right] + \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of assets} & \text{of assets} \end{array} \right] - \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of liabilities} & \text{of liabilities} \end{array} \right] \\
 & [20,000 - 1,000] + [0 - 0] - [20,000 - 0] \\
 & = -\$1,000
 \end{aligned}$$

Venus & Co has a liability to make good on the option, that is, to meet the demand when it falls due or to allow an opportunity to exercise the option. This is a depreciating liability. It has an initial tax value equal to the amount received of \$20,000, being the proceeds of incurring the liability.

²⁴⁸ Section 104-30 of the ITAA 1997.

Year 2

Venus & Co's net income is worked out as:

$$\begin{aligned} & [0 - 0] + [0 - 0] - [0 - 20,000] \\ & = 20,000 \end{aligned}$$

In Year 2, when the option is not exercised the liability is extinguished, and the company is assessed on the \$20,000. This is not an investment asset gain, as the option is not an investment asset.

16.31 Under TVM, the gain or loss is brought to account at the same time as the current law, although under TVM the cost of issuing the options immediately reduces net income. In contrast, under the current law the cost of issuing the options is not recognised until the option ends.

CGT Event D1

16.32 CGT event D1²⁴⁹ happens if you create a contractual right or other legal or equitable right in another entity. The event happens when you enter into the contract or create the other right.

16.33 The TVM core rules bring to account gains or losses covered by CGT event D1. Under TVM, the receipt of the money for the creation of the contractual right or other legal or equitable right is offset by the liability created. Generally this liability will be a depreciating liability that will decline over its life [section 72-45]. The gain will be assessed as the liability depreciates. Any expenditure paid to create the contractual right or other legal or equitable right is written-off immediately. This is different to the time the gain is brought to account under the current provisions. This timing change allows the expenses to reduce taxable income immediately, and spreads the gain over the life of the right.²⁵⁰

Example 16.8 How TVM applies to creation of a legal right in another entity.

Marion sells her business – Marion's Magnificent Muffins – to Tim on the first day of Year 1. As part of the sale of the business she received \$10,000 to provide endorsements for the business over the next 4 years. It costs Marion \$500 in legal fees to have the endorsement drafted.

Year 1

²⁴⁹ Section 104-35 of the ITAA 1997.

²⁵⁰ This is a consequence of the recommendations dealing with rights in ATSR (recommendation 4.6(b) and section 10).

Marion has a depreciating liability on hand at the end of Year 1 – the obligation to provide the endorsements. The liability has an effective life of 4 years, and depreciates over that time.²⁵¹

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

$$[10,000 - 500] + [0 - 0] - [7,500 - 0]$$

$$= \$2,000$$

In Year 1 Marion expenses the cost of entering into the agreement with Tim. The gain is not an investment asset gain.

Year 2

Marion's net income in Year 2 is worked out as:

$$[0 - 0] + [0 - 0] - [5,000 - 7,500]$$

$$= \$2,500$$

The \$2,500 gain represents the depreciation on Marion's liability during the year. The gain is not an investment asset gain.

Year 3

Marion's net income in Year 3 is worked out as:

$$[0 - 0] + [0 - 0] - [2,500 - 5,000]$$

$$= \$2,500$$

The \$2,500 gain represents the depreciation on Marion's liability during the year. The gain is not an investment asset gain.

Year 4

Marion's net income in Year 4 is worked out as:

$$[0 - 0] + [0 - 0] - [0 - 2,500]$$

$$= \$2,500$$

At the end of Year 4, Marion's liability has a tax value of zero, as it has been fully depreciated. The gain is not an investment asset gain.

16.34 The gain or loss in this type of transaction is brought to account at a different time when compared with the current law. This difference is a result of recognising that the obligation to provide endorsements in

²⁵¹

It is assumed the endorsements are provided at regular intervals.

Example 16.8 is a liability with a limited life that depreciates over that life.

CGT Event D2

16.35 CGT event D2²⁵² happens if you grant an entity an option. The event happens when the option is granted.

16.36 The TVM core rules bring to account gains or losses covered by CGT event D2. Under TVM, the receipt of the money for the option is offset by a liability to allow the exercise of the option (initially valued as the proceeds of incurring the liability). If the option is not exercised or expires, the liability is extinguished and the gain assessed. Any expenditure paid to bring the option into existence is expensed immediately, as there is no asset held to offset the expenditure.

Example 16.9 How TVM applies to the end of an option.

In Year 1 Eleanor grants Michelle the option to purchase her music teaching business before she puts it on the open market. Michelle pays Eleanor \$20,000 for the option.

Year 1

Eleanor's net income in Year 1 is worked out as:

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

$$[20,000 - 0] + [0 - 0] - [20,000 - 0] = \$0$$

Eleanor received \$20,000 for the creation of a contractual right. Eleanor has a liability to make good on the option with a starting tax value of \$20,000 being what Eleanor received in order to incur the liability.

Year 2

In Year 2 the option ends without being exercised and accordingly, Eleanor's liability to perform under the option has expired. Eleanor's net income in Year 2 is worked out as:

$$[0 - 0] + [0 - 0] - [0 - 20,000]$$

$$= \$20,000$$

This is not an investment asset gain.

²⁵²

Section 104-40 of the ITAA 1997.

16.37 The result achieved under TVM delays the taxing point when compared with the existing law. Under TVM the gain is realised when the obligation to perform under the option lapses. This outcome aligns the taxing point with the termination of the liability to perform under the option agreement.

CGT Event E4

16.38 CGT event E4²⁵³ happens when a trustee makes a capital payment for a trust interest. The core rules of the TVM together with Division 78 of the prototype legislation will result in gains being taxed in the same way as CGT Event E4. A separate investment asset event is, however, required to ensure that the investment asset discount can be applied and that such gains can be offset by other investment asset losses.

16.39 It is proposed that the trust capital distribution event will apply in a similar way to the non-dividend payment for shares event (see paragraph 15.55).

CGT Event G1

16.40 CGT event G1²⁵⁴ happens when a company pays a non-assessable amount. The core rules of the TVM together with Division 78 of the prototype legislation will result in gains being taxed in the same way as CGT Event G1.

16.41 Paragraphs 15.51 to 15.54 of Chapter 15 discuss the non-dividend payment for shares event.

CGT Event H1

16.42 CGT event H1²⁵⁵ happens when a deposit paid to you is forfeited because a prospective sale or other transaction does not proceed. The time of the event is when the deposit is forfeited.

16.43 The TVM core rules automatically bring to account gains or losses covered by CGT event H1. The gain or loss is brought to account when the forfeiture occurs.

Example 16.10 How TVM deals with a non-refundable deposit - settlement deferred to year following payment of deposit

Jenny purchases a unit for \$200,000 in Year 1. She enters into a contract for the sale of the unit in Year 2 for \$210,000. Sarah pays a deposit of \$21,000 to Jenny. Settlement is proposed to occur in Year 3. The sale does not proceed in Year 3 and Jenny retains the deposit.

²⁵³ Section 104-70 of the ITAA 1997.

²⁵⁴ Section 104-135 of the ITAA 1997.

²⁵⁵ Section 104-150 of the ITAA 1997.

Year 1

Jenny's net income in Year 1 is worked out as:

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

$$[0 - 200,000] + [200,000 - 0] - [0 - 0]$$

$$= 0$$

Year 2

In addition to the \$21,000 deposit received, Jenny has a right to receive a further \$189,000 from Sarah.²⁵⁶ Therefore, her closing tax value of assets is \$389,000 (\$200,000 + \$189,000). She has a liability to transfer the asset to Sarah valued at \$210,000.²⁵⁷

$$[210,000 - 189,000] + [389,000 - 200,000] - [210,000 - 0]$$

$$= 0$$

Of course, part of the liability offsets the corresponding right to be paid \$189,000, so for practical purposes that part of the liability and the right can be ignored, along with the matching deemed receipts and payments.

Year 3

When the transaction falls through, Jenny no longer holds the right to receive the further payments of \$189,000 and the liability to transfer the asset (valued at \$210,000) is extinguished.

$$[0 - 0] + [200,000 - 389,000] - [0 - 210,000]$$

$$= \$21,000$$

This is not an investment asset gain.

See also Example 16.2 for a discussion of what would happen if the sale proceeded.

16.44 The TVM core rules deal with the unwinding of the sale via the net income formula in the year that the sale falls through without the need for any special rules.

²⁵⁶ Under the short-term credit rule (section 16-15), Jenny is deemed to receive \$189,000 for assuming her liability to provide the property and to have paid the same amount for her right to get the \$189,000 in Year 3.

²⁵⁷ The liability reflects the obligation held to transfer the asset to the purchaser. The liability of \$210,000 is recognised under sections 14-75 and 14-80 as the amount received that gives rise to the obligation to transfer the asset being the deposit of \$21,000 and the deemed receipt of \$189,000 (see footnote 256).

CGT Event H2

16.45 CGT event H2²⁵⁸ happens if an act, transaction or event occurs in relation to a CGT asset that you own and no adjustment is made to the asset's cost base or reduced cost base. The time of the event is when the act, transaction or event occurs.

16.46 The TVM core rules automatically bring to account gains or losses covered by CGT event H2. The gain or loss is brought to account when the act, transaction or event occurs.

Example 16.11 How TVM deals with receipt of money in relation to an investment asset

In Year 1 Kevin purchases land for \$500,000 on which he intends to construct a manufacturing facility. In Year 2 Craig who runs a business promotion organisation pays Kevin \$50,000 as an inducement to start construction early. No contractual or equitable rights or obligations are created by the arrangement.

Year 1

The purchase of the land does not have an impact on Kevin's net income in Year 1.

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

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

$$= 0$$

Year 2

The \$50,000 received from Craig is brought to account as a receipt in working out Kevin's net income.

$$[50,000 - 0] + [500,000 - 500,000] - [0 - 0]$$

$$= \$50,000$$

This is not an investment asset gain.

16.47 TVM brings to account receipts related to an investment asset by the operation of the net income formula without the need for any special rules.

²⁵⁸

Section 104-155 of the ITAA 1997.

CGT Event K5

16.48 Section 234-70 of the prototype legislation deals with situations covered by CGT event K5.²⁵⁹ CGT Event K5 applies to the fall in value of a collectable of a company or trustee of a trust that is held for the shareholder's or interest holder's (or their associate's) personal use or enjoyment. The fall in value is treated as a collectable loss. The special investment asset loss from high-cost collectables replicates this rule. See paragraph 18.42 to 18.47.

Other Events

16.49 The remaining events have not been exhaustively analysed under TVM. However, preliminary analysis of how these events will operate under TVM is outlined in the following table.

16.50 Of the remaining 27 events, up to 5 could require an investment asset event to be developed to give investment asset treatment to gains or losses that arise from those transactions, or further rules to correctly bring to account the gains or losses from these transactions.

Table 16.2 Analysis of other CGT Events

<i>Event</i>	<i>Description</i>	<i>Investment asset event needed</i>	<i>Explanation</i>
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 prototype legislation.
E2	Transferring a CGT asset to a trust	No	Main case - ceasing to hold applies under the prototype legislation.
E3	Converting a trust to a unit trust	Possibly	May be required.
E5	Beneficiary becoming entitled to a trust asset	No	Main case - ceasing to hold applies under the prototype legislation.
E6	Disposal to beneficiary to end income right	No	Main case - ceasing to hold applies under the prototype legislation.
E7	Disposal to beneficiary to end capital interest	No	Main case - ceasing to hold applies under the prototype legislation.

²⁵⁹

Section 104-225 of the ITAA 1997.

<i>Event</i>	<i>Description</i>	<i>Investment asset event needed</i>	<i>Explanation</i>
E8	Disposal by beneficiary of capital interest	No	Main case - ceasing to hold applies under the prototype legislation.
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.
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.
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	Possibly	May be required – to be considered when roll over provisions dealt with.

<i>Event</i>	<i>Description</i>	<i>Investment asset event needed</i>	<i>Explanation</i>
J2	Change in status of a CGT asset that was a replacement asset in a roll-over under Subdivision 152-E of the ITAA 1997	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 of the ITAA 1997	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	Possibly	May be dealt with together with non-investment asset losses.
K3	Asset passing to tax-advantaged entity	No	Will be addressed in cost/proceeds rules.
K4	CGT asset starts being trading stock	Possibly	The existing trading stock provisions deem 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 an investment asset. This issue could be examined further when trading stock and roll-over rules are developed.
K6	Pre-CGT shares or trust interest	No	Similar treatment to be provided in the provisions dealing with pre-CGT assets.
K7	Disposal of depreciating asset used for private purposes	Possibly	May be required.

Chapter 17

Private or domestic issues

Outline of Chapter

17.1 This Chapter describes the principles underlying the concept of ‘private or domestic’ and explains:

- the meaning of the expression in the different contexts in which it arises; and
- the mechanisms used to give effect to the ‘private or domestic’ exclusion.

17.2 The ‘private or domestic’ concept is used to assist in calculating the taxable income of individuals and partnerships that have at least one individual as a partner. This Chapter is not relevant to other types of taxpayers.

17.3 The ‘private or domestic’ rules are contained in Division 222 of the prototype legislation.

Context of Reform

17.4 The prototype legislation introduces a new formula for working out how much income tax is payable by an individual. It replaces the old method, which uses the expressions ‘assessable income’ and ‘deductions’, with one that embraces ‘receipts’, ‘payments’, ‘assets’ and ‘liabilities’.

17.5 However, some classes of these new items will be excluded from the formula. In the case of individual taxpayers, an exclusion will most commonly turn upon whether the expression ‘private or domestic’ could be said to apply in the particular circumstance. The same may also be true when partners of partnerships calculate taxable income.

17.6 Under the new system, an individual’s income comprises the excess of money receipts over money payments plus the change in tax value of assets and liabilities over the year. Such a system attracts a number of advantages, including the extension of tax relief to business related expenditure that is ‘preliminary’ and therefore not ‘incurred in deriving the assessable income’ (often called ‘blackhole expenditure’).

17.7 Such a simple system is not suitable for individuals without some modification. For individuals, some receipts, such as gifts, and many

payments, such as expenditure on food, clearly should fall outside the tax calculation. In a similar vein, some liabilities, such as certain debts to a parent, and the falling tax value of assets used up through personal enjoyment should also be excluded.

17.8 The current law makes these kinds of exclusions by applying the notions of ‘income’, ‘capital’, ‘private or domestic’ and ‘incurred in deriving the assessable income’. Under the prototype legislation all receipts, payments, assets and liabilities are included unless they are specifically excluded.

17.9 So, without the ‘private or domestic’ exclusions, the operation of TVM would produce a grossly inappropriate result. For this reason, the private or domestic rules (which are essentially a set of exclusionary provisions) are used to define the tax base for individuals and some partnerships, and do so in such a manner that will not materially alter the present outcome for individuals.

17.10 TVM will achieve this by applying concepts such as:

- ‘receipts of a private or domestic nature’;
- ‘payments of a private or domestic nature’;
- ‘private asset’;
- ‘private liability’ and
- ‘private percentage’.

Summary of prototype legislation

17.11 The process of working out the income tax liability of an individual will comprise a number of steps:

- the income tax liability for any income year is worked out by applying the tax rates to the individual’s taxable income and then subtracting tax offsets;
- taxable income is worked out by determining net income, adding the taxable income adjustment and subtracting unused tax losses;
- net income is worked out by subtracting payments from receipts and adding (or subtracting) the net change in the tax value of assets and liabilities; and

- the taxable income adjustment is worked out by subtracting downward adjustments from upward adjustments. Upward adjustments and downward adjustments are specifically listed.

17.12 Essentially the same process would be followed in calculating taxable income for partnerships that have an individual as a partner.

17.13 For individuals and those partnerships subject to Division 222, considerations of ‘private or domestic’ will arise in the process of working out both net income and taxable income adjustments.

‘Private or domestic’ and calculating taxable income

17.14 There are 2 core themes to Division 222 which apply to exclude most²⁶⁰ private or domestic things from an individual’s taxable income calculation:

- the initial exclusion – things that are excluded from net income; and
- the adjustment exclusion – applying taxable income adjustments to recognise the private or domestic use or nature of things that are included in net income.

The initial exclusion

17.15 Net income generally excludes items if they contain private or domestic features:

- receipts and payments will be excluded to the extent that they are of a private or domestic nature;
- liabilities will, in most cases, be excluded if they are solely of a private or domestic nature – liabilities that are excluded are known as ‘private liabilities’; and
- *some* assets will be excluded if they are used solely for private or domestic purposes or are essentially private or domestic in nature – assets that are excluded are known as ‘private assets’.

17.16 All other receipts and payments (including any proportion of a receipt or payment to the extent that it is not private or domestic in nature) as well as all other assets and liabilities are normally included in net income.

²⁶⁰

Some things may be considered to be ‘private or domestic’ but nonetheless will not be excluded from net income – for instance, investment assets such as land.

The adjustment exclusion

17.17 The ‘private or domestic’ exclusion operates differently in the case of depreciating assets and liabilities that have some degree of private or domestic use or nature.

17.18 In those cases, any change in tax value (e.g. depreciation) or any gain or loss made on realisation or extinguishment of the asset or liability will have been fully reflected in net income even though the asset or liability was used or had a nature that was partly private or domestic.

17.19 A taxable income adjustment then offsets the effect on net income to the extent to which it relates to private or domestic considerations. (The prototype legislation acknowledges that these rules must also extend to appreciating liabilities. The same treatment will not be applied to appreciating assets; the only appreciating assets are financial assets, which can never be ‘private assets’.)

Assets and liabilities entering or leaving the tax system

17.20 Because nature and intent can change, some assets and liabilities can move *in* and *out* of the tax system. The rules that deal with these movements may be referred to as ‘conversion of use’ rules.

17.21 Conversion occurs where items, previously excluded from net income because they are being used privately, are required to be included in net income because of a change in nature or intent, and vice versa. It applies equally to assets and liabilities – more specifically it applies to those assets and liabilities where intended usage or nature is the driver for determining whether the asset or liability in question is a ‘private asset’ or ‘private liability’.

17.22 The conversion is akin to a sale or acquisition of the asset or liability. Generally taxpayers will be treated as if they had either received or paid an amount equal to market value for the asset or liability in question and that amount will form either the cost or proceeds of that asset or liability as the case may be. The exception is in the case of trading stock that becomes a private asset. In that case, cost is substituted for market value as the amount the individual is taken to have received as the proceeds of realising the asset.

Who do the ‘private or domestic’ rules apply to?

17.23 Currently, the prototype legislation is prepared on the basis that the rules will apply to individuals and to partnerships that have a least one partner that is an individual.

17.24 That said, all types of entities can be involved in things that have a private or domestic connection. As such, the prototype legislation notes that the approach taken to deal with partnerships could, in principle, also

be extended to companies and trusts. However as the treatment of companies and trusts in this area is still under consideration pending any review of trusts issues, this should not be interpreted as a comment on the preferability of widening the scope of these rules to include companies and trusts.

Comparison of key features of prototype legislation and current law

17.25 Table 17.1 highlights the key features of how private or domestic items are excluded from the calculation of taxable income.

Table 17.1 Comparison of key features of prototype legislation and current law

<i>Prototype legislation</i>	<i>Current law</i>
<p>Receipts and payments are excluded to the extent that they are private or domestic.</p> <p>Assets and liabilities are, in most cases, excluded if they are wholly private or domestic.</p> <p>Adjustments are made so that partly private or domestic assets and liabilities do not affect taxable income to the extent that they are private or domestic.</p>	<p>On revenue account:</p> <ul style="list-style-type: none"> • items that come in are excluded if they do not fall within the notions of ordinary income; and • outgoings are excluded if they are: <ul style="list-style-type: none"> – not incurred in the course of deriving the income; or – private or domestic. <p>On capital account, for example:</p> <ul style="list-style-type: none"> • CGT recognises gains and losses from many assets but some assets that have a private flavour are exempt from CGT; and • depreciation is allowed, but to the extent it is attributable to private or domestic purposes, it is excluded.

17.26 As noted, Division 222 deals with private or domestic matters. Placing this comparison into perspective, rules in respect of these matters are spread throughout the current law, and include:

- ordinary income rule (section 6-5 of the ITAA 1997) to the extent it deals with private or domestic issues;
- general deductions rule (section 8-1 of the ITAA 1997) to the extent it deals with private or domestic issues;

- subsections 40-25(2) and (7) and 40-650(1), paragraphs 40-515(4)(b) and 40-645(1)(b) and section 40-835 of the ITAA 1997 (dealing with the extent to which depreciation deductions are not allowed);
- section 40-290 of the ITAA 1997 (dealing with balancing adjustments for disposal of depreciating assets used partly for non-taxable purposes);
- sections 70-30, 70-90 and 70-110 of the ITAA 1997 (dealing with conversion of assets to or from trading stock and disposals of trading stock outside the ordinary course of business);
- Subdivision 108-C and subsection 118-10(3) of the ITAA 1997 (defining and dealing with personal use assets – these are CGT provisions);
- section 51AF of the ITAA 1936 (private car expenses of employees); and
- section 245-25 and paragraph 245-40(c) of Schedule 2C of the ITAA 1936 (dealing with the scope of debts subject to the debt forgiveness provisions).

Detailed explanation of prototype legislation

17.27 Basic to the process of calculating income tax liability under the new method is the concept of net income. Under the formula in section 6-55, net income is worked out by subtracting payments from receipts and adding (or subtracting) the net change in the tax value of assets and liabilities (see Chapter 6).

17.28 For individuals and partnerships with at least one individual as a partner, the application of this formula is modified in order to take into account private and domestic considerations. Without such modifications, those taxpayers would be subject to taxation on family gifts and would obtain tax relief for their expenditure on food and entertainment.

17.29 In order to avoid such results, the prototype legislation provides that in the case of individuals and those partnerships, receipts, payments, liabilities and most assets will be excluded from the calculation of taxable income to the extent that they have a private or domestic character or use. *[Section 222-1]*

17.30 In addition, individuals will generally account for their transactions on a cash basis²⁶¹. As such, many assets and liabilities will not need to be brought to account at all.

Who ‘private or domestic’ applies to

17.31 Division 222 applies in working out an individual’s taxable income [subsection 222-5(1)]. It also applies in working out a partnership’s taxable income for an income year where at any time during that year an individual was a partner of the partnership [subsection 222-5(2)]. While most of these rules apply equally to individuals and partnerships, additional rules are provided to extend some of the private or domestic concepts to partnerships where necessary. Those rules are located in Subdivision 222-G and are discussed at paragraphs 17.261 to 17.265.

17.32 As the concepts are essentially the same, any reference this Chapter makes to individuals also extends to those partnerships unless a contrary intention is present.

What makes up an individual’s ‘tax world’?

17.33 Taking an abstract view, the world could be visualised as consisting of economic benefits that flow to and from individuals and other entities. Some of these economic benefits may be stored in things for future use; the stores of these future economic benefits are called ‘assets’. Equally, economic benefits could be promised to someone else in which case the future sacrifice of those benefits gives rise to a ‘liability’. Economic benefits may also pass between parties; these transfers of economic benefits are made through ‘receipts’ and ‘payments’. So, an individual is likely to ‘hold’ assets, ‘have’ liabilities, get receipts and make payments.

17.34 What represents an individual’s tax affairs could be considered to be their ‘tax world’. Included in their tax world are things that affect or could affect their taxable income (upon which their income tax liability is calculated). Conversely, things that are outside the tax world cannot affect taxable income. Thus these things do not need to be recognised or valued by the tax system.

17.35 TVM defines this ‘tax world’ by way of exclusion; what is left represents an individual’s ‘tax world’. The following phrases are important in the process of drawing this dichotomy:

- ‘receipts of a private or domestic nature’;
- ‘payments of a private or domestic nature’;

²⁶¹ This arises from recommendation 4.4 in ATSR. Paragraphs 17.143 (about financial assets) and 17.201 (about financial liabilities) discuss this recommendation.

- ‘private asset’; and
- ‘private liability’.

17.36 Exclusion is also made *to the extent* that a receipt or payment may have some private or domestic nature or that an asset other than a ‘private asset’ is used for private or domestic purposes or a liability other than a ‘private liability’ has a private or domestic nature.

17.37 In addition to the private or domestic rules located in Division 222, other rules also assist in shaping an individual’s ‘tax world’. These include the exclusion of pre-CGT assets and the affairs of foreign residents without the necessary connection to Australia.²⁶² Exempt income forms a quarantined part of an individual’s tax world as it may be used to reduce the tax losses made by the individual.

Applying ‘private or domestic’

What does ‘private’ mean?

17.38 ‘Private’ is a word that can carry a number of shades of meaning. The meaning that it carries in the context of taxation laws is one that can be contrasted with ‘income earning’ or ‘commercial’ or ‘business’. A transaction of a private character and the private use of an asset or liability is typically associated with the enjoyment or sharing of wealth in contrast to its creation or growth. ‘Private’ does not carry the shade of meaning that can be contrasted with ‘public’, being the meaning it bears in, for example, ‘private property’ and ‘a private income’.

What does ‘domestic’ mean?

17.39 ‘Domestic’ can be used to describe those things that are of, or pertaining to, the household. Its meaning is similar to, though less general than, ‘private’.

17.40 Further explanation about the meanings of ‘private’ and ‘domestic’ is best done in the various contexts in which they arise.

What are receipts and payments?

17.41 The vast majority of cases will, as one would expect, involve the passing of money from one party to another.

17.42 When money is not actually exchanged, Chapter 10 explains how TVM will apply to deem a receipt and payment to be made even if there has been no money changing hands.

²⁶²

The application of TVM to foreign residents is discussed in Chapter 21.

17.43 Also, receipts and payments are taken to occur where there is a transaction not directly involving the individual, but which occurs on the individual's behalf. It is taken to involve both a receipt and a payment by the individual. [*Section 6-70*]

Example 17.1

Thomas conducts a car dealership business and Lydia is an accountant. She decides to extend him some credit. Over a period she provides him with \$80,000 worth of accounting services. Instead of asking him to settle up with a direct payment, she asks him to pay the money to one of her creditors in partial satisfaction of a debt. Upon payment, Lydia is taken to have received a payment of \$80,000 in satisfaction of Thomas's debt, and is taken to have spent the money in reducing her own liabilities.

Treatment of receipts and payments

17.44 For individuals, the general rule is that receipts and payments are not taken into account to the extent that they are private or domestic in nature [*sections 222-10 and 222-20*]. To the extent that the receipts or payments are not taken into account, it is because they are 'receipts of a private or domestic nature' or 'payments of a private or domestic nature'.

Example 17.2

Thomas pays a newsagent \$120, half of which covers newspapers for personal use and the other half is for the newsagent to include promotional material for his business in the newspapers that they home deliver. The payment is of a private or domestic nature to the extent of \$60.

17.45 Not taking receipts or payments into account means that they are not included in net income, either through step 1 or step 2 of the method statement in section 6-55. Conversely if receipts and payments are taken into account, they are included in net income by reference to those steps of that method statement.

Matching

17.46 Receipts and payments that are costs or proceeds of assets or liabilities form the exception to this general rule, in that these receipts and payments instead take on the character of the asset or liability to which they relate. This Chapter refers to these receipts and payments as being 'matched'. While the concept of matching is only implicitly recognised in the structure of the rules in TVM, it forms the basis on which the 'private or domestic' rules are built.

17.47 A payment which forms the cost of an asset, or a receipt that forms the proceeds of realising an asset, are not classified according to whether they are 'payments of a private or domestic nature' or 'receipts of

a private or domestic nature'. Instead, they are classified according to whether or not the asset is a 'private asset'. In that way, it is the private asset definition that provides the test for whether or not that payment or receipt should be reflected in net income. [Paragraphs 222-10(1)(b), 222-10(2)(a), 222-20(1)(c) and 222-20(2)(b)]

Example 17.3

Ashley purchases a computer for \$2,000. As he intends to use the computer solely for private or domestic purposes, it is a private asset. His net income calculation will not include the payment of \$2,000 or the asset, which has a cost of \$2,000.

Example 17.4

Lydia buys a computer costing \$8,000 for her accountancy business but she intends to use it partly for private or domestic purposes. Her net income calculation will include the whole of the \$8,000 as a payment and the asset, which has a cost at that time equal to \$8,000.

17.48 Liabilities are treated in a symmetrical way. [Paragraphs 222-10(1)(c), 222-10(2)(b), 222-20(1)(b) and 222-20(2)(a)]

Example 17.5

Lydia borrows the \$8,000 from a financial institution. Even though the funds will provide some private advantage, the whole of this resulting liability is included in net income calculations along with the whole of the \$8,000 loan principal, which is included as a receipt.

17.49 Examples 17.3, 17.4, and 17.5 illustrate that whether the receipt or payment is included in net income is dependent on the treatment of the asset or liability to which the receipt or payment relates (i.e. to the asset or liability the receipt or payment is *matched* to). This is consistent with the net income formula being a double-entry system.

How 'private or domestic' is to be applied

17.50 It will be necessary for individuals to examine their transactions to determine to what extent they are of a private or domestic nature. Some of those transactions will be associated with assets or liabilities of the individual and will be subject to the 'matched' treatment.

17.51 Of course in a vast number of cases this will be so simple that individuals would not turn their minds to the matter at all. The tax implications of such obviously private or domestic things as purchase of family groceries, children's toys or kitchen appliances, or the increasing of a credit card debt will not concern the individual at the time those events happen or at the time of preparing an income tax return.

17.52 Indeed the system countenances such behaviour by deliberately excluding wholly private or domestic transactions from the net income

formula so that individuals are released from any requirement to record and account for these innumerable transactions.

17.53 This section of the Chapter has provided a snapshot of the rules. What follows is a detailed examination of each part of the net income formula:

- receipts;
- payments;
- assets; and
- liabilities.

Receipts

Excluding receipts from net income

17.54 Private or domestic considerations can cause:

- some receipts to be wholly or partially excluded from the net income formula – this applies to receipts that are *unmatched*; and
- other receipts to be wholly included or wholly excluded from the net income formula – this applies to receipts that are *matched*.

17.55 The ‘matched’ concept (i.e. ‘matched’ to an asset or liability) is a tool implicitly used by Division 222 to prescribe the treatment of receipts.

17.56 Payments are treated similarly.

17.57 To the extent that a receipt has a private or domestic nature, it is excluded from net income by not taking that amount into account under step 1 of the method statement in section 6-55. [*Paragraph 222-20(1)(a)*]

Example 17.6

Melissa received \$20 from her aunt as a birthday gift. It is a receipt of a private or domestic nature and is not included in step 1 of the method statement in section 6-55.

Melissa also received \$10 interest on her bonus saver account. It is not of a private or domestic nature and is included in step 1 of the method statement in section 6-55.

17.58 This rule does not apply to *matched* receipts.

17.59 Excluding matched receipts from net income only occurs if the asset is a ‘private asset’ or the liability is a ‘private liability’. That is, an amount that an individual receives in an income year is not taken into account under step 1 of the method statement in section 6-55 to the extent that it becomes included during the income year in the:

- proceeds of incurring a private liability that the individual has; or
- proceeds of realising an asset that the individual stopped holding during the income year and it was a private asset immediately before the individual stopped holding it.

[Paragraphs 222-20(1)(b) and (c)]

17.60 As such, step 1 of the method statement in section 6-55 includes matched receipts that are *not* matched to a private asset or private liability. This means that a receipt that could be considered to be partly of a private or domestic nature, but is matched to an asset or liability, is *not* subject to apportionment when recording the amount in step 1 of the method statement in section 6-55. *[Subsection 222-20(2)]*

Example 17.7

David sells his television for \$100. As his television is a private asset, the receipt of \$100 is not included in step 1 of the method statement in section 6-55.

David also sells his car for \$10,000, which he has been using partly in his business as a salesman for some years. Despite the car being used partly for private or domestic purposes, the full \$10,000 receipt is included in step 1 of the method statement in section 6-55. The car’s tax value will be included in step 4 of the method statement in section 6-55, but not step 3 of that method statement.

17.61 Once a receipt has been excluded from net income by the operation of paragraph 222-20(1)(a) (i.e. because it has a private or domestic nature), it cannot, in a later income year, be absorbed into the proceeds of incurring a liability that is included in net income. *[Subsection 222-20(3)]*

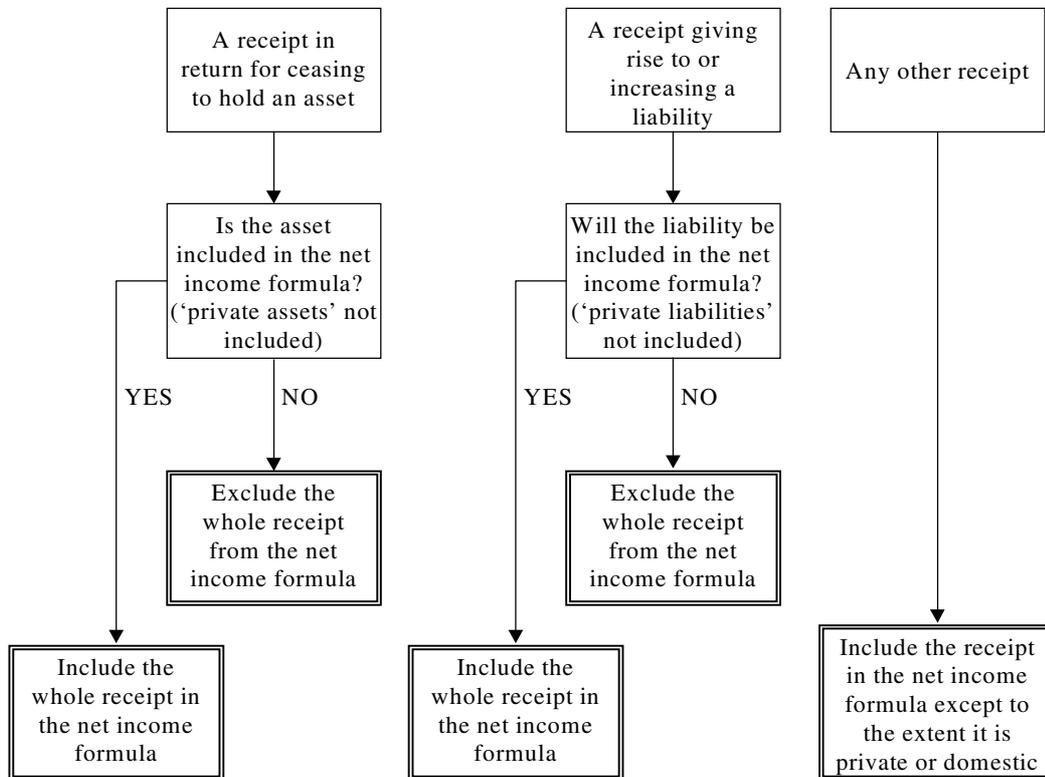
Taxable income adjustments

17.62 It should be noted that receipts that are matched to assets or liabilities which are used partly for private or domestic purposes or are partly of a private or domestic nature may become the subject of adjustments when calculating taxable income. These adjustments are calculated with respect to the extent that the matched asset was used for private or domestic purposes or the matched liability has a private or domestic nature. (Discussion on taxable income adjustments commences at paragraph 17.219.)

Categories of treatment for receipts

17.63 Diagram 17.1 summarises the different kinds of treatment that can apply to receipts.

Diagram 17.1 Treatments that can apply to receipts



Receipts of a private or domestic nature

17.64 This concept drives the treatment of all *unmatched* receipts that have private or domestic considerations. (For *matched* receipts, the receipt is instead classified according to the tests for ‘private assets’ or ‘private liabilities’.)

Which kinds of receipts have a private or domestic nature?

17.65 It will be the facts and circumstances surrounding the receipt and the individual who gets the receipt that determine whether a receipt has a private or domestic nature.

17.66 Generally speaking, the kinds of receipts that are presently taxed because they constitute ‘income’ within the ordinary meaning of that word would not be expected to be excluded under the proposed regime on the basis that they could be considered to be private or domestic. This is because it has always been inherent in the notion of ‘income’ that the expression tends not to embrace non-commercial, private or domestic affairs. That is, the meaning of ‘income’ already tends to exclude private or domestic receipts.

Example 17.8

A father provides \$10,000 to help his daughter in carrying on her nursing care business. The decision to make the payment has little to do with the nature of the business and much to do with the family relationship. As such, the receipt would be of a private or domestic nature.

On the other hand, if the daughter was entitled to a subsidy of \$10,000 because of the nature of her business, the receipt would not be of a private or domestic nature.

Wages etc.

17.67 Salaries, wages and fees for services provided would rarely be private, although the situation might arise in a purely domestic situation. For example, a child might be paid an allowance for performing household chores. This would not give rise to taxable income.

17.68 In providing services, if a receipt is not for the services themselves (say, the painting of a room), but is merely a reimbursement of costs incurred in performance (the cost of the paint), then the receipt may well be of a private or domestic nature.

Inherently non-private receipts

17.69 Interest, rent, company dividend and trust distribution receipts would not be expected to have a private or domestic nature.

Extending the meaning of receipts of a private or domestic nature

17.70 Section 222-25 outlines receipts that have more of a 'commercial' flavour than a 'private or domestic' one, but nonetheless should not represent part of the tax system.

17.71 The purpose of the extended meaning is to exclude those things that might otherwise not be excluded by the ordinary meaning of the phrase 'receipts of a private or domestic nature'.

Receipts from hobbies or recreational pursuits

17.72 To the extent that the receipt from any of those activities is a reward for the individual's efforts or skills, the receipt will *not* have a private or domestic nature. [*Subsection 222-25(2)*]

17.73 So, things such as prizes or gifts that arise from the individual's hobbies or recreational pursuits and which are not a reward or compensation for their time or expertise, will be receipts that have a private or domestic nature. [*Paragraph 222-25(1)(a)*]

Example 17.9

Lee, a suburban footballer, was awarded with \$100 from his club's sponsor for being best on ground in the Grand Final. The \$100 award is a receipt of a private or domestic nature as it arose from his recreation.

However if he was paid to play, then although playing football is a recreational pursuit of his, any match payments and the \$100 award he receives will be rewards for his efforts and skill and will be included in calculating his net income.

Example 17.10

Annie plays the poker machines once a week at a local golf club. Any winnings are receipts of a private or domestic nature as this is a recreational activity of hers.

17.74 Note that the carrying on of a genuine business would not be considered to be the carrying on of a hobby.

Compensation receipts

17.75 Under the current law, the concept of ordinary income includes compensation for lost income but compensation for the loss of income earning capacity is capital and thus should be excluded from the tax system. This distinction is drawn in Division 222, with compensation for any wrong, injury or illness the individual suffers personally which does not represent the replacement of salary or wages or any other earnings being taken to be of a private or domestic nature. [*Paragraph 222-25(1)(b)*]

Example 17.11

Derek, an employee of a lawn mowing business, received \$100,000 as compensation after a bizarre gardening accident. As the compensation is for the loss of income earning capacity rather than the replacement of earnings, it is a receipt of a private or domestic nature.

Windfalls and gifts

17.76 Windfall receipts, such as lottery wins, fall within the extended meaning of 'private or domestic' and the same would generally apply to gifts. However amounts received in relation to the individual's employment or out of their business, investment or other commercial activities, such as tips or bonuses, would not be excluded from the net income formula. [*Paragraph 222-25(1)(c)*]

Example 17.12

Anna, a waitress at a busy restaurant, occasionally receives tips from customers in appreciation of her prompt table service. These receipts are not of a private or domestic nature.

Receipts that are proceeds

17.77 Receipts that are proceeds of realising an asset or the proceeds of incurring a liability are *matched* receipts. The treatment of these types of receipts is determined by whether the matched asset or liability was, at that time, a 'private asset' or 'private liability'. Those receipts are not ascribed a treatment that is independent of the asset or liability – that is, the test in those circumstances does not focus on whether or not they are 'receipts of a private or domestic nature'. The focus is instead on the asset or liability.

17.78 Discussion of what is a 'private asset' and what is a 'private liability' commences at paragraph 17.134 and paragraph 17.194 respectively.

17.79 Some common examples of *matched* receipts include:

- receipts on disposal of assets:
 - will be included in net income *if* the asset that is being disposed of is not a 'private asset', otherwise the receipt will be excluded;
- receipt of borrowed funds from a lender:
 - will be included in net income *if* the liability that has been assumed is not a 'private liability', otherwise the receipt will be excluded;
- debt defeasance receipt:
 - this is a receipt which constitutes consideration for taking over someone else's liability and would be treated in the same way as the receipt of borrowed funds; and
- receipt being the repayment of a loan:
 - as the right to be repaid is an asset (generally, a financial asset), the repayment is the proceeds of realising the asset and would be treated in the same manner. It should be noted that this kind of receipt will always be included in net income because a financial asset can never be a 'private asset'.

Payments

Excluding payments from net income

17.80 Private or domestic considerations can cause:

- some payments to be wholly or partially excluded from the net income formula – this applies to payments that are *unmatched*; and
- other payments to be wholly included or wholly excluded from the net income formula – this applies to payments that are *matched*.

17.81 The ‘matched’ concept (i.e. ‘matched’ to an asset or liability) is a tool implicitly used by Division 222 to prescribe the treatment of payments.

17.82 Receipts are treated similarly.

17.83 To the extent that a payment has a private or domestic nature, it is excluded from net income by not taking that amount into account under step 2 of the method statement in section 6-55. [*Paragraph 222-10(1)(a)*]

Example 17.13

Denis paid \$50 to visit an astrologer to get a personalised horoscope. It is a payment of a private or domestic nature and is not included in step 2 of the method statement in section 6-55.

Denis, who works in information technology, also paid \$300 to attend a workshop on a software package that he is using to complete his current project. The payment is not of a private or domestic nature and is included in step 2 of the method statement in section 6-55.

17.84 This rule does not apply to *matched* payments.

17.85 Excluding matched payments from net income only occurs if the asset is a ‘private asset’ or the liability is a ‘private liability’. That is, the amount of a payment that an individual makes in an income year is not taken into account under step 2 of the method statement in section 6-55 to the extent that it becomes included during the income year in the:

- cost of a private asset that the individual holds; or
- cost of extinguishing a liability that the individual stopped having during the income year if it was a private liability immediately before the individual stopped having it.

[*Paragraphs 222-10(1)(b) and (c)*]

17.86 As such, step 2 of the method statement in section 6-55 includes matched payments that are *not* matched to a private asset or private liability. This means that a payment that could be considered to be partly of a private or domestic nature, but is matched to an asset or liability, is *not* subject to apportionment when recording the amount in step 2 of the method statement in section 6-55. [*Subsection 222-10(2)*]

Example 17.14

Amanda buy a television for \$800. As her television is a private asset, the payment of \$800 is not included in step 2 of the method statement in section 6-55.

Amanda also buys a car for \$15,000, which she intends to use partly in her business. Despite the car being used partly for private or domestic purposes, the full \$15,000 payment is included in step 2 of the method statement in section 6-55. The car's tax value will be included in step 3 of the method statement in section 6-55 as she still intends to use the car for those purposes at the end of the income year.

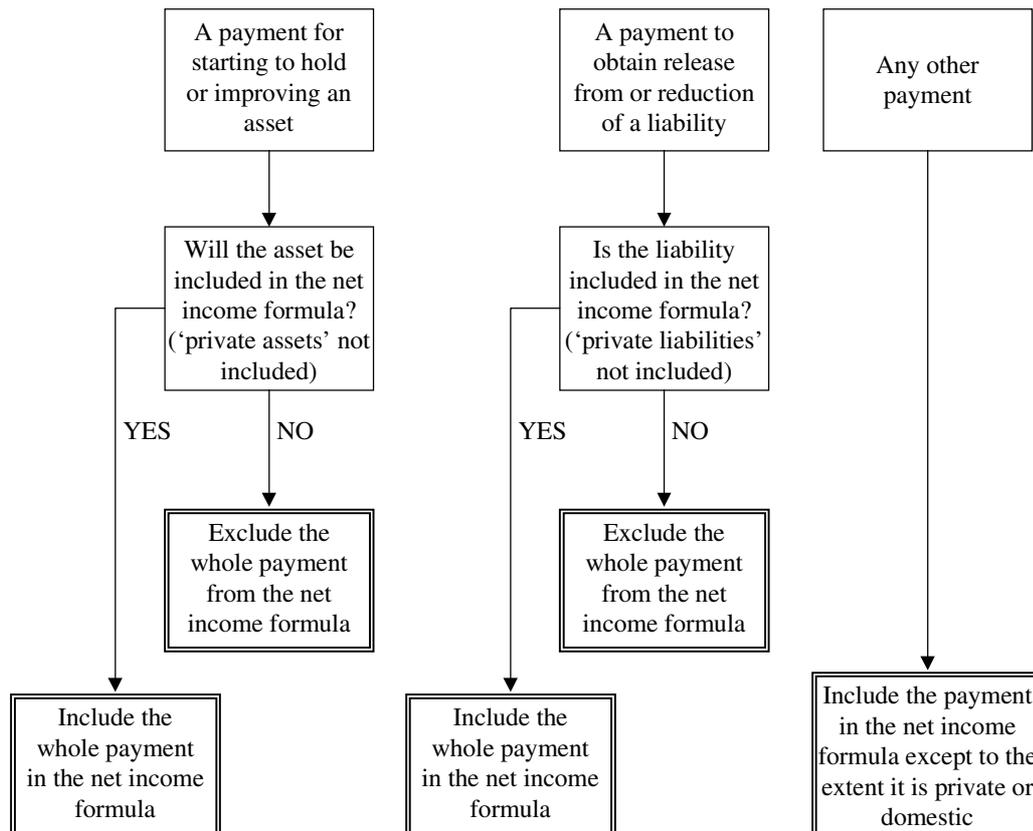
17.87 Once a payment has been excluded from net income by the operation of paragraph 222-10(1)(a) (i.e. because it has a private or domestic nature), it cannot, in a later income year, be absorbed into the cost of an asset that is included in net income. [*Subsection 222-10(3)*]

Taxable income adjustments

17.88 It should be noted that payments that are matched to assets or liabilities which are used partly for private or domestic purposes or are partly of a private or domestic nature may become the subject of adjustments when calculating taxable income. These adjustments are calculated based on the extent that the matched asset was used for private or domestic purposes or the matched liability has a private or domestic nature. (Discussion on taxable income adjustments commences at paragraph 17.219.)

Categories of treatment for payments

17.89 Diagram 17.2 shows the different kinds of treatment that can apply to payments.

Diagram 17.2 Treatments that can apply to payments***Payments of a private or domestic nature***

17.90 This concept drives the treatment of all *unmatched* payments that have private or domestic considerations. (For *matched* payments, the payment is instead classified according to the tests for ‘private assets’ or ‘private liabilities’.)

Which kinds of payments have a private or domestic nature?

17.91 Payments will have a private or domestic nature if they are calculated to achieve a private or domestic purpose.

17.92 There will be many more payments of a private or domestic nature than there will be receipts of this kind. This is not surprising when one bears in mind that a vast array of consumption transactions – purchases by non-business consumers of goods and services – involve a business receipt on one side but a private or domestic payment on the other.

17.93 Under the current law, expenditure comes within the general deduction provision (section 8-1 of the ITAA 1997) if it fulfils a number of requirements, including the requirement that it not be of a private or domestic nature. As such, all expenditure that currently qualifies as being deductible under that section will not fail to provide tax relief under the new law solely on the basis that it is private or domestic in nature.

Gifts

17.94 A gift would usually be of a private or domestic nature, although there would regularly be occasions where a gift is not private or domestic because it is made by a business to further its reputation and so sustain or improve its profitability.

Example 17.15

Leong voluntarily contributes to the construction costs of a bypass road so that heavy vehicles do not detract from the amenity of a small town. Such a payment would not have a private or domestic nature if it was to secure the favour of the local community in respect of Leong's business interests.

Food and drink

17.95 Normally an individual's payments for food and drink would be of a private nature, and this is the case even where an employer has prescribed the type and amount to be consumed.

Example 17.16

Matthew is a professional footballer who would be a more effective player if he was bigger. His coach tells him to build himself up by eating lots of steak and potatoes and drinking more beer. The payments for the food are of a private or domestic nature.

17.96 On the other hand, expenditure on such items may not be private if it is made in the context of work-related travel that involves the individual being away from home overnight.

Example 17.17

Nicholas conducts a rice exporting business and regularly travels to Japan to maintain contacts. During these business trips his payments for food and accommodation would not be of a private or domestic nature.

17.97 Clearly, expenditure on food or drink is not of a private or domestic nature if the food and drink is trading stock of a business.

17.98 It can be seen that whether or not a payment is private or domestic is to be determined not primarily by reference to the nature of the item or service that has been purchased, but by the nature of the activities involved, the context of the transaction in relation to those activities, and the nature of the advantage that the item or service will procure.

Child minding

17.99 Payments to obtain child minding services provide another example of this proposition. Such payments would normally be of a private or domestic nature even in the case where it is necessary to make such payments in order to earn one's income.

Example 17.18

Timothy is the sole parent of a 3 year old boy. It would not be possible for him to continue his employment in a department store unless he uses child care facilities. The cost of this care is private or domestic.

17.100 However, if an individual carrying on business makes payments to secure child minding benefits for his or her employees, those payments would not be of a private or domestic nature.

Travel

17.101 Travel payments, too, illustrate the proposition. Costs of travel to and from work are normally private or domestic, even in the case where taxis are necessary because of the absence of public transport. However, if an individual, in carrying out their earning activities, could be said to be itinerant, payments in respect of travel to and from work may not be private or domestic.

Example 17.19

Freya is a travelling saleswoman who does not undertake any home-based work. The payments Freya makes when she travels to and from visiting potential customers would not be of a private or domestic nature.

17.102 There is no intention for TVM to set up a departure from the current tax treatment of travel to and from work.

Wages, payments for services, rent etc.

17.103 Payments of wages or payments for services will be of a private or domestic nature where a private or domestic advantage accrues. This will apply, for example, to the payment of wages to a cleaner that is in respect of cleaning the employer's own residence.

17.104 Payments for rent, hire and leasing will be of a private or domestic nature to the extent to which the property is used for private or domestic purposes.

Interest

17.105 Interest is of a private or domestic nature, and so excluded, to the extent to which the borrowed funds are being used for a private or domestic purpose.

Example 17.20

Benny borrowed \$50,000 and used the funds to purchase a ute. He uses the ute half the time for private or domestic purposes, and half for business purposes. Each year he pays interest of \$4,000. \$2,000 of the interest payment is excluded from net income as being of a private or domestic nature.

Post-cessation expenses

17.106 The fact that employment or business, investment or commercial activity has ceased will not necessarily preclude a payment from being included in net income. However, for that to be the case, the payment cannot give rise to a private or domestic advantage.

Example 17.21

Nadia owns a rented house that has been vacated by the previous tenants. She decides to move into the house, but before she does, she spends \$300 to repair damage caused by the tenants. The \$300 will be included as a payment in her net income.

Extending the meaning of payments of a private or domestic nature

17.107 Section 222-15 outlines payments that are not so much ‘private or domestic’, but nonetheless will fall outside the tax system. Those payments relate to the individual’s:

- education or training;
- travel;
- accommodation;
- sustenance; or
- health;

but only to the extent that the payments are for the purposes of the individual’s:

- field of employment that they have not yet entered; or
- business, investment or other commercial activities that have not yet begun.

[Subsection 222-15(1)]

17.108 Referring to things that have “not yet begun” is designed to exclude from the calculation of net income payments that are considered to come ‘too soon’ to be included in step 2 of the method statement in section 6-55.

Example 17.22

Tim, from Sydney, is looking for a change of career and travels to Melbourne to meet a potential employer. His travel costs fall within the extended meaning of payments of a private or domestic nature.

Tim paid a recruitment consultant \$100 to prepare a resume for him. That payment will not fall within the extended meaning of payments of a private or domestic nature.

17.109 The purpose of the extended meaning is to exclude those things that might otherwise not be excluded by the ordinary meaning of the phrase 'payments of a private or domestic nature'.

17.110 Some self-education expenses fall within the ordinary meaning of payments of a private or domestic nature, some within the extended meaning of that phrase, and some will not be excluded.

Example 17.23

Leif paid \$250 to attend a stress-management course to help him deal with stress at work and at home. This is a payment of a private or domestic nature.

Example 17.24

Jodie is studying full-time for an accountancy degree. The cost of the accounting course will fall within the extended meaning of payments of a private or domestic nature.

Example 17.25

Maxwell, a greeting card salesman, takes 6 months leave without pay to undertake a business administration course. He has an agreement with his employer that, upon successful completion of the course, he will be promoted to an assistant manager position with his current employer. The costs of the course will be payments that are included in Maxwell's net income because they are neither of a private or domestic nature nor fall within the extended meaning of that expression.

17.111 The meaning of payments of a private or domestic nature is also extended in the case of hobbies or recreation. In that regard, a payment of a private or domestic nature includes a payment an individual makes to the extent that it relates to their hobbies or recreation. [*Subsection 222-15(2)*]

17.112 A payment made in relation to an individual's hobbies or recreation may, in some cases, be considered to have a commercial flavour. To the extent that this is the case, this subsection ensures that the payment is excluded from net income calculations.

17.113 That payment will not necessarily be excluded from net income if, and to the extent that, the amount relates to the individual providing

their efforts or skills associated with the hobby or recreation [*subsection 222-15(3)*]. However, the payment will still have a private or domestic nature to the extent that it satisfies the ordinary meaning of ‘payments of a private or domestic nature’.

Payments that are costs

17.114 Payments that form the cost of an asset or the cost of extinguishing a liability are *matched* payments. The treatment of these types of payments is determined by whether the matched asset or liability was, at that time, a ‘private asset’ or ‘private liability’. Those payments are not ascribed a treatment that is independent of the asset or liability – that is, the test in those circumstances does not focus on whether or not they are ‘payments of a private or domestic nature’. The focus is instead on the asset or liability.

17.115 Discussion of what is a ‘private asset’ and what is a ‘private liability’ commences at paragraph 17.134 and paragraph 17.194 respectively.

17.116 Some common examples of *matched* payments include:

- payments for assets:
 - will be included in net income *if* the asset that has been acquired is not a ‘private asset’, otherwise the payment will be excluded;
- extending loan funds to another party:
 - a payment that constitutes the extension of loan funds is effectively consideration for the acquisition of the resulting debt, which is a financial asset and will *always* be included in net income as a financial asset can never be a ‘private asset’;
- extending credit to another party:
 - the treatment is similar to the extension of loan funds except that the extension of credit involves the non-cash transaction rules and thus gives rise to deemed, rather than actual, payments;
- repaying a loan:
 - payments that are for the release from a liability are included in net income *if* the liability is not a ‘private liability’, otherwise the payment is excluded; and
- debt defeasance payment:

- this is a payment which is made in order that someone else will agree to incur the liability (a debt defeasance payment), and as such will be treated in the same way as a repayment of borrowed funds.

Assets

17.117 Private or domestic considerations can cause:

- some assets to be excluded from net income– this exclusion is built on the notion of ‘private assets’; and
- other assets to be the subject of adjustments when calculating taxable income – these adjustments are based on the extent that the asset was used for ‘private or domestic purposes’.

17.118 Both concepts are tools used by Division 222 to prescribe the treatment of assets.

17.119 Liabilities are treated similarly.

Excluding assets from net income

17.120 Excluding private assets from the net income formula is achieved by not taking them into account when calculating the closing tax value of assets as at the end of the income year and consequently the opening tax value of assets as at the start of the next income year. As such, private assets are excluded from both step 3 and step 4 of the method statement in section 6-55. [Section 222-40]

Example 17.26

In Year 1, Raymond purchased a camera for \$1,000. It is a private asset as he intends to use it solely for private or domestic purposes. At the end of the income year he still owns the camera. It is not included in step 3 of the method statement in section 6-55 for Year 1, nor is it included in step 4 of the method statement in section 6-55 for Year 2.

In Year 2, Raymond started a business taking photos for cookbooks authored by celebrity chefs. The camera is no longer a private asset and, at the end of that year, it is included in step 3 of the method statement in section 6-55 (assuming he still owns the camera).

Assets that are included in net income but require adjustment

17.121 Assets used *partly* for ‘private or domestic purposes’ are included in net income at their full value. These assets do not satisfy the ‘private asset’ definition. Adjustments are made to exclude any private or domestic elements *to the extent* that the asset was used for those purposes when the asset depreciates and again upon disposal. These adjustments are made after net income has been calculated. (The taxable income adjustment

rules are located in Subdivision 222-F – see paragraph 17.219 and following.)

Example 17.27

Bob, a builder, purchases a ute for \$30,000 which he sometimes uses to transport building supplies to the building site. The ute is not a private asset and will be included in step 3 of the method statement in section 6-55 if he stills uses the ute for those purposes at the end of the income year. (The payment of \$30,000 will also be included in net income at step 2 of the method statement in section 6-55 for the year in which the payment is made.) For that income year, Bob will also have to calculate a taxable income adjustment to exclude depreciation of the ute to the extent it relates to his private or domestic use.

Use for ‘private or domestic purposes’

17.122 The concept of use of an asset for ‘private or domestic purposes’ drives the treatment of most assets that have private or domestic aspects – both in terms of whether an asset satisfies the ‘private asset’ definition or whether it should be subject to a taxable income adjustment.

17.123 The concept is applied:

- prospectively – when assessing whether an asset meets the ‘private asset’ definition; and
- retrospectively – when assessing whether an asset should be subject to a taxable income adjustment as it depreciates or on disposal.

What is a ‘private or domestic purpose’?

17.124 Broadly, the purpose for which an asset is used is ascertained by considering all the circumstances surrounding holding the asset, including the origin of the need for that asset and the object which the use of that asset is calculated to achieve. Where the need for an asset has its origin in meeting the personal requirements of an individual (such as, the requirements to wear clothes and to provide food, shelter and education for family members), assets which are used to meet those requirements (such as, clothes, food, a dwelling, and textbooks) are held for ‘private or domestic purposes’.

17.125 A private or domestic purpose, in respect of the use of an asset, is one which concerns the personal enjoyment or sharing of an asset rather than using it for wealth creation or maintenance. ‘Private or domestic purpose’ is used in contradistinction to an employment, business, investment or other commercial purpose.

Example 17.28

Adam is a travelling salesman and uses his car for business purposes. In that capacity, the car is not being used for private or domestic purposes – he is looking to earn money.

Adam uses his car to inspect his rental properties. In that capacity, the car is not being used for private or domestic purposes – he is looking to protect his income earning assets.

Adam uses his car to drive to the coast for a holiday. In that capacity, the car is being used for private or domestic purposes.

What is “use”?

17.126 ‘Use an asset’ is defined to mean consume or receive the economic benefits embodied in the asset [*subsection 72-30(2)*]. (This concept is explained in detail in Chapter 12, at paragraphs 12.29 to 12.39.)

17.127 ‘Use’ extends to the individual applying the asset to the benefit of others. If the asset was lent to another individual to use with no consideration payable, then it would often be akin to a gift. In those cases, the individual would be taken to have used the asset for private or domestic purposes because the individual has derived no real business or commercial advantage from that use. The use to which the other individual put the asset (that is, whether the asset was used for business or private purposes) would usually be irrelevant.

Example 17.29

Adam’s friend Ellie needs a car in her catering business, but hers is temporarily off the road. Adam lets her use his car. In that capacity, the car is being used for private or domestic purposes – Adam is sharing his wealth by entering into a private or domestic arrangement with Ellie.

Extending the meaning of private or domestic purpose

17.128 The purpose of the extended meaning is to exclude those things that would otherwise not be excluded by the ordinary meaning of the phrase ‘private or domestic purpose’. [*Paragraph 222-50(1)(c)*]

17.129 Section 222-50 outlines uses of assets that are not so much ‘private or domestic’, but nonetheless will fall outside the tax system. Those uses are for the purposes of the individual’s:

- education or training;
- travel;
- accommodation;

- sustenance; or
- health;

and those purposes are in respect of the individual's:

- field of employment that they have not yet entered; or
- business, investment or other commercial activities that have not yet begun.

[Subsection 222-50(1)]

17.130 Referring to things that have “not yet begun” is designed to exclude tax effects that arise from the use of assets that is ‘too soon’ to be included in step 3 of the method statement in section 6-55.

17.131 The meaning of ‘private or domestic purposes’ is also extended in the case of hobbies or recreation. In that regard, using an asset for private or domestic purposes includes an individual’s use of the asset to the extent that it relates to their hobbies or recreation. *[Subsection 222-50(2)]*

17.132 An individual’s use of an asset that relates to their hobbies or recreation may, in some cases, be considered to have a commercial flavour. To the extent that this is the case, TVM will account for that use as being for ‘private or domestic purposes’.

17.133 That will not necessarily be the case if, and to the extent that, the use relates to the individual providing their efforts or skills associated with the hobby or recreation *[subsection 222-50(3)]*. However, the asset will still be considered to be used for private or domestic purposes to the extent that it satisfies the ordinary meaning of ‘private or domestic purposes’.

The private asset table

17.134 The table at subsection 222-45(1) provides the tests for determining whether an individual’s asset is a ‘private asset’ or not. In most cases the status of an asset can vary from time to time, as circumstances change. However this is generally not the case with:

- collectables –unless they are later subsumed into the individual’s trading stock;
- investment assets, financial assets and trading stock – because those assets that can never be ‘private assets’; and
- assets which are essentially private or domestic in nature for the individual.

17.135 In the case of assets that are susceptible to a change in status, ‘conversion of use’ rules apply to deal with assets that become private

assets or cease being private assets [sections 222-55 and 222-60]. These rules are explained at paragraphs 17.171 and following.

Item 1 of the private asset table

17.136 An item of trading stock can never be a private asset [subsection 222-45(1), item 1 in the table]. This reflects the current law's treatment of trading stock.

17.137 If, however, the asset ceases being held as trading stock and is instead intended to be used for private or domestic purposes, it may become a private asset at that time. This is reliant on the asset then satisfying one of the tests in the table in subsection 222-45(1).

Item 2 of the private asset table

17.138 A financial asset can never be a private asset. [Subsection 222-45(1), item 2 in the table]

17.139 This reflects the current treatment of interest receipts, which are never private. Quasi-interest, such as that arising from bonds bought at a discount, should receive equivalent treatment. To this end, then, assets that embody a quasi-interest component cannot be 'private assets' even if those assets have a private or domestic character. To avoid classification problems, financial assets are never private assets.

Example 17.30

Jarrod has the choice of investing in 2 financial products that differ in legal form but economically provide him with the same return (over the same term):

- a \$1,000 fixed term deposit of one year that will return 5% interest at conclusion of the term; or
- a one year commercial bill with face value of \$1,050 and which was issued at a \$50 discount.

Both investments return (over the same term) \$50 on the original investment. So that net income recognises this return of interest or earnings in the nature of interest, financial assets are never private assets.

17.140 While the treatment of interest drives Division 222's treatment of financial assets, the definition of financial assets is far wider than just interest-producing investments.

17.141 A *financial asset* is an asset that consists only of one or more of the following:

- a right to receive an amount;

- a right to receive all or part of an asset that is a financial asset because of any other application or applications of this definition;
- foreign currency (except a collectable).

[Section 76-10]

17.142 The following are examples of what a ‘financial asset’ includes:

- an individual’s bank account – such as their savings or cheque account;
- other investments of money that return interest – such as term deposits, bonds and loans;
- a right to be paid for the sale of anything or the provision of any service;
- a right to be paid winnings – such as winning lottery tickets or betting slips; and
- a right to cash refunds, or cash payments in relation to insurance claims – such as when returning a faulty product to the store of purchase or making a claim under an insurance policy.

17.143 However, while ‘financial assets’ are defined widely and can never be private assets, the actual effect should be negligible for most individuals as they will not be required to account for things that they do not account for currently. This is because TVM will provide for individuals to use cash accounting for certain types of transactions (this is in accordance with recommendation 4.4 in ATSR which has not yet been drafted).

17.144 Financial assets will often interact with the non-cash transaction rules in Division 16 because a financial asset, being a right to get money, is an example of a ‘non-cash benefit’. The non-cash transaction rules apply to any arrangement where one entity gives one or more ‘non-cash benefits’ in return for something other than money or in return for nothing. The non-cash transaction rules operate by ascribing notional receipts and payments to those non-cash benefits.

Example 17.31

Martin has a motorcycle. It is not a private asset.²⁶³ The motorcycle has a tax value of \$5,000. He sells his motorcycle in exchange for a promise to be paid \$6,000 in 2 months. This is a non-cash transaction. The non-cash transaction rules deem a receipt, which represents the

²⁶³ Refer to subsection 222-45(1), item 5 of the table.

proceeds of selling his motorcycle for \$6,000 and deem a payment, which represents the cost of his financial asset, being the right to get \$6,000.

17.145 Forgiving a loan is also a type of ‘non-cash benefit’. The act of forgiving a loan will give rise to a one-sided non-cash transaction and would be treated in much the same way as gifting an asset for private or domestic purposes. That is, there would be deemed a payment and a receipt equal to the market value of the loan forgiven. The deemed receipt would offset the tax effect of the asset falling away and the payment would be of a private or domestic nature, and so disregarded. The result is that forgiveness does not give rise to tax relief.

Item 3 of the private asset table

17.146 A collectable, or an interest in a collectable, is a private asset if it satisfies the tests in section 234-35. [*Subsection 222-45(1), item 3 in the table*]

17.147 Chapter 18 deals with collectables and interests in collectables in detail. Briefly though, a collectable or interest in a collectable will be:

- included in the calculation of net income if it was acquired for more than \$10,000 regardless of the individual’s intended use of the collectable;
- included in the calculation of net income if it was acquired for \$10,000 or less but only if it is intended to be used solely for non-private or domestic purposes; and
- in all other cases - excluded from the calculation of net income as it will be a private asset.

17.148 To summarise, collectables are private assets if they were acquired for \$10,000 or less and are intended to be used at least partly for private or domestic purposes.

Item 4 of the private asset table

17.149 Investment assets that are not collectables, or interests in collectables, can never be private assets [*subsection 222-45(1), item 4 in the table*]. In practice this is to cover land, as most other types of investment assets, such as shares, would not normally be considered to have a private or domestic element to them (with the possible exception of some perpetual rights).

Example 17.32

Will Dennis purchased a block of land near a rainforest. He plans to build a house and retire there. Despite intending to use the land solely for private or domestic purposes, the land can never be a private asset.

17.150 There are some special points associated with land:

- the main residence exemption; and
- the capitalisation of certain private or domestic expenses.

17.151 Although the main residence exemption has not yet been drafted, its inclusion has been foreshadowed in item 1 of the table at section 222-65.

17.152 In accordance with the policy recommended in ATSR,²⁶⁴ directly attributable expenditure (such as interest and rates) is added to the cost of land (as a second element cost) to the extent that the land is not used for income producing purposes (other than a gain on realisation).

Item 5 of the private asset table

17.153 Item 5 assets are those assets which do not fall within the scope of the kinds of assets listed at items 1 to 4 of the private asset table. They are any other assets except those consisting of a right to hold another asset that the individual does not hold. This item essentially covers:

- depreciating assets (except for those that are rights to hold other assets); and
- listed zero tax value assets (as defined in subsection 68-10(1)).

17.154 These assets will be private assets if:

- the individual intends to use the asset solely for private or domestic purposes so long as they hold it; or
- the asset is, for the individual, essentially private or domestic in nature.

[Subsection 222-45(1), item 5 in the table]

Example 17.33

Robert is a professional portrait photographer and buys a small camera so that he can take it with him on his holidays. The asset is a private asset and is excluded from net income because it is intended to be used solely for private or domestic purposes.

An exclusion based on a test of intention

17.155 The first test is one of intention. The frame of reference for the test is the period from the time the individual first holds the asset, or any subsequent time that the test is applied, until the time when the individual no longer plans to hold the asset. It is a prospective test. So, an asset will

²⁶⁴

As per recommendation 4.13(d)(i).

be a private asset if the intention is to use the asset solely for private or domestic purposes for that period. In all other cases (and unless the test at paragraph (b) applies), the asset will be reflected in net income calculations.

Example 17.34

Rebecca left the health care company she was working for and started up her own consultancy business. She already owned a computer, which she bought to use solely for playing computer games, and now intends to use it in her consultancy business. At that time, the computer will cease being a private asset.

17.156 The fact that there is a possibility that an item will be used for purposes other than private or domestic purposes will not disqualify an asset from being private – it is the individual’s intention that counts.

17.157 Intention is also important if the asset ceases to be held before it is actually used for any purpose.

Example 17.35

Rebecca prepaid \$100 to get an internet account, which included 6 months access. She opened the account so that she could keep in contact with clients via email when she worked from home.

The right to get internet access is not a private asset. This treatment does not change even if she did not end up using the account.

17.158 The prospective nature of this test reflects the fact that assets are stores of future economic benefits and how those future economic benefits are expected to be used up is determinative of whether or not an asset should be included in the tax system. Thus a change of intention may change how the asset is treated and, if so, the ‘conversion of use’ rules will apply to move the asset in or out of the tax system, as appropriate.

An exclusion based on essentially private or domestic in nature

17.159 The second test excludes assets from the tax system that are ‘essentially private or domestic in nature’ for the individual, even though they might not be used exclusively, predominantly, or even at all for private or domestic purposes. In most circumstances, it will exclude assets such as food, shelter, and clothing, which are necessities in life even though they have some connection to income earning capacity.

Example 17.36

Audrey is the manager of a plant nursery and gardening centre who pays \$200 for drill shirts and trousers she wears at work. This clothing is not protective in nature. The clothing is essentially private or domestic in nature for Audrey and as such is a private asset of hers.

Example 17.37

Charles plays saxophone for a State Symphony Orchestra. To play in the band his employer requires him to wear a formal suit (including tails). Charles paid \$900 for the suit. The suit is a private asset as it is essentially private or domestic in nature for Charles.

17.160 Other likely examples include watches and sunglasses.

The types of assets which fall within item 5

17.161 The dominant category of assets within this item are depreciating assets. A **depreciating asset** is an asset that can be used only for a limited period [*subsection 72-30(1)*]. Notably, this concept is broader than the current law's definition of 'depreciating asset'. As Chapter 12 (Depreciating Assets) highlights, the broader concept covers assets that do not generally decline in value over the course of their effective lives but instead lose all, or substantially all, of their value when they cease to exist. Accordingly, assets such as rights to get services may be depreciating assets.

17.162 'Listed zero tax value assets', defined at subsection 68-10(1) can fall within item 5. They are assets that are given a tax value of zero irrespective of the asset's cost (for a further explanation of listed zero tax value assets, see Chapter 7). Most listed zero tax value assets will not fall within the scope of Division 222, though, because they will not have a private or domestic character. Routine rights are the main exception. The other possible exceptions are consumable stores, spare parts and office supplies under the proviso that they are not part of the individual's trading stock.

17.163 If the asset (being the consumable stores, spare parts or office supplies) is intended to be used solely for private or domestic purposes as long as the individual holds it, then the asset is a private asset. Thus, as discussed earlier, neither the payment nor the asset will be included in net income calculations.

17.164 However for those assets that are intended to be used partly for private or domestic purposes, the fungible nature of these kinds of assets means that the asset is susceptible to segregation into 2 – a private asset the size of which reflects the degree of intended private or domestic use and an asset which will be reflected at step 3 of the method statement in section 6-55 at a zero tax value. Splitting the asset takes place at the time of acquisition and broadly mirrors the current law in that a deduction is allowed "to the extent" that it satisfies one of the positive limbs of section 8-1 of the ITAA 1997.

Example 17.38

Joe owns a cotton farm. All of his farm machinery and his car use diesel. At the end of Year 1, he purchased 5,000 litres of diesel for \$5,000 but didn't use any of the diesel in that income year. Joe intends

to use 1,000 litres of the diesel purchased for private or domestic purposes.

The diesel Joe has acquired is a consumable store and is treated as a listed zero tax value asset. Joe's net income for Year 1 records a \$4,000 payment, which is matched to an asset that has a tax value of zero. Also, a \$1,000 payment is matched to an asset which is a private asset (being that portion of the diesel purchased that is intended to be used for private or domestic purposes). Both the \$1,000 payment and the private asset are excluded from net income.

17.165 When actual usage does not mirror intended usage, some adjustments must be made. Those adjustments are made through the application of the 'conversion of use' rules (see paragraphs 17.171 and following).

Item 6 of the private asset table

17.166 Item 6 assets are assets (other than those assets which fall within the scope of items 1 to 5 of the private asset table) that consist of a right to hold another asset that the individual does not hold. An asset of that type will be a private asset if:

- the individual intends to use the *other* asset solely for private or domestic purposes so long as they hold the other asset; or
- the *other* asset is for the individual essentially private or domestic in nature.

[Subsection 222-45(1), item 6 in the table]

17.167 Item 6 therefore generally provides for the right to take on the nature that would be ascribed to the underlying asset if the underlying asset were held by the individual.

Example 17.39

Peter ordered and paid for a new sedan from a car dealer and will get delivery of the car in 2 weeks. He has a right to hold the car at that time. As he intends to use the car partly for private or domestic purposes, the right to hold the car will not be a private asset.

17.168 Notably though, rights arising from hire-purchase arrangements are not treated as rights to hold another asset and thus are not captured by item 6. Instead, item 1 of the table at section 24-10 looks to the *substance* of the arrangement and deems the hire-purchaser to hold the underlying asset rather than merely holding a right to hold the underlying asset. So in that case, whether or not the underlying asset will be a 'private asset' is determined according item 5 of this table.

Rights to hold assets and the private asset table

17.169 Assets that consist of a series of rights to hold an asset are treated as consisting of one right to hold the other asset (being the underlying asset) [subsection 222-45(2)]. However the private asset table (at subsection 222-45(1)) only applies to the right to hold that underlying asset and not to any of the other rights [subsection 222-45(3)].

Assets subject to specialised treatment

17.170 Some special classes of assets that have a measure of private or domestic character are subject to specialised treatment under other provisions. Such assets include an individual's main residence (see discussion at paragraph 17.151), collectables (see discussion at paragraphs 17.146 to 17.148), and a decoration for valour or brave conduct. [Section 222-65]

Applying the 'conversion of use' rules to assets

17.171 The 'conversion of use' rules apply to assets that are capable of satisfying the definition of 'private asset' and the asset shifts *to* or *from* being a private asset. In essence, these 'conversion of use' rules represent the gateway for some assets and liabilities to enter or leave the tax system.

17.172 When an asset is not part of the tax system, the tax system (through Division 222) disregards the individual's holding of that asset. The fact that the individual still holds the asset is only relevant if the asset ceases being a private asset and enters or re-enters the tax system. It is from that time that the 'conversion of use' rules reset the period from which that asset began being held. Equally, if the asset ceases to be a private asset and leaves the tax system, the 'conversion of use' rules treat the asset as though it is no longer held.

17.173 These rules only apply if the individual continues to hold the asset. They do not apply if, for instance, the individual sold their private asset to someone who began to use it for business purposes.

Private assets entering the tax system

17.174 At the time the asset ceases being a private asset and enters, or re-enters, the tax system, the individual is treated as if they had started to hold the asset at the time that is immediately after it stopped being a private asset. As an asset that has come into the tax system, it needs to be ascribed a cost. Accordingly, the individual is taken to have paid an amount for the asset which is equal to its market value. The market value is determined as at the time paragraph 222-55(1)(a) deems the individual to have started holding the asset. [Subsection 222-55(1)]

Example 17.40

In Year 1, Tracy purchased a moped for \$4,000. At that time, it is a private asset. In Year 3, she started working for a florist and uses her moped when delivering flowers to customers. When she first intended to use her moped in this manner, it ceased being a private asset from that time.

Tracy is taken to have started holding the moped as soon as it ceased being a private asset. Also she is taken to have paid an amount equal to its market value at that time, which was \$2,000. Both the \$2,000 payment and the asset (the moped) will be reflected in her net income calculations.

17.175 The deemed payment equal to the asset's market value when it enters, or re-enters, the tax system forms its first element of cost [*subsection 14-25(1)*]. It follows therefore that amounts that would otherwise have formed either first or second elements of cost prior to the time that market valuation relates to should not later be absorbed into the cost of the asset. [*Subsection 222-55(2)*]

Private assets leaving the tax system

17.176 At the time the asset becomes a private asset and thus leaves the tax system, the individual is treated as if they had stopped holding the asset at the time that is immediately before it became a private asset. As an asset that has left the tax system, it is similar to a disposal of the asset and as such needs to be ascribed some proceeds of realising the asset. Accordingly, the general principle is that the individual is taken to have received an amount for the asset which is equal to its market value. The market value is determined as at the time paragraph 222-60(1)(a) deems the individual to have stopped holding the asset. [*Paragraph 222-60(1)(a) and subparagraph 222-60(1)(b)(i)*]

Example 17.41

This example continues on from the previous example.

In Year 5, Tracy changed jobs and no longer needed to use her moped for work purposes. At that time, it became a private asset. She is treated as if she stopped holding the asset and received an amount equal to the moped's market value (which was \$1,000) because she stopped holding the asset. The receipt is included in her net income calculations.

17.177 An exception applies for assets that were trading stock immediately before they became private assets. In those cases, the proceeds of realising the asset are the asset's cost as at the time paragraph 222-60(1)(a) deems the individual to have stopped holding the asset [*subparagraph 222-60(1)(b)(ii)*]. This exception accords with the policy evident in section 70-110 of the ITAA 1997.

17.178 Although subsection 222-60(1) treats the individual as if they no longer hold the asset once it has become a private asset, that is merely a signal that the tax system is not concerned with the asset while it retains private asset status. However as the asset is still held by the individual, it can, at a later point in time, re-enter the tax system. [*Subsection 222-60(2)*]

Liabilities

17.179 Private or domestic considerations can cause:

- some liabilities to be excluded from net income– this exclusion is built on the notion of ‘private liabilities’; and
- other liabilities to be the subject of adjustments when calculating taxable income – these adjustments are based on the extent that the liability has a ‘private or domestic nature’.

17.180 Both concepts are tools used by Division 222 to prescribe the treatment of liabilities.

17.181 Assets are treated similarly.

Excluding liabilities from net income

17.182 Excluding ‘private liabilities’ from the net income formula is achieved by not taking them into account when calculating the closing tax value of liabilities as at the end of the income year and consequently the opening tax value of liabilities as at the start of the next income year. As such, private liabilities are excluded from both step 5 and step 6 of the method statement in section 6-55. [*Section 222-80*]

Example 17.42

On 30 June Year 1, Mathew borrowed \$100,000 to purchase a rental property. Mathew’s financial liability is not a private liability and is reflected in step 5 of the method statement in section 6-55. In Year 2, Mathew sells the rental property and reapplies the funds to purchase a yacht which he plans to use for a sailing holiday. In Year 2, the tax value of the liability will be included in step 6 of the method statement in section 6-55 but not in step 5 of that method statement because during the year it became a private liability.

Liabilities that are included in net income but require adjustment

17.183 Liabilities that are *partly* of a private or domestic nature are included in net income at their full value. These liabilities do not satisfy the ‘private liability’ definition. Adjustments are made to exclude any private or domestic elements *to the extent* that the liability had that nature when the liability depreciates or appreciates and again upon extinguishment. These adjustments are made after net income has been

calculated. (The taxable income adjustment rules are located in Subdivision 222-F – see paragraphs 17.219 and following).

Private or domestic nature

17.184 This concept drives the treatment of most liabilities that have private or domestic aspects – both in terms of whether a liability satisfies the ‘private liability’ definition or whether it should be subject to a taxable income adjustment.

17.185 The concept is used:

- contemporaneously – when assessing whether a liability meets the ‘private liability’ definition; and
- retrospectively – when assessing whether a liability should be subject to a taxable income adjustment as it depreciates or appreciates or on extinguishment.

What is a ‘liability of a private or domestic nature’?

17.186 A liability, of itself, does not possess a nature that is susceptible to this kind of classification. As such, the nature of a liability is generally ascertained by considering the attendant circumstances, including the reasons why the liability was incurred and the advantages²⁶⁵ provided by its existence.

17.187 A liability of a private or domestic nature is one which is calculated to enable the consumption or sharing of wealth rather than its creation or maintenance. A liability of a private or domestic nature is contrasted with a liability connected with employment, business, investment or other commercial purposes.

Example 17.43

Paul owns a credit card which he uses to meet personal expenses. His obligation to repay the amount borrowed is a liability of a private or domestic nature.

Extending the meaning of a liability of a private or domestic nature

17.188 The purpose of the extended meaning is to exclude those things that might otherwise not be excluded by the ordinary meaning of the phrase ‘liabilities of a private or domestic nature’.

17.189 Section 222-90 covers liabilities that have a nature that is not so much ‘private or domestic’, but nonetheless will fall outside the tax system. Such liabilities are those that relate to the individual’s:

²⁶⁵ Not all liabilities give rise to advantages – for example, a liability to pay a speeding fine or a liability to pay compensation after a customer slipped on a wet floor in a supermarket.

- education or training;
- travel;
- accommodation;
- sustenance; or
- health;

and those liabilities are in respect of the individual's:

- field of employment that they have not yet entered; or
- business, investment or other commercial activities that have not yet begun.

[subsection 222-90(1)]

17.190 Referring to things that have “not yet begun” is designed to deny tax relief flowing from circumstances that occur ‘too soon’.

17.191 The meaning of ‘liabilities of a private or domestic nature’ is also extended in the case of hobbies or recreation. In that regard, a liability of a private or domestic nature includes a liability an individual has to the extent that it relates to their hobbies or recreation. *[Subsection 222-90(2)]*

17.192 A liability incurred in relation to an individual's hobbies or recreation may, in some cases, be considered to have a commercial flavour. To the extent that this is the case, this subsection ensures that the liability is excluded from net income calculations.

17.193 That liability will not necessarily be excluded from net income if, and to the extent that, incurring the liability relates to the individual providing their efforts or skills associated with the hobby or recreation *[subsection 222-90(3)]*. However, the liability will still have a private or domestic nature to the extent that it satisfies the ordinary meaning of ‘liability of a private or domestic nature’.

The private liability table

17.194 The table at section 222-85 provides the tests for determining whether a individual's liability is a ‘private liability’ or not. In most cases, the status of a liability can vary from time to time as circumstances change.

17.195 The exception (i.e. where the test is not contemporaneous) is where the individual's liability is to provide an asset that they hold and that asset for them is a collectable, an item of trading stock, a financial asset or an investment asset.

17.196 In the case of liabilities susceptible to a change in status, ‘conversion of use’ rules apply to deal with liabilities that become private liabilities or cease being private liabilities [sections 222-95 and 222-100]. These rules are explained at paragraph 17.212 and following.

Item 1 of the private liability table

17.197 A financial liability is a private liability if, for the individual, the liability is solely a liability of a private or domestic nature, having regard to:

- how the proceeds of incurring the liability are currently applied; and
- the purpose for which, and the reasons why, the individual began to have the liability.

[Section 222-85, item 1 in the table]

Example 17.44

A personal loan used to fund an overseas holiday is a financial liability, which, because of the manner in which the proceeds are being applied, is a private liability.

17.198 This test reflects the current treatment of interest expenses, regardless of whether they relate to the payment of interest or the recognition of interest that has accrued, such as that arising from bonds bought at a discount. As interest can be private, so too a financial liability can be private. The distinction between the treatment of financial assets and financial liabilities is a result of the asymmetric treatment of interest.

17.199 A *financial liability* is a liability that consists of one or more of the following:

- an obligation to pay an amount;
- an obligation to provide a financial asset.

[Section 76-110]

17.200 The following are examples of what a financial liability includes:

- an individual’s bank account (if in overdraft) or credit cards;
- other borrowings of money that include an interest component – such as personal and home loans;
- obligation to provide money for the purchase of anything or the provision of any service; and
- obligation to return money – such as providing cash refunds.

17.201 However, while ‘financial liabilities’ are defined widely, the number of liabilities an individual will need to test to determine whether it is a private liability should be negligible as they will not be required to account for things that they do not account for currently. This is because TVM will provide for individuals to use cash accounting for certain types of transactions (this is in accordance with recommendation 4.4 of ATSR which has not yet been – but will be – drafted).

17.202 Financial liabilities will often interact with the non-cash transaction rules in Division 16 because a financial liability, being an obligation to provide money, is an example of a ‘non-cash benefit’. The non-cash transaction rules apply to any arrangement where one entity gives one or more ‘non-cash benefits’ in return for something other than money or in return for nothing. The non-cash transaction rules operate by ascribing notional receipts and payments to those non-cash benefits.

Example 17.45

Sharyn, a sole trader, buys some computer software for \$500 on credit terms that require payment in 30 days. This is a non-cash transaction. As she intends to use the software partly for private or domestic purposes, the obligation to pay \$500 is not a private liability of hers.²⁶⁶ The non-cash transaction rules deem a payment representing the cost of the software and deem a receipt, representing the proceeds of incurring the financial liability.

17.203 As paragraph 17.199 illustrates, the definition of ‘financial liabilities’ is far wider than just debts with an interest component. Whilst both limbs of the test are obviously relevant for borrowings, that does not preclude applying either or both limbs to other promises to pay.

17.204 The limbs of the test comprise an objective element (the first limb which focuses on *use*) and a subjective element (the second limb which focuses on *purpose*).

17.205 In the case of borrowings, the first limb will be used to ascertain whether the liability is solely of a private or domestic nature by reference to the objective circumstances of the use to which the borrowed funds are put. However, it is made readily applicable to other financial liabilities by the invocation of the expression “the proceeds of incurring the liability”.

17.206 The purpose of borrowing funds and the use of those funds will not always correspond. For this reason, the second limb is a test that can look past how the proceeds have been applied and characterise the financial liability with reference to the individual’s motivation and subjective purpose. As it may not always be appropriate to look at the underlying purpose of a transaction, the test is phrased in terms of “having regard to”.

²⁶⁶ See section 222-85, item 1 of the table.

17.207 Like most assets and liabilities, a financial liability can potentially shift between being a private liability and a liability that is recognised in net income. For this to eventuate, it will require a change in the application of the proceeds. That is, it is *current* use that will generally drive the treatment to be afforded to the financial liability in those cases where a conversion is possible.

Example 17.46

Tommy bought a car with the proceeds he acquired from entering into a loan agreement with a lending institution. As Tommy intended to use the car for business purposes occasionally, neither the car nor the loan would be a private asset or a private liability. However, if at a later time Tommy intends to use the car solely for private or domestic purposes, the car becomes a private asset. As the use to which the loans funds have been put has changed in nature, at that time the loan will become a private liability.

Item 2 of the private liability table

17.208 An individual's liability to provide an asset that they hold is a private liability if the asset is, for them, a private asset. [*Section 222-85, item 2 in the table*]

17.209 As the liability takes on the nature that is ascribed to the underlying asset, the liability will be a private liability if the asset is a 'private asset' and vice versa. This allows for the gain or loss on sale of the underlying asset is recognised where appropriate – and that appropriateness is judged by the definition of 'private asset'.

17.210 This treatment is similar to the treatment of rights to hold other assets (see paragraph 17.166).

Example 17.47

Jose entered into a contract to sell his laptop computer for \$4,000. At the end of the income year, Jose received the proceeds from sale but still held the asset.

- If the asset was a private asset, the liability would be a private liability. As any gain or loss on the sale of the private asset will not be recognised by the tax system, the liability does not need to be recognised.
- However, if the asset was only used for private or domestic purposes occasionally, Jose's liability will be recognised by the tax system (and will be recognised at its (full) tax value). Jose can then calculate the gain or loss on sale, and adjust it for any private or domestic use.

Item 3 of the private liability table

17.211 Any other liability is a private liability if, for the individual, the liability is *solely* a liability of a private or domestic nature. [*Section 222-85, item 3 in the table*]

Example 17.48

Bradley was liable to repair some damage he caused to a unit he was renting while on holidays. It is a liability of a private or domestic nature.

Applying the ‘conversion of use’ rules to liabilities

17.212 These rules apply to liabilities that are capable of satisfying the definition of ‘private liability’ and the liability shifts *to* or *from* being a private liability. In essence, these ‘conversion of use’ rules represent the gateway for some assets and liabilities to enter or leave the tax system.

17.213 When a liability is not part of the tax system, the tax system (through Division 222) disregards the individual having that liability. The fact that the individual still has the liability is only relevant if the liability ceases being a private liability and enters or re-enters the tax system. It is from that time that the ‘conversion of use’ rules reset the period from which the incurring of that liability began. Equally, if the liability ceases being a private liability and leaves the tax system, the ‘conversion of use’ rules treat the liability as though it is no longer one the individual has.

17.214 These rules only apply if the individual continues to have the liability. That is, they do not apply if for instance, the individual assigned the liability to someone else.

Private liabilities entering the tax system

17.215 At the time the liability ceases being a ‘private liability’ and enters, or re-enters, the tax system, the individual is treated as if they had started to have the liability at the time that is immediately after it stopped being a private liability. As a liability that has come into the tax system, it needs to be ascribed some proceeds of incurrence. Accordingly, the individual is taken to have received an amount for incurring the liability which is equal to the liability’s market value. The market value is determined as at the time the individual is taken to have assumed the liability because of receiving the deemed proceeds. [*Subsection 222-95(1)*]

Example 17.49

Matthew borrowed \$50,000 for the purpose of buying a sports car which he intended to use for private or domestic purposes. The loan is a private liability. He subsequently changed his mind and used the funds to purchase a windsurfer for \$2,000 and invested the remainder of the borrowed funds on the stock market. At the time he applied the

funds towards purchasing shares, he is taken to have stopped holding a private liability.

Matthew is now recognised as having a liability and to have received an amount equal to its market value at that time. Both the deemed receipts and the liability will be reflected in his net income calculations.

17.216 The liability's market value when it enters, or re-enters, the tax system forms the first element of the liability's proceeds [*subsection 14-80(1)*]. It follows therefore that amounts that would otherwise have formed either first or second elements of those proceeds prior to the time that market valuation relates to should not later be absorbed into the proceeds of incurring the liability. [*Subsection 222-95(2)*]

Private liabilities leaving the tax system

17.217 At the time the liability becomes a 'private liability' and thus leaves the tax system, the individual is treated as if they had stopped having the liability at the time that is immediately before it became a private liability. As a liability that has left the tax system, it is similar to extinguishing the liability and as such needs to be ascribed a cost of extinguishment. Accordingly, the general principle is that the individual is taken to have paid an amount for the liability which is equal to its market value. The market value is determined as at the time paragraph 222-100(1)(a) deems the individual to have stopped having the liability. [*Subsection 222-100(1)*]

Example 17.50

This example continues on from the previous example.

Later on, Matthew decides to sell the shares and instead use the borrowed funds to purchase a sports car after all. At that time, the liability will become a private liability. He is treated as if he stopped having the liability and paid an amount equal to the liability's market value in order to extinguish the liability.

17.218 Although subsection 222-100(1) treats the individual as if they no longer have the liability once it has become a private liability, that is merely a signal that the tax system is not concerned with the liability while it retains private liability status. However as the liability is still had by the individual, it can, at a later point in time, re-enter the tax system. [*Subsection 222-100(2)*]

Adjusting for private use

17.219 As explained earlier in this chapter, the exclusion of private or domestic items from the calculation of taxable income is achieved by:

- fully excluding assets and liabilities that are (wholly) private (as defined);
- fully including other assets and liabilities, even those that have some private or domestic aspects;
- ensuring that receipts and payments that are *matched* to assets or liabilities are either fully included or fully excluded, consistent with the inclusion or exclusion of the *matched* item;
- ensuring that *unmatched* receipts and payments are excluded to the extent to which they are private or domestic; and
- providing for adjustments to be made in the case of assets and liabilities that have some private aspects, but are nonetheless fully included (see the second dot point above).

17.220 The necessity for adjustments to exclude certain private matters from the tax calculation is attributable to Division 222's approach of initially bringing to account, in full, assets and liabilities that have some non-private aspects.

17.221 There are 2 sets of circumstances involving an asset or liability with some private aspects that can call for an adjustment to be made:

- When the tax value of a part-private asset declines (i.e. depreciation is allowed) over the tax year, that decline gives rise to tax relief, and it is inappropriate that tax relief should follow from depreciation attributable to private enjoyment. A depreciation adjustment will be required. An analogous situation exists with liabilities.
- When a profit or loss is made upon the disposal of a partly private asset, it is inappropriate that taxable income should be affected by the proportion of the profit or loss that is identified with the private aspects of the asset. A profit or loss adjustment may be required. An analogous situation exists with liabilities.

17.222 It is evident that the former set of circumstances (depreciation) can arise only in the case of assets or liabilities that decline in value. On the other hand, the latter set of circumstances (profit or loss) might arise in the case of a wider range of assets and liabilities. However, Subdivision 222-F provides for adjustments to exclude private or domestic items only in the cases of depreciating assets and depreciating liabilities in *both* sets of circumstances.

Interaction with Division 72

17.223 As the adjustment provisions apply to depreciating assets and depreciating liabilities, they draw heavily on the concepts located in Division 72 – notably, the definitions of ‘depreciating asset’, ‘depreciating liability’ and ‘decline in tax value’. But, it is the decline in tax value of the asset or liability (or the sum of all such declines while the asset was held or liability had) that is central to the operation of the adjustment provisions. Thus, Subdivision 222-F does not contain separate rules for calculating the decline in tax value. Instead it only seeks to adjust that decline or sum of declines to reflect the degree of private or domestic use or nature.

Depreciating assets that have a private percentage*Depreciation adjustments*

17.224 An individual has an **upward adjustment** for a depreciating asset equal to the decline in tax value multiplied by the asset’s private percentage. [*Subsection 222-120(2)*]

17.225 In other words, the taxable income adjustment calculated for a depreciating asset’s decline in tax value is:

Upward adjustment = Decline in tax value × Private percentage

17.226 For this taxable income adjustment to be made:

- the asset must be a ‘depreciating asset’;
- the individual must hold it for some or all of the income year [*paragraph 222-120(1)(a)*];
- its tax value must be worked out under Division 72 (about depreciating assets) [*paragraph 222-120(1)(b)*];
- it must have a ‘private percentage’ for a period that is some or all of an income year – that period is not only exclusive of any time when the asset is a private asset but the period is defined in such a manner that at no time during the period to which the private percentage relates can the asset have been a private asset [*paragraph 222-120(1)(d)*]; and
- the asset must have a ‘decline in tax value’ calculated for that income year [*paragraph 222-120(1)(c)*].

Relevant period

17.227 In calculating a taxable income adjustment for a period, the period for which an upward adjustment is calculated cannot include a

period where the asset was a ‘private asset’ [paragraph 222-120(1)(d)]. For example, if a depreciating asset was held as a private asset for the month of January then the private percentage is not calculated for the combined period of July through to December and February through to June. Rather the private percentage would be calculated for 2 distinct (and not at all related) periods with:

- July to December being the first period for which a ‘private percentage’ is calculated; and
- February to June being the second period for which a ‘private percentage’ is calculated.

17.228 This example illustrates that any later private percentage calculation must be independent of that earlier private percentage calculation even if they both relate to periods that are part of the same income year. [Subsection 222-120(3)]

The ‘private percentage’ table

17.229 The concept of ‘private percentage’ provides the measure of the extent of private or domestic use for a given period, and this may be all or part of an income year. Typically, ‘private percentage’ is focussed on actual use.

17.230 The private percentage table, at subsection 222-130(1), serves 2 purposes; firstly indicating whether a particular depreciating asset can have a private percentage and secondly, providing the test for determining what that private percentage should be.

Item 1 depreciating assets

17.231 Item 1 deals with depreciating assets other than those consisting of a right to hold another asset that the individual does not hold. These depreciating assets have a ***private percentage*** for a period that fairly represents the extent to which the individual used the asset for private or domestic purposes during that period. [Subsection 222-130(1), *item 1 in the table*]

17.232 The period in which the test is framed will not exceed an income year. The period:

- commences at the later of the beginning of the income year and when the individual started to hold the depreciating asset; and
- concludes at the earlier of the end of the income year and when the individual ceased holding the depreciating asset. [subsections 222-120(1) and 222-120(3)]

Example 17.51

In Year 1, Luke commenced working at a pizza delivery store on 1 October (at which point the market value of his panel van was \$5,000 – previously it was a private asset). He used his panel van to deliver pizzas, and his log book showed that he was using the panel van for work purposes for 60% of the time until 31 March that same income year. For the remainder of the income year, he only used it for work purposes 30% of the time as he was close to losing his licence after incurring several traffic infringements. The panel van has an effective life of 10 years.

Using the straight-line method, the decline in tax value of Luke's panel van for the year ended 30 June Year 1 is \$374 ($\$5,000 \times 273 \text{ days} / 365 \text{ days} \times 100\% / 10 \text{ years}$). The closing tax value of his panel van is thus $\$5,000 - \$374 = \$4,626$.

However as the panel van was used partly for private or domestic purposes over the income year, Luke has to calculate an upward adjustment to apply when calculating his taxable income. The upward adjustment equals \$187. This is calculated as $\$374 \times [(182 \text{ days} / 273 \text{ days} \times 60\%) + (91 \text{ days} / 273 \text{ days} \times 30\%)]$. So, Luke's taxable income at that time (and ignoring all other transactions) would be:

$$\text{Taxable Income} = -\$374 + \$187 = -\$187$$

Item 2 depreciating assets

17.233 Item 2 deals with rights to hold another depreciating asset that the individual does not hold. In those cases, the **private percentage** for the period is the percentage that fairly represents the extent to which the individual intends to use the other asset (the underlying asset – see subsection 222-130(2)) for private or domestic purposes. [*Subsection 222-130(1), item 2 in the table*]

17.234 As with item 6 of the private asset table at subsection 222-45(1), subsection 222-45(2) applies so that the right to hold an asset can look through interposed rights and instead focus on the underlying asset. Subsection 222-45(3) also applies. [*Subsection 222-130(2)*]

17.235 The item 1 private percentage test looks backwards at actual use. The item 2 rule is different because determining the 'private percentage' looks to the intended use of the underlying asset and not to the more immediate asset – the right to hold the underlying asset.

17.236 Items 1 and 2 exclude assets consisting of a right to hold:

- an item of trading stock;
- a financial asset; or

- an investment asset that is not a collectable or interest in a collectable,

even though those rights to hold may be depreciating assets. Because these assets should be treated in the same manner as the underlying asset, by excluding these assets from the table in subsection 222-130(1), those assets effectively have a ‘private percentage’ of nil.

Profit or loss adjustments

17.237 Section 222-120 applies up to the point in time of ceasing to hold the asset (or ceasing to hold the asset in a non-private capacity). The final application of that provision determines the asset’s tax value immediately before the individual stops holding it (‘final tax value’); that value is then used in the calculation of the taxable income adjustment on disposal (or deemed disposal).

17.238 Section 222-125 provides for an adjustment if the proceeds of realising an asset do not equal its final tax value.

17.239 A perfect match (where final tax value equals the proceeds of realisation) indicates that the aggregate effect of the depreciation claimed equates to the aggregate fall in the asset’s market value. So, as the depreciation claimed already reconciles with the asset’s fall in market value, section 222-125 does not need to apply. *[Paragraph 222-125(1)(b)]*

17.240 In any other instance, a final adjustment must be made unless the asset is capital works covered by Division 73 of the prototype legislation.²⁶⁷ *[Section 222-125]*

17.241 The amount of that adjustment is calculated as:

- the difference (expressed as a positive amount) between the asset’s tax value immediately before the individual stops holding it and the proceeds of realising the asset;
 - multiplied by:
- the total of the one or more upward adjustments under section 222-120;
 - divided by:
- the total of each decline in tax value used to work out the amount of any of the one or more upward adjustments.

[Subsection 222-125(3)]

²⁶⁷ Division 73 is not yet drafted but would be based upon Division 43 of the ITAA 1997.

17.242 Whether the taxable income adjustment is an upward adjustment or a downward adjustment is determined by whether or not the asset's tax value immediately before the individual stops holding it exceeds the proceeds of realising that asset. If it does, the individual has an **upward adjustment**. Otherwise, the individual has a **downward adjustment**.
 [Subsection 222-125(2)]

17.243 An alternative expression of the calculation of the taxable income adjustment when the individual ceases to hold the depreciating asset is (expressed as a positive amount):

$$\left(\begin{array}{l} \text{Asset's tax value} \\ \text{immediately before that} \\ \text{time} \end{array} - \begin{array}{l} \text{Proceeds of} \\ \text{realising asset} \end{array} \right) \times \frac{\begin{array}{l} \text{The total of the one or more upward} \\ \text{adjustments under section 222-120} \end{array}}{\begin{array}{l} \text{The total of each decline in tax value used to} \\ \text{work out the amount of any of the one or more} \\ \text{upward adjustments} \end{array}}$$

[Subsection 222-125(3)]

Example 17.52

Continuing on from example 17.51, assume Luke sold his panel van on 30 June Year 1 for \$3,000. The net income formula would record a loss on sale of -\$1,626, as the van's tax value immediately before he sold it was \$4,626, which is more than the \$3,000 proceeds he received.

However as Luke used the van partly for private or domestic purposes, he is not entitled to apply the entire loss to his taxable income. Instead, when net income records the disposal, he will also record an **upward adjustment** equal to \$813. This is calculated as \$1,626 × (\$187 / \$374).

17.244 As noted in paragraph 17.239, no taxable income adjustment is required upon ceasing to hold where the asset's tax value immediately before ceasing to hold equals the proceeds of realising the asset.

Example 17.53

Mary-anne paid \$1000 for an option to purchase a car at a later date for a predetermined price. At that time, Mary-anne expects to be using the car for private or domestic purposes for 30% of the time.

Later that same income year, Mary-anne does not end up exercising her right to purchase the car and the right lapses.

She records a \$1,000 net loss, which represents the asset's decline in tax value. As she intended to use the car for private or domestic purposes 30% of the time, that is her private percentage.²⁶⁸ Mary-anne then must calculate an upward adjustment to apply to her net income.

²⁶⁸ See subsection 222-130(1), item 2 of the table.

The amount of that adjustment is \$300 which is calculated as $\$1,000 \times 30\%$.

No further adjustment is required upon lapse of the option.

Depreciating liabilities that have a private percentage

Depreciation adjustments

17.245 An individual has a *downward adjustment* for a depreciating liability equal to the decline in tax value multiplied by the liability's private percentage. [Subsection 222-150(2)]

17.246 In other words, the taxable income adjustment calculated for a depreciating liability:

Downward adjustment = Decline in tax value \times Private percentage

17.247 For this taxable income adjustment to be made:

- the liability must be a 'depreciating liability' [paragraph 222-150(1)(a)];
- the individual must have it for some or all of the income year [paragraph 222-150(1)(a)];
- it must have a 'private percentage' for a period that is some or all of an income year – that period is not only exclusive of any time when the liability is a private liability but the period is defined in such a manner that at no time during the period to which the private percentage relates can the liability have been a private liability [paragraph 222-150(1)(c)]; and
- the liability must have a 'decline in tax value' calculated for that income year [paragraph 222-150(1)(b)].

Relevant period

17.248 In calculating a taxable income adjustment for a period, the period for which an downward adjustment is calculated cannot include a period where the liability was a 'private liability'. [Paragraph 222-150(1)(c)]

17.249 Furthermore, a new liability is separate and distinct from any previous liability, so if the liability stopped being a private liability at a later time, that later time when the liability is again recognised is not part of the same period that section 222-150 refers. This is because section 222-95 treats an individual as incurring a new liability at the time immediately after their liability stopped being a private liability.

The ‘private percentage’ table

Item 1 depreciating liabilities

17.250 Item 1 deals with liabilities to provide an asset that the individual holds. These liabilities have a ***private percentage*** of nil for any given period. *[Section 222-160, item 1 in the table]*

17.251 The ‘private liability’ table classifies liabilities to provide assets according to the underlying asset – see item 2 of the table at section 222-85 and paragraphs 17.208 to 17.210. This means that liabilities to provide private assets are private liabilities, and are not considered by Subdivision 222-F. All other liabilities to provide assets are thus subject to item 1 of the table at section 222-160, and can have no private percentage. This allows for the taxable income adjustment to be calculated from the perspective of the underlying asset rather than the liability to provide the asset.

Item 2 depreciating liabilities

17.252 Item 2 deals with all remaining depreciating liabilities. These depreciating liabilities have a ***private percentage*** for a period that fairly represents the extent to which the liability was, from time to time, a liability of a private or domestic nature. *[Section 222-160, item 2 in the table]*

17.253 The period in which the test is framed will not exceed an income year. The period:

- commences at the later of the beginning of the income year and when the individual started having the depreciating liability; and
- concludes at the earlier of the end of the income year and when the individual ceased having the depreciating liability.

[Paragraph 222-150(1)(c)]

Profit and loss adjustments

17.254 Section 222-150 applies up to the point in time of ceasing to have the liability (or ceasing to have the liability in a non-private capacity). The final application of that provision determines the liability’s tax value immediately before the individual stops holding it (‘final tax value’); that value is then used in the calculation of the taxable income adjustment on extinguishment (or deemed extinguishment).

17.255 Section 222-155 reconciles a depreciating liability’s effect on net income by comparing how well the tax value of the liability has tracked market value (which should be reflected in the cost of extinguishing the liability).

17.256 A perfect match (where final tax value equals the cost of extinguishment) indicates that the aggregate effect of the depreciation claimed equates to the aggregate fall in the liability's market value. So, as the depreciation claimed already reconciles with the liability's fall in market value, section 222-155 does not need to apply. [*Paragraph 222-155(1)(b)*]

17.257 In any other instance, a final adjustment must be made. [*Section 222-155*]

17.258 The amount of that adjustment is calculated as:

- the difference (expressed as a positive amount) between the liability's tax value immediately before the individual stops having it and the cost of extinguishing the liability;
 - multiplied by:
- the total of the one or more downward adjustments under section 222-150;
 - divided by:
- the total of each decline in tax value used to work out the amount of any of the one or more downward adjustments.

[*Subsection 222-155(3)*]

17.259 Whether the taxable income adjustment is an upward adjustment or a downward adjustment is determined by whether or not the cost of extinguishing that liability exceeds the liability's tax value immediately before the individual stops having it. If it does, the individual has an **upward adjustment**. Otherwise, the individual has a **downward adjustment**. [*Subsection 222-155(2)*]

17.260 An alternative expression of the calculation of the taxable income adjustment when the individual ceases to have the depreciating liability is (expressed as a positive amount):

$$\left(\begin{array}{r} \text{Cost of} \\ \text{extinguishing} \\ \text{liability} \end{array} - \begin{array}{r} \text{Liability's tax value} \\ \text{immediately before that} \\ \text{time} \end{array} \right) \times \frac{\begin{array}{r} \text{The total of the one or more} \\ \text{downward adjustments under section 222-150} \end{array}}{\begin{array}{r} \text{The total of each decline in tax value used to} \\ \text{work out the amount of any of the one or more} \\ \text{downward adjustments} \end{array}}$$

[*Subsection 222-155(3)*]

Special rules for partnerships

17.261 Subdivision 222-G extends Division 222 to ensure that it applies to certain partnerships, being those with at least one individual as a partner. This subdivision outlines the circumstances in which a partnership has things of a private or domestic character; as such, ensuring that those factors are taken into account when calculating taxable income.

Receipts of a private or domestic nature

17.262 An amount received by a partnership will be a ***receipt of a private or domestic nature*** for the partnership to the extent that:

- it is a receipt of a private or domestic nature for an individual who is a partner of the partnership; or
- it would be a receipt of a private or domestic nature for such an individual if he or she had received the amount instead of the partnership.

[Subsection 222-200(2)]

Payments of a private or domestic nature

17.263 A payment made by a partnership will be a ***payment of a private or domestic nature*** for the partnership to the extent that:

- it is a payment of a private or domestic nature for an individual who is a partner of the partnership; or
- it would be a payment of a private or domestic nature for such an individual if he or she had made the payment instead of the partnership.

[Subsection 222-200(1)]

Private or domestic purposes

17.264 A partnership uses an asset for ***private or domestic purposes*** to the extent that is for the private or domestic purposes of an individual who is a partner of the partnership. *[Subsection 222-200(3)]*

Liabilities of a private or domestic nature

17.265 A liability that a partnership has will be a ***liability of a private or domestic nature*** for the partnership to the extent that:

- it is a liability of a private or domestic nature for an individual who is a partner of the partnership; or

- it would be a liability of a private or domestic nature for such an individual if he or she had the liability instead of the partnership.

[Subsection 222-200(4)]

Appendix A

Expanded examples of private or domestic issues

This appendix provides a sample of illustrative examples that would be included in explanatory material that would accompany the TVM legislation if it were to proceed. The examples would be designed to demonstrate the practical application of the TVM to a wide range of common transactions.

Example 17A.1 How is expenditure on business suits and other similar clothing worn at work treated?

Mario is a solicitor who is required by his employer to wear a business suit at work. This year, Mario spent \$600 to purchase a suit.

Current treatment

The \$600 paid by Mario for the suit is not an allowable deduction under section 8-1 of the ITAA 1997 as the expenditure is private in nature. The clothing is of a type considered conventional in nature and is not unique to his profession. It is clothing which may be worn regardless of the occupation. It is essentially worn to meet his personal requirements for modesty and warmth even though the standard of dress required by his employer may be higher than that of some other members of society.

TVM treatment

The \$600 Mario paid for the suit he wears to work will not reduce his taxable income.

This is because the suit would be a 'private asset' as it is, for Mario, essentially private or domestic in nature (see subsection 222-45(1), item 5 of the table). Accordingly, both the payment and the asset will not be taken into account under steps 2 and 3 of the method statement in section 6-55 (paragraph 222-10(1)(b) and subsection 222-40(1)).

Example 17A.2 How are child-care expenses treated when an employee is 'on-call'?

Tracey is a Visiting Medical Officer at a local hospital. The nature of her work requires her to be on call for 12 hour shifts at least nine times a month for accident and emergency duties. When Tracey's partner is not working he looks after the children, however, when he is away, she employs a carer on a live-in basis to care for the children when Tracey is called out on emergency.

Current treatment

The expenses incurred in employing a carer to assist in caring for Tracey's children are not an allowable deduction under section 8-1 of the ITAA 1997. The expense is neither relevant nor incidental to the

production of Tracey's assessable income. The fact that the child-care expenses are necessitated by the on call and emergency nature of Tracey's employment does not alter the private character of the expense.

TVM treatment

The amount Tracy paid for child-care will not reduce her taxable income.

This is because the payment of child-care expenses would be a payment of a private or domestic nature. Accordingly, the payment will not be taken into account under step 2 of the method statement in section 6-55 (paragraph 222-10(1)(a)).

Example 17A.3 How are travel insurance expenses treated when an employee travels on work-related purposes?

Peta is a teacher and was granted an International Teaching Fellowship in Canada. Expenses associated with the travel included a payment of \$150 for travel insurance.

Current treatment

The payment of \$150 travel insurance is not an allowable deduction under section 8-1 of the ITAA 1997 as the expenditure is private in nature. The travel insurance covers items that are generally private in nature, for example illness, loss of baggage and theft or damage to belongings.

TVM treatment

The \$150 Peta paid for travel insurance will not reduce her taxable income.

This is because the travel insurance would be a 'private asset' as Peta intends to use the insurance asset solely for private or domestic purposes (see subsection 222-45(1), item 5 of the table). Accordingly, both the payment and the asset will not be taken into account under steps 2 and 3 of the method statement in section 6-55 (paragraph 222-10(1)(b) and subsection 222-40(1)).

Example 17A.4 How are house auction expenses treated when an employee moves house at the employer's request?

Thomas is a public servant. He was transferred at the request of his employer from Perth office to the central office of the department in Canberra. Thomas decided to sell the house in which he resided in Perth. An auction was held and the expenses of the auction were \$1,000. The expenses of the auction were not reimbursed by his employer.

Current treatment

The expenses of the auction of \$1,000 (i.e. expenses incurred in selling a home) are not an allowable deduction under section 8-1 of the ITAA 1997. The essential nature of the expenses of the auction is private or domestic.

TVM treatment

The amount Thomas paid for auction expenses will not reduce his taxable income.

This is because the payment of auction expenses would be a payment of a private or domestic nature. Accordingly, the payment will not be taken into account under step 2 of the method statement in section 6-55 (paragraph 222-10(1)(a)).

Example 17A.5 Running expenses which relate to a home office

Robert has set aside a room in his home for use as a home office where he undertakes some of his business activities. For an income year, he paid total electricity and cleaning expenses of \$1,500. He can establish that of this amount \$100 is additional expenditure he paid as a result of his income producing activities at home.

Current treatment

If a taxpayer can establish that they have paid additional expenditure on electricity charges and cleaning as a result of their income producing activities, taxpayers are entitled to a deduction under section 8-1 for the additional expenditure actually incurred.

Robert is entitled to a deduction for the additional expenditure of \$100.

TVM treatment

\$100 of the \$1,500 Robert paid throughout the income year on electricity and cleaning charges will reduce his taxable income.

This is because the payment of those electricity and cleaning expenses are of a private or domestic nature to the extent of \$1,400.

Accordingly, \$1,400 of the payments made will not be taken into account under step 2 of the method statement in section 6-55 (paragraph 222-10(1)(a)). The \$100 payment of additional electricity and cleaning expenses will, however, be included in step 2 of the method statement in section 6-55.

Example 17A.6 Personal grooming expenses - haircuts

Brian, an officer in the Australian Defence Forces (ADF), is required to maintain a short back and sides hairstyle. Failure to meet the rigid requirements set by the ADF could result in disciplinary action being taken. Consequently, Brian has his hair cut twice a month and wishes to claim a deduction for this expense.

Current treatment

A deduction is not allowable for the cost of Brian's haircuts, as this personal grooming cost is a private expense. The fact that Brian's employer has rigid grooming standards does not alter the private nature of the expense.

TVM treatment

The amount Brian paid for haircuts will not reduce his taxable income.

This is because the payments made for his haircuts would be payments of a private or domestic nature. Accordingly, the payments will not be taken into account under step 2 of the method statement in section 6-55 (paragraph 222-10(1)(a)).

Example 17A.7 Cosmetics and other grooming expenses

Sarah is an executive secretary to the managing director of an international company. She is required to be well groomed at all times when at work. When accepting her position, her employer made it very clear that good grooming was of critical importance to the organisation and that her presentation would be regularly monitored. In recognition of the importance of grooming to her employer, Sarah is paid a grooming allowance of \$20 per week. Sarah wants to claim expenses incurred on hairdressing and cosmetics that relate solely to work and for which she receives an allowance.

Current treatment

While this allowance will be included in Sarah's assessable income (under section 6-5 of the ITAA 1997), that does not necessarily mean that a deduction is automatically allowable for any related expenses. The additional feature that Sarah's employer requires good grooming is not sufficient to alter the characterisation of the expense as essentially private in nature, and thus not deductible under section 8-1 of the ITAA 1997.

TVM treatment

The amount Sarah receives as an allowance will increase her taxable income as the allowance for grooming is received in the course of her employment. The amount of the allowance would be included as a receipt in step 1 of the method statement in section 6-55.

However, the amounts Sarah spends on hairdressing and cosmetics will not reduce her taxable income.

This is because the payments for:

- hairdressing would be payments of a private or domestic nature; and

- cosmetics would form the cost of an asset (i.e. the cosmetics) which is a private asset (see section 222-45, item 5 of the table).

The fact that Sarah receives an allowance for grooming will not change the character of either the payment for haircut or the cosmetics.

Accordingly:

- the payment for hairdressing will not be taken into account under step 2 of the method statement in section 6-55 (paragraph 222-10(1)(a)), and
- the payment for the cosmetics and the asset (being the cosmetics) will not be taken into account under steps 2 or 3 of the method statement in section 6-55 (paragraph 222-10(1)(b) and subsection 222-40(1) respectively).

Chapter 18

Collectables

Outline of Chapter

18.1 This Chapter explains how collectables are treated under TVM, and compares that treatment to how they are dealt with under the current law.

Context of Reform

18.2 Under Subdivision 108-B of the ITAA 1997, gains and losses from collectables are subject to capital gains tax treatment only if:

- they are purchased for more than \$500; and
- they are used or kept mainly for the person's, or their associate's, personal use and enjoyment.

18.3 Collectables include artwork, jewellery, antiques, coins, medallions etc., kept mainly for personal use and enjoyment.

18.4 Capital losses from such collectables are quarantined and can only be offset against capital gains from such assets.

18.5 Under TVM, any gains from disposing of collectables or interests in collectables will be included in taxable income only if:

- the amount or amounts paid to start to hold the asset is more than \$10,000; and
- when the asset was first held it was intended to be used at least partly for private or domestic purposes.

18.6 Losses from collectables or interests in collectables that satisfy the above tests can only be offset against gains from those assets.

18.7 The above treatment reflects recommendations 4.13(f)(ii) and (iii) of ATSR. The increase in the threshold to \$10,000 will limit the number of collectables that an entity needs to keep account of for taxation purposes thereby reducing compliance costs for taxpayers.

18.8 Collectables and interests in collectables that satisfy the personal usage test but do not exceed the \$10,000 threshold are treated as being

private assets, and as such any gain or loss on their disposal will not be included in net income.

18.9 Payments made in relation to collectables with at least some intention of private use²⁶⁹ are subject to an apportionment rule which was the subject of recommendation 4.13(f)(i) of ATSR. The rule limits the amount of such payments that can be included in net income (see paragraphs 18.31 to 18.38).

Personal use assets

18.10 The CGT provisions in the current law contain special rules in Subdivision 108-C of the ITAA 1997 that apply to personal use assets. Personal use assets are CGT assets (other than collectables) that are used or kept mainly for personal use or enjoyment. Under these rules any capital losses from personal use assets are disregarded and capital gains from such assets are disregarded if the asset was purchased for \$10,000 or less²⁷⁰.

18.11 There are no special rules that apply under TVM to such personal use assets. Instead the private or domestic provisions in Division 222 provide similar treatment for most of these assets. As personal use assets are generally depreciating assets, *any* gains and losses will be excluded from taxable income, if the asset is intended to be used solely for private or domestic purposes. Furthermore, for assets that are not used solely for private or domestic purposes, Division 222 excludes any gain or loss made on the assets to the extent that they are used for private or domestic purposes.

Summary of prototype legislation

18.12 The following table summarises the range of treatments that apply to collectables under the prototype legislation.

²⁶⁹ This includes both collectables valued at \$10,000 or less that are treated as being private assets and also collectables that are valued at more than \$10,000 and that when the asset was first held it was intended to be used at least partly for private use.

²⁷⁰ See subsection 118-10(3) of the ITAA 1997.

Table 18.1 Summary of the treatment of collectables

	Private-use collectables bought for \$10,000 or less	High-cost (i.e. bought for more than \$10,000) private-use collectables	Collectables bought with the intention of no private use
<i>Asset category</i>	Private asset. ²⁷¹	Investment asset.	Trading stock, depreciating asset or investment asset. ²⁷²
<i>Gains and losses from disposal</i>	Gains and losses are not included in net income.	Gains included in net income and eligible for the investment asset discount. Losses quarantined against similar collectable gains.	Gains and losses included in net income as usual and not subject to collectable treatment.
<i>Expenses related to the collectable that do not form part of its cost</i>	Payments are included in net income to the extent of non-private receipts that are not proceeds of realisation of the asset.	Payments are included in net income to the extent of non-private receipts that are not proceeds of realising the asset.	Payments are included in net income as usual and not subject to collectable treatment.

18.13 Entities, other than individuals or partnerships that have at least one individual as a partner, cannot hold assets that get collectable treatment. This is because these entities cannot hold private assets or high-cost private use collectables. Investment asset treatment, however, applies to collectables that are not depreciating assets because they have an unlimited life (such as gold coins) and are not held as trading stock. Losses from these collectables are subject only to the investment asset quarantining rather than the special collectables quarantining.

Example 18.1 Collectables asset category

Max owns an antique desk that he uses in his antique business as his office desk. The desk is not for sale. He also owns a French antique clock that he bought for \$11,000 and another that he bought for \$2,000. These clocks have always been kept at home for his personal use and he does not intend to sell them in his business.

²⁷¹ See paragraph 100-115(c) of the prototype legislation, which provides that a private asset does not get Division 100 treatment.

²⁷² If the collectable is not trading stock and has an unlimited effective life then it will qualify as an investment asset.

The antiques that Max owns for sale in the ordinary course of business are trading stock. The antique desk is a depreciating asset that Max can write off over its effective life. The antique clock bought for \$11,000 is a high-cost private-use collectable that is an investment asset. The \$2,000 clock is a collectable²⁷³ but is a private asset and therefore is not included in working out net income.

Comparison of key features of prototype legislation and current law

18.14 The following table sets out how TVM will apply to collectables compared to the current law.

Table 18.2 Comparison of key features of prototype legislation and current law

<i>Prototype legislation</i>	<i>Current law</i>
Collectables	
<p>Collectables include but are not limited to artwork, jewellery, an antique, a coin, medallion, rare folio, manuscript, book, postage stamp or first day cover. Collectables must be tangible assets. <i>[Subsection 234-15(1)]</i></p> <p>An interest in a collectable includes an option or right to start to hold a collectable <i>[subsection 234-15(2)]</i>.</p>	<p>A collectable is:</p> <ul style="list-style-type: none"> • an artwork, jewellery, an antique, coin, medallion, rare folio, manuscript, book, postage stamp or first day cover; • if it is used or kept mainly for the taxpayer's or their associate's personal use or enjoyment. <p>An interest in a collectable, a debt arising from a collectable and a option or right to acquire a collectable is also a collectable (section 108-10 of the ITAA 1997).</p>

²⁷³

But not a high-cost private-use collectable.

<i>Prototype legislation</i>	<i>Current law</i>
Gains and losses from disposal of collectables excluded from taxable income	
<p>Investment asset gains and losses from ceasing to hold a collectable are not included in taxable income if:</p> <ul style="list-style-type: none"> • it is acquired for \$10,000 or less and is not trading stock; and: • when it was first held, it was intended to be used at least in part for private or domestic purposes. <p><i>[Section 234-35, items 1 and 2 in the table]</i></p>	<p>A capital gain or loss from collectables is disregarded if the collectable was acquired for \$500 or less (section 118-10 of the ITAA 1997).</p>
Treatment of income and expenditure relating to collectables	
<p>Payments relating to a collectable do not generally reduce net income if:</p> <ul style="list-style-type: none"> • the collectable was intended to be used at least partly for private or domestic purposes; and • the payments do not form part of the cost of the collectable. <p>However, net income is reduced to the extent that the payments are able to offset receipts that relate to the collectable that are not:</p> <ul style="list-style-type: none"> • of a private or domestic nature; or • included in the proceeds of realising the collectable. <p>Insurance and interest expenses are examples of payments that can offset receipts in relation to a collectable.</p> <p><i>[Section 234-30]</i></p>	<p>Payments made that relate to a collectable such as insurance and interest are deductible to the extent that they are incurred in gaining or producing assessable income (section 8-1 of the ITAA 1997).</p>

<i>Prototype legislation</i>	<i>Current law</i>
Quarantining of losses from collectables	
<p>To the extent that investment asset gains from high-cost private-use collectables exceed such losses, the gains can be offset by other investment asset losses [subsection 234-55(2)].</p> <p>However, if investment asset losses from high-cost private-use collectables exceed such gains then the losses are quarantined and can only offset gains made from like assets [subsection 234-55(3)].</p>	<p>To the extent that capital gains from collectables exceed such losses, the gains can be offset by other capital losses (section 102-5 of the ITAA 1997).</p> <p>However, if capital losses from collectables exceed such gains then the losses must be quarantined (subsection 108-10(1) of the ITAA 1997).</p>
Losses from disposing of shares or trust interest which holds collectables	
<p>The fall in value of a high-cost private-use collectable of a company or trustee of a trust that is held for the shareholder's or interest holder's (or their associate's) personal use or enjoyment is treated as an investment asset loss from a high-cost private-use collectable (see paragraph 18.22) [section 234-70].</p>	<p>CGT event K5 applies to the fall in value of a collectable of a company or trustee of a trust that is held for the shareholder's or interest holder's (or their associate's) personal use or enjoyment. The fall in value is treated as capital loss from a collectable (section 104-225 of the ITAA 1997).</p>

Detailed explanation of prototype legislation

What are collectables?

18.15 A *collectable* takes the ordinary meaning of the term collectable but also includes artwork, jewellery, antiques, coins, medallions, rare folios, manuscripts, books, postage stamps and first day covers. Collectables must be tangible assets [subsection 234-15(1)].

18.16 An *interest in a collectable* includes but is not limited to:

- an option or right to start to hold a collectable; or
- an option or right to start to hold an option or right to start to hold a collectable.

[Subsection 234-15(2)]

Collectables with private use

18.17 There are 2 rules that apply to collectables and interests in collectables that are used or intended to be used at least partly for private or domestic purposes. These are rules for:

- the recognition (or otherwise) of the gain or loss on realising the asset; and
- the apportionment of receipts and payments that flow from the use of the asset.

These rules apply to individuals and partnerships with one or more individuals as partners *[section 234-10]*.

Recognising collectables that are used privately

18.18 Private assets are disregarded when a taxpayer works out their taxable income *[section 222-40]*. Similarly, payments and receipts that form the costs of, or proceeds of realising, a collectable that is a private asset are disregarded when working out taxable income *[section 234-35]*.

When a collectable is a private asset

18.19 A collectable will be a private asset if:

- it is not a high-cost private-use collectable (see paragraph 18.22);
- it is not trading stock; and
- when the taxpayer began to hold the collectable, they intended to use it at least partly for private or domestic purposes.

[Section 234-35, item 1 in the table]

18.20 Similarly, an interest in a collectable will be a private asset if:

- it is not an interest that is a high-cost private-use collectable;
- neither the interest nor the collectable is your trading stock; and
- when the taxpayer began to hold the interest, they intended to use the collectable at least partly for private or domestic purposes.

[Section 234-35, item 2 in the table]

18.21 High-cost private-use collectables, however, can never be private assets *[section 234-35, item 3 in the table]*. Therefore investment asset gains

and losses from ceasing to hold such collectables are recognised when the taxpayer works out their taxable income.

What is a 'high-cost private-use collectable'?

18.22 A collectable will be a ***high-cost private-use collectable*** if:

- when it is first held, you intended to use it, at least in part, for private or domestic purposes;
- you pay more than \$10,000 to start to hold the collectable.

[Subsection 234-20(1)]

18.23 An interest in a collectable will be a ***high-cost private-use collectable*** if:

- when you began to hold the interest, you intended to use it, at least in part, for private or domestic purposes;
- the market value of the collectable exceeds \$10,000 when you first begin to hold the interest.

[Subsection 234-20(2)]

18.24 A taxpayer may start to hold a collectable that is a high-cost private-use collectable because they have purchased the collectable for more than \$10,000. Alternatively, the taxpayer may start to hold such a collectable because they are the beneficiary of a deceased estate and the deceased had purchased the collectable for more than \$10,000. This reflects that like the current law, the tax value of the asset²⁷⁴ for the beneficiary equals the cost to the deceased of acquiring it.

Intention to use privately

18.25 An individual or a partnership with at least one individual as a partner must make an assessment of future use, at the time they first hold a collectable or an interest in a collectable. They must determine whether they *intend* to use the collectable or interest in the collectable at least partly for private or domestic purposes. Use has a wide meaning (see Chapter 17). If this intention is present, then the collectable will be either a private asset or a high-cost private-use collectable depending on whether the cost of starting to hold the collectable was more than \$10,000.

18.26 The fact that there is a possibility that an item will not be used for private or domestic purposes will not prevent a collectable from satisfying the intention test – it is the taxpayer's *intention* at the time they started to hold the collectable that is important.

²⁷⁴

Other than pre-CGT assets which receive separate treatment.

18.27 The intended usage test only applies at the time the collectable starts to be held and sets the tax consequences that flow from holding the collectable. This is designed to reduce compliance costs for a taxpayer holding the asset.

Example 18.2 Treatment of gain from disposal of high-cost private use collectable

Continuing example 18.1, Max sells both antique clocks in Year 1. He sells the antique clock that is a high-cost private-use collectable for \$15,000 and the other clock that is a private asset for \$3,000.

Accordingly, the gain of \$4,000 (\$15,000 – \$11,000) from the high-cost private-use collectable is an investment asset gain that is included in net income. However the gain of \$1,000 (\$3,000 – \$2,000) from the disposal of the private asset is not included in net income. No taxable income adjustments apply because Max held the clock for less than 12 months.

Accordingly, Max's net income in Year 1 is:

$$\begin{aligned} & \left[\begin{array}{c} \text{Receipts} \\ - \\ \text{Payments} \end{array} \right] + \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of assets} & \text{of assets} \end{array} \right] - \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of liabilities} & \text{of liabilities} \end{array} \right] \\ & = [15,000 - 0] + [0 - 11,000] - [0 - 0] \\ & = \$4,000. \end{aligned}$$

His taxable income for Year 1 is:

$$\begin{aligned} & \text{Net income +/- taxable income adjustments - unused losses} \\ & = \$4,000 - \$0 - 0 \\ & = \$4,000 \end{aligned}$$

Change of intention

18.28 In almost all cases, the intended usage test will not allow for a collectable that receives collectable treatment to be re-classified at a later time even if there is a change of intended use of the collectable. The exception is if the collectable later forms part of the taxpayer's trading stock. However this only applies in the case of a collectable that is a private asset [section 234-35, paragraph (a) of both item 1 and item 2 in the table]. When that change in use occurs, the taxpayer will be deemed to have acquired the collectable for its market value at the time immediately after the taxpayer stopped holding the asset as a private asset [section 222-55].

18.29 Similarly, a collectable that is first held as a depreciating asset or trading stock but is then held for private use can never receive collectable treatment.

Improvements to collectables

18.30 The \$10,000 threshold test that applies to high-cost private-use collectables applies only to amounts paid to start to hold the collectables. Accordingly, any amounts paid to improve or upgrade the asset are disregarded in working out if the threshold applies. [*Paragraph 234-20(1)(c)*]

The treatment of receipts and payments that flow from the use of private-use collectables

18.31 The treatment of payments relating to private-use collectables under TVM differs from the apportionment method for payments that are partly of a private or domestic nature. The apportionment rule for collectables is based on recommendation 4.13(f)(i) of ATSR. This apportionment method applies to all collectables and interests in collectables that are first held with the intention that they be used at least partly for private or domestic purposes.

18.32 Under TVM *only* payments that are:

- reasonably attributable to the collectable; and
- not included in the cost of the collectable during the income year;

are included in net income up to the total of certain amounts received that are included in net income. However, the excess of these payments over the receipts are excluded from net income. This means that such payments will only reduce the taxpayer's taxable income to the extent of any receipts. [*Subsection 234-30(1)*]

18.33 The receipts during an income year to which the apportionment method applies are those amounts, to the extent that they:

- are reasonably attributable to the collectable; and
- are *not* receipts of a private or domestic nature; and
- do not become included during the income year in the proceeds of realising the collectable.

18.34 Examples of payments to which the apportionment method applies include interest on funds borrowed to purchase or improve the collectable and insurance or storage costs. Examples of receipts include amounts received for the use of the collectable.

Example 18.3 Holding costs of collectables

David owns a rare old Australian historic manuscript. He purchased the manuscript for \$50,000. He holds it for private or domestic purposes but occasionally allows it to be exhibited for a small fee.

David pays \$200 to insure the manuscript each year. In Year 1 he receives \$100 for exhibiting the manuscript. Accordingly, he is entitled to offset \$100 of the insurance payment (i.e. equal to the fee he has received for exhibiting). The remaining \$100 is a private or domestic amount that is excluded from net income.

Accordingly, David's net income in Year 1 is:

$$\begin{aligned} & \left[\text{Receipts} - \text{Payments} \right] + \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of assets} & \text{of assets} \end{array} \right] - \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of liabilities} & \text{of liabilities} \end{array} \right] \\ & = [100 - 100] + [50,000 - 50,000] - [0 - 0] \\ & = \$0. \end{aligned}$$

His taxable income for Year 1 is nil.

18.35 Thus, the apportionment mechanism in section 234-30 of the prototype legislation ensures that no net losses can be realised from the holding costs of collectables that were intended to be used at least partly for private or domestic purposes when the taxpayer began to hold the collectable. Also, as the apportionment is made on the basis of amounts received and payments made during the income year, any excluded payments are not carried forward to be offset in future income years.

18.36 Payments attributable to one collectable cannot be applied to receipts from other collectables. The payment must be attributable to *that* collectable.

18.37 If all or part of a payment has been excluded from net income by the special apportionment rule that relate to collectables, the payment cannot, in later income years, be included in the cost of an asset [*subsection 234-30(2)*]. This ensures that there is no double counting of the payment.

18.38 The special apportionment rule for payments that relate to collectables and interests in collectables does not apply if they are also trading stock or depreciating assets. It only applies if the collectable or interest in the collectable is a high-cost private-use collectable or private asset.

Collectables that are investment assets

18.39 Collectables acquired with the intention of no private use that are not trading stock or depreciating assets are investment assets. Such assets will have an unlimited life (for example gold coins held for display only by an antique dealer). As such, investment asset gains arising from such collectables potentially qualify for the investment asset discount [*subsection 100-75(2), step 3 of the method statement*]. Any losses made on the sale of these collectables are subject only to the general investment asset quarantining. This replicates how the current law applies to such collectables.

18.40 Collectables that are private assets do not get investment asset treatment. Gains and losses from such collectables are not included in net income. [*Paragraph 100-15(c) and section 222-40*]

18.41 'High-cost private-use collectables' are investment assets [*section 78-10*]. They are potentially eligible for the investment asset discount.

Quarantining of losses from collectables

18.42 Rather than the general quarantining that applies to investment asset losses, losses from high-cost private-use collectables will be quarantined so that they can only offset gains from high-cost private-use collectables [*section 234-50*]. To the extent that investment asset gains from high-cost private-use collectables exceed such losses, the gains may be offset by other investment asset losses [*subsection 234-55(2)*].

18.43 Where high-cost private-use collectable gains exceed losses, taxpayers will be able to choose the order in which gains are offset. Accordingly, gains that do not qualify for the investment asset discount can be offset first by losses, allowing any gains that qualify for the discount to remain. [*Subsection 234-55(2), step 1 of the method statement*]

18.44 In working out the amount by which high-cost private-use collectable gains exceed losses, high-cost private-use collectable losses of the current year and any unapplied carry forward investment asset losses from high-cost private-use collectables are offset against the gains. [*Subsection 234-55(2), steps 1 and 2 of the method statement*]

18.45 A downward adjustment arises equal to the amount of unapplied carry-forward investment asset losses from high-cost private-use collectables that are offset against high-cost private-use collectable gains. [*Subsection 234-55(2), step 2 of the method statement*]

18.46 The downward adjustment recognises that the gains which the unapplied losses are offset against are included in net income. Accordingly, to exclude them from taxable income, it is necessary to have a taxable income adjustment. No taxable income adjustments are necessary where current year high-cost private-use collectable losses are offset against similar gains because the amount of the loss is already included in net income.

18.47 However, if investment asset losses from high-cost private-use collectables exceed such gains then the losses must be quarantined. This is done by an upward adjustment equal to the excess. [*Subsection 234-55(3)*]

Losses from disposing of shares or trust interest which holds collectables

18.48 A loss from a high-cost private-use collectable will arise if a taxpayer directly disposes of such an asset. Such a loss will also arise in certain circumstances upon ceasing to hold shares or interests in a trust.

18.49 This will ensure that there is comparable treatment when high-cost private-use collectables are held directly as opposed to collectables that are held by the taxpayer via a company or trust [*subsection 234-70 (1)*].

18.50 The rule provides that the following conditions must be satisfied for such a loss to arise where shares or an interest in a trust is disposed of.

18.51 Firstly, the taxpayer must have ceased holding shares or an interest in a trust and the loss that arises does not qualify for:

- a roll-over; or
- an exemption.

[Paragraph 234-70(2)(a)]

18.52 Secondly, there must be:

- a fall in market value of a collectable that is held by a company or trustee of a trust during the period the taxpayer held the shares or interest in the trust;
- the collectable must be held mainly for the shareholder's or interest holder's (or their associate's) personal use or enjoyment; and
- more than \$10,000 must have paid²⁷⁵ to start to hold the collectable.

[Paragraphs 234-70(2)(b) and (c)]

18.53 Finally, the market value of the shares or interest in the trust (when worked out ignoring the fall in market value of the collectable during the period the taxpayer held the shares or trust interest) must exceed the amount received for ceasing to hold the shares or trust interest. This ensures that the rule only applies if it results in a higher amount being substituted for the proceeds of realising the shares or trust interest.

[Paragraph 234-70(2)(d)]

18.54 Where the rule applies it changes the way that investment asset gains and losses from ceasing to hold such assets are worked out.

²⁷⁵

This will include both cash and non cash benefits.

18.55 Firstly, in working out the gain or loss, the market value of the shares or trust interest when the asset ceased to be held (worked out as if the fall in market value of the collectable had *not* happened) is substituted for the proceeds of realising the shares or trust interest [*subsection 234-70(3)*].

18.56 Secondly, a loss from a high-cost private-use collectable arises equal to:

- the market value of the shares or trust interest when they ceased to be held (worked out as if the fall in market value of the collectable had *not* happened); less
- the proceeds of realising the shares or trust interest.

[*Subsection 234-70(4)*]

18.57 The operation of the rule ensures that the investment asset provisions apply to the sale of the shares or trust interest as if the fall in the value of the collectable had not occurred. The rule also recognises the loss that is realised from the fall in value of the collectable as a quarantined loss from a high-cost private use collectable.

18.58 This rule provides for similar treatment to that achieved by CGT event K5 under the current law (see section 104-225 of the ITAA 1997).

Chapter 19

The simplified tax system (STS) under TVM

Outline of Chapter

19.1 This Chapter explains how the Simplified Tax System ('the STS') varies the net income and taxable income of some small businesses. The relevant provisions are in Division 545.

Context of Reform

19.2 The STS was added to the current law in 2001. It provides some measures intended to simplify the practical application of the income tax law for certain small businesses.

19.3 The version in the prototype legislation largely replicates the STS provisions in the current law with minor changes that are necessary mostly because of the different core rules used in TVM.

Summary of prototype legislation

19.4 Business taxpayers with average turnovers below \$1 million may be eligible to elect into the STS.

19.5 If they do enter the STS:

- They go onto a cash accounting system that, broadly, ignores most short-term financial assets and liabilities except to the extent that they are related to disposing of, or acquiring, a depreciating asset or an investment asset.
- They also get to allocate their depreciating assets (except some intangible ones) into 2 pools; one for long life depreciating assets and one for all other depreciating assets. Each pool is treated like a single depreciating asset with a single depreciation rate.
- They have the option of ignoring any difference between the opening and closing tax values of their trading stock, so long as that difference is no more than \$5,000.

Comparison of key features of prototype legislation and current law

Table 19.1 Comparison of key features of the prototype legislation and the current law

<i>Prototype legislation</i>	<i>Current law</i>
You do not bring to account short-term financial assets received for providing any non-cash benefit (except a depreciating asset or an investment asset).	The same result is achieved through the mechanism of treating ordinary income as derived only when received.
You do not bring to account short-term financial liabilities incurred for receiving any non-cash benefit (except a depreciating asset or an investment asset).	The same result is achieved through the mechanism of treating general deductions as incurred only when paid.
No equivalent necessary.	Special rules prevent double counting and non-counting of amounts: <ul style="list-style-type: none"> • derived but not received; • received but not derived; • incurred but not paid; or • paid but not incurred when you enter or leave the STS.
The STS depreciation rules apply to a limited range of assets ('STS depreciating assets').	Same as the prototype legislation.
Low cost assets have a closing tax value of nil unless improvements made to the asset in the year cost \$1,000 or more. This allows immediate relief for the full cost of a low cost asset and any low cost improvements to it. There is an adjustment to prevent the taxable income being reduced by the private part of the asset.	The same result is achieved by fully writing-off the taxable purpose proportion of the cost of low cost assets. There is no mechanism to deduct the cost of any later improvements to low cost assets.
A low cost asset goes into the general STS pool if improvements to it in a year cost \$1,000 or more.	No equivalent.
Two STS pools are created, a long life pool and a general pool. STS depreciating assets go into a pool and no longer get separately recognised.	Same as the prototype legislation.

<i>Prototype legislation</i>	<i>Current law</i>
<p>Only the non-private part of an asset's value goes into the pool.</p> <p>There is an adjustment to prevent the taxable income being reduced by the private part.</p>	Same as the prototype legislation.
<p>The pools get written off as if they were single depreciating assets. There is an adjustment to cancel half the write-off of assets added to the pool in the year.</p>	Same as the prototype legislation.
<p>The non-private portion of the proceeds of realising a pooled asset is deducted from the pool.</p> <p>There is an adjustment to prevent the taxable income being increased or reduced by the private part of any gain or loss.</p>	Same as the prototype legislation.
<p>There is an adjustment to pool values if the private percentage of a pooled asset changes by more than 10 percentage points.</p> <p>There is an adjustment to taxable income to restore the right outcome after the new private percentage.</p>	Same as the prototype legislation.
<p>Taxpayers can choose to make the closing tax value of trading stock the same as the opening tax value if the difference is \$5,000 or less.</p>	Same as the prototype legislation.
<p>You can be an STS taxpayer if:</p> <ul style="list-style-type: none"> • you are in business; • your average turnover (including associated entities) is less than \$1m; and • the tax value of your (and your associated entities') STS depreciating assets is less than \$3m at the end of the year. 	Same as the prototype legislation.
<p>You can enter the STS if you are eligible and notify the Commissioner.</p>	Same as the prototype legislation.
<p>You leave the STS if you are no longer eligible or if you choose to. Again, you have to notify the Commissioner. If you leave voluntarily, you cannot re-enter for 5 years.</p>	Same as the prototype legislation.

Detailed explanation of prototype legislation

19.6 The STS legislation has 3 effects on the way the income tax law applies to taxpayers who qualify to be STS taxpayers and elect into the system. It gives them a cash accounting treatment for some transactions; it pools their tangible (and some intangible) depreciating assets and gives those pools a single, usually accelerated, rate of depreciation; and it allows them to choose not to have to bring to account small changes in trading stock values.

19.7 It also explains who is eligible to be in the STS and provides the rules for entering and leaving it.

19.8 The version of the STS included in the prototype legislation does the same things as the current law, and preserves the current law's structure, but has been drafted to fit with the core rules of TVM.

Cash accounting

19.9 The STS in the current law aims to put STS taxpayers onto a cash accounting system for ordinary income and general deductions. That is, it brings such income to account and allows such deductions *only* when received or paid. Other things that the law includes in assessable income (statutory income), and other things that it allows to be deducted (specific deductions) follow the normal timing rules.

19.10 The version in the prototype legislation does the same thing but has to do it in a different way because the concepts of ordinary income and general deductions do not exist under TVM.

Basic rule

19.11 The prototype legislation achieves essentially the same outcome as the current law by saying that, in working out your net income, you *do not* take into account the closing tax value of:

- short-term financial assets received for providing a non-cash benefit that is not another financial asset (e.g. trade debtors); *[subsection 545-105(1)]* and
- short-term financial liabilities incurred to get a non-cash benefit that is not a financial asset (e.g. trade creditors) *[subsection 545-120(1)]*.

19.12 Short-term financial assets and liabilities are rights to get money, and liabilities to pay money, within 12 months of them coming into existence. Normally, the tax value of these assets and liabilities would equal their nominal value, so their amount will be brought to account as the right or liability comes into existence *[section 76-15, items 1 and 2 in the table; section 76-115, items 1 and 2 in the table]*. Because STS taxpayers do not

bring the closing tax value of these assets and liabilities to account, the amount will instead be brought to account when received or paid.

Example 19.1 Cash treatment of services provided on credit

Kellmaster Sports Management engages Jerry to clean its office windows for \$500, payable within 30 days of billing. Jerry cleans the windows but Kellmaster has not paid by the end of the year.

If Kellmaster were not an STS taxpayer, it would bring a \$500 liability to account, reducing its net income by \$500. If it is an STS taxpayer then, because the liability is in return for a non-cash benefit (the window cleaning services), it would not bring the closing tax value of that liability to account. Instead, it would recognise the \$500 in the next year when it pays Jerry.

Similarly, if Jerry were an STS taxpayer, he would not bring to account the closing tax value of his right to be paid \$500 in the first year. He would only recognise the amount when he received it in the second year.

19.13 An important point to note is that the closing tax value of short-term financial assets and liabilities is only stopped from being taken into account if the financial asset or liability was in exchange for a *non-cash benefit* that was not a financial asset. STS taxpayers would still account on an accruals basis for purchases and sales of financial assets (e.g. bills of exchange) on credit.

Exception for amounts matched to other assets

19.14 Sometimes a short-term financial asset is received for ceasing to hold an asset that the tax system brought to account (e.g. you might have a right to be paid for selling a depreciating asset or a block of land). When you cease to hold such an asset, your net income is reduced by its tax value because you no longer have to bring the asset to account. If the financial asset you got instead was not recognised, there would be a net decline in your taxable income equal to the tax value of the asset you ceased to hold. That reduction in the first year would be matched by an increase in the second year when payment was received.

19.15 There could be a similar anomaly if a short-term financial liability were incurred to start holding an asset the tax system brought to account. If the tax value of the liability were not also brought to account, there would be an increase in taxable income in the first year and a reduction in the year the liability was paid out.

19.16 To avoid such anomalies, the closing tax value of financial assets is not excluded to the extent that they are for ceasing to hold *depreciating* assets or *investment* assets. [Subsection 545-105(2)]

19.17 Similarly, the closing tax value of financial liabilities is not excluded to the extent that they are for starting to hold depreciating assets or investment assets. In this case though, the exception does not apply to depreciating assets that are rights to have things done, so a financial liability incurred to acquire such a right would still be excluded. That preserves the existing prepayments treatment in section 82KZM of the 1936 Act. [*Subsection 545-120(2)*]

19.18 It is important to note that short-term financial assets or liabilities are only not excluded *to the extent* that they relate to a depreciating asset or an investment asset. That covers the case where a single financial asset or liability relates to several things, only one of which is a depreciating asset or an investment asset.

Example 19.2 Financial assets and liabilities related to recognised assets

At the end of the year, Marcus, an STS taxpayer, has a new work bench that Maria sold to him. He has a liability to pay her \$3,500 within 30 days for:

- the bench (worth \$2,000); and
- a 2 year maintenance contract (worth \$1,500).

Normally, STS taxpayers would not bring financial liabilities to account but the work bench is a depreciating asset, so the closing tax value of Marcus' financial liability must be taken into account to that extent. The right to maintenance is a depreciating asset but it is not covered by the exception because it is a right to have things done, so the part of the liability that relates to the maintenance will not be taken into account.

For that year, Marcus will only take into account the \$2,000 of the liability's closing tax value that relates to the work bench. That matches the \$2,000 increase in the tax value of his assets because of the work bench. He will take the rest of his expense into account only when he pays.

Liabilities matching financial assets excluded by the basic rule

19.19 A financial asset might be related to a liability (e.g. you might have a right to be paid in return for promising to provide services). As the rules exclude the closing tax value of financial assets, there would be an anomaly if the liability was recognised. In effect, it would allow STS taxpayers deductions for agreeing to provide future services.

19.20 Therefore, when the STS cash accounting rules prevent the closing tax value of a financial asset being taken into account, the closing tax value of any related liability is not taken into account to the same extent. [*Section 545-110*]

Example 19.3 Excluding liabilities that match excluded financial assets

Maria in the previous example ended the income year with a financial asset being the right to \$3,500 from Marcus. If she is an STS taxpayer, she would exclude the closing tax value of that right (since none of it relates to realising either a depreciating asset or an investment asset).

Maria also has a liability to maintain the work bench for 2 years. Because her financial asset's tax value is excluded, the tax value of this related liability is also excluded. Effectively, she brings neither of them to account until payment.

Assets matching financial liabilities excluded by the basic rule

19.21 A similar rule excludes the closing tax value of an asset if the rules exclude the tax value of a financial liability that forms part of the asset's cost. This prevents an anomaly that would otherwise tax STS taxpayers on the value of services they will receive in the future. [Section 545-125]

Example 19.4 Excluding assets that match excluded financial liabilities

In the previous example, Marcus had a financial liability that was excluded to the extent that it related to his right to maintenance. His right to maintenance is an asset. Because the related part of his financial liability's tax value is excluded, the tax value of his maintenance right is excluded too.

Entering and leaving the STS

19.22 The STS cash accounting rules in the current law deal with what happens when a taxpayer enters or leaves the STS. Those rules are needed in the current law to prevent an amount being counted twice or not at all when a taxpayer swaps to or from a cash accounting treatment.

19.23 The prototype legislation has no equivalent rules because TVM eliminates such problems in its core rules. The opening tax value of assets and liabilities is *always the same* as the closing tax value that was taken into account in the previous year [section 6-85]. Because there cannot be any difference in an asset's or liability's tax value from the end of one income year to the start of the next, there is no possibility of double counting, or not counting, an amount even when entering or leaving a regime like the STS that varies tax values.

Example 19.5 Entering and leaving the STS regime

Hugo sells widgets. Most of his sales are to trade customers on 30 days credit. At the end of Year 1, Hugo is not an STS taxpayer so brings the amount outstanding for widget sales to account as a \$5,000 financial

asset. In effect, he is taxed on those sales in Year 1 even though he has not yet been paid for them.

If he enters the STS in Year 2, the opening tax value of his assets will include that \$5,000 even though STS does not normally bring such financial assets to account. When he receives the \$5,000 in Year 2, he would bring it into his net income calculation. However, he would not be taxed a second time because, when he is paid, he stops holding his right to be paid, so the tax value of his assets would decline by \$5,000 to offset the receipt.

Suppose Hugo leaves the STS in Year 3 and is owed another \$5,000 at the start of the year. The opening tax value of that financial asset in Year 3 would be nil because the STS rules would have prevented it being taken into account at the end of Year 2. When he gets paid, he will bring the receipt to account but there will be no offsetting decline in the tax value of his asset because it had a nil value. So, the amount would be taxed in Year 3 and in no other year.

Depreciating assets

19.24 The second way that the STS alters the law for STS taxpayers is that it pools depreciating assets and writes them off as a single asset at a single depreciation rate. There is one pool for longer life assets and one pool for all other assets. Assets that cost less than \$1,000 can instead be fully written off in their first year.

19.25 The version of the pooling rules in the prototype legislation is much the same as the current law. It makes some changes needed to conform to TVM's structure.

What assets are covered?

19.26 The provisions in the prototype legislation cover depreciating assets just like the current law. However, under TVM there are many new depreciating assets (e.g. depreciating rights), so the prototype legislation has to include rules to limit the STS depreciation treatment to the same assets as now. Those assets are called ***STS depreciating assets***. Broadly, they are tangible depreciating assets, intellectual property, mining rights, in-house software, and certain communications rights. [*Section 545-175*]

Exclusions

19.27 As with the current law, some assets within that broad description are excluded. They are:

- primary production assets you choose not to bring within the STS treatment [*section 545-180*];
- horticultural plants [*section 545-185*];

- assets predominantly let on a *depreciating asset lease* (a right to use a depreciating asset, except under a short-term hire or a hire purchase agreement) [section 545-190];
- assets in another pool (e.g. a low value pool) [section 545-195];
- long life assets the taxpayer held before July 2001 and chooses not to bring within the STS treatment [section 545-200].

Low cost assets

19.28 Depreciating assets (except horticultural plants) with a cost of less than \$1,000 in the year they start to decline are **low cost assets**. [Subsection 545-205(2)]

19.29 Low cost assets that start to decline while you are an STS taxpayer have a closing tax value of nil [subsection 545-205(1)]. Effectively, that means STS taxpayers can fully deduct the cost of low cost assets in the year the asset starts to decline.

19.30 This rule also means that, unlike the current law, the cost of additions to a low cost assets (e.g. the cost of an improvement) is also fully deductible when made.

19.31 There is an upward adjustment to taxable income equal to the percentage of the low cost asset's cost (or the cost additions) that represents its private use. This adjustment prevents tax relief for the private portion of the asset's decline in value. Because there is an immediate 100% write-off for low cost assets, the taxpayer has to estimate that private use over the life of the asset. [Subsections 545-205(3) and (4)]

Example 19.6 Partly private low cost asset

Jeremiah, an STS taxpayer, buys an oscillating videorama for \$800. Most of the time he uses it to promote his business but, occasionally, he brings it home to entertain his friends. He estimates that its private use is 5%.

The videorama is a low cost asset, so Jeremiah gives it a closing tax value of nil in the year he starts to use it. However, he has an upward adjustment to his taxable income of \$40 (5% of \$800) because of its private use. Effectively, he has deducted \$760 for the videorama.

In Year 2, Jeremiah spends \$300 adding the second cartridge option to the videorama. This increases its cost to \$1,100 but the videorama's tax value stays at nil. There is an upward adjustment to Jeremiah's taxable income of \$15 (5% of \$300) for the private use. Effectively, he has deducted \$285 of the cost of the addition.

19.32 If the cost additions to a low cost asset during a year are \$1,000 or more, the low cost asset goes into an STS pool instead of getting a nil tax value. [Paragraph 545-205(1)(b), subsection 545-220(4)]

Pooling

19.33 The idea behind pooling is that STS taxpayers will not have to worry about calculating the decline in value of individual depreciating assets. Instead, they are merged into a pool with a single depreciation rate, so that only one calculation needs to be done.

Creating STS pools

19.34 When a taxpayer first becomes an STS taxpayer, two STS pools are created, one for assets with effective lives of 25 years or more (the **long life STS pool**) and one for other assets (the **general STS pool**) [subsection 545-215(1)]. These pools last forever, even when the taxpayer stops being an STS taxpayer. Whenever the taxpayer is an STS taxpayer, STS depreciating assets (except low cost assets) get allocated to these pools. They stay there for as long as the taxpayer holds the asset [subsection 545-220(7)].

19.35 The pools are treated like depreciating assets [subsection 545-215(2)]. The real depreciating assets allocated to the pools are no longer treated separately; the treatment of the pool replaces that [subsection 545-220(6)].

Allocating assets to STS pools and their cost

19.36 STS depreciating assets go into the STS pools at the times described in this table. The table also shows the effect that pooling the asset has on the cost of the STS pool.

Table 19.2 Allocating assets to STS pools and effect on cost

<i>In this case...</i>	<i>This STS depreciating asset...</i>	<i>Is allocated to an STS pool...</i>	<i>And does this to the pool's cost...</i>	<i>Reference</i>
If you enter, or re-enter, the STS in a year	An asset you held at the end of the previous year that had already started to decline	At the start of the current year	Add the asset's opening tax value at that time to the <i>first element</i> of the pool's cost	<i>subsection 545-220(2)</i>
If you are an STS taxpayer for a year	An asset (except a low cost asset) that starts to decline in the year	When it starts to decline	Add the asset's cost at that time to the <i>second element</i> of the pool's cost	<i>subsection 545-220(3)</i>
If you are an STS taxpayer for a year	A low cost asset that has additions of at least \$1,000 made to the second element of its cost in the year	When those additions reach \$1,000	Add those additions at that time to the <i>second element</i> of the pool's cost	<i>subsection 545-220(4)</i>

19.37 When an amount is included in the second element of the cost of an asset already in an STS pool (e.g. if an improvement is made to the asset), that amount is included in the *second element* of the cost of the pool at the same time. [Subsection 545-220(5)]

Example 19.7 Allocating assets to STS pools

Katy, a cobbler who specialises in making single shoes for odd-sized feet, re-enters the STS after an absence of a few years. At the start of the year, her general STS pool (from when she was first in the STS) has an opening tax value of \$900. She also has a boot last, acquired since she first left the STS, that is outside the pool. It has an opening tax value of \$400. It is added to the pool and that adds \$400 to the *first element* of the pool's cost.

In September, she buys a new buffing machine for \$1,100 and starts to use it straight away. It goes into her pool immediately and \$1,100 is added to the *second element* of the pool's cost.

She also adds an extra cartridge to her glue gun, which is already in the pool. The improvement costs her \$100 and that amount is also added to the *second element* of the pool's cost.

Tax value of STS pools

19.38 The opening tax value of an STS pool for an income year is the same as its closing tax value in the previous year, like any other asset [subsection 545-225(2)]. Its tax value at any other time is worked out as if that time were the end of an income year, just like normal depreciating assets [subsection 545-225(3)].

19.39 A 3-step process determines the pool's closing tax value for an income year. It incorporates the calculation of the pool's decline in tax value for the year.

Step 1 base value

19.40 You start with the pool's base value and reduce it by 30% for a general STS pool or 5% for a long life STS pool [subsection 545-225(1), step 1 of the method statement and section 545-235].

19.41 An STS pool's **base value** is its opening tax value plus any amounts added to its cost (first or second element) during the year. [Section 545-230]

Step 2 adjust for new assets added to the pool

19.42 Next, you increase the result by:

- 15% of any amounts added to the *second element* of the cost of a general STS pool; or

- 2.5% of any amounts added to the *second element* of the cost of a long life STS pool.

[Subsection 545-225(1), step 2 of the method statement]

19.43 In effect, this step cancels half the decline in tax value attributable to new assets added to the pool in the year. The decline in value of normal depreciating assets would be apportioned under Division 72 on a daily basis in the year they start to decline. Under STS, every new asset gets half a year's decline regardless of when in the year the decline started.

19.44 The adjustment only applies to assets whose value is added to the *second element* of the pool's cost. Essentially, these are assets that have not yet started to decline.

19.45 The adjustment does not apply to assets that are added to the pool at the start of the year that a taxpayer enters, or re-enters, the STS because those assets' values are added to the *first element* of the pool's cost. They are assets that have already started to decline before the year, so any apportionment would not be appropriate.

Step 3 adjust for disposals

19.46 Finally, you reduce the result by the proceeds of realising each pooled asset that you stopped holding during the year. That brings you to the pool's closing tax value [*subsection 545-225(1), step 3 of the method statement*]. If this reduces the pool's value to less than nil, its closing tax value will be nil instead of the negative value [*subsection 10-40(2)*].

19.47 For normal depreciating assets outside a pool, any gain or loss when you cease to hold them is brought to account immediately in the difference between the proceeds of realising the asset and the tax value it had at the start of the year. For assets in a pool, any gain or loss is offset against the pool's tax value. In effect, the tax treatment of gains and losses on ceasing to hold pooled assets are deferred until the pool's tax value declines to nil.

Example 19.8 Closing tax value of STS pools

From the previous example, Katy's general STS pool had an opening tax value of \$900. During the year, she added \$400 to the first element of its cost and \$1,200 to the second element. Its base value therefore is $(900 + 400 + 1,200 =) \$2,500$.

During the year, she sells her curing oven, one of the assets in her pool, for \$1,600.

Under step 1, she reduces the pool's base value by 30% (\$750) to \$1,750. Under step 2, she adds back 15% (\$180) of the \$1,200 she added to the second element of the pool's cost in the year. That brings

the result to \$1,930. Under step 3, she reduces the result by the proceeds of realising the curing oven she sold (\$1,600) to bring the closing tax value of the pool for the year to \$330.

19.48 The tax value of an STS pool is reduced to nil if its tax value, ignoring that year's decline, would otherwise be less than \$1,000. You work this out by taking the proceeds of realising each pooled asset away from the pool's base value for the year. [Section 545-240]

Example 19.9 Low value of STS pools

From the previous example, the base value of Katy's general STS pool was \$2,500. Taking away from that the \$1,600 she got for selling the curing oven, we get \$900. Since that is less than \$1,000 the tax value of her pool is nil instead of the \$330 we worked out previously.

Private use of pooled assets

19.49 The previous discussion assumed that the assets added to STS pools were wholly for business use. However, for individuals and some partnerships, it is possible that depreciating assets might be used partly in business and partly for private purposes. A number of rules change the outcome in such cases so that tax relief is only given for the part of expenditure on depreciating assets that relates to their business use.

Adding partly private assets to an STS pool

19.50 The amount added to an STS pool when you first allocate an asset to it is reduced by the asset's private percentage for that income year [subsection 545-250(1)]. The **private percentage** of an asset is explained in Chapter 17.

19.51 The rules for normal depreciating assets work out an asset's annual decline in value and then exclude the private portion. Under the STS, only the business portion of the asset's value ever goes into the pool so the entire private exclusion happens at that moment, rather than on an annual basis.

19.52 When the private percentage is excluded, there is an upward adjustment to increase the taxable income by the amount of the private percentage [subsection 545-250(2)]. This is necessary to prevent tax relief being given for the private part of the cost of the asset.

Example 19.10 Excluding the private percentage of a new asset

Gunter, an STS taxpayer, buys a ute for \$18,000 and adds it to his general STS pool. He uses it privately for 40% of the time in the year, so does not add the \$7,200 private percentage to the cost of the pool, adding only the remaining \$10,800.

Because the ute is not solely for private and domestic purposes, it is not a private asset.²⁷⁶ Therefore, none of the \$18,000 payment is excluded as being private because it is all included in the cost of an asset that is not a private asset.²⁷⁷ Gunter's net income from this purchase is:

$$[0 - 18,000] + [10,800^{278} - 0] - [0 - 0] = -7,200$$

The reduction here of \$7,200 represents the private percentage of the ute, so should not get tax relief. There will be an upward adjustment of \$7,200 to prevent tax relief being given for the private percentage of Gunter's ute.

Adding to the cost of assets already in a pool

19.53 A similar process applies when an amount is added to the cost of an asset already in an STS pool. The amount added to the pool for the cost addition is reduced by the asset's original private percentage unless that private percentage has ever changed by more than 10 percentage points since the asset went into the pool. [*Subsection 545-255(1), paragraphs 545-255(2)(a) and (3)(a)*]

19.54 If the private percentage of the asset has changed by more than 10 percentage points, there will have been an adjustment to the pool's tax value (see paragraphs 19.60 and following). In that case, the amount added to the pool for the cost addition is reduced by the private percentage the asset had the last time there was such an adjustment [*subsection 545-255(1), paragraphs 545-255(2)(b) and (3)(b)*].

19.55 In either case, there will be an upward adjustment equal to the amount of the reduction [*subsection 545-255(4)*]. Again, this is necessary to prevent tax relief being given for the private part of the expenditure.

Proceeds of realising pooled assets

19.56 A similar process also reduces the proceeds of realising an asset in an STS pool. This is needed because the pool's tax value will only include the business part of the asset's value but the proceeds of realising it will also cover the private part of its value. Therefore, that private part needs to be excluded from the amount taken out of the pool when the taxpayer stops holding a pooled asset. It is also excluded under section 545-240 when working out if the pool's base value, minus the proceeds of realising pooled assets, comes to less than \$1,000. [*Subsection 545-260(1)*]

19.57 The reduction in the proceeds is the same as the asset's original private percentage unless that private percentage has ever changed by

²⁷⁶ See subsection 222-45(1), item 5 of the table.

²⁷⁷ See subsection 222-10(2).

²⁷⁸ This figure assumes that the only asset in the pool is the ute, and ignores the pool's decline in value for the year, to make the point clearly. In fact, the pool's closing value would be reduced by 15% (\$1,620) to \$9,180. The \$1,620 decline is the correct tax relief in this case.

more than 10 percentage points since the asset went into the pool.
[Paragraph 545-260(1)(c), subsection 545-260(2)]

19.58 If the private percentage of the asset has changed by more than 10 percentage points, the reduction uses an average of the asset's private percentage over its time in the pool (to a maximum of its first 4 years in the general STS pool or 21 years in the long life STS pool). The percentage used for its first year in the pool is the original private percentage. Each other year uses the same percentage as the previous year unless it is more than 10 percentage points different, in which case it uses that new percentage. [Paragraph 545-260(1)(d), subsection 545-260(3)]

19.59 In either case, there will be a downward adjustment to taxable income equal to the amount of the reduction [subsection 545-260(4)]. This prevents the private part of the proceeds of realising an asset from being taxed.

Example 19.11 Excluding the private part of the proceeds of realising a pooled asset

Suppose Gunter in the previous example kept his ute for 6 years before selling it. The private percentage changed from 40% in Year 1, to 50% in Year 2, 60% in years 3 and 4 and 75% in years 5 and 6. In Year 6, he sold the ute for \$8,000.

He has to reduce the proceeds of realising the ute by an average of his private percentage over the time he held the ute. He would count 40% for Year 1. Year 2 is also 40% because it has not changed by *more than* 10 percentage points. Years 3 and 4 are 60% because that is more than 10 percentage points different from 40%. Years 5 and 6 are more than 10 percentage points different from the Year 4 percentage but they still are not counted because only the first 4 years are relevant to the general STS pool.

So, the average used is $(40\% + 40\% + 60\% + 60\%)/4 = 50\%$. Therefore, only \$4,000 of the proceeds of realising the ute is taken out of Gunter's general STS pool. He would also have a downward adjustment to his taxable income of \$4,000.

Changing private percentage of pooled assets

19.60 Although a taxpayer makes a genuine effort to work out the private percentage for an asset when it goes into an STS pool, there is always the possibility that its private percentage may change. In such cases, it is necessary to adjust the pool's value to ensure that the appropriate portion of the asset's remaining value is in the pool.

19.61 However, such an adjustment is only made in a year if the private percentage of the asset for that year is more than 10 percentage points different from the last percentage used for that asset. [Subsection 545-265(1)]

19.62 Also, an adjustment is never made:

- for an asset in the general STS pool– in its 5th or later income year in the pool; or
- for an asset in the long life STS pool– in its 22nd or later income year in the pool.

[subsection 545-265(2)]

19.63 The adjustment is made to the pool’s base value for the year and is worked out using this formula:

$$\text{NTV} \times \left[\frac{\text{Old percentage} - \text{New percentage}}{100\% - \text{Old percentage}} \right]$$

where “NTV” (notional tax value) is the opening tax value the asset has in the pool for that year. You work that out by assuming that the asset was the only asset ever allocated to the pool. [Subsection 545-265(3)]

Example 19.12 Changing private percentage of pooled asset

Phil has a general STS pool with an opening tax value in Year 3 of \$12,500. He added a car with a 50% private percentage to the pool in Year 1. He had bought the car for \$15,000. In Year 3, its private percentage has changed to 25% so he has to make an adjustment.

He works out the car’s NTV. In Year 1, he added \$7,500 to the pool (after reducing the \$15,000 by its private percentage). It declined by 15% in that year to \$6,375. In Year 2, it declined by 30% to \$4,462.50. That is the opening tax value it had in the pool at the start of Year 3.

Now, he applies the formula:

$$4,462.50 \times \frac{50\% - 25\%}{100\% - 50\%}$$

The result of that is an adjustment of \$2,231.25 to the pool’s base value. Therefore, the pool’s base value in Year 3 would be $(12,500 + 2,231.25) = \$14,731.25$. Its decline would then be the normal 30% $(\$4,419.38)$, leaving a closing tax value of \$10,311.88.

19.64 If the adjustment *increases* the pool’s base value (i.e. if the private percentage is lower), there is also a downward adjustment to taxable income equal to the increase [subsection 545-265(4)]. If the adjustment *decreases* the pool’s base value (i.e. if the private percentage goes up), there is an upward adjustment equal to the decrease [subsection 545-265(5)]. These adjustments ensure that the change to the pool’s base value has no immediate effect on taxable income.

Example 19.13 Adjustment for changed private percentage

In the previous example, the \$2,231.25 increase in the base value of Phil's general STS pool means that Phil's taxable income will have a downward adjustment of \$2,231.25.

Trading stock

19.65 STS taxpayers do not have to record a change in the total tax value of their trading stock if their reasonable estimate of the total closing tax value of their trading stock is within \$5,000 of its total opening tax value [subsection 545-285(1)]. If the difference is more than \$5,000, they will have to do a stocktake and bring the correct closing tax value to account. They can always choose to do that anyway [subsection 545-285(3)].

19.66 Usually, it will be enough to just bring to account an unchanged total stock figure. However, the rules do provide for working out the tax value of individual items of stock should that ever be necessary. They do that by dividing the total opening stock value between all items of stock in proportion to their relative costs. The result for an item will be its individual closing tax value. [Subsection 545-285(2)]

Example 19.14 Tax value of trading stock

Jamie's Bikes Ltd, an STS taxpayer, sells bicycles and bicycling equipment. The opening tax value of its stock for a year is \$35,000. Jamie's estimates that the cost of its stock at the end of the year is \$38,000. Since that is within \$5,000 of its opening stock, it can bring in an unchanged figure of \$35,000 for its closing stock.

If it needed to work out the closing tax value of a bicycle that cost it \$500, Jamie's would multiply \$35,000 by $500/38,000$ to get a closing tax value for the bicycle of \$460.53.

Eligibility to be in the STS

19.67 Apart from minor wording changes to reflect differing terminology, the provisions in TVM's version of the STS eligibility rules are identical to those in the current law. [Section 545-365, 545-370, 545-375, 545-380]

19.68 Broadly, you can elect to be an STS taxpayer in a year if:

- you are in business in the year;
- your STS average turnover is less than \$1 million (this is normally worked out over any 3 of the previous 4 years and takes into account the turnovers of certain related entities but not intra-group transactions); and

- the closing tax value of depreciating assets (excluding most intangible depreciating assets) that you and the related entities have at the end of the year is less than \$3 million.

[Section 545-365]

Entering and leaving the STS

19.69 Again, the only changes made to TVM's version of the STS entry and exit rules are minor wording changes to reflect differing terminology.

19.70 Broadly, you can choose to enter the STS if Subdivision 545-E makes you eligible to be an STS taxpayer. You make the choice by notifying the Commissioner. *[Section 545-435]*

19.71 You leave the STS by becoming ineligible to stay or by choosing to leave. Again, you have to notify the Commissioner. *[Section 545-440]*

PART 3:

**AREAS OF LEGISLATION NOT YET
DEVELOPED**

Chapter 20

Effect of the goods and services tax (GST)

Outline of Chapter

20.1 This Chapter outlines how TVM would interact with the goods and services tax (GST). This methodology would be developed further and may change as legislation is prepared.

20.2 The Chapter outlines 2 possible legislative approaches for addressing the interaction between TVM and GST:

- the ‘asset and liability’ approach; and
- the ‘exclusion’ approach.

20.3 The preparation of draft legislation relating to GST has not yet commenced and is not included in the prototype legislation.

Context of Reform

20.4 In the current law, overlaps between income tax and GST are prevented by a large number of specific rules, occupying almost 16 pages of legislation. These rules, which are scattered throughout the ITAA 1997, remove:

- GST payable from assessable income;
- increasing adjustments from assessable income;
- GST from elements in ‘calculation of amounts’;²⁷⁹
- input tax credits from deductions;
- decreasing adjustments from deductions;
- the effect of input tax credits and decreasing adjustments on CGT cost bases;
- ‘net GST’ from capital proceeds for CGT purposes;²⁸⁰

²⁷⁹ See sections 17-15 and 27-20 of the ITAA 1997.

²⁸⁰ See subsection 116-20(5) of the ITAA 1997.

- the effect of decreasing adjustments on capital proceeds for CGT purposes;
- input tax credits from the value of trading stock;
- the effect of input tax credits and increasing and decreasing adjustments from cost and adjustable value for capital allowance purposes;
- GST payable from termination value;
- The effect of increasing and decreasing adjustments on termination value.

20.5 The policy behind the TVM-GST interaction would be precisely the same as the policy behind the current income tax-GST interaction. TVM, like the current law, would recognise that, in most cases, GST is an independent tax which has a neutral effect on the income tax base. However, the methodology used by TVM is likely to be much simpler than it is under the current law.

Explanation of proposed TVM treatment

20.6 Broadly, there are 2 possible approaches to addressing the interaction:

- the asset and liability approach; and
- the exclusion approach.

20.7 Unlike the current law, TVM would require few, *if any*, anti-overlap provisions; especially if the asset and liability approach were adopted. This is because TVM automatically treats GST in accordance with its economic substance: a series of assets and liabilities arising from transactions.

The ‘asset and liability’ approach

20.8 Rights and obligations arising from the operation of the GST law²⁸¹ can be recognised, in accordance with their economic substance, as assets and liabilities under TVM. This treatment would serve to *automatically* remove most of the GST-income tax overlaps, *with no need for any special rules*.

20.9 For example, an entity which purchases trading stock in a creditable acquisition acquires 2 assets: the trading stock and an input tax credit. Because the acquisition price must be allocated across these 2

²⁸¹

A New Tax System (Goods and Services Tax) Act 1999.

assets, only that part of it which is attributable to the trading stock will find its way into the stock's cost.

20.10 Equally, an entity which sells trading stock in a taxable supply will stop holding an asset, receive money and start having a liability (GST payable). Because the sale price must be allocated across both an asset and a liability, only that portion of the receipt which is not attributable to GST payable will find its way into the stock's proceeds of realisation.

20.11 In a similar way, increasing adjustments can be recognised as a liability, and decreasing adjustments as an asset. The deemed receipts and payments arising from the non-cash transaction rules would automatically provide these assets and liabilities with an appropriate tax value. This approach excludes these amounts from an entity's income tax result *without any special rules*.

The 'exclusion' approach

20.12 The alternative approach is to exclude GST rights, liabilities and cashflows from the income tax system in a similar way to that proposed in the private or domestic rules (see Chapter 17).

20.13 This could be done by:

- excluding a receipt from the method statement in section 6-55 to the extent that it is attributable to GST payable or an increasing adjustment; and
- excluding a payment in a similar manner, to the extent that it is attributable to an input tax credit to which the entity is entitled or a decreasing adjustment.²⁸²

20.14 Because these receipts and payments would also be disregarded for the purposes of the cost and proceeds rules, the creditable component of an asset's cost and the GST payable component of an asset's proceeds of realisation would be automatically excluded.

20.15 This approach would also automatically take increasing and decreasing adjustments into account, since the deemed receipts and payments arising under the non-cash transaction rules upon an adjustment event would be net of GST.

20.16 Assets such as input tax credits, decreasing adjustments and negative net amounts could be given a tax value of nil. Liabilities such as GST payable, increasing adjustments and positive net amounts could be treated in the same way. All of these items could therefore be ignored for income tax purposes.

²⁸²

If section 6-60 is being used by the taxpayer, the change in cash would be adjusted instead.

Practical compliance issues

20.17 Regardless of what method is used, TVM would not increase a taxpayer's compliance effort in relation to GST. This is because TVM changes the legislative mechanism *behind* the interaction, *not* the interaction itself. Entities would be able to account for cash flows and asset values net of GST, in the same way as they do now.

Chapter 21

Effect of TVM on foreign residents

Outline of Chapter

21.1 This Chapter outlines how TVM will apply to foreign residents. This methodology will be developed and may change as legislation is prepared.

21.2 The Chapter deals with how the formula for calculating taxable income under TVM will apply to foreign residents, how the components of the taxable income formula that relate to Australia will be identified and, in a preliminary way, how specific assessment regimes applying to foreign residents may be dealt with.

21.3 The preparation of draft legislation has not yet commenced and is not included in the prototype legislation.

Context of Reform

21.4 The calculation of taxable income under the ITAA 1997 and ITAA 1936 relies heavily on the internationally recognised concepts of residence and source (sections 6-5 and 6-10 of the ITAA 1997). While the 1997 Act recognises that both ordinary income and statutory income can be included in a foreign resident's assessable income on a basis other than source this usually relies on a sufficient connection with Australia to ground a taxing right over that income (the obvious example is CGT assets with the necessary connection with Australia).

21.5 The use of the term 'source' in the current legislation invariably refers to the common law rules that have developed to determine where income has been derived. Ordinary income and statutory income included on a basis other than source are included on a basis that in effect is nothing more than a statutory 'source' rule.

21.6 Under TVM there will be no change to the circumstances in which a taxpayer is considered to be an Australian resident or a foreign resident for tax purposes. However, the reliance placed in determining taxable income on a taxpayer's receipts, payments, assets and liabilities will require, in the case of foreign residents, determining when these items have a sufficient territorial connection to Australia for them to be taxed by Australia in the hands of the foreign resident.

Summary of proposed TVM treatment

21.7 Under TVM the taxable income formula for residents will be:

Taxable income = Net income + Taxable income adjustment – Unused Tax Losses.

21.8 Net income will be determined by the formula:

Net Income = Receipts – Payments +/- Net change in tax value of assets and liabilities.

21.9 For the reasons outlined above the formula will need to be modified for foreign residents. This would be done by defining what are ‘Australian receipts’, ‘Australian payments’, ‘Australian assets’ and ‘Australian liabilities’. This would involve a combination of principle based drafting and specific inclusions.

21.10 The table in section 4-15 of the prototype legislation carries with it the possibility that the taxable income of a foreign resident could be calculated under its own Division. This could entail a modified net income formula referring to Australian receipts, payments, assets and liabilities. Alternatively, foreign residents could be accommodated by a provision confining receipts, payments, assets and liabilities in the net income formula in Division 5 to Australian receipts, payments, assets and liabilities as defined. The preferred approach will be one for the drafter.

21.11 The core to determining the taxable income of a foreign resident in the source country jurisdiction will be to use concepts currently referred to in determining transfer pricing issues. The concepts are those of functions performed, assets held or used and risks assumed in Australia. It is generally considered that reference to these criteria determine where value is added in the provision of goods and services and that the country where the value is added should be able to tax that increment. A statutory source rule to this effect was recommended in ATSR recommendation 23.2(c)(i).

21.12 These core concepts will be at the heart of the definition of ‘Australian receipt’ which will be defined comprehensively along with ‘Australian asset’. The reason for this is that clearly the major components of a foreign resident’s taxable income in a country other than their country of residence are things done in the other country, the cash flows that come from assets held or used in that country and changes in the value of those assets arising out of factors attributable to that jurisdiction.

21.13 To a large extent payments and liabilities will be Australian to the extent that they relate to Australian receipts and Australian assets but Australian liabilities may also relate to Australian payments.

21.14 In similar fashion to the exclusion from the taxable income formula of private or domestic receipts, payments, assets and liabilities, certain Australian receipts, payments, assets and liabilities will be

excluded to take account of factors such as the special assessment regime that exists for dividend, interest and royalty withholding taxes and for the application of double tax agreements to exempt certain receipts and assets from Australian tax.

Detailed explanation of proposed TVM treatment

Components of the net income formula

What is an Australian receipt?

21.15 ‘Australian receipt’ could be defined using the broad principle outlined in ATSR recommendation 23.2(c)(i). The recommendation proposes a general source principle providing that income is to be sourced in Australia to the extent that it comes from:

- functions performed in Australia;
- assets located or used in Australia; or
- risks assumed in Australia.

21.16 The aim of this principle is to limit Australia’s taxing jurisdiction over foreign residents to situations where there is significant economic value added in Australia. The principle is already familiar in its use in determining the position under the ‘arm’s length’ principle for transfer pricing purposes.

21.17 Under this principle, an Australian receipt would include a receipt from the disposal use of an Australian asset. Using an asset means consuming or receiving economic benefits in respect of the asset [subsection 72-30(2)]. It would include activities such as leasing or hiring an asset, granting rights over intangible property, holding shares in companies to receive distributions from them and holding the asset to obtain royalties.

21.18 It may also be necessary to include in the definition more specifically targeted receipts. Possible additional provisions include:

- distributions, interest or royalties paid by an Australian resident or an Australian permanent establishment;
- a dividend paid by a company that is not resident in Australia out of its Australian profits and payments on non-share equity paid out of Australian receipts of a company that is not resident in Australia;
- an amount received in connection with personal services performed in Australia, provided to one or more Australian

residents, or, where the results of providing the services relate to Australia, for example, an architect providing plans for a building to be constructed in Australia;

- a receipt attributable to a permanent establishment in Australia; and
- a receipt to the extent that it relates to an Australian liability where the liability relates to an Australian payment or an Australian asset.

Distributions, Interest and Royalties

21.19 The first dot point is necessary because of the uncertainty that exists about the source rules for such amounts and the fact that the general principle may not be considered by the courts to cover such receipts. It reflects the current effective statutory source rules contained in the withholding tax provisions of the current Assessment Acts. However, refer to paragraph 21.39 dealing with how these receipts may be treated for purposes of the net income formula.

21.20 Source based on the residence or location of the payer could also be used in relation to passive income such as annuities, payments (other than interest) on financial assets, superannuation paid by an Australian resident superannuation or approved deposit fund, pensions and other social security benefits.

Dividends paid out of Australian profits

21.21 The second dot point is designed to cover dividends paid by companies that are not resident in Australia out of Australian sourced profits and payments in relation to non-share equity from Australian sources (currently section 44(1)(b) of the ITAA 1936).

Personal Services

21.22 The third dot point would include wages and salaries, some pensions and superannuation benefits and possibly some payments for government service (unless they are dealt with by a separate rule). The reference to 'functions performed' in the general principle may render it unnecessary to have a specific rule for employment income.

21.23 Amounts received by employees in government service could be dealt with in the same way as wages and salaries.

21.24 To make clear some minimal, objective cases where receipts from the provision of services would be taxed in Australia, Australian receipt could also extend to remotely provided services where those services are performed for an Australian resident or the results flowing from the services relate to Australia.

Receipts attributable to a permanent establishment

21.25 In relation to the fourth dot point, ATSR recommended that a specific source rule be included in legislation covering income attributable to a permanent establishment (PE) that could be considered to have a foreign source at common law (recommendation 23.2(c)(iii)). Our Double Tax Agreements already provide for this result but it is not clear that it extends to residents of countries with which Australia does not have a Double Tax Agreement.

21.26 Many receipts covered by the other suggested dot points may also come within this category but the reverse would not be true. Depending on the contribution of the PE, amounts received by the PE could be wholly Australian, partly Australian or not an Australian receipt at all. Attribution to the PE would be determined on the basis of the general principle and as a result there may be no need for this provision. However, as noted ATSR does recommend a specific source rule along these lines and there may be advantages to making it explicit.

21.27 A consequence of this provision would be to allow foreign residents a tax offset in relation to income attributable to the foreign resident's PE in Australia that is subject to tax in another country.

Receipts that relate to an Australian liability

21.28 The last dot point is needed to prevent the reduction in taxable income that would result from certain Australian liabilities being owed at the end of the year. Clearly, it depends on the Australian character of the liability being determined other than by reference to the character of a receipt (see definition of 'Australian liability' at 21.37). For example, if a foreign resident borrows funds or receives a payment for an annuity contract where the loan, etc is an Australian liability (eg. a loan to fund business of an Australian PE), the receipt will be an Australian receipt. If this were not the case the increase in Australian liabilities would lead to a decrease in net income (effectively there would be a deduction).

What is an Australian asset?

21.29 'Australian asset' would be defined to cover:

- an investment asset with the necessary connection with Australia;
- a right to an Australian receipt;
- an asset used or held for use for the purpose of getting an Australian receipt;
- an asset used at any time in carrying on a business through a PE in Australia.

21.30 The tax value of assets is included in the calculation of net income for 2 purposes:

- (a) to ensure that receipts and payments don't affect net income while they are matched to the tax value of an asset or a liability;²⁸³
- (b) to include in net income the change in tax value of assets whether on an accruing or depreciating basis or on realisation.²⁸⁴

21.31 For a foreign resident, we may not wish to capture (b) in respect of a particular asset that according to the above is an Australian asset (e.g. a portfolio shareholding in an Australian resident public company). As such assets should not be taxed on disposal it is necessary that appropriate adjustments be made to the net income formula to arrive at the taxable income of a foreign resident. This could be done in one of 2 ways:

- by providing for a downward adjustment that effectively excludes from taxable income Australian receipts, payments, assets and liabilities that relate to the disposal of investment assets that do not have the necessary connection with Australia; or
- by excluding from the formula all effects arising from the acquisition and disposal of investment assets that are not subject to CGT under the current law, in the same way that private receipts, payments, assets and liabilities are taken out of the formula.

Comments are invited on which of these alternatives should be adopted.

21.32 In relation to the second approach it would be necessary to define the assets that are to be excluded negatively, e.g. all assets that do not have the necessary connection with Australia.

Investment Assets

21.33 The first dot point in paragraph 21.29 is included, to satisfy purpose (b) at paragraph 21.30. Subject to the definition of investment assets, those with the necessary connection with Australia are those listed in section 136-25 of the ITAA 1997.

Right to an Australian receipt

21.34 The second dot point is needed to ensure the correct taxable income for accruals taxpayers (i.e. the taxpayer includes the asset on

²⁸³ Chapter 1 explains what 'matched' means.

²⁸⁴ See Chapter 7.

accrual of the amount to be received and then takes it out when payment is received).

Assets used in carrying on business through a PE

21.35 In relation to the fourth dot point, an asset used in carrying on a business through a PE in Australia may or may not be located in Australia (the PE may carry on some of its business outside Australia and use assets outside Australia in the course of doing so). Further, an asset of the PE located in Australia may not be 100% effectively connected with the PE because the receipts generated by that asset are not entirely Australian receipts (e.g. a loan to a foreign resident). The definition will need to provide for such apportionment or it could be dealt with in a similar manner to private or domestic expenditure.

What is an Australian payment?

21.36 As noted in paragraph 21.13, it is proposed that an Australian payment will be defined as a payment that relates²⁸⁵ to an Australian receipt. It would also be intended to treat as an Australian payment:

- a payment that forms part of the cost of an ‘Australian asset’. This would cover both payments made in order to start to hold the asset, and those made to bring it to its present condition and location,²⁸⁶ and
- payments that are holding expenses (like repairs or maintenance)²⁸⁷ or running costs (like fuel) to the extent the asset is used to get Australian receipts.

What is an Australian liability?

21.37 An ‘Australian liability’ will cover:

- a liability that relates to getting an Australian receipt (an example could be the liability to make sub-licence payments in relation to a licensing arrangement which generates Australian receipts for the foreign resident); and
- a liability to make an Australian payment (see paragraph 21.36).

²⁸⁵ How the relationship might be described in legislation may be determined by the way in which the relationship between payments made in relation to exempt receipts is described.

²⁸⁶ A similar mechanism is used in the rules dealing with private or domestic issues (see Chapter 17).

²⁸⁷ See section 14-35 of the prototype legislation.

Modifications to the net income formula?

Dividends, Interest and Royalties

21.38 It is proposed that Australian receipts, payments, assets and liabilities that relate to amounts subject to dividend, interest or royalty withholding tax will be taken out of the net income formula for a foreign resident and the receipts will continue to be taxed under a separate Division applicable to them (Division 11A of Part III of the ITAA 1936). The alternative is to deal with these items as downward adjustments. However, that alternative could become somewhat complicated given that dividend, interest and royalty withholding tax is imposed on a gross rather than a net basis. These items could be taken out of the net income formula in a way similar to the way private or domestic receipts, payments, assets and liabilities are taken out of the formula.

Double Tax Agreements

21.39 Similar treatment could be accorded to Australian receipts, payments, assets and liabilities that Australia cannot tax under a Double Tax Agreement.

Special Assessment Regimes

21.40 Consideration is also being given to how to take out of taxable income Australian receipts, payments, assets and liabilities that relate to special assessment regimes currently in the ITAA 1936. Examples of such regimes include the non-resident resident shipping regime (where a foreign resident is taxed on 5% of the shipping charge in certain circumstances); non-resident insurance; and offshore banking unit income.

21.41 The special tax treatment that applies as a result of the application of these regimes could be provided through taxable income adjustments or by removing relevant amounts directly from the calculation of net income. In relation to the non-resident shipping regime, the adjustment approach would exclude from the calculation of net income 95% of the Australian receipts and 100% of any associated Australian payments, assets and liabilities. The alternative would exclude all receipts, payments, assets and liabilities arising from such activities from the net income formula and then add 5% of prescribed receipts as an upward adjustment.

Chapter 22

Small business concessions relating to investment assets

Outline of Chapter

22.1 This Chapter explains the anticipated treatment under TVM of the present CGT small business concessions contained in Division 152 of the ITAA 1997. Prototype legislation for this has not yet been drafted.

Context of Reform

22.2 Currently there are 4 CGT concessions that apply where CGT events occur for small businesses and a net capital gain is included in taxable income. The concessions reduce the amount of capital gains. The concessions are as follows:

- small business 15-year exemption;
- 50% reduction for active assets;
- small business retirement exemption; and
- small business roll-over.

22.3 Under TVM, it is proposed that the same concessions will be available for:

- investment asset gains²⁸⁸ if they exceed current investment asset losses and carry forward investment asset losses; and
- gains from creating a contractual right or other legal or equitable right in another entity, where the right created is inherently connected with an investment asset that is an active asset.²⁸⁹

²⁸⁸ ATSR recommendation 17.5 – see also recommendations 4.10 and 8.11(c).

²⁸⁹ This extends the application of the concessions to gains that CGT event D1 applies to under the current law.

Summary of proposed TVM treatment

22.4 It is proposed that under TVM the small business concessions for the:

- small business 15-year exemption;
- 50% reduction for active assets;
- small business retirement exemption; and
- small business roll-over;

will be retained for small business assets that are investment assets (see paragraph 15.38 for the range of assets that will get investment asset treatment).

22.5 In addition to applying to investment assets, it is proposed that the concessional treatment will also apply to gains from creating a contractual right or other legal or equitable right in another entity, where the right created is inherently connected with an investment asset that is an active asset.

22.6 The concessions will, generally, be provided in the form of a downward taxable income adjustment. This has the effect of reducing taxable income. The small business roll-over is proposed to be achieved by modifying the tax value of the replacement asset to defer the realisation of the gain on the disposal of the investment asset to which roll-over relief applies.

22.7 The basic qualifying tests that currently apply under Division 152 of the ITAA 1997 such as the:

- maximum net asset test; and
- active asset test;

will continue to apply.

22.8 It is proposed that the small business concession rules will not be part of the investment asset treatment rules in Division 100 of the prototype legislation but, rather, will be self-contained in a separate Division in a part of the legislation dealing with small business issues.²⁹⁰

²⁹⁰

See Chapter 24.

Detailed explanation of proposed TVM treatment

What are the small business concessions?

22.9 The small business concessions proposed under TVM are the:

- small business 15-year exemption;
- 50% reduction for active assets;
- small business retirement exemption; and
- small business roll-over.

How will the concessions be provided under TVM?

22.10 Under TVM, the small business 15-year exemption, the 50% reduction for active assets and the small business retirement exemption will be provided by taxable income adjustments to reduce the amount of the investment asset gain included in taxable income. This is achieved by downward taxable income adjustments.

22.11 The small business roll-over will be achieved by modifying the tax value of the replacement asset to defer the realisation of the gain from ceasing to hold the investment asset that qualifies for roll-over relief. The gain will only be included in taxable income when the replacement asset ceases to be held (assuming no further roll-over applies).

22.12 Similar to the current law, the small business 15-year exemption will apply before any other concession. It is proposed that the exemption will result in a downward adjustment that is specific to the gain for qualifying assets. This adjustment will have the effect of reducing the total investment asset gain from those qualifying assets to nil [section 100-65]. The other concessions will be available after the downward taxable income adjustment for the discount is applied. Like the current law, it is proposed that the same choices will be able to be made about the order of application of the other concessions.

Maximum net asset value test

22.13 Under TVM, it is proposed that the \$5 million maximum net asset value test apply to all assets other than those assets that are currently excluded under the law (such as private assets). This will result in the assets to which the test applies being equivalent to the current law.

Active asset test

22.14 Under TVM, it is proposed that the active asset test will apply to investment assets in the same way the current law's active asset test applies to CGT assets (see paragraph 15.38 for a description of assets that qualify for investment asset treatment).

22.15 As under the current law, the active asset test will apply differently to gains that arise as a result of creating a contractual right or other legal or equitable right in another entity. The gain will qualify for the small business concessions where the right created is inherently connected with an investment asset that is an active asset.

22.16 A number of examples are set out below which show how each of the small business concessions would be expected to apply under TVM.²⁹¹

Small business 15-year exemption

22.17 Under TVM it is proposed to replicate the current small business 15-year exemption. The exemption will apply to investment asset gains and gains from creating certain rights in another entity.

22.18 Broadly, to qualify for the small business 15-year exemption the investment asset must be an active asset and must have been held for at least 15 years. For gains arising from the creation of a contractual or other legal or equitable right, the exemption will apply if the right is inherently connected with an investment asset that is an active asset that the taxpayer has held for at least 15 years.

22.19 The exemption will apply by way of a downward adjustment equal to the amount of the gain included in net income. This will have the effect of excluding the gain from taxable income.

Example 22.1 Small business 15-year exemption

Nero started a bakery over 15 years ago. He sells the bakery for \$200,000 made up of \$150,000 for goodwill and \$50,000 for depreciating assets. The depreciating assets had a tax value at the start of the year of \$50,000²⁹². As Nero satisfies the small business 15-year exemption, there is no investment asset gain remaining to apply the discount to. Nero's net income is:

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

$$= [200,000 - 0] + [0 - 50,000] - [0 - 0]$$

$$= \$150,000.$$

Work out the investment asset gain or loss for the goodwill [section 100-45].

²⁹¹ Note for the purposes of the examples in this Chapter it is assumed that no unused carry forward investment asset losses or general unused losses are available.

²⁹² In the same way as the current law, the small business 15-year exemption is not available on gains from ceasing to hold depreciating assets.

$$\begin{aligned}
 & \text{Proceeds of realising the asset} \quad - \quad \text{Asset's tax value} \quad - \quad \text{Incidental costs of ceasing to hold} \\
 & = 150,000^{293} - 0^{294} - 0 \\
 & = \$150,000
 \end{aligned}$$

The \$150,000 gain is an investment asset gain.

As Nero qualifies for the small business 15-year exemption, he has a downward adjustment equal to the amount of the investment asset gain, \$150,000.

His taxable income is:

$$\begin{aligned}
 & \text{Net income +/- taxable income adjustment} - \text{unused tax losses} \\
 & = \$150,000 - \$150,000 - 0 \\
 & = \$0
 \end{aligned}$$

Small business 50% reduction for active assets

22.20 Under TVM, it is proposed to replicate the current 50% reduction for active assets for:

- investment asset gains; and
- gains from granting rights in other entities that are inherently connected to an investment asset that is an active asset.

22.21 It is proposed that the same basic conditions as those in the current law would apply.

22.22 The concession will be applied as a downward adjustment equal to 50% of the gain included in net income, but only after the gain has been reduced by any other concessions that may apply to it (e.g. the general 50% investment asset discount for individuals). This will have the effect of excluding half of the remaining gain from taxable income.

Example 22.2 Small business 50% reduction for active assets

Charlotte owns 100% of the shares in Lottie & Co, which she bought 11 months ago for \$15,000. The company operates a florist. The florist business is the only asset of the company. She sells the shares to Henry for \$20,000.

²⁹³ The \$150,000 is the proceeds of realising the goodwill.

²⁹⁴ Note internally generated goodwill has a tax value of zero – section 78-50 of the prototype legislation. Under the current law the result is the same because the goodwill would have a cost base of zero.

The net income formula applies to Charlotte as follows:

$$\begin{aligned} & \left[\text{Receipts} - \text{Payments} \right] + \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of assets} & \text{of assets} \end{array} \right] - \left[\begin{array}{cc} \text{Closing} & \text{Opening} \\ \text{tax value} & \text{tax value} \\ \text{of liabilities} & \text{of liabilities} \end{array} \right] \\ & = [20,000 - 0] + [0 - 15,000] - [0 - 0] \\ & = \$5,000 \end{aligned}$$

The gain from selling the shares qualifies for the 50% active asset reduction. There is a downward adjustment equal to 50% x \$5,000 = \$2,500.

Charlotte's taxable income is:

$$\begin{aligned} & \text{Net income} +/ - \text{taxable income adjustment} - \text{unused tax losses} \\ & = \$5,000 - \$2,500 - 0 \\ & = \$2,500 \end{aligned}$$

Small business retirement exemption

22.23 Under TVM, it is proposed to replicate the current small business retirement exemption for:

- qualifying investment asset gains; and
- gains from granting rights in other entities that are inherently connected to an investment asset that is an active asset.

22.24 It is proposed that the same basic conditions as those under the current law would apply. It is also proposed that the retirement exemption limit of \$500,000 that exists under the current law will continue.

22.25 The concession will be applied as a downward adjustment equal to the qualifying gain included in net income, but only after the gain has been reduced by any other concessions that may apply to it (e.g. the 50% investment asset discount for individuals). This will have the effect of excluding the remaining gain from taxable income.

Example 22.3 Small business retirement exemption

Jack is 55 years old. He has been carrying on an import business that he started himself 14 years ago. He sells the business and receives \$400,000 for the goodwill of the business. He qualifies for the investment asset discount and the 50% reduction for active assets. He also applies the small business retirement exemption and accordingly has a downward taxable income adjustment equal to the gain on the disposal of the goodwill.

Jack's net income:

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

$$= [400,000 - 0] + [0 - 0] - [0 - 0]$$

$$= 400,000$$

Work out the investment asset gain or loss [section 100-45].

$$\begin{array}{r} \text{Proceeds of} \\ \text{realising the asset} \end{array} - \begin{array}{r} \text{Asset's tax value} \end{array} - \begin{array}{r} \text{Incidental costs of} \\ \text{ceasing to hold} \end{array}$$

$$= 400,000 - 0^{295} - 0$$

$$= \$400,000$$

The \$400,000 gain is an investment asset gain.

Jack qualifies for a downward taxable income adjustment of \$200,000 (50% × \$400,000) representing the investment asset discount.

As Jack also qualifies for the small business 50% reduction for active assets and the small business retirement exemption, he has further downward adjustments.

The small business 50% reduction for active assets results in a downward adjustment of \$100,000 (50% × \$200,000).

The small business retirement exemption results in a downward adjustment equal to the amount received for the goodwill less the downward adjustment for the investment asset discount and the small business 50% reduction in active assets (\$400,000 – \$200,000 – \$100,000 = \$100,000).

Total downward adjustments are \$400,000.

Jack's taxable income is:

$$\text{Net income +/- taxable income adjustments} - \text{unused tax losses}$$

$$= 400,000 - 400,000 - 0$$

$$= 0$$

Small Business roll-over

22.26 Under TVM, it is proposed to replicate the small business roll-over for qualifying investment asset gains.

²⁹⁵ Note internally generated goodwill has a tax value of zero – section 78-50 of the prototype legislation.

22.27 It is proposed that the same basic conditions as those under the current law would apply.

22.28 The concession will be applied in the form of an adjustment to the tax value of the replacement investment asset to defer the realisation of an investment asset gain. The gain will not be recognised when the investment asset to which roll-over relief applies ceases to be held. Instead it will be recognised when a replacement asset which does not qualify for roll-over relief, ceases to be held.

Example 22.4 Small business roll-over

In Year 1, Michael sells a newsagency for \$70,000, comprising \$5,000 for depreciating assets and \$65,000 for goodwill. The depreciating assets had a tax value of \$5,000 at the beginning of Year 1. Michael started the business 11 months prior to the sale. Michael buys an established newsagency in another town in Year 1. He pays \$80,000 for goodwill. Michael chooses not to apply the 50% reduction for active assets. He applies the small business rollover relief to the sale of the goodwill.

The purchased goodwill is sold for \$100,000 in Year 2. No replacement asset is purchased.

Like the current law, trading stock and depreciating assets do not qualify for the small business concessions under TVM.

As Michael elects to apply the small business rollover relief to the sale of goodwill, the closing tax value of the purchased goodwill in Year 1 equals the cost of the purchased goodwill (replacement asset) less the gain on disposal of the original asset.

$$= \$80,000 - \$65,000$$

$$= \$15,000$$

Net income Year 1

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

$$= [70,000^{296} - 80,000^{297}] + [15,000^{298} - 5,000^{299}] - [0 - 0]$$

$$= 0 + 0 - 0$$

$$= 0$$

²⁹⁶ \$70,000 received for the sale of the newsagency.

²⁹⁷ \$80,000 paid for the goodwill of the new newsagency.

²⁹⁸ \$15,000 represents the closing tax value of the purchased goodwill taking the roll-over into account.

²⁹⁹ \$5,000 represents the opening tax value of the depreciating assets of the old newsagency.

Net income Year 2

The purchased goodwill is sold for \$100,000 in Year 2, after being held for less than 12 months. No replacement asset is purchased. The gain is not eligible for the investment asset discount, however the small business concession and/or small business retirement exemption apply to the gain. He applies the small business retirement exemption.

$$= [100,000 - 0] + [0 - 15,000] - [0 - 0]$$

$$= \$85,000$$

Work out the investment asset gain or loss [section 100-45].

Proceeds of realising the asset	—	Asset's tax value	—	Incidental costs of ceasing to hold
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$$= \$100,000 - \$15,000 - 0$$

$$= \$85,000$$

The \$85,000 gain is an investment asset gain.

The investment gain of \$85,000 assessed in Year 2 equals the gain of \$65,000 attributable to the disposal of the goodwill from the original business and the \$20,000 gain from the sale of second newsagency (\$100,000-\$80,000).

As Michael qualifies for the small business retirement exemption, he has a downward adjustment equal to the amount of the investment asset gain of \$85,000.

Taxable Income Year 2

Net income +/- taxable income adjustment – unused tax losses

$$= \$85,000 - \$85,000 - 0$$

$$= 0$$

Chapter 23

Effect of TVM on complying superannuation funds

Outline of Chapter

23.1 There is no policy under TVM to change the current taxation outcomes for superannuation funds. Accordingly, this Chapter outlines how it is anticipated TVM would apply to replicate the tax treatment of a complying superannuation fund under the current law.

23.2 Importantly, this Chapter is not intended to comprehensively describe the application of TVM. Instead, it draws on the general discussion in the core chapters of this explanatory material to explain areas of particular importance and relevance to the superannuation industry.

23.3 The transactions of a superannuation fund that are relevant to working out its taxable income can be analysed according to 3 stages: the contribution stage, the earnings stage, and the benefit stage.

Contribution stage

23.4 Under TVM, contributions made to a superannuation fund will be a receipt of the fund.³⁰⁰ This amount is received in respect of a liability that the fund has to the member³⁰¹ (i.e. a liability to pay the member a benefit in the future). The liability will have a tax value equal to the amount of the contribution and effectively offsets the receipt, which means that a fund's taxable income is not affected when a contribution is made.

23.5 Thus, to replicate the current law's treatment of contributions, TVM will:

- only need to apply the core rules for non-taxable contributions; and
- augment the operation of the core rules with a taxable income adjustment for taxable contributions. The taxable income adjustment will be an upward adjustment equal to the amount

³⁰⁰ For further explanation of the concept of a 'receipt' see Chapter 6.

³⁰¹ For further explanation of the concept of a 'liability' see Chapter 8.

of the taxable contribution, which will have the effect of including the amount of that contribution in the fund's taxable income.

Example 23.1 Receipt of a contribution

Grouse superannuation fund receives a \$1,000 contribution on behalf of a member. Grouse's net income will include the receipt of \$1,000 and the corresponding liability it now has to provide future benefits to the member. That liability has a tax value equal to the amount of the contribution.

TVM calculates the net income of the fund as:

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

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

If the contribution was non-taxable, Grouse would also record a taxable income of \$0.

However, if the contribution was taxable, Grouse's taxable income will be worked out by adding an upward adjustment (equal to the taxable contribution of \$1,000).

Taxable income	=	Net income	+	Taxable income adjustment	-	Unused tax losses
\$1,000	=	0	+	1,000	-	0

Other contributions related issues

Rolling over ETPs into a superannuation fund

23.6 Eligible termination payments that are rolled-over into a superannuation fund are treated in a similar manner as contributions. The untaxed element of those rolled-over amounts will be treated as taxable contributions.

Transferring a liability for tax on contributions to a PST / life company

23.7 By agreement, a superannuation fund can transfer its liability to pay income tax on the taxable contributions it receives to PSTs or life companies. If, and to the degree that, a fund satisfies the requirements of an equivalent to section 275 of the ITAA 1936, no *upward* adjustment for the taxable contributions received will be included in the fund's taxable income calculations.

Earnings stage

23.8 The prototype legislation already applies to many of the revenue and expenses that the trustee of a superannuation fund has when it administers the fund and subsequently calculates the fund's taxable income.

23.9 Expenses of a fund that are currently deductible will continue to get tax relief under TVM; for example, administration costs, investment-related expenses, accountancy and audit fees, and depreciation. Similarly, amounts that currently represent assessable income will continue to be subject to tax;³⁰² for example, dividends, interest and earnings in the nature of interest, and (realised) gains made on investment assets.³⁰³

23.10 Importantly, TVM provides for almost all entities (including superannuation funds) to get tax relief for 'blackhole' expenditure. Accordingly, expenses relating to costs incurred by the trustee of a superannuation fund in amending the fund's trust deed and upfront fees incurred in investing money will get tax relief whereas under the current law, those expenses may be of a capital nature and not deductible.³⁰⁴

23.11 TVM provides immediate tax relief for any payments that do not form the cost of an asset.³⁰⁵ In that regard, TVM will also overcome the need for provisions, such as section 277 of the ITAA 1936, which currently provide for tax relief for expenses relating to contributions where those contributions are not assessable income.

Some special rules are required

Amounts paid by the fund on behalf of the member

23.12 Generally, a special rule that exists in the current law will have to be replicated in TVM. For instance, taxable income adjustments will be required to replicate the current law's disallowance of certain amounts from affecting taxable income. Typically, amounts denied a deduction are

³⁰² Noting, of course, that taxable contributions will be subject to tax once an upward adjustment is made to net income.

³⁰³ Under TVM, an investment asset regime replaces the current CGT regime. The investment asset regime will still apply to assets like shares and land (but not to depreciating assets). The 33 1/3% discount still applies to gains that a fund makes from investment assets, subject to satisfying the same pre-conditions, (see section 100-80 of the prototype legislation) and similarly, losses from those assets are still subject to quarantining.

³⁰⁴ Taxation Ruling TR 93/17 'Income tax: income tax deductions available to superannuation funds' does, however, note instances where amendments to trust deeds may be deductible under section 8-1 of the ITAA 1997.

³⁰⁵ However if a payment has an exempt character, that payment can only be applied to earnings that also have an exempt character.

those expenses that a superannuation fund pays on behalf of the member,³⁰⁶ such as payments relating to:

- income tax on taxable contributions; and
- surcharge.

23.13 TVM will reproduce the same outcome for the surcharge by including an upward adjustment equal to the amount of that expense when the fund calculates taxable income.

23.14 TVM will also disregard income tax expense for all entities. Thus, these amounts will not be reflected in the fund's net income calculation.³⁰⁷

23.15 An insurance premium for death or disability cover for a member is another payment that is made by the fund on behalf of the member. Unlike the payments mentioned above, these payments are, at least in part, deductible to the fund in the year the expense was paid. However as TVM will, through the depreciating asset rules, allocate the insurance premium expense to the periods to which it relates, a taxable income adjustment will be necessary to replicate the current law's effect. The amount of the adjustment will be equal to the difference between the decline in tax value of the insurance premium and the amount of the premium paid (or whatever portion of that payment an equivalent to section 279 of the ITAA 1936 deems appropriate).³⁰⁸

Transactions that are exempt from tax

23.16 Taxable income adjustments will also be used to give effect to the current law's exemption from income tax:

- when a unit in a PST or an interest in rights under a life insurance policy or an annuity is disposed of; and
- for so much of a fund's income as is attributable to its liability to pay current pensions.³⁰⁹

³⁰⁶ That is, they are expenses that are more directly attributable to the member than to the general administration of the fund.

³⁰⁷ TVM will disregard both the payments of income tax (regardless of how it is remitted to the ATO) and also liabilities that arise to pay income tax. Furthermore, any tax-related assets or liabilities that are recognised in the financial accounts of entities which apply AAS 3/AASB 1020 *Income Taxes* (the revised standard) or AAS 3/AASB 1020 *Accounting for Income Tax (Tax-Effect Accounting)* (the existing standard) are also disregarded. Other taxes or charges, such as GST or the surcharge will not be disregarded when calculating net income. However to the extent those taxes or charges are not currently deductible then TVM will apply an upward adjustment to offset the expense that will be recorded in net income.

³⁰⁸ The adjustment would also apply in any following income years where a decline in tax value is still calculated for that premium.

³⁰⁹ This adjustment will be done through the net exempt income calculation (see Chapter 6).

Quarantining special income

23.17 With respect to special income and determining a fund's 'special component', TVM will have provisions to segregate those amounts of special income and any related expenses from the fund's 'standard component'. The prototype legislation already contains provisions for quarantining investment asset losses, and uses taxable income adjustments to prevent those amounts from influencing taxable income. It is envisaged that a similar mechanism will be used in TVM to isolate the 'special component' from the remainder of the taxable income result.

Benefit stage

23.18 The obligation that a superannuation fund has to provide future benefits for its members (the original liability) is an 'uncertain' obligation, and remains so until the member has a vested interest in the benefits. As at that time, the fund's obligation to pay the benefits become certain. This will be the same regardless of whether the fund is an accumulation or defined benefit fund.

23.19 Once the fund has a certain liability to pay the benefits (and those benefits are greater than the amount of contribution made by or on behalf of the member),³¹⁰ it is taken to have received an amount equal to the difference between the amount of the benefit and the tax value of the liability the fund has to the member [section 28-60]. This will be added to the tax value of that liability.³¹¹

23.20 When the fund actually pays the benefit to a member, this will be a payment it makes.³¹² This payment will be offset by the extinguishment of the liability that the fund has to the member. In other words, the net effect to the fund is nil when it satisfies its obligations to pay the member.

Example 23.2 Payment of a benefit from a superannuation fund to a member

Following the facts given in example 23.1, the member in Grouse superannuation fund attains a vested interest in a \$1,275 benefit in a later income year.

³¹⁰ Where that is not the case, a downward adjustment will apply to ensure that the 'gain' net income realises from the liability being extinguished for less than its tax value is not reflected in calculating the fund's taxable income.

³¹¹ The rules dealing with uncertain obligations becoming certain are explained in detailed in Chapter 10.

³¹² For further explanation of the concept of a 'payment' see Chapter 6.

Grouse is aware of its commitment to pay this benefit and sells bonds it purchased for \$850 after receiving the contribution.³¹³ Grouse sold those bonds for \$1,350. Looking at that transaction in isolation, Grouse's net income at the time of the sale of the bonds would be:

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

$$[1,350^{314} - 0] + [0 - 850^{315}] - [1,000 - 1,000] = 500^{316}$$

Further, at the moment the member gains a vested interest in a benefit, Grouse's uncertain liability crystallises into a certain liability (to pay \$1,275). Grouse is taken to have received an amount equal to the difference between the benefit payable and the liability's tax value (which is \$1,000). Thus, again viewed in isolation, the fund's net income would be:

$$[275^{317} - 0] + [0 - 0] - [1,275^{318} - 1,000] = 0$$

Assuming Grouse pays the benefit to the member in the following income year, its net income will be:

$$[0 - 1,275^{319}] + [0 - 0] - [0^{320} - 1,275] = 0$$

No taxable income adjustments are necessary in relation to the vesting or paying of the benefit to the member. Thus, at that time net income will also equal taxable income in this example.

23.21 The current law disallows a fund a deduction for paying benefits. TVM provides the same outcome without a special rule (as example 23.2 has illustrated).

³¹³ Although \$1,000 was contributed, Grouse only invested \$850 in the bonds. The fund set aside the remaining \$150 to pay its upcoming income tax liability on the taxable contribution (assuming the fund's taxable income for that year was \$1,000).

³¹⁴ The receipt representing the proceeds of realising (selling) the bonds.

³¹⁵ This amount reflects the opening tax value of the bonds. (There is no closing tax value because the bonds were sold during the income year.)

³¹⁶ Assuming the fund has no taxable income adjustments for this year or any carried forward tax losses, this amount will also be the fund's taxable income and will be subject to tax at a rate of 15%.

³¹⁷ Once an uncertain obligation becomes certain, TVM operates to deem the fund to have received an amount equal to the difference between the tax value of the liability (\$1,000) and the market value of the certain obligation (\$1,275).

³¹⁸ That deemed receipt of \$275 is included in the proceeds of incurring the liability to pay the benefit (which is added to the liability's tax value). This results in there being no tax consequence arising from that deemed receipt.

³¹⁹ The payment of the \$1,275 benefit.

³²⁰ That payment is made in full satisfaction of the liability, so the liability no longer exists.

Conclusion

23.22 This Chapter illustrates that calculating taxable income using TVM does not represent a policy change for the taxation of superannuation funds. The same tax outcomes will be maintained.

23.23 Despite not changing outcomes (except in the case of allowing tax relief for 'blackholes'), TVM does proffer benefits to superannuation funds. These benefits include assessments that more appropriately reflect economic outcomes, the removal of timing anomalies, standardised definition of income and core rules, and a reduced volume of law. These are the same benefits that apply to all taxpayers (either directly or indirectly).

Chapter 24

Legislative structure for TVM

Outline of Chapter

24.1 This Chapter contains a draft structure for an Income Tax Assessment Act under TVM. It invites comments on the suitability of the proposed structure and suggestions on how it might be improved.

Detailed explanation of structure

24.2 This is a draft structure for an Income Tax Assessment Act under TVM. Like the ITAA 1997, it is divided into 6 Chapters, but the content is slightly different. It proposes a new Chapter (Chapter 3) that groups rules that only relate to a particular type of entity. It also proposes to move all the rules in the current Chapter 5 (about administration) into the Administration Act.

24.3 Otherwise, the structure should be very familiar:

- Chapter 1 will explain how the Act is put together and the core rules that describe who must pay tax, what is being taxed (taxable income) and what are the broad components in working it out (e.g. assets, liabilities, adjustments, losses, offsets).
- Chapter 2 will contain the more detailed rules that describe those broad components and some exceptions and qualifications likely to apply widely (e.g. exemptions, trading stock, discounting investment asset gains and explaining the offsets).
- Chapter 3 will contain the rules that only apply to a particular type of entity (e.g. the rules about private things that can only apply to individuals, the rules about dividend imputation and the rules about trusts).
- Chapter 4 will contain the rules that are only applicable to a particular type of transaction or industry but not to any particular type of entity (e.g. small business rules, primary producer rules and treatment of insurance).

- Chapter 5 will contain the rules relating to foreign taxpayers and international transactions.
- Chapter 6 will contain generally applicable concepts and definitions.

24.4 The draft structure allocates existing rules (to Divisional level) to those Chapters. There are often choices about where a rule can be located within this structure. For instance, the treatment of superannuation covers deductions for contributions by employers and the self-employed, assessment of benefits received by fund members, and how superannuation funds deal with contributions, investments and payments to members. One possibility would be to group all these rules in Chapter 4 in an area dealing with superannuation. Another would be to put them all into an area about superannuation funds in Chapter 3. The draft structure chooses instead to break it into 3 areas. There are other cases where the same thing is done and still others where a grouping approach is followed. Comments are sought about the best treatment in these sorts of cases.

24.5 The draft shows, in an indicative way, (to Divisional level) where in the ITAA 1997 and ITAA 1936 the rules came from,³²¹ although some reflect possible RBT reforms.³²² The presence of an existing Division in the structure does not mean that all of its rules (or any of them) will necessarily be needed under TVM. Nor does its absence mean that none of its rules will appear under TVM. Rather, the structure merely reflects our preliminary analysis about which rules are likely (or unlikely) to be needed under TVM to achieve current outcomes. Those views may change and views are welcome on whether they should and to what extent.

Draft structure (to Chapter level)

Chapter 1—Introduction and core rules

Chapter 2—Rules of general application

Chapter 3—Rules specific to individuals and other types of entity

Chapter 4—Rules about particular industries and transactions

Chapter 5—International aspects of income tax

Chapter 6—The Dictionary

³²¹ Divisions in the case of the 1997 Act and Division/Part or just Part in the case of the 1936 Act. Not all equivalent provisions in the current law have necessarily been identified in the draft.

³²² For example, Consolidated groups.

Draft structure (to Part level)

Chapter 1—Introduction and core rules

Part 1-1—Preliminary

Part 1-2—A Guide to this Act

Part 1-3—How to work out your income tax

Part 1-5—How to work out your income tax if you are an Australian resident

Part 1-7—Assets and liabilities

Chapter 2—Rules of general application

Part 2-1—Overview of Chapter

Part 2-5—Special rules about receipts, payments, assets and liabilities

Part 2-10—How to work out the tax value of assets and liabilities

Part 2-15—Taxable income adjustments

Part 2-20—Net exempt income

Part 2-25—Rollovers

Part 2-30—Unused tax losses

Part 2-35—Tax Offsets

Part 2-40—Anti-avoidance

Chapter 3—Rules specific to individuals and other types of entity

Part 3-1—Overview of Chapter

Part 3-5—Individuals (and partnerships in which they are partners)

Part 3-10—Corporate taxpayers and corporate distributions

Part 3-15—Corporate tax losses

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