The tax value method

Discussion paper on issues raised in consultations during December 1999 and January 2000

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Section 1 Introduction

Background

1.1 On 11 November 1999 the Government announced its second stage response to the recommendations of the Review of Business Taxation (RBT). As part of that announcement the Government gave its in-principle support to implementing the tax value method of determining taxable income, often referred to as Option 2, and the associated high level reforms proposed by the Review. However, the Government recognised the importance of developing a workable system that can be implemented with minimum disruption.

1.2 A working group involving business representatives and officials has been established to develop the tax value method. Mr Dick Warburton, Chairman, Business Coalition for Tax Reform, is leading the business representation in these consultations. The objective of the consultation is to progress development of the tax value method, such that it could be ready for implementation by 1 July 2001.[1]

1.3 The Treasury and Australian Taxation Office (ATO) are aware that consultation is required across a broad range of policy and legislative issues associated with the tax value method, including the other high level reforms to which the Government has given its in-principle support. The initial aim of the consultation process is to resolve key issues surrounding the implementation of the tax value method itself. It is intended that consultation on the tax value method will be ongoing along with consultation on the associated high level rules.

1.4 An initial meeting of business representatives and Treasury/ATO officials was held on 8 December 1999 in Sydney. The objective of that meeting was to identify key issues surrounding implementation of the tax value method. The key issues identified at that meeting are listed below.

1 Expenditure that gets an immediate deduction.

2 The treatment of routine rights and obligations.

3 The impact of the tax value method on compliance costs.

4 International issues under the tax value method.

5 The treatment of private receipts, payments, assets and liabilities.

6 How capital gains tax (CGT) fits into the tax value method.

Working group on tax value method

1.5 A working group of ATO/Treasury officials and business representatives was established to consider the issues raised and prepare a response to them in the form of a position paper. The working group was required to respond to the broader consultative forum by mid-February. Written submissions on issues relating to the tax value method and the other associated high

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[1] On 7 August 2000 the Treasurer announced that the tax value method would not commence from 1 July 2001. Further development of the tax value method will be done through a process of consultation and education by the Board of Taxation.

level rules were invited from all participants at the 8 December 1999 meeting. Two submissions were received.

1.6 The members of the working group are:

Business Representatives	**ATO/Treasury Representatives**
Paul Abbey (Shaddick and Spence)	Andrew England (ATO)
Gordon Cooper (TIA)	Bob Jones (ATO)
Frank Drenth (CTA)	Martin Keating (ATO)
Joycelyn Morton (Shell Australia)	Greg Pinder (ATO)
Kevin Stevenson (Stevenson McGregor)	Hayden Scott (ATO)
Anthony Stolarek (Arthur Andersen)	Scott Bartley (Treasury)
Ken Traill (ICAA)	Robert Cotgrove (Treasury)
	Shaun Larcom (Treasury)

1.7 The working group process was initiated through a phone conference in mid December. It was agreed that ATO/Treasury would prepare draft material on the identified issues for comment by the business representatives in the working group. The business representatives were encouraged to also prepare material as a means of stimulating debate and promoting workable solutions. A second phone conference was held in late January to discuss the drafting of the position paper and identify key outstanding issues surrounding each of the topics considered by the working group.

1.8 Due to the short timeframe it has not been possible to fully consider and resolve each of the issues raised for consideration by the working group. In the timeframe available, an attempt has been made to outline a feasible approach to dealing with the issues raised. Of the issues listed, principle focus was given to the first three. Initial drafts of material on the first three issues were circulated toward the end of December/early January. Draft papers on the remaining issues were circulated during January, with the exception of capital gains tax. The working group did not have time to properly consider the CGT issue.

1.9 This paper has been prepared with the aim of facilitating further consultation on the issues identified and should be viewed as a record of work in progress. The views expressed in the paper have been considerably influenced by comments and suggestions made by the business representatives of the working group. The consultative process undertaken through the working group has been of considerable value in increasing understanding about the intended operation of the tax value method and its implications, and in working towards the achievement of acceptable solutions to problems raised. Although this paper has been drafted primarily by the ATO/Treasury officers involved in the working group, it should be noted that the content may not reflect the final position of the ATO/Treasury, or that of the Government.

References to defined terms

1.10 Various sections of this paper propose legislative definitions of terms or refer to definitions in *A Tax System Redesigned: Draft Legislation* (the RBT draft legislation). References in the paper to these defined terms are marked by an asterisk. Attachment A lists where each definition can be found.

Section 2 What is the tax value method?

The conceptual base

2.1 The tax value method is a principle-based framework that is fundamental to the reform of the business tax system. The income tax base (as distinct from an expenditure tax base) will remain the fundamental principle for taxing business arrangements. The subject of the business tax system - the concept of income - is the increase in a taxpayer's net assets (ignoring, in the case of entities, contributions by its owners). However, that increase is, in most cases, worked out on a realisation basis, so that unrealised gains are not usually taxed.

2.2 The advantage of the tax value method is that it explicitly recognises the two components of income, being net annual cash flows from having relevant assets and liabilities and the change in the value of those assets and liabilities. It also provides a flexible framework within which the change in asset and liability values can be measured in a practical way by using a judicious mix of different tax value rules – estimated asset life, accruals, elective mark-to-market, and realisation.

The tax value method is a way to work out taxable income

2.3 The tax value method is a new way of working out the taxable income (or tax loss) of a taxpayer. It will provide a high level principle from which the whole income tax law can flow. Figure 2.1 shows what the new method is.[2]

Figure 2.1 – The tax value method[3]

Taxable income =

Net income + Income tax law adjustment – Unused tax losses

(Receipts – Payments) + (Closing tax value of assets – Opening tax value of assets) – (Closing tax value of liabilities – Opening tax value of liabilities)

Relationship to accounting concepts

2.4 At the conceptual level, this method of working out taxable income, with its focus on assets and liabilities, is consistent with current accounting concepts.

2.5 The key component of the tax value method is the net income formula, with its emphasis on assets.[4]

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2 Further details of the method are set out in Chapter 3 of *A Tax System Redesigned: Explanatory Notes* (the RBT explanatory notes).

3 Assets exclude money; liabilities exclude debit balances in money accounts; most private or domestic amounts are excluded. Refer to the RBT explanatory notes for further details.

4 For the purposes of this discussion liabilities can be treated as negative assets.

Treatment of assets under the financial reporting framework

2.6 Accounting concepts exist for financial reporting reasons (i.e. to contribute to the ability of users of financial reports to allocate scarce economic resources). Attachment B 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 this way:

- The term ‘asset’ is defined broadly as ‘any future economic benefit that arises as a result of past transactions or events’.

- Not all assets are recognised in the accounts – recognition criteria determine when an asset should be so recognised. 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.

- The value of recognised assets is measured using applicable accounting standards or principles. Practice is characterised by a mixed valuation model that employs both cost and value-based measurements.

Treatment of assets under the tax value method

2.7 The building blocks under the tax value method parallel those under financial reporting, as indicated in Attachment C. More specifically, at a conceptual level the treatment of assets under the tax value method parallels that under financial reporting, in this way:

- The term ‘asset’ is defined broadly in a manner consistent with the accounting definition.

- Not all assets are recognised under the tax value method. Those that are to be recognised are those that are ‘held’ and specifically identified in the tax value table as having a tax value other than zero. Those that are not recognised will explicitly be given a tax value of zero.[5]

- Recognised assets are given a tax value (measured) in accordance with specific tax value rules aimed, with limited exceptions, at reproducing a realisation basis of taxation.

2.8 While consistent with accounting concepts at this level, the tax value method will not recognise every asset 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. Section 3 of this paper, which discusses the immediate deductibility of expenses, illustrates this in some detail.

Why is the notion of ‘asset’ important in achieving the reform outcomes?

2.9 ‘Asset’ is defined in the draft as “any thing (tangible or intangible) that embodies future economic benefits”.[6]

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[5] ‘Private assets’ are excluded altogether (see section 12-15 of *A Tax System Redesigned: Draft Legislation* (the RBT draft legislation)).

[6] See subsection 6-15(1) of the draft legislation accompanying *A Tax System Redesigned: Overview, Recommendations, Estimated Impacts* (the RBT Report).

2.10 This definition draws upon, and is consistent with, the accounting definition, although its wording is not precisely the same.

2.11 The broad principle for accounting purposes is that expenditure should be written off over the period the benefits are used up rather than be fully expensed in the year the expenditure is made. In very broad terms, accounting defines 'revenues' by reference to an increase in assets and 'expenses' by reference to decreases in assets, with 'profit' being the change in net assets. Revenues and expenses could be analysed into cash flows and net asset movements (e.g. some sales are for cash and others are on credit), just as is now proposed for tax purposes.

The current law

2.12 That broad principle also underlies the present income tax law, with its denial of deductions for capital outgoings, coupled with its various (but incomplete) regimes for deducting some of that expenditure over time or when there is a disposal of an asset. It is worth noting, though, that the usual characterisation of expenditure on short life or low cost assets as 'revenue' outgoings provides immediate deductibility even though the assets may have continuing value at the end of an income year, providing for easier compliance with the law (e.g. expenditure on magazines).

2.13 However, the revenue/capital distinction is an uncertain one that has been applied with inconsistent results, and the capital allowance regimes were never comprehensive. Indeed, to make the revenue/capital distinction consistent would bring you to the economic concepts of revenues, expenses, assets, liabilities and equities.

The Ralph reforms

2.14 The Ralph Review set out to treat expenditure in a more certain and uniform way and in a way that substantially parallels the accounting treatment.[7]

2.15 That proposed treatment involves recognising *all* commercial expenditure for tax purposes (whether currently deductible or not).[8] That recognition is:

- for expenditure that doesn't give rise to future economic benefits at the end of an income year - immediate deductibility; and

- otherwise - deductibility in each year only to the extent that the benefits are used up in that year.[9]

2.16 The proposed definition of 'asset' was designed to facilitate that result, and the tax value method was seen by the Review as being, among other things, the most effective way of implementing it.

2.17 The treatment set out in paragraph 2.15 may be varied by specific policy decision in particular cases.[10]

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7 See pages 39 to 44 of *A Platform for Consultation*; pages 157-158 of the RBT Report.
8 This would overcome denial of recognition of expenses because of characterisation under narrow judicial nexus tests which have failed to cover many types of business expense.
9 Certain 'assets' will be given a statutory write-off.
10 See pages 163 to 168 of the RBT Report (recommendations 4.2 and 4.3) – dealing with zero tax values and, therefore, immediate deductibility.

2.18 The asset concept provides a coherent basis for providing deductibility for expenditure. It achieves the Review's policy objective of spreading deductibility for expenditure on long term benefits because:

- an asset is the thing brought to account at the end of an income year to balance (in whole or in part) the deduction for the expenditure; and
- an asset's tax value is deducted over time as its benefits are consumed.

2.19 This is essential for ensuring the operation of an income tax base, rather than a cash flow or an expenditure tax base.

2.20 Accordingly, the notion of recognising assets, and the definition of 'asset', are appropriate to achieving the policy outcomes recommended by the Review.

2.21 However, the Review recognised the practical need to allow immediate deductibility of some expenditure that does give rise to an asset (such as customer recognition from advertising or where it is too difficult to value, or ascertain the life of, the asset). Accordingly, those assets will be given a tax value of zero, so that there would be no value to bring to account to balance the deduction for expenditure.[11] Also, the rules determining the cost of an asset will ensure that expenditure remote from the asset will not form part of its value recognised for tax purposes and hence will be immediately deductible.[12]

Why is the wording of the proposed asset definition not precisely the same as the wording of the accounting definition?

2.22 Accounting requires that assets be classified according to nature or function. This is a process of attribution of future economic benefits to enable readers to refine their views on the financial position and performance of a reporting entity. The proposed taxation approach seeks to attribute future economic benefits to the categories identified in Table 3.2.[13] The term 'thing' is merely a reference to an item in such a category. As stated above, the important point is that a thing *must* embody future economic benefits.

Section 3 How the tax value method treats expenditure that currently gets an immediate deduction

3.1 This section discusses how immediate deductibility of expenditure is achieved under the tax value method and proposes changes to the RBT draft legislation to improve the way this is done.

A more generous treatment of some capital expenditure?

3.2 Some expenditure that is capital is currently never deductible. The tax value method will result in that expenditure being deductible over time or deductible when the resulting asset is disposed of or, in some cases, immediately deductible (through a zero tax value or not being included in the cost of an asset).

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[11] See recommendations 4.2 and 4.3 of the RBT Report.
[12] See Subdivision 6-E of the RBT draft legislation.
[13] See paragraphs 3.16 and 3.17.

3.3 In respect of capital expenditure, the tax value method would, under the approach taken in this paper, usually result in an equivalent outcome to the current law (where specific policy changes are not made). In some cases, it would result in a more generous outcome for taxpayers. For example, a timing benefit would arise in the case of capital expenditure in developing knowledge which leads to an item of intellectual property. Such expenditure is currently deductible over time,[14] but would not be part of the cost of the intellectual property under the approach to cost discussed later in this paper.[15]

3.4 Under that approach to cost, such capital expenditure would be immediately deductible. This outcome is, on its face, inconsistent with recommendation 4.1(c) in the RBT Report (that current outcomes should be maintained unless specifically recommended for change). There should be further consideration as to whether this is appropriate, including by the Government. *Is there a better way to approach this issue?*

A similar treatment of revenue expenditure?

3.5 Currently, expenditure that is revenue in nature is usually immediately deductible. Even though under the tax value method revenue type expenditure can give rise to an asset (and theoretically defer deduction), features of the new system ensure that revenue expenditure will continue to be immediately deductible. This is achieved by using zero tax values (e.g. consumables costing in aggregate under $25,000 and office supplies) or the proposed cost rule. The exception is where a specific recommendation provides otherwise (e.g. the recommendations for a comprehensive treatment of leases and rights reflecting economic substance).

In what circumstances will immediate deductibility be achieved under the tax value method?

3.6 The table discusses how immediate deductibility for expenditure is achieved under the tax value method.

Table 3.1 How immediate deductibility arises under the tax value method

Circumstance	**Comments**
No asset arises from the expenditure (i.e. it does not lead to future economic benefits)	***Example:*** Some gifts.
There is an asset created during the income year, but its future economic benefits are consumed during that year	***Example:*** Salary or wages in most cases.
There is an asset created during the income year but you do not hold it at the end	***Example:*** Expenditure to create or acquire an asset that is disposed of prior to the end of the income year, such as trading stock manufactured and sold in the same year.

[14] See Division 373 of the *Income Tax Assessment Act 1997* (the ITAA 1997).
[15] This approach is discussed in paragraphs 3.35 to 3.38.

Circumstance	Comments
The asset is given a tax value of zero	There may be policy or practical reasons for not recognising an asset (achieved by a zero tax value) leading to immediate deductibility for expenditure on the asset. ***Example:*** Internally generated goodwill.
The asset has a tax value but the expenditure does not form part of its cost	Expenditure may be connected to an asset, but the expenditure may be too remote to form part of its cost. ***Example:*** Cost of legal advice about the implications of acquiring the asset.

3.7 Concerns have been raised about how the outcomes in the last two rows will be implemented. It is also relevant to consider when an asset is 'held'. These issues are discussed below.

What kinds of assets are given a zero tax value?

3.8 The Ralph Review recommended that a range of assets be given a tax value of zero. They are essentially of these kinds:

- *routine rights;[16]
- internally generated goodwill, and benefits (except some externally obtained information) that are not owned;
- other specifically listed assets such as office supplies (except trading stock), certain rights to distributions from an entity, and most assets arising from advertising expenditure (this specific listing mechanism was, among other things, the Review's way of dealing with materiality issues).

3.9 *Routine rights are dealt with separately in section 4 of this paper. The specifically listed assets are set out in the RBT Report and draft legislation. This section of the paper will concentrate on the second point.

Internally generated goodwill and benefits that are not owned

3.10 Items 12, 13 and 14 of the tax value table in section 6-40 of the RBT draft legislation dealt with goodwill, and benefits that are not legally or equitably owned.

3.11 Benefits that are not owned[17] are, or are of the same nature as, goodwill. Carrying on a business gives rise to goodwill and any expenditure that contributes to the carrying on of a business tends to contribute to goodwill. While goodwill as an item of property is indivisible, its value derives from all the benefits secured by business expenditure.

3.12 However, not all expenditures contribute to the same extent. Some will give rise to future economic benefits that are largely reflected in the identifiable assets to which they relate (e.g. expenditure on a truck), whilst others will generate benefits disproportionate to any such assets. Indeed, there may be no identifiable assets involved (e.g. expenditure on staff training).

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[16] See recommendations 10.2 and 10.7 of the RBT Report.
[17] These benefits include information/knowledge.

3.13 As those examples show, the value of goodwill is often more greatly affected by expenditure that gives rise to benefits which are difficult to separately identify and value. These types of benefit are generally not in the form of property and so cannot be owned. Given that these benefits affect the value of goodwill so directly, they can for all practical purposes be taken to be a part of goodwill. On this view, the concept of goodwill used in the modifications to the draft legislation proposed below tends towards the accounting concept rather than the legal concept.

3.14 This is why benefits that are not property should be given the same treatment as goodwill, or be treated as part of goodwill.[18] Item 12 of the tax value table in the RBT draft legislation gives a tax value of zero to internally generated goodwill, and a tax value of cost to goodwill acquired from someone else as goodwill.[19]

3.15 Items 12, 13 and 14 in the RBT draft legislation were intended to achieve the outcome in the previous paragraph. But there may be ways to improve the legislative expression of these ideas.

Proposed changes to the tax value table

3.16 The tax value table in section 6-40 of the RBT draft legislation could be replaced entirely by the table below.[20] Items shaded in grey (items 1 to 7 and 10) are the same as the equivalent item numbers in the table in the RBT draft legislation. These items are included for the sake of completeness.[21]

3.17 A precise equivalent to item 14 of the tax value table in the RBT draft legislation is not included here. Rather, items 12 and 14 of the tax value table in the RBT draft legislation are collapsed into item 14 in the table proposed below. The implication of the approach to goodwill discussed above is that the original item 14 is no longer needed because there are no assets other than rights, property and goodwill.[22]

Table 3.2 The tax value of assets

Item	For this kind of asset:	The tax value at that time is:
1A	A *listed zero tax value asset	Nil
1	An item of *trading stock	The amount worked out under Division 38
2	A *depreciating asset (or something that is treated as a depreciating asset)	The amount worked out under Division 40
3	An asset consisting of your right to receive an amount that is *due and payable	The amount you have the right to receive

[18] However, rights would derive their tax values from the various rules covering rights.

[19] This appears consistent with accounting practice (see for example AASB 1013 ‘Accounting for Goodwill’, paragraphs 4.1 and 5.1).

[20] There is no intention to disturb current outcomes under specific regimes that are not the subject of recommendations for change (e.g. assets arising from research and development activities currently given a special treatment (section 73B of the *Income Tax Assessment Act 1936* (the ITAA 1936))). Reflecting these outcomes may involve further modifications to the tax value table or increasing or decreasing adjustments.

[21] These items may still be further developed during the consultation process.

[22] Externally acquired information not protected by an item of intellectual property is the exception (see item 13 of Table 3.2).

Item	For this kind of asset:	The tax value at that time is:
4	An asset consisting of your right to receive: (a) an amount for a supply of goods or services on terms that require payment within a period of 6 months or less; or (b) an amount by way of interest on such an amount	The amount you have the right to receive
5	A membership interest (except one for which you have elected under Subdivision 45-D to work out the tax value on a market value basis)	The *cost of the asset as at that time (unless its tax value has changed under a provision of Part 3-5 (about tax entities and their members))
6	An asset covered by the table in section 6-145 (arising from the relationship between a tax entity and its members)	Nil
7	A *financial asset (except one covered by another item in this table (except item 9))	The amount worked out under Division 45
8A	A *prepaid right	The amount worked out under the proposed rules in Table 5.1 of this paper[23]
8	A *routine right	Nil[24]
9	A *non-routine right	The amount worked out under Subdivision 96-B[25]
10	An asset consisting of your right to have an amount applied in discharging your liability to pay *tax imposed by an Australian law	That amount
11	A *right (except a right covered by an earlier item)	The *cost of the asset as at that time
12	Property (except property covered by an earlier item, and goodwill)	The *cost of the asset as at that time
13	Information: • you obtained from another *taxpayer (but not to the extent it has been generated by that taxpayer in accordance with an agreement you have with them); and • the *cost of which is mainly attributable to the lack of general availability of that information	The *cost of the asset as at that time

23 When the new law is drafted, it could be considered whether the prepaid rights rules would be better included as an integral part of the rules dealing with routine rights and non-routine rights.
24 See the proposed rules in Table 4.1 of this paper.
25 These rules are still to be developed. The rights covered would include those under non-routine leases.

Item	For this kind of asset:	The tax value at that time is:
14	Goodwill For this purpose, goodwill is taken to embody any future economic benefit that is not separately embodied in an asset covered by an earlier item of this table. [26]	(a) To the extent if any that the goodwill includes goodwill that you have acquired from another *taxpayer – the *cost of the acquired goodwill when you acquired it; and (b) Otherwise - nil

What is a listed zero tax value asset?

3.18 A ***listed zero tax value asset*** would be defined as an asset set out in recommendation 4.3 of the RBT report, and any others that are subsequently, and specifically, identified as meeting the criteria, set out in recommendation 4.2, for getting a zero tax value. The category of listed zero tax value assets could be further refined during policy development with a view to minimising compliance costs.

3.19 The advertising assets defined as a listed zero tax value asset consistent with recommendation 4.3(vi) (advertising) would include any intellectual property in an advertising campaign or advertising material obtained by the *taxpayer whose products or services are being advertised.

What is a right?

3.20 A ***right*** could be limited to rights that can be protected or enforced using the legal system.[27] A right would only fall within item 11 if it was *not* covered by an earlier item (e.g. if it was not a *listed zero tax value asset, a *depreciating asset, a *routine right or a *non-routine right). In practice, very few rights may fall within item 11. One example might be a right arising under tort that was not a depreciating asset. If within item 11, it would be expected to initially have a cost of zero. Any other future economic benefits, which might be described by some as 'rights', would get a tax value of zero under item 14 of the proposed tax value table as part of goodwill.

Is the proposed tax value table consistent with accounting concepts?

3.21 In accounting, goodwill comprises the future economic benefits from unidentifiable assets. Unidentifiable assets are assets that are not individually recognised because:

- they are too difficult to separately identify; or
- if they can be identified, it is not possible to reliably measure to what extent they will generate future economic benefits.

3.22 An example of an unidentifiable asset is market penetration.

3.23 The approach taken in the above tax value table is consistent with this concept of goodwill with an important difference: where the line that separates identifiable assets from

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[26] When the new law is drafted, it may be appropriate to define goodwill for tax purposes in these terms in order to clearly distinguish between goodwill as understood by the courts and goodwill as understood for tax purposes.

[27] The definition in subsection 995-1(1) of the RBT draft legislation would be removed.

unidentifiable assets is drawn. Under the tax value method, an asset is treated as identifiable, in effect, if it falls within the categories set out in items 1 to 13 of the above tax value table.

3.24 In accounting, financial controllers must decide if an asset is identifiable or not by *directly* applying the principles in paragraph 3.21 in forming their judgement. This can lead to different outcomes for different reporting entities. Under the tax value method, the distinction between identifiable and unidentifiable assets, for income tax purposes, is made definite: the distinction is codified into the tax value table by its list of assets approach. Implicit in the tax value table is a judgement that some types of assets are too difficult to separately identify and ascribe tax values to. This treatment serves to provide certainty, reduce compliance costs and ensure an equivalent treatment for all taxpayers.

3.25 Therefore, just as in accounting, the tax value method will treat goodwill as a residual asset that groups together all the future economic benefits of unidentifiable (unlisted) assets.

Will taxpayers have to keep records, for tax purposes, of assets given a zero tax value?

3.26 The effect of giving an asset a zero tax value (e.g. those under items 1A, 6, 8 and 14 of the proposed tax value table (Table 3.2)) is that:

- expenditure (e.g. a payment) on creating or acquiring the asset is immediately deductible; and
- consideration on disposal of the asset is assessed on receipt.

3.27 In other words, assets that are given a tax value of zero are not themselves recognised in working out taxable income. In practical terms, this means taxpayers can ignore such assets. Only transactions that occur around such assets would be accounted for (e.g. payments and receipts).

3.28 It follows that taxpayers would need to keep records only of the actual transactions conducted around such assets (e.g. bank statements evidencing payments and receipts), just as they would for any other transactions affecting their calculation of taxable income. Taxpayers would already keep such records as a matter of course.

3.29 Put another way, taxpayers would *not* need to create records of assets given a tax value of zero; to do so would be pointless as such assets cannot themselves affect taxable income. In fact, no income tax return would provide fields for recording such assets because they do not feed into the calculation of taxable income. As a result, taxpayers that complied with the Commissioner's prescribed form in preparing and lodging an income tax return, would never identify or account for such assets.

How should the asset 'hold' table be modified in light of the proposed changes to the tax value table?

3.30 By treating as goodwill any future economic benefit that is not separately embodied in an asset listed before item 14 of the proposed tax value table, there remain no assets, apart from acquired information, that are not property or rights. As such, there is no need to grapple with the difficult question of how to determine whether such an economic benefit is a separate asset that is held. The treatment proposed in the RBT draft legislation[28] would be difficult to interpret, but could be removed under this approach.

3.31 Items 6 and 7 of the hold table in section 6-15 of the RBT draft legislation could be replaced by the following items.

Table 3.3 Who holds an asset

Item	**This kind of asset:**	**Is held by this *taxpayer:**
6	A *right	The owner (or the legal owner if there is both a legal owner and an equitable owner)
7	Property (except an asset covered by an earlier item)	The owner (or the legal owner if there is both a legal owner and an equitable owner)
8	Information: • you obtained from another *taxpayer (but not to the extent it has been generated by that taxpayer in accordance with an agreement you have with them); and • the *cost of which is mainly attributable to the lack of general availability of that information	(a) So long as the information remains not generally available - you; and (b) Otherwise - nobody

3.32 Goodwill, as understood by the courts, is property and falls under item 7 of this table. This would cover acquired goodwill, which is given a tax value of cost under item 14 of the proposed tax value table (Table 3.2).

3.33 All other assets before item 12 in the tax value table proposed above are either property or rights and are therefore covered by items 1 to 7 of the hold table, as modified above. The wording of proposed items 6 and 7 avoids the expression 'capable of ownership', which had caused some concern.

3.34 As there are no other assets, apart from the assets covered by the proposed item 13 of the tax value table, item 7 of the existing hold table could be removed.

What types of expenditure should enter the calculation of 'cost'?

How the cost rule will operate

3.35 At present, 'cost' is relevant in the trading stock, CGT and capital allowance provisions. There is not a full statutory definition of the concept for trading stock purposes. However, judicial guidance can be found in some cases, most prominently *Philip Morris Ltd v FCT* 79 ATC 4352. For CGT purposes, there is a definition of 'cost base'[29] which specifies the things that are to be taken into account. The capital allowances generally use 'cost' without definition but several of them specifically include certain things.

3.36 The Ralph Review proposed a uniform definition of 'cost' with 2 elements:

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[28] Item 7 of the table in subsection 6-15(3).

[29] See Subdivision 110-A of the ITAA 1997.

- The first element – expenditure in order to come to hold the asset – is worked out when you began to hold it; and

- The second element – expenditure to bring the asset to its present condition and location – is worked out when the asset's tax value needs to be subsequently calculated.

3.37 It is a question of fact and degree as to what expenditure would be expenditure to hold an asset, or to bring it to its present condition and location, under these principles.

3.38 The first element[30] includes expenditure to create or acquire the asset and expenditure incidental to its acquisition or creation.

- Manufacturing costs would be a typical example of the costs of creating an asset, and in the *Philip Morris* case the court decided that the appropriate method of working out the cost of a manufacturer's trading stock was absorption costing.

- Consideration paid for an asset would be a typical example of the costs of acquiring it.

Expenditure to win or negotiate contracts

3.39 Concerns were raised that the *benefit* of having a contract can itself be an asset and that the expenditure on securing the contract would be brought to account as the tax value of that benefit. However, that benefit would be part of goodwill for tax purposes and would have a zero tax value (see proposed item 14 of Table 3.2).

3.40 The question remains whether the expenses of securing a contract form part of the cost of any asset that is acquired under a contract.

3.41 Obviously, the main element of the cost of that asset would be the contractual consideration paid. It is a question of fact and degree as to what other expenditure would form part of the cost.

3.42 This table lists some examples of this other expenditure, which could be described as expenses of securing a contract.

Table 3.4 Expenses of securing contracts

Types of contracts	**Expenses commonly incurred**
Contract for purchase of equipment – e.g. a contract for purchase of a truck for use in business.	Fees for legal advice, expenses incurred in choosing type/brand of equipment to purchase.
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, costs of feasibility studies, expenses of meeting with prospective builders.

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30 See section 6-105 of the RBT draft legislation.

Types of contracts	Expenses commonly incurred
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, expenses incurred conducting market research.
Contract to commence mining operations on a particular site.	Costs of feasibility studies, fees for legal advice, exploration/ prospecting expenses.
Contract for consultancy services – e.g. a university academic performing consultancy services for a company.	Consultant – cost of attending interviews, 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, materials for tenders. Client – fees for legal advice, costs of meeting with prospective advertising agencies, expenses in determining the need for advertising.
Contract for a bank loan	Borrower - fees for legal advice, accountant's fees (e.g. charges for producing documents detailing the business's financial position). Bank – advertising expenses, salary of loans staff.

3.43 The current law would normally treat these expenses as revenue (and therefore deductible), although they have sometimes been treated as capital.[31] These expenses would not be part of the cost of the asset 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.

3.44 For example, at present, such expenses are not included in the cost of depreciable plant. Taxation Ruling *IT 2197* states that 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.

3.45 Under the tax value method, these costs of securing a contract would also not be in the cost of the asset acquired under the contract. They would, therefore, be immediately deductible.[32] As discussed in paragraphs 3.2 to 3.4, in some cases this would result in a more generous outcome than the current law.

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[31] See for instance Case J7, (1958) 9 TBRD.

[32] Note, however, that expenditure on a feasibility study, and some other expenditure, associated with a project may form part of a project development pool. A project development pool is treated as if it were a depreciating asset with the expenditure therefore being written-off over time (see recommendation 8.9 of the RBT Report and Subdivision 40-B of the RBT draft legislation).

The cost of intellectual property

3.46 Information, unless purchased from someone else, has a zero tax value as part of goodwill in item 14 of the proposed tax value table (Table 3.2).[33]

3.47 The form in which information is presented can give rise to a copyright, which is a separate asset that can have a positive tax value.

3.48 Information can also lead to a patent, a registered design, a trademark, a circuit layout, etc. These, too, are separate assets that can have positive tax values.

3.49 Concerns have been raised that expenditure in generating information, which this paper proposes be given a zero tax value (as part of goodwill), would instead be imputed to the tax values of the separate intellectual property assets that are associated with that information. However:

- even though the information has a zero tax value, it still has a cost and the things that go into that cost *cannot* also be taken into the cost of any other assets;[34] 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)[35] and not the costs of creating the information they are based on.

3.50 As discussed in paragraphs 3.2 to 3.4, in some cases this would result in a more generous outcome than the current law.

Examples

Example 1 - advertising

3.51 XYZ 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.

3.52 XYZ engages ABC Pty Ltd, an advertising agency, to prepare a campaign. ABC produces the campaign and copyright in it passes to XYZ.

3.53 The result of the market research is information which is treated as part of internally generated goodwill, and so has a zero tax value. Accordingly, expenditure on the research is immediately deductible.

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[33] But note:
- recommendation 8.19, which proposes that the current R&D tax concession be maintained; and
- no change is proposed to the current write-off for software development expenses.

[34] 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 are held concurrently.

[35] Note, however, that the effect of section 373-5 of the ITAA 1997 will be retained, as there is no recommendation to change it.

3.54 The expenditure on the advertising campaign (including the copyright in it) is also immediately deductible. Any assets arising directly from that expenditure are 'listed zero tax value assets', and accordingly have a zero tax value.

Example 2 – staff procedures manual

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

3.56 Staff costs in researching and developing procedures give rise to information which is treated as part of internally generated goodwill and so has a zero tax value.

3.57 The copyright in the manual is property that is separate from that information. In this case, the cost of the copyright is zero because there was no need to make any expenditure directly to obtain the copyright.

Example 3 – development of a production process

3.58 Over a number of years, XYZ Ltd's staff develop a new process for handling dangerous chemicals. XYZ is subsequently granted a patent in respect of that process.

3.59 Staff costs in researching and developing the process give rise to information which is treated as part of internally generated goodwill, and so has a zero tax value.

3.60 The patent in respect of the process is a separate asset that is property. Its cost would be made up of the direct expenses of getting the patent (e.g. expenses of preparing the documents setting out the process that are used for registration. Expenses currently deductible under section 373-5 of the ITAA 1997 would specifically not form part of the cost (see the 1st row of Table 3.5 below).

Examples of particular items of expenditure

3.61 The table sets out various items of expenditure raised in consultations and explains how they would be treated under the principles discussed in this section.

Table 3.5 Examples of particular items of expenditure

Item of expenditure	**Treatment under the tax value method (as discussed in this section)**
Patent renewal fees	Expenditure incurred in the grant or extension of the term of a patent is specifically deductible under the current law (section 373-5 of the ITAA 1997). There is no recommendation to change this outcome, so it would continue to be the case.[36] A specific provision would need to be included, to replicate the effect of section 373-5, so that such expenses would not form part of the cost of the patent.

[36] See recommendation 4.1(c) of the RBT Report.

Legal fees in developing leases	Expenditure incurred in the preparation, registration and stamping or surrender of a lease is specifically deductible under the current law (section 25-20 of the ITAA 1997). There is no recommendation to change this outcome, so it would continue to be the case.[37] A specific provision would need to be included, to replicate the effect of section 25-20, so that such expenses would not form part of the cost of the lease.
Staff training costs paid to external consultants	Any future economic benefit arising from the training would form part of internally generated goodwill, which is given a tax value of zero under item 14 of the tax value table proposed in this section (Table 3.2).
Employee recruitment costs	These are expenses of the nature dealt with at paragraphs 3.42 to 3.45 above. The 2nd and 7th rows of Table 3.4 illustrate expenses of this nature. They would be immediately deductible for the reasons set out in paragraphs 3.43 to 3.45.
Costs of developing new versions of existing computer software for internal use	Under the current law, these costs are dealt with under Division 46 of the ITAA 1997 - a regime for writing off the development costs. As a result, these costs are not immediately deductible under section 8-1. However, they may be immediately deductible in some situations, e.g. research and development. There is no intention to alter this outcome under the tax value method. The reformed regime for depreciating assets will ensure this.

Section 4 Treatment for routine rights and obligations under the tax value method

4.1 The rules set out in Division 96 of the RBT draft legislation only dealt with rights in respect of assets. This section outlines a new scheme that includes such rights as well as routine rights and obligations relating to the delivery of assets and receipt of services. Under this scheme, the rules on routine rights in Division 96 of the RBT draft legislation would not be enacted in the form in which they appear in that legislation. Further consultation will be undertaken to refine the application of this approach, particularly in respect of its interrelationship with the recommendations in section 10 of the RBT Report.

Purpose of special rules for routine rights and obligations

4.2 The tax value method is, as discussed in Section 2, intended to introduce a universal statutory measure of income. Income derives from a collection of assets and comprises cash flows and the change in the tax value of net assets.

4.3 Rights that can be protected using the legal system, whether arising under contract, statute or other arrangements, are assets. Liabilities include related obligations (e.g. an obligation to pay for the thing that you have a right to get).

4.4 Rights and related obligations are intended to be taxed under a framework that more closely reflects the economic substance of the arrangements under which they arise.[38]

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[37] See recommendation 4.1(c) of the RBT Report.
[38] See section 10 of the RBT Report.

4.5 Many, but not all, arrangements[39] result in a taxpayer having a right and related obligation whose economic value[40] is largely equal in each income period. The *tax values* of the taxpayer's right and obligation would equal each other (on the assumption that tax values should reflect economic value wherever possible). Therefore, they would not have a net effect on taxable income.

4.6 It follows that working out a tax value that reflects the economic value of each of those rights and obligations, both when they first arise and on an ongoing basis, would involve unnecessary compliance costs.

4.7 Accordingly, those rights and obligations ('routine rights' and 'routine obligations') can automatically be given a tax value of zero.[41]

4.8 The rules dealing with these routine rights and obligations are intended to achieve that outcome.

Operative rules

4.9 The tax value of a *routine right and a *routine obligation would be zero.

4.10 However, if a prepayment has been made in connection with a *routine right, the taxpayer making the prepayment would be taken to have a separate asset that has a tax value in accordance with the rules on *prepaid rights.[42] This is necessary to prevent a partial prepayment in relation to a routine right changing the status of the entire right, with consequent compliance costs. Also, the other party's *routine obligation that matches the prepaid right would be taken to be a separate liability with a tax value in accordance with the rules on prepaid rights.[43]

4.11 When an amount becomes due and payable, or is payable for a supply on 6 months terms, the taxpayer with the right to payment would have a separate asset whose tax value would be worked out under item 3 or 4 of the proposed tax value table (Table 3.2). The matching liability of the payer would have a tax value worked out under item 1 or 2 of the table in section 6-75 of the RBT draft legislation.[44]

4.12 It would not be appropriate for financial assets and liabilities subject to accruals or elective mark-to-market rules to be covered by these routine rights and obligations rules.

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[39] Some other rights, such as those arising as a result of torts and some statutory rights, do not fit within this configuration. The initial tax value of a right arising under tort would be its cost, which in almost every case would be zero. This is discussed at paragraph 3.20.

[40] In an arm's length arrangement, any profit is embedded in the economic value of the right.

[41] See recommendations 10.2 and 10.7 of the RBT Report.

[42] See section 5 of this paper.

[43] Part of the consultation on the policy recommendations in the RBT Report will include consideration of how to deal with delayed payments (i.e. where payment significantly follows the receipt of benefits).

[44] Items 1 and 4 in sections 96-100 and 96-200 of the RBT draft legislation replicate the effect of some of these items, and are not necessary.

What is a routine right?

4.13 The table identifies the rights that would be ***routine rights***.[45] The first applicable item in the table would be used. For example, item 1 would cover a right that can be characterised as both a right to use a depreciating asset and a right for the doing of a thing.

4.14 Whether a right is routine would be judged at the time the right comes into existence, or at each time there is a substantial change in the nature of the right.

4.15 In working out whether a right mentioned in the table is routine, it would be necessary to characterise the right. In doing so, it may be necessary to determine whether a collection of legally separate rights is in substance a single right to something else.

4.16 For example, if you agree under contract to buy an asset and also have a statutory right to the asset being of merchantable quality, you would be treated as having a single right to acquire an asset of merchantable quality.

Table 4.1 Rights that are routine rights[46]

Item	**A *right you are granted to…**	**Is a routine right…**
1	Use a *depreciating asset	[Based on the principles in section 96-105 of the RBT draft legislation – these criteria can be further refined through the ongoing consultative process on the treatment of rights]
2	Use any other *asset	[Based on the principles in section 96-205 of the RBT draft legislation – these criteria can be further refined through the ongoing consultative process on the treatment of rights]
3	Have someone work for you as an employee	Always
4	Have one or more things done,[47] or get one or more *assets, or both	If the payments you will make for each thing will: • be due and payable before the expiry of 6 months after the thing is done or you get the asset; and • each be reasonable having regard to the market value of what the payments are for
5	Be paid in respect of an obligation you owe that is covered by items 1 to 4 of the routine obligations table (Table 4.2)[48]	Always

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45 The rules set out in Division 96 of the RBT draft legislation dealt with rights *in respect of* assets. Concerns have been raised about the breadth of that expression. Items 1 and 2 of the table propose replacing that phrase with 'use'. Whether this is appropriate can be considered further along with the criteria for determining when such a right is routine.

46 In some cases, a right may involve a mixture of things (e.g. using an asset, having things done and getting assets). Further development will be required to determine how such rights should be treated under this table.

47 It may be necessary to clarify that a thing is done when a taxpayer is getting a continuous flow of benefits, such as when a loan is made, or an insurance policy granted. This issue is dealt with in the current rules dealing with prepayments (see subsection 82KZL(2) of the ITAA 1936).

48 This would apply to the other party to the transaction and not a third party.

4.17 A right to have one or more things done could arise in any way, for example, under contract, by operation of statute or in accordance with an order of a court.

What is a routine obligation?

4.18 The table identifies the liabilities that would be ***routine obligations***. The first applicable item in the table would be used.

4.19 Whether an obligation is routine would be judged at the time the obligation comes into existence, or at the time there is a substantial change in the nature of the obligation.

Table 4.2 Liabilities that are routine obligations

Item	An obligation you undertake to…	Is a routine obligation…
1	Allow someone else to use a *depreciating asset	[Based on the principles in section 96-105 of the RBT draft legislation – these criteria can be further refined through the ongoing consultative process on the treatment of rights]
2	Allow someone else to use any other *asset	[Based on the principles in section 96-205 of the RBT draft legislation – these criteria can be further refined through the ongoing consultative process on the treatment of rights]
3	Work for someone else as an employee	Always
4	Do one or more things, or give one or more *assets to someone else, or both	If the receipts you will get for each thing will: • be due and payable before the expiry of 6 months after the thing is done, or you give the asset; and • each be reasonable having regard to the market value of what the receipts are for
5	Make a payment in respect of a *right you hold that is covered by items 1 to 4 of the routine rights table (Table 4.1)[49]	Always

Examples of routine rights and obligations (and related prepaid rights)

Example 1

4.20 Amy contracts Peter to clean her office once a week for a 5 year term. Under the terms of their agreement, Amy has an obligation to pay Peter monthly in arrears. The rate is $20 per hour, a rate that is within the market range for services of this type.

4.21 Amy's right to have the cleaning done is a routine right under item 4 of the routine rights table. Each week's cleaning is a thing done in accordance with the right. The right is routine since Peter will be paid within 6 months of each week's cleaning being done, and the payments reflect the market value of cleaning services of that type.

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[49] This would apply to the other party to the transaction and not a third party.

4.22 For the same reason, the right held by Peter to be paid for each thing is routine under item 5 of the routine rights table (i.e. he has a right to be paid for making good on Amy's right to have her office cleaned).

Example 2

4.23 Salvabore Pty Ltd was contracted by Dorian Grey Ltd to paint a mural on the boardroom wall depicting its chairman. The payment terms were that the company would pay Salvabore $2,000 in advance, then amounts of $2,500 at the end of each of the 12 months the work was to take, then a final payment of $5,000 when the mural was complete. The company pays the $2,000 at the end of June. Salvabore starts the mural in July.

Dorian Grey's position

4.24 The contract gives Dorian Grey a right to have a thing done: have Salvabore provide a completed mural within 12 months. It also creates an obligation for Dorian Grey to make payments (i.e. interim and final payments). The right is routine because all the payments (i.e. interim and final payments) for the mural are due and payable within 6 months of completing the mural. Also, because Salvabore and Dorian Grey have dealt at arm's length, it is reasonable to assume that the payments to be made for the completed mural reflect its market value. The obligation is routine because it is to make a payment for a routine right. As a result, a tax value of zero is given to Dorian Grey's right (an asset) and obligation (a liability).

4.25 However, the first payment of $2,000 by Dorian Grey creates a prepaid right that is treated as a separate asset. It is given a tax value under the rules dealing with prepaid rights.

Net income in year 1: [0 – 2,000][50] + [2,000 – 0][51] – [0 – 0][52] = 0

Net income in year 2: [0 – 35,000] + [37,000 – 2,000][53] – [0 – 0] = 0

Salvabore's position

4.26 The contract obliges Salvabore to do a thing: provide Dorian Grey with a mural within 12 months. It also gives it the right to payment (i.e. interim and final payments). The obligation is routine because it will be entitled to payment on, and in some cases before, completing the mural (i.e. within 6 months of doing the thing). The right is routine because it is a right to be paid for making good on its routine obligation, i.e. providing a mural. As a result, a tax value of zero is given to Salvabore's right (an asset) and obligation (a liability). However, the $2,000 advance payment results in an obligation for Salvabore that matches Dorian Grey's prepaid right.

Net income in year 1: [2,000 – 0] + [0 – 0] – [2,000 – 0] = 0

Net income in year 2: [35,000 – 0] + [0 – 0] – [0 – 2,000] = 37,000

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50 Receipts of zero minus the $2,000 payment.
51 Closing tax value of prepaid right of $2,000 (its cost) less its opening tax value ($0).
52 No liabilities with a tax value other than zero.
53 The $37,000 closing tax value of assets reflects the tax value of the mural (this may be a depreciating asset).

Section 5 Treatment for prepayments under the tax value method

Purpose of prepayment rules

5.1 The purpose of this section is to show how the prepayment rules would apply under the tax value method (taking into account the policy recommendations in section 10 of the RBT Report). It is necessary to explain these rules here so that the proposed rules dealing with routine rights and obligations can be more easily understood. The rules proposed in this section cover prepayments made in relation to all *routine rights.[54] They could also be applied to all other prepayments.

5.2 These rules will also ensure the appropriate recognition of income on the part of the taxpayer receiving the prepayment. They do this by ensuring that the taxpayer has a liability with a tax value that reflects the prepayment. As things are done in accordance with the prepayment, the tax value of the liability will decline, ensuring the appropriate recognition of the income.[55]

Operative rules

5.3 The tax value of a *prepaid right and a matching obligation is set out in the table.[56]

Table 5.1 Tax value of prepaid rights and matching obligations

Item	**For this kind of right or obligation…**	**The tax value is…**
1	A *prepaid right	(a) Where the right is steadily declining in value - the *written down cost of the right; or (b) In any other case - the *cost of the right reduced by the proportion of that cost that is reasonably attributable to: • each thing (if any) that has been done; or • each asset that you have received in accordance with your right
2	An obligation to make good on a *prepaid right somebody else has against you[57]	The tax value of that prepaid right

5.4 Further rules would be needed to implement the recommended prepayment rules for individuals and small businesses electing into the Simplified Tax System, including the prepayment rules for tax shelters.[58] These would be specified as part of the work on implementing regimes for those taxpayers.

5.5 The proposed rules in the table for the tax value of prepaid rights give effect to the policy underlying the recommendations in section 10 of the RBT Report, that the tax value of rights

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[54] See Table 4.1.

[55] This deals with the *Arthur Murray* issue, and implements recommendation 4.6 in the RBT Report.

[56] Further consideration will need to be given to how the proposals dealing with financial assets and liabilities (section 9 of the RBT Report) interact with these rules.

[57] The tax value table for liabilities in section 6-75 of the RBT draft legislation will need to include this item, or a cross reference to it.

[58] See recommendations 4.4, 4.6 and 17.2 of the RBT Report.

should reflect their economic value.[59] Under this approach, the tax value of the prepaid right would decline in accordance with the consumption of economic benefits arising under the right. On the income side, the proposed approach is consistent with the *Arthur Murray* principle, that income should only be brought to account when it is earned.

What is a prepaid right?

5.6 Each of these is a ***prepaid right***:[60]

- a *right to have one or more things done if you have paid, or incurred payment, for them before they are done;

- a *right to get one or more *assets if you have paid, or incurred payment, for them before you begin to *hold them.

5.7 However, a ***prepaid right*** would not arise if the payment is 'excluded expenditure'.[61]

What is the written down cost of a prepaid right?

5.8 The ***written down cost*** of a *prepaid right before the eligible service period[62] begins would be its *cost.

5.9 The ***written down cost*** of a *prepaid right at a particular time after the eligible service period starts would be worked out using this formula:

$$\text{Cost} - \left[\text{Cost} \times \frac{\text{Days since the eligible service period started}}{\text{Days in the eligible service period}}\right]$$

Example of proposed prepayments rules

5.10 In year 1, Ben, a professional dancer, pays $1,200 to George's Fancy Shoes Dancing for just over 2 years of dancing lessons. The lessons, which are given each Thursday night, start on 1 June in year 1. The 'eligible service period' runs for 760 days starting from that date.

Ben's position

5.11 Ben does not get an immediate deduction for his payment. Instead, the tax effect of the initial payment is spread over the 3 income years that Ben receives the services. This is achieved by recognising Ben's prepaid right for services and amortising it over the 'eligible service period'. The tax value of the prepaid right is worked out under paragraph (a) of item 2 of the prepaid rights table, because the dancing lessons are to be provided steadily over the period of the right. This gives a straight line write-off over that period. The following calculations show how this works:

Net income in year 1: [0 – 1,200] + [1,150 – 0] – [0 – 0] = –50

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59 See, in particular, recommendation 10.3.

60 Further consideration will need to be given to whether this definition is sufficient to deal with prepayments for the use of assets.

61 See section 82KZL of the ITAA 1936. There was no recommendation in the RBT Report to apply the prepayment rules to 'excluded expenditure that is not subject to the prepayments rules in the existing law. This ensures, for example, that insignificant prepayments (those under $1,000) do not need to be accounted for as assets.

62 See section 82KZL of the ITAA 1936.

Net income in year 2: [0 – 0] + [550 – 1,150] – [0 – 0] = –600

Net income in year 3: [0 – 0] + [0 – 550] – [0 – 0] = –550

George's position

5.12 George is not immediately assessed on his receipt. Instead, George is assessed progressively as he earns the receipt by providing services. This result is achieved by recognising an obligation that matches Ben's prepaid right. The tax value of George's obligation matches the tax value of Ben's prepaid right throughout the 'eligible service period'. The following calculations show George's net income over the 3 income years in which the services are provided:

Net income in year 1: [1,200 – 0] + [0 – 0] – [1,150 – 0] = 50

Net income in year 2: [0 – 0] + [0 – 0] – [550 – 1,150] = 600

Net income in year 3: [0 – 0] + [0 – 0] – [0 – 550] = 550

Section 6 Impact of the tax value method on compliance costs

Introduction

6.1 A common theme of submissions to the RBT was the need to simplify the current tax law, given the large ongoing compliance cost burden it imposes. This theme is also reflected in the underlying principles of simplicity, transparency and durability that featured prominently in the Ralph Review's recommendations. Once introduced, the tax value method will involve simpler, shorter and more easily managed tax legislation and lower compliance costs, particularly for those presently unfamiliar with the tax law. The greater transparency of the new law, particularly its clearer outline of exceptions to its underlying principles, will increase certainty for taxpayers.

6.2 The implementation of the Government's tax reforms will place a high compliance cost burden on the accounting profession and business taxpayers over the next couple of years. The demands imposed by this agenda, and the consequent pressure it will place on accountants' dealings with their clients, have raised concerns about the ability of the accounting profession to cope with the reforms. There are also concerns that smaller taxpayers will have difficulty in obtaining accounting services and meeting lodgement dates.

6.3 Implementing the tax value method will add to the already significant quantum of change. However, the impact on compliance costs is expected to be of a temporary nature, though it may span several years. There will also be some offsetting benefits associated with the implementation of other business tax reforms due to commence around that time.

6.4 The meeting of the Consultative Forum held on 8 December 1999 organised these concerns into five key issues that need to be addressed in considering the compliance cost impact of introducing the tax value method. These issues are discussed within this section of the paper.

Ongoing compliance costs of the tax value method

6.5 At the Consultative Forum there was a perception that the tax value method will result in increased compliance costs on an ongoing basis. Two key factors leading to this view were uncertainty about the need to identify new types of assets and liabilities, particularly in respect of transactions that are presently treated as revenue items, and uncertainty about the extent to which the tax value method would require additional calculations in deriving taxable income.

Identification of new assets and liabilities

6.6 Sections 2 and 3 of this paper clarify the way in which the asset framework will apply to expenditures that are currently treated as revenue items. Resolution of the issues surrounding the treatment of such expenditures will provide greater certainty as to which expenditures lead to the creation of assets and liabilities and their treatment under the tax value method. Resolving the issues surrounding the identification of assets and liabilities will address this area of concern about the impact of the tax value method on ongoing compliance costs.

Compliance costs of calculating taxable income

6.7 In considering the compliance impact of the tax value method in deriving taxable income it is important to distinguish between the tax value method itself and the many other business tax reforms that have been announced by the Government. Deriving taxable income using the tax value method should not, of itself, require any additional information to that currently used by taxpayers to complete their returns. Nor should it require any significant increase in computation. This reflects the fact that the tax value method will not change tax law outcomes and that the revenue/capital distinction applied under the existing law already requires taxpayers to keep records of asset/liability values for tax purposes.

6.8 The compliance impact of a range of transactions has been considered by the working group. In each case, the compliance impact could be attributed to a source other than the tax value method. In most cases the compliance impact arose in respect of requirements under the existing law or in complying with a separate business tax reform announced by the Government. For example, the changes to the prepayment rules have already been implemented and, hence, will have the same impact on compliance costs under the existing law as they will under the tax value method.

6.9 There is little difference in the compliance impact of deriving taxable income, regardless of whether a taxpayer derives taxable income from financial accounts or using a set of tax accounts. The same information is required to compute taxable income under either law.

6.10 Taxpayers will not be required to maintain an asset/liability register or report the opening and closing values for every asset and liability. Under the tax value method, only overall changes in asset and liability tax values need to be included in taxable income. Therefore, only information relating to changes in tax values is required. There is no need for the tax values of individual assets to be updated annually — all that is necessary is that they can be calculated when required, such as when the asset is sold.

6.11 These information requirements match those required under the current law. It means that there is no need for taxpayers to separately recognise assets with zero tax values.[63] It also means that taxpayers will have no requirement to calculate tax values (i.e. cost bases) of assets ahead of their ultimate disposal.

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[63] See paragraphs 3.26 to 3.29.

6.12 It has been suggested that the revaluation of assets for accounting purposes would require adjustments to accounting profit in order to derive corresponding tax values for those assets. However, such adjustments would also need to be made under the current law to remove the effect of accounting adjustments on taxable income. No additional adjustments would be needed under the tax value method as tax values would not be affected when assets are revalued.

The compliance impact of the transition to the tax value method

6.13 As noted above, the tax value method will impose a transitional compliance cost burden while the changes are being learnt and applied. For example, taxpayers and the accounting profession will need to become familiar with the provisions affecting transactions and their application under the new law. As part of this process they may take extra precautions to ensure that they have properly met their obligations.

6.14 The ATO will consider the type of information it could provide to improve the transparency and certainty of the treatment of transactions and taxpayer requirements under the tax value method. One topic for which such information would be of value would be to clarify the circumstances in which rights and other contractual obligations can be treated as routine rights.[64]

6.15 While the introduction of the tax value method will have a transitional impact on compliance costs, there are likely to be some offsetting benefits from implementing the tax value method at the same time as many of the other business tax reforms. These offsetting benefits will arise due to the existence of a more consistent framework in which to implement the other policy changes. For example, the reforms to the taxation of financial arrangements and blackhole expenditures fit logically into the asset/liability framework. Aspects of the entities regime, particularly the consolidation provisions, and the Simplified Tax System would also be easier to understand in the context of a law framed around the tax value method.

6.16 Larger businesses could benefit significantly from the greater consistency between the tax value method and the other reforms. For many smaller taxpayers, the tax value method would have relatively little impact because of the existence of the Simplified Tax System and the equivalent treatment for individuals. That said, the Simplified Taxation System will greatly reduce the compliance burden for those taxpayers that access it.

6.17 It will not be possible to redraft the entire tax law into the tax value framework in time for implementation by 1 July 2001. One approach to minimise the extent of legislative change, and the need to learn and apply that legislation, during the intervening period would be to restrict the initial implementation to: the tax value method and associated high level rules that define the framework of the new law; other business tax reforms commencing around that time; and any areas of the existing law that would result in significant compliance benefits. Other parts of the law, such as superannuation, and the CFC and FIF regimes, could initially remain drafted in the existing law with the result of those regimes being added as an income tax law adjustment.

6.18 It has been proposed that due to the extent of the tax reform agenda that the implementation of the tax value method be deferred by one or more years. Deferring the introduction of the tax value method would provide time for taxpayers to focus on other changes to the tax law before addressing the introduction of the tax value method. Such an approach would also provide more time to redraft the existing tax law into the tax value framework.

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64 Routine rights are dealt with in section 4 of this paper.

6.19 This proposal would require all of the business tax reforms announced by the Government to be enacted using the current legislative framework. However, that legislation would still have to employ many of the tax value concepts, as those concepts are integral to the design of the reforms. The result would be a more complex and less consistent law than if those measures were introduced along with the tax value method.

6.20 A significant disadvantage associated with this approach is that it would significantly increase the overall extent and duration of the tax reform process because of the need to draft and apply many of the business tax reforms under both the existing law and the tax value method. The other offsetting compliance cost benefits that can arise by implementing the tax value method and other business tax reforms concurrently would be forgone.

Treatment of substituted accounting periods

6.21 The introduction of the tax value method and other business tax reforms is complicated by the existence of substituted accounting periods (SAPs) and the implementation timetable for other major elements of the tax reform agenda. Its implementation with respect to SAPs cannot be considered in isolation of the approach for other measures.

6.22 Other reforms due to commence from 1 July 2001 for which SAPs are important include: commencement of the entity regime, particularly consolidation; the treatment of blackhole expenditures; the other high level reforms associated with the tax value method; the taxation arrangements for financial assets and liabilities; and the Simplified Tax System.

Commencement Options

6.23 Setting aside the broader reform context, there are three ways of implementing the tax value method to achieve effect from a notional start date of 1 July 2001.

- Commence the tax value method on the basis of the first income year starting on or after 1 July 2001.

- Commence the tax value method from 1 July 2001 for all taxpayers irrespective of accounting years. Under this approach taxpayers with SAPs would be required to account for the financial year spanning 1 July 2001 on the basis of two different tax laws.

- Commence the tax value method from 1 July 2001 for all taxpayers but adjust the length of the income years surrounding that date so as to avoid the need to prepare three returns in two years. For example, for a taxpayer with a SAP of 1 January to 31 December, the period from 1 January 2001 to 31 December 2002 might be allocated into two income years spanning 1 January 2001 to 30 June 2001 and 1 July 2001 to 31 December 2002.

Commence the tax value method on an income year basis

6.24 Under this approach it would be necessary to draft all measures commencing from 1 July 2001 in both the existing and new law, given that some taxpayers will be operating under each law at that point in time. The administrative and compliance burden associated with such a requirement would be unworkable. Such an approach would also create compliance difficulties for a group with entities having different SAPs that may be operating on the basis of different tax laws.

6.25 Implementing the measures due to start from 1 July 2001 on an income year basis would avoid the need to draft two sets of legislation for those measures but would create potential tax arbitrage opportunities between taxpayers with different income years. While tax arbitrage would not be a significant issue for the tax value method itself, given that the treatment of transactions for tax purposes would not be altered, it could be significant with respect to other reforms due to be implemented at that time.

Commence the tax value method from 1 July 2001

6.26 Commencing the tax value method from 1 July 2001 for all taxpayers irrespective of accounting years would require taxpayers with SAPs to prepare the equivalent of two tax returns in the income year spanning 1 July 2001. This approach would have the advantage of not impacting upon the reduction in the company tax rate to 30 per cent, because the income year of the entity would remain unaltered. There may also be some compliance advantages from having a distinct break in the income year at the time of implementation of the entity regime and other reforms due to commence from 1 July 2001. However, given concerns about the extent of the compliance burden associated with tax reform, there would be significant advantage in avoiding the need to prepare additional tax return calculations.

Commence the tax value method from 1 July 2001 by adjusting the length of income years surrounding the commencement date

6.27 Subject to further consideration of the interactions with other business tax reforms, one approach to implementing the tax value method from 1 July 2001 would be to truncate at 30 June 2001 those accounting periods that include 30 June 2001 but finish after that date. The first income year commencing after 1 July 2001 would be correspondingly lengthened. For some taxpayers this approach would result in one very short accounting period, such as for an April balancing taxpayer. In those cases the last income year ending prior to 1 July 2001 could be lengthened to include the period to 30 June 2001. Some examples of how such an approach might work for taxpayers with different SAPs are provided in Attachment D. The examples are provided for illustrative purposes only.

6.28 This approach would have the compliance advantage of all taxpayers commencing to operate under the new tax law from a common date and obviating the need to prepare an additional tax return. Nevertheless, such an approach is likely to introduce some consequences that would need to be resolved before it could be implemented. Two key areas requiring resolution are the implementation of the reduction in the company tax rate to 30 per cent and the implications for the payment of instalments under PAYG.

6.29 The company tax rate is due to be reduced to 34 per cent for the 2000-01 income year and 30 per cent for the 2001-02 income year. Implementing the reduction in the company tax rate on the basis of adjusted income years would affect the timing of the second rate cut for some taxpayers — some being advantaged, others being disadvantaged. Depending upon the revenue implications and the potential impact on competitive neutrality, it may be necessary to apply a weighted average tax rate to the adjusted 2000-01 and 2001-02 income years.

6.30 Tax instalments would need to be adjusted in alignment with the change in the length of the two accounting periods surrounding the implementation date. For example, in the second example above, the 2001-02 income year would consist of two quarterly tax instalments while the 2002-03 income year would consist of six instalments. Further consideration would need to be given as to the timing of instalments where the adjustment to the income year does not align with the quarterly instalment pattern.

Application of the PAYG system under the tax value method

6.31 The PAYG method of collecting income tax by instalments was designed with business tax reform in mind. As a consequence, the PAYG framework can readily be adapted to accommodate the tax value method. Adjusting PAYG instalments for the tax value method is likely to be less complex than adjusting the instalment rate for other reforms that are due to commence at that time. Many taxpayers would be unaffected by the change in the tax law. For example, personal investors can elect to pay a PAYG instalment amount based on their most recent tax return uplifted by a GDP growth factor.

6.32 PAYG quarterly instalments are calculated by multiplying a business's instalment income for the quarter by its instalment rate. To ensure that a correct and fair amount of income tax is collected, it is important for there to be a reasonably stable relationship between instalment income and tax paid. For this reason, PAYG instalment income and the instalment rate are based on a business's trading income and exclude irregular receipts.

6.33 For the vast majority of businesses, the trading position is reasonably approximated by gross sales. In the context of the PAYG legislation it is represented by the tax concept of ordinary income. Statutory income, such as capital gains and foreign source income is excluded from PAYG calculations because of its irregular nature and because it may only be known at the end of the year. For most taxpayers the inclusion of such income items could result in an inappropriate instalment rate being applied from year to year. However, capital gains are included in the instalment calculations of those businesses that earn regular and considerable amounts of capital income, such as superannuation funds.

6.34 Adapting PAYG to the tax value method is expected to be a relatively straightforward process. For many businesses, *receipts* would approximate their trading position. Netting off irregular receipts, such as those for depreciable assets, capital gains assets and foreign source income would produce an income benchmark not dissimilar to the ordinary income concept used in the PAYG legislation to define instalment income. An equivalent approach could be used in the calculation of the instalment rate.[65]

6.35 The receipts based measure of instalment income would apply from the 2001-02 income year (or adjusted income year as appropriate). In the first year under the tax value method the instalment rate would be based on income calculated under existing the law but applied to a receipts based definition of instalment income. In order to determine the appropriate instalment rate in 2001-02, it will be necessary to derive the receipts based measure of instalment income for the 2000-01 income year. It is expected that such a calculation would be relatively easy to compute from business records.

6.36 For a business wishing to vary down its tax instalment rate in 2001-02 income year, a new calculation of taxable income would need to be undertaken. In theory, this could be done under either law, taking into account the policy changes. However, given that other policy changes to be introduced for 1 July 2001 would be drafted under the tax value method, attempting to vary the instalment rate may require the calculation of taxable income to be made using tax value concepts.

6.37 Further consideration is being given to these issues.

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[65] *Notional tax would be calculated in much the same way as under the current law. Notional tax would be then divided by the receipts based measure of *instalment income.

Treatment of transactions in the transition to the new law

6.38 Transitional arrangements will be required to ensure that upon commencement of the tax value method, assets and liabilities are assigned their correct tax values and that income and deductions are assessed once and once only.

6.39 In the majority of cases, the tax value that an asset or liability will assume upon commencement of the tax value method will be readily identifiable. For example, depreciable assets will have an opening tax value equal to their tax written down value while trading stock, land, shares, trade debtors and the like would have an opening value equal to that used under the existing law. Market valuations would only be required for those financial assets for which a taxpayer elects to use a mark-to-market valuation basis for assigning tax value.

6.40 To clarify the treatment of transactions, assets and liabilities upon commencement of the tax value method, it has been proposed that a mapping table be developed to indicate the appropriate opening tax value for the new law.

Section 7 International issues under the tax value method

7.1 The tax value method would affect the international aspects of the law for residents and non-residents differently. The following paragraphs show that for residents deriving foreign source income, the impact would almost entirely be at the stage of adjustments. On the other hand, the tax value method would encompass the fundamental rules of what is to be included in the calculation of net income for non-residents as well as the adjustments to be made to net income.

Calculating net income

Calculating net income for residents

7.2 No special international rules for *residents* are likely to be needed to calculate net income. All receipts and payments and the tax values of all assets and liabilities would be included in the calculation, unless otherwise specifically excluded. As foreign income will continue to be taxed (in Australia) gross of foreign income tax, payments of foreign income tax should be handled in the same way as the payment of Australian income tax. Foreign withholding taxes would be dealt with in the same manner as domestic withholding taxes applying to amounts derived by residents (these would be treated as a constructive receipt).

Calculating net income for non-residents

7.3 For *non-residents*, we would start with a comprehensive definition of what is an Australian receipt, payment, asset or liability (RPAL). While the details of these definitions are to be worked out, some indication of direction is possible at this time. To reduce the compliance burden for non-residents, any such amounts subject to final Australian withholding tax (or exempt from both withholding tax and assessment tax) and amounts not taxable in Australia because of a DTA would be excluded from the calculation.

7.4 The definition of 'Australian receipt' would capture the current statute and thinking on Australian source income modifying it where necessary to be consistent with Recommendation 23.2(c) of the RBT Report. Picking up Recommendation 23.2(c)(i), an Australian receipt would include amounts received because of functions performed in Australia, assets located or used in Australia or risks assumed in Australia. It would also be made clear that the place where a contract is signed is to be disregarded for this purpose. Further categories of Australian receipt could be added (e.g. for profit distributions, interest or royalties paid by an Australian resident) so that the full extent of Australia's taxing rights is preserved. Whether explicitly or by illustration, Recommendation 23.2(c)(iii) concerning amounts attributable to an Australian permanent establishment of a non-resident would be implemented.

7.5 An 'Australian asset' would be defined principally to cover CGT assets with the necessary connection with Australia as listed in the current law and assets used or held for use for the purpose of gaining or producing an Australian receipt. Gains on these assets will continue to be taxed principally on a realisation basis, except as decided for financial assets. *Payments and liabilities* would likely be identified by their relationship with an Australian receipt and/or Australian asset (apportionment may be required). Payments, assets or liabilities related to Australian receipts that are excluded from the calculation would also be excluded unless they had to be retained for other reasons (e.g. to take account of gains or losses on shares in Australian subsidiaries).

Foreign RPAL will need to be defined for residents for the purposes of calculating classes of foreign income

7.6 While there is no need to define what is a *foreign RPAL for a resident* for the purpose of determining net income, it is needed at the next step. The definition of foreign RPAL for residents would be made to complement the definition of Australian RPAL and would also need to encompass the various existing statutory definitions of foreign income (or like concepts). Some modification of that approach may be needed in relation to foreign assets because of the restricted class of capital gains on which non-residents may be taxed in Australia. As is currently the case, amounts of attributable income of a CFC or FIF would be classed as foreign amounts but they would not be foreign receipts. Instead they would be included in taxable income as an increasing adjustment (see below). Foreign RPAL would have to be allocated to the existing classes of foreign income for loss quarantining and foreign tax credit purposes. Receipts would be allocated according to their character, while payments, assets and liabilities would generally be allocated according to the receipt to which they relate.

Income tax law adjustments

7.7 International provisions will impact mostly by creating either an increasing adjustment or a decreasing adjustment. These are too numerous to go through here but following are some of the more important.

Adjustments for exempt foreign source income

7.8 For residents, amounts of *exempt foreign source income*, including exempt foreign branch income and capital gains, would be dealt with in a manner comparable with the treatment of other exempt amounts. This may entail the calculation of a measure of net exempt income for each class of foreign source income, using a defined concept of exempt RPAL (see page 64 of the RBT explanatory notes). Exempt receipts would be defined in amended versions of the relevant provisions while exempt payments, etc. would generally be defined by reference to the exempt receipts. The existing variations in the treatment of expenses that relate to these amounts (e.g. between exempt section 23AI and 23AJ dividends) would be retained. Where the resulting net exempt income amount for a particular foreign income class is positive, a decreasing adjustment would be allowed, and vice-versa. The same amounts of foreign RPAL would be included in the calculation of the resident's overall net exempt income.

Adjustments for foreign loss quarantining

7.9 The *foreign loss quarantining* provisions (sections 79D and 160AFD of the ITAA 1936) govern to a large extent the calculation of taxable income of a resident. They require the determination of whether an amount used in the calculation of net income is foreign or not, the separation of these amounts into classes and the determination of a taxable income figure for each class. This last determination would be made after making all other adjustments that would have an effect on the taxable income of a class of foreign income. If the result for any class is negative, an increasing adjustment would be required to arrive at a final taxable income figure. In most respects, this loss quarantining would be dealt with in a similar manner to that used for capital losses that are quarantined. If the result for a class is positive no further adjustment is made (an increasing adjustment may already have arisen because of attributable income).

No adjustments are needed for foreign tax credits

7.10 No adjustment would be created by the entitlement to a *foreign tax credit* (instead, that gives rise to a tax offset to be handled in a similar manner to other tax offsets). No changes to the substance of the foreign tax credit provisions are contemplated.

Adjustment for thin capitalisation

7.11 The proposed *thin capitalisation* provisions, which could apply to non-residents, foreign-controlled resident entities and other Australian residents, may result in an increasing adjustment.

Adjustments for attributable income under the CFC and FIF rules

7.12 Where a resident is an *attributable taxpayer in a CFC or a FIF*, the amount to be attributed to the resident would be an increasing adjustment (for the modified passive income class). Because of the many exclusions from the attributable income of a CFC, it may be better to count only the amounts listed in section 384 or 385 of the ITAA 1936 when calculating the net income of the CFC rather than include all amounts and then make adjustments for some. That approach would mean that the CFC would not have to keep an account of all the other amounts for Australian tax purposes (unless they were Australian RPAL). It may result in some departures from the normal treatment of exempt income derived by a resident. There are many such modifications to the normal operation of the law in calculating the attributable income of a CFC that have to be considered. One example is that where a foreign company becomes a CFC, there are special cost base rules for the assets it holds at that time. Those CFC rules will require some modification of the tax value rules for a CFC, but this reflects what is currently required in these cases.

7.13 Where a taxpayer elects under Subdivision 45-D of the RBT draft legislation to use market value for the tax value of an interest in a FIF, rules will be required to prevent attribution of income of the FIF to the taxpayer. The current rules that prevent double taxation on the disposal of interests in CFCs or FIFs that have given rise to attributable income would be given effect by a decreasing adjustment. Some transfers of benefits covered by section 47A of the ITAA 1936 may necessitate an increasing adjustment.

Impact of transfer pricing rules

7.14 One international provision that would not apply at the income tax law adjustment level is the *transfer pricing* rules. Where a taxpayer makes an adjustment to use an arm’s length amount rather than an actual amount, or where the Commissioner makes that adjustment, it is the amounts (RPAL) included in the calculation of net income that should be adjusted. Apart from the obvious impacts on receipts and payments, an asset or liability could have a tax value different from what it would otherwise be because of such an adjustment. This treatment reflects the view that the international arm's length rule constitutes a fundamental principle of the tax system and should be adopted in calculating net income. As is currently the case, the transfer pricing provisions may be applied where an Australian taxpayer incurs expenses for the benefit of a foreign associate without an arm's-length consideration being received.

Unused tax losses

7.15 The final component of the calculation is the deduction of unused tax losses. Because of the foreign loss quarantining provisions, these losses do not include foreign losses that can be recouped (instead, they would be included as a decreasing adjustment of the relevant class, at the preceding stage of the calculation). On the international front, however, there are some special rules concerning amounts of exempt foreign income that are not offset against losses before those losses may be deducted.

7.16 Flow charts showing how the international rules may affect the calculation of tax under the tax value method are at Attachments E and F. *The apparent complexity of the charts reflects existing international tax policy and law and is not exacerbated by the tax value method.*

Conclusion

7.17 The international provisions of the law do not present insurmountable barriers to the adoption of the tax value method but it may have to be modified in some special cases. These modifications are no more, however, than those made currently either consciously or in practice.

Section 8 The treatment of private receipts, payments, assets and liabilities under the tax value method

The current position

8.1 In a significant departure from the treatment of other classes of taxpayer under the tax value method, *individuals* would be required to exclude from their net income calculations 'private or domestic' items (hereafter referred to as 'private'). Division 12 of the RBT draft legislation sets out the details in this area. This section of the paper discusses options for dealing with possible concerns about what is 'private'. On the expenses side, the policy intention is not to alter the current deductibility of non-business expenses (e.g. payments for travel to and from work and child care).

Receipts and payments relating to assets and liabilities

8.2 Private assets and private liabilities are excluded from the tax calculation.[66] Each category is defined in the draft legislation.

8.3 Payments that are included in the tax value of a private asset are excluded from the tax calculation, and payments that are included in the tax value of a non-private asset are included in the tax calculation. Similarly, receipts that are from the disposal of a private asset are excluded

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[66] Section 12-15 of the RBT draft legislation.

from the tax calculation, and receipts that are from the disposal of a non-private asset are included in the tax calculation.[67]

8.4 An analogous situation exists in the case of liabilities.[68]

8.5 Thus, the tax value method entails the rules set out in the table for determining which receipts and payments relating to assets and liabilities are, or are not, included in working out net income, irrespective of whether they are private or not. These reflect the effect of the rules in section 12-25 of the RBT draft legislation.

Table 8.1 Receipts and payments included in net income even if they are private

Item	**This receipt or payment:**	**Is included in net income:**
1	A receipt to the extent that it is (or forms part of) the *proceeds of a realisation event for an asset you held that was a *private asset	Never
2	A receipt to the extent that it is (or forms part of) the *proceeds of a realisation event for an asset you held that was *not* a *private asset	Always
3	A receipt to the extent that it becomes included in the tax value of a liability that is a *private liability	Never
4	A receipt to the extent that it becomes included in the tax value of a liability that is *not* a *private liability	Always
5	A payment to the extent that it becomes included in the tax value of an asset that is a *private asset	Never
6	A payment to the extent that it becomes included in the tax value of an asset that is *not* a *private asset	Always
7	A payment to the extent that it reduces the tax value of a liability that is a *private liability	Never
8	A payment to the extent that it reduces the tax value of a liability that is *not* a *private liability	Always

Other receipts and payments

8.6 It is also necessary for individuals to determine whether any remaining receipts and payments (i.e. receipts and payments not related to assets or liabilities in the way described above) are to any extent of a private nature.[69] The discussion below presents options for doing this.

Concerns

8.7 Concerns have been expressed about the clarity of the legislation dealing with private assets and liabilities, and receipts and payments.[70]

8.8 In particular, those concerns centre on the following requirements:

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67 Section 12-25 of the RBT draft legislation.
68 Section 12-25 of the RBT draft legislation.
69 Section 12-10 of the RBT draft legislation.
70 A related issue concerns the ‘private’ expenses that should form part of the cost of land (see recommendation 4.13(d)(i), and subsection 6-110(4) of the RBT draft legislation). This issue is not discussed in this paper.

- Receipts and payments that are *"of a private or domestic nature"*, other than those dealt with in paragraph 8.5, are not included in working out net income.

- In order to determine whether an asset is a private asset, it is necessary to determine whether an asset is held for use *"for private or domestic purposes"*.

- In order to determine whether a liability is a private liability, it is necessary to determine whether it is *"of a private or domestic nature"*

The RBT explanatory notes

8.9 Chapter 4 of the RBT explanatory notes is designed to assist in interpreting the terms in paragraph 8.8, and includes many examples.

Options for further addressing concerns

8.10 3 options are discussed:

1. Leave the terms undefined.

2. Use the first option but also specify certain things as being private.

3. A separate approach for receipts and payments.

First option - leave the terms undefined

8.11 This option involves accepting the draft legislation as it is, and leaving the terms discussed at paragraph 8.8 undefined. Arguably, the notion of private is one that is widely appreciated, and expresses the intent of the Ralph Review. Difficulties at the margin will always arise no matter what form of expression is used, but guidance could be sought from the Explanatory Memorandum, and resulting judicial consideration, and through administrative mechanisms such as tax rulings.

Second option - specify some instances

8.12 To assist in the interpretation of the terms discussed in paragraph 8.8, it may be useful to particularise in the statute some instances of what is private and what is not private. Arguably, this may be useful for instances that are common or contentious. These are examples of what could be specified:

- Transactions associated with non-commercial gambling activities of the taxpayer could be private.

- Payments made out of natural love and affection could be private.

- Interest receipts could be never private.

Third option – a separate approach for receipts and payments

8.13 While the *concept* of private is relevant to both receipts and payments, the *basis* for determining if a receipt is private probably differs from that used in deciding whether a payment is. This offers the prospect that private receipts could be defined in a different way to private payments. This in turn would allow the respective definitions to be more closely targeted.

Meaning of private receipt under third option

8.14 The tax value method needs to capture receipts that are currently thought of as either income or capital[71] in nature. On one view, these may be considered non-private receipts. Thus private receipts may be thought of as the kind of receipts that the courts have held to be neither income nor capital in nature. Historically, such receipts have fallen into 2 categories:

- gifts and windfalls; and
- receipts explicable *solely* on the basis of family or personal relationships (in many cases such receipts may constitute gifts).

8.15 Therefore, this option involves defining, in the law, these things as private receipts. In this way, the definition of private receipts would be exhaustive. On a minimalist approach, it would be enough to simply refer to the categories, for example, in the case of the first category, 'gifts'. The courts would not be without guidance on the meaning of that term as they have needed to consider the notion of gifts many times in an income tax context.

Meaning of private payment under third option

8.16 In the case of payments, the concept of private serves to distinguish payments that are expenses (e.g. payments that contribute to production of goods and services in the economy) from those that result in consumption (e.g. payments that effect a withdrawal of goods and services from the income-production cycle so they can be used for personal gain). Thus private payments are payments that are *not* connected to the commercial activity of the payer. In contrast, non-private payments are payments that are connected or contribute to that commercial activity. That is, the benefits secured by the non-private payments enter into activities that generate cash flow, assets or increases in the value of net assets.

8.17 On this basis, a payment could be defined in the law as private to the extent that it is *not* made in the course of commercial activity undertaken by the *taxpayer making the payment. That connection could be determined on the basis of a payment's essential character.

When an asset is used for private purposes under third option

8.18 An asset held by a *taxpayer would be used for private purposes when it is *not* used, or held for use, for, or in the course of, the taxpayer's commercial activity.

When a liability is of a private nature under third option

8.19 A liability owed by a *taxpayer would be of a private nature when it is *not* incurred for the purposes of, or in the course of, the taxpayer's commercial activity.

Private expenses channelled through entities

8.20 There is an issue about how the new law will deal with arrangements to incur expenses, which are essentially private in nature, through entities (e.g. an individual who undertakes his recreational gambling through his private company). Rules dealing with distributions from

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[71] These capital receipts would be those currently dealt with by the capital gains tax rules.

entities and fringe benefits tax may be appropriate to deal with this issue.[72] However, further consideration is required as to whether additional safeguards are necessary.

[72] See recommendation 4.12 in the RBT Report.

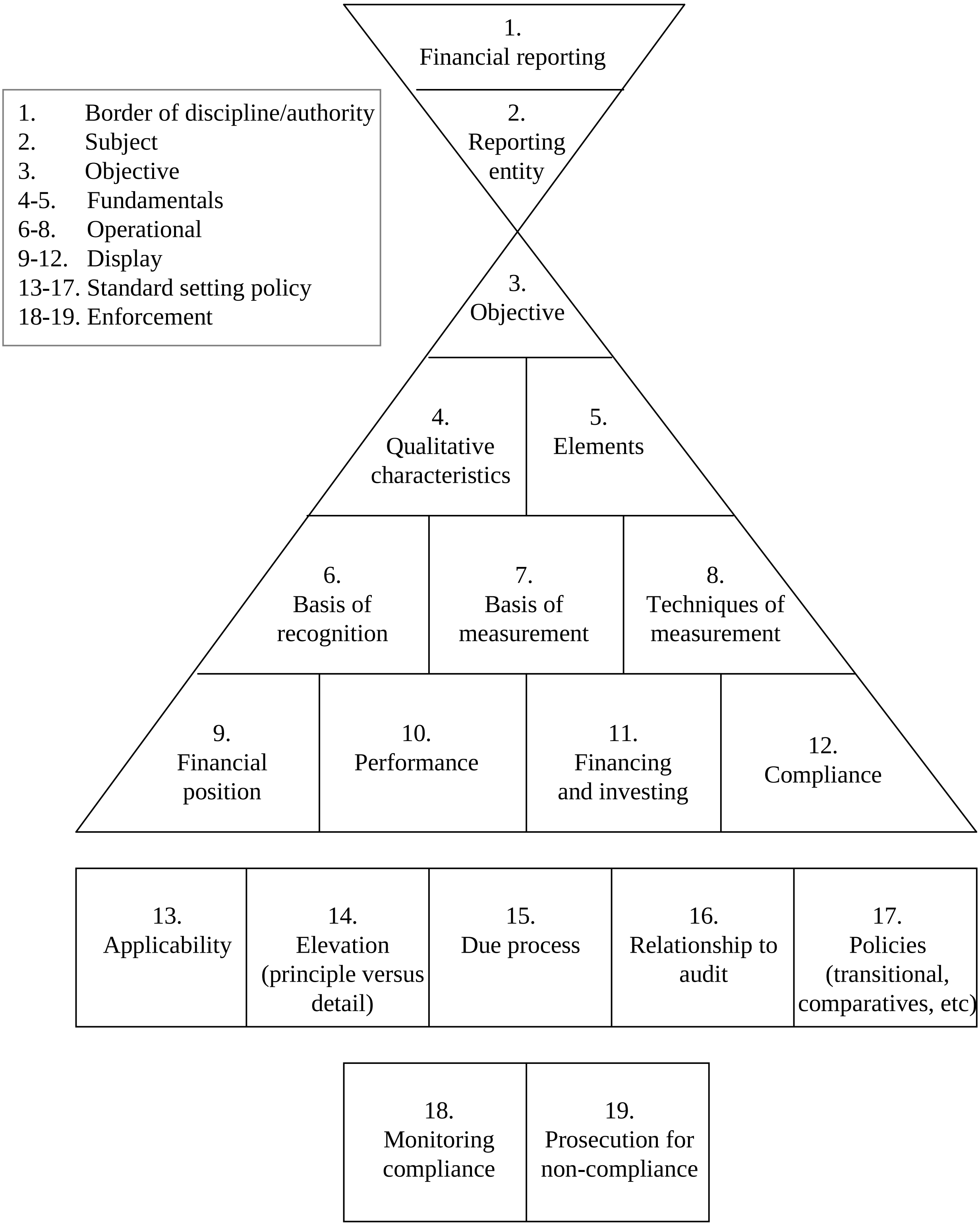
Attachment A

Where to find defined terms asterisked in this paper

Term	**Where defined**
Asset	Subsection 6-15(1) of the RBT draft legislation
Cost	Subdivision 6-E and section 45-70 of the RBT draft legislation
Depreciating asset	Section 40-15 of the RBT draft legislation
Due and payable	Subsection 995-1(1) of the RBT draft legislation
Financial asset	Section 45-10 of the RBT draft legislation (definition to be developed)
Hold (an asset)	Subsection 6-15(3) of the RBT draft legislation, as proposed to be modified by Table 3.3 in this paper (paragraph 3.31)
Instalment Income	Section 45-120 *A New Tax System (Pay As You Go) Bill*
Listed zero tax value asset	Paragraphs 3.18 and 3.19 of this paper
Membership interest	Section 960-120 of the RBT draft legislation
Non-routine right	Subdivision 96-B of the RBT draft legislation (definition to be developed)
Notional Tax	Section 45-325 *A New Tax System (Pay As You Go) Bill*
Private asset	Subsection 12-20(1) of the RBT draft legislation
Private liability	Subsection 12-20(2) of the RBT draft legislation
Proceeds of a realisation event	Subsection 995-1(1) of the RBT draft legislation (definition to be developed)
Right	Paragraph 3.20 of this paper
Routine obligation	Table 4.2 of this paper (paragraph 4.19)
Routine right	Table 4.1 of this paper (paragraph 4.16)
Tax imposed by an Australian law	Subsection 995-1(1) of the RBT draft legislation
Taxpayer	Section 960-100 of the RBT draft legislation
Trading stock	Section 38-10 of the RBT draft legislation
Written down cost (of a prepaid right)	Paragraphs 5.8 to 5.9 of this paper

Attachment B

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 (eg usefulness for the allocation of scarce economic resources) and for whose benefit it is intended (eg 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 (eg 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 (eg 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

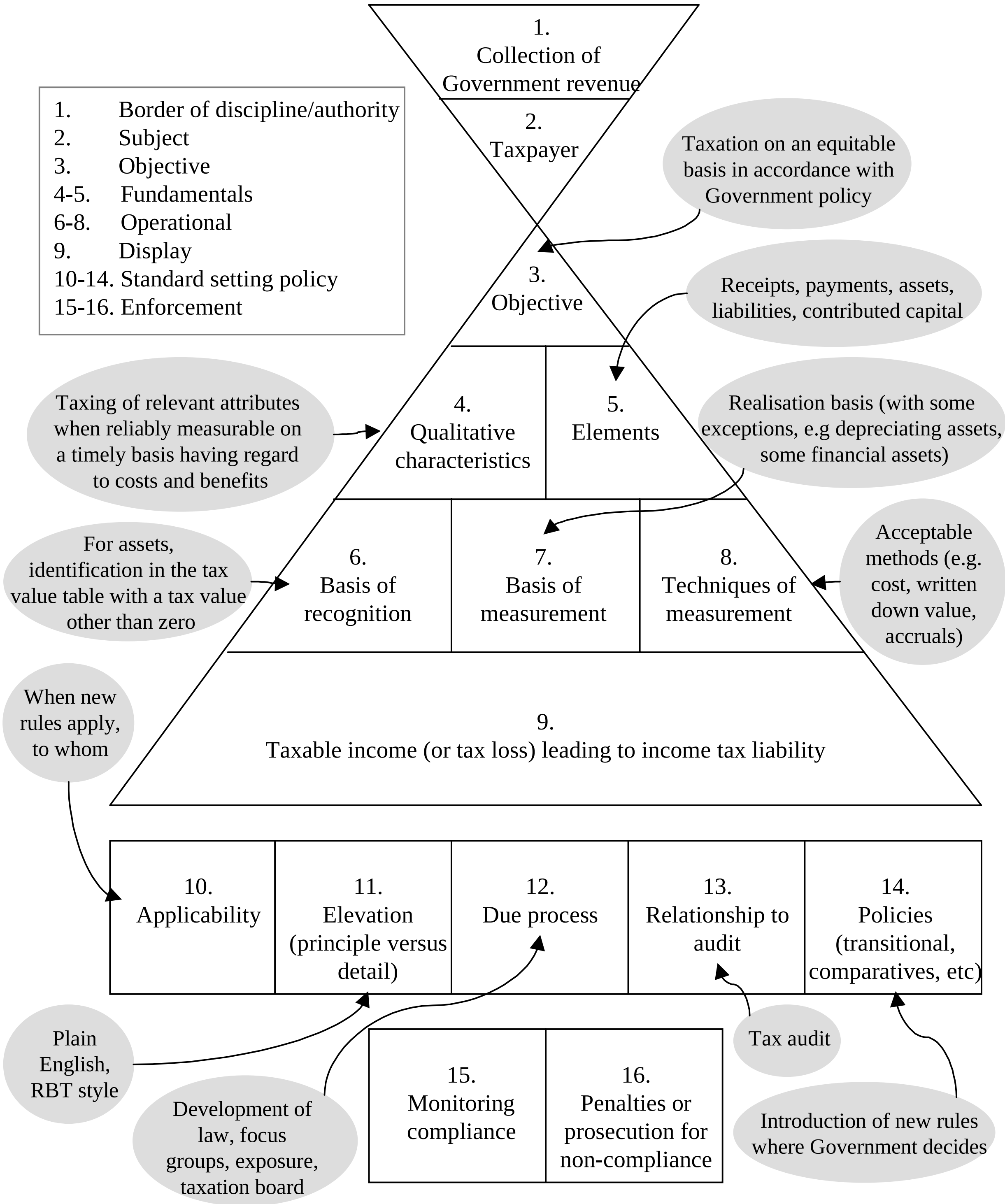
These are the guiding rules/policies for the development of financial reporting requirements.

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.

Attachment C

Building blocks of the conceptual framework under the tax value method

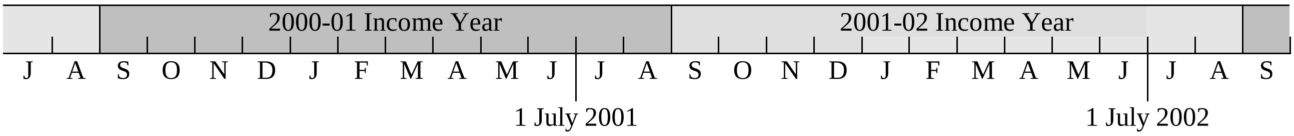


Attachment D

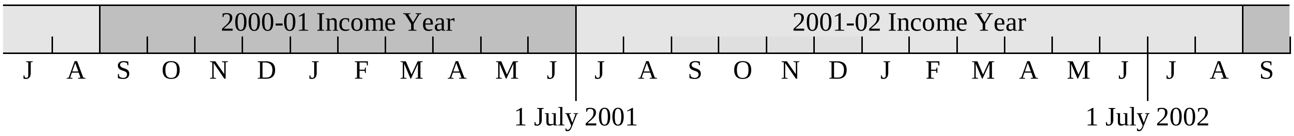
Examples of how SAPs might be adjusted to facilitate implementation of the Tax Value Method and other business tax reforms commencing from 1 July 2001

Example 1. August balancing taxpayer

Current income years

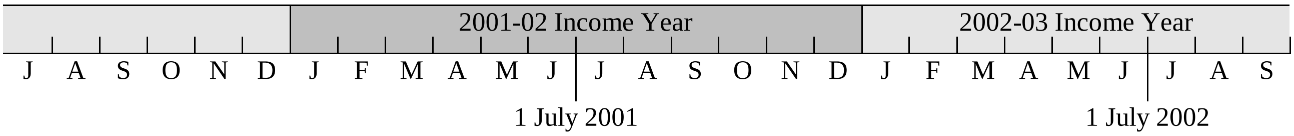


Transitional income years

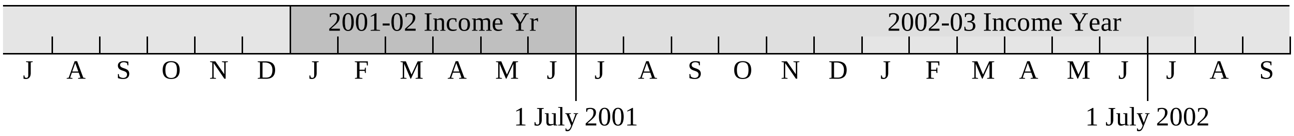


Example 2. December balancing taxpayer

Current income years

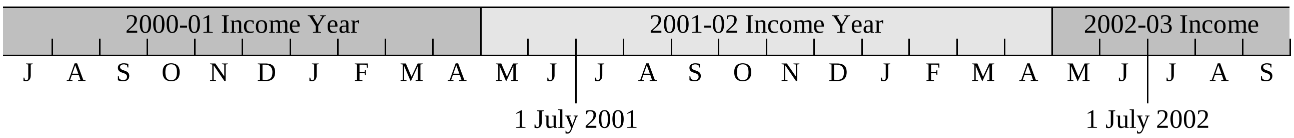


Transitional income years

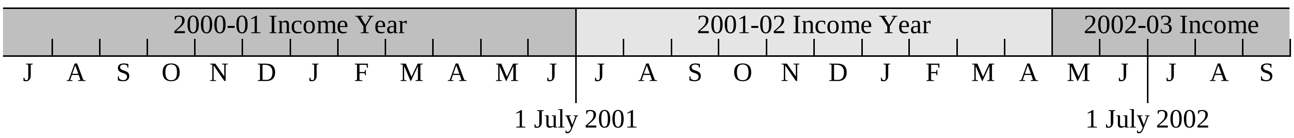


Example 3. April balancing taxpayer

Current income years

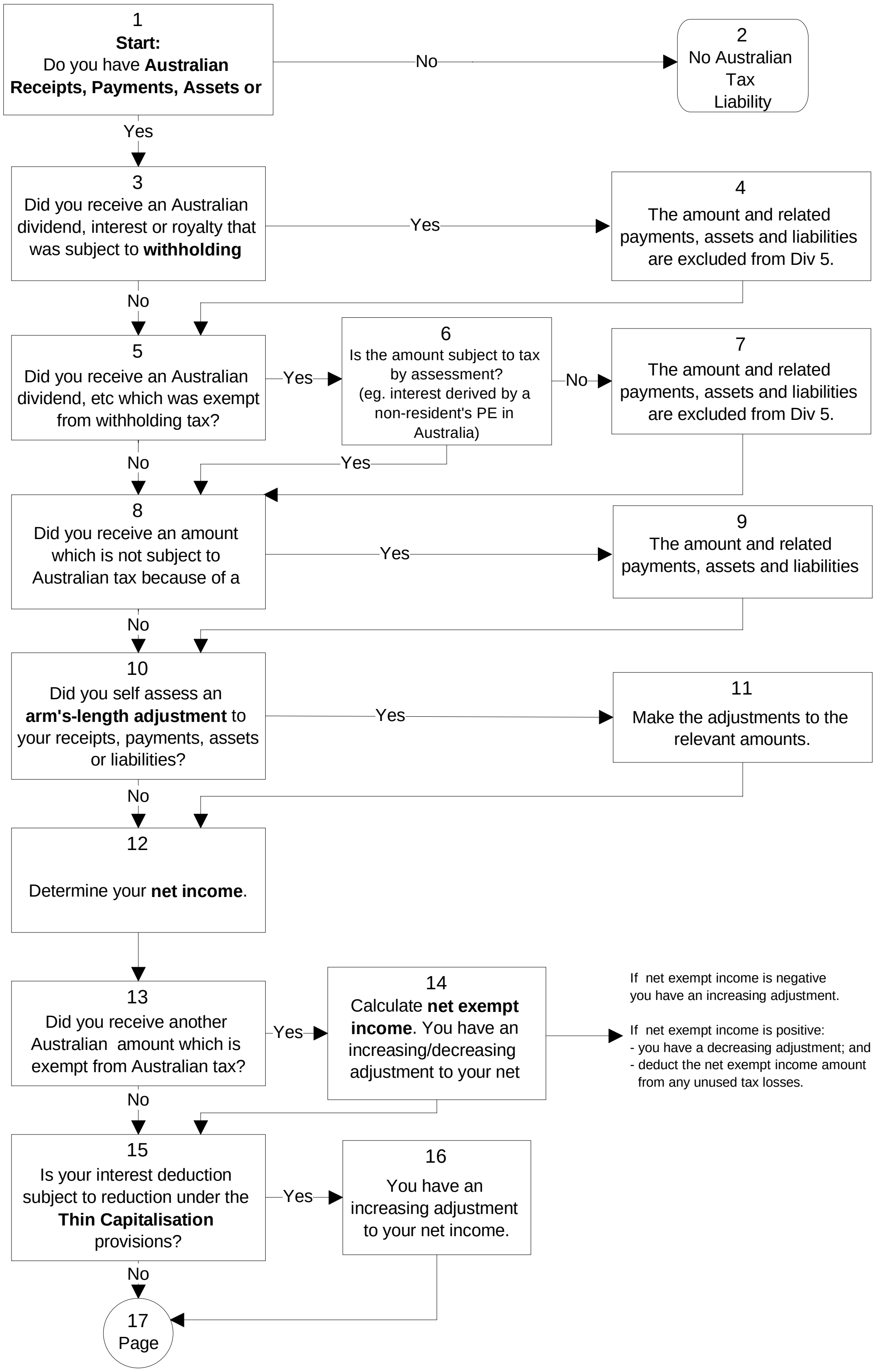


Transitional income years

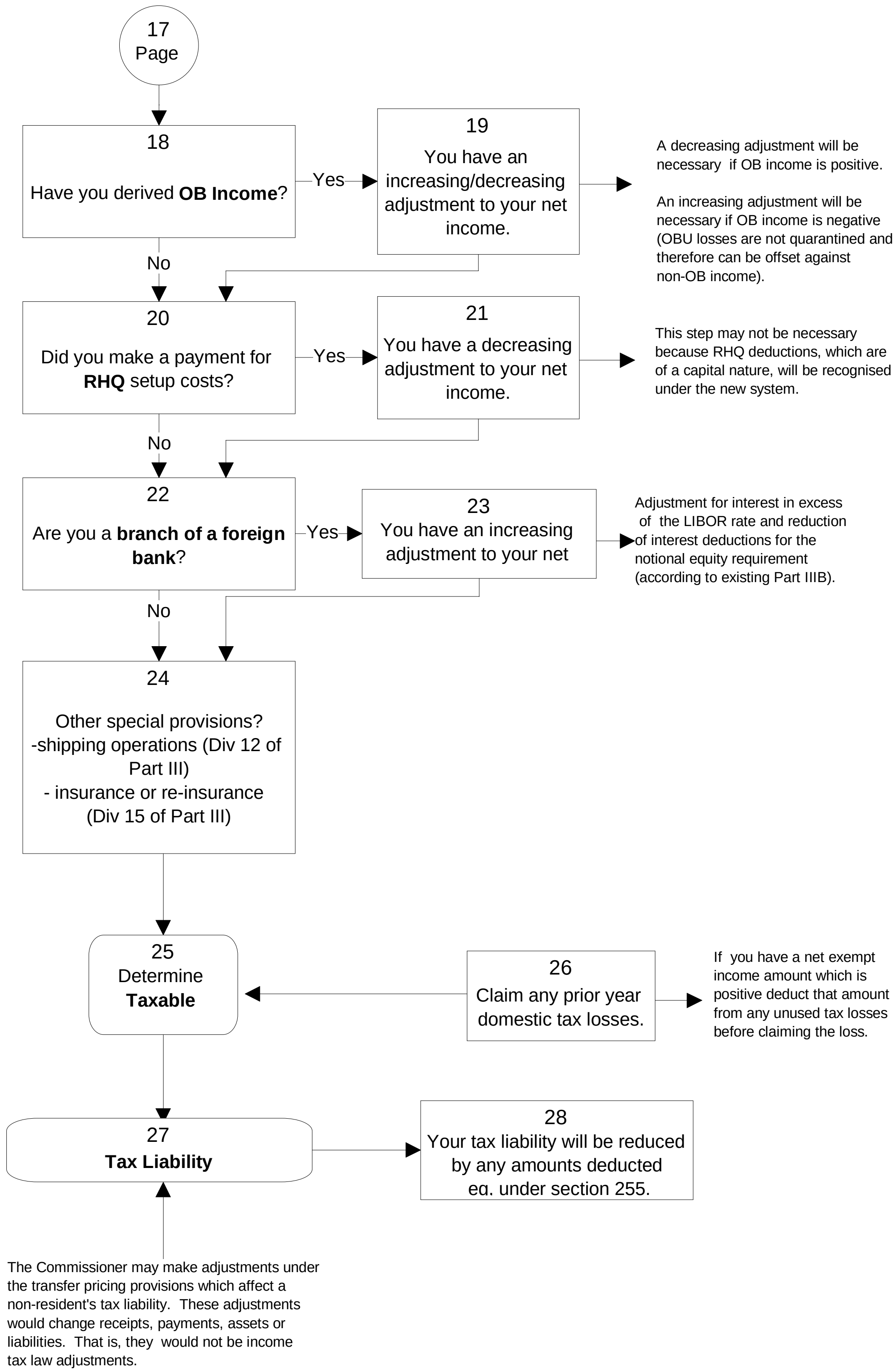


Attachment E

Non-residents – international aspects of the tax value method

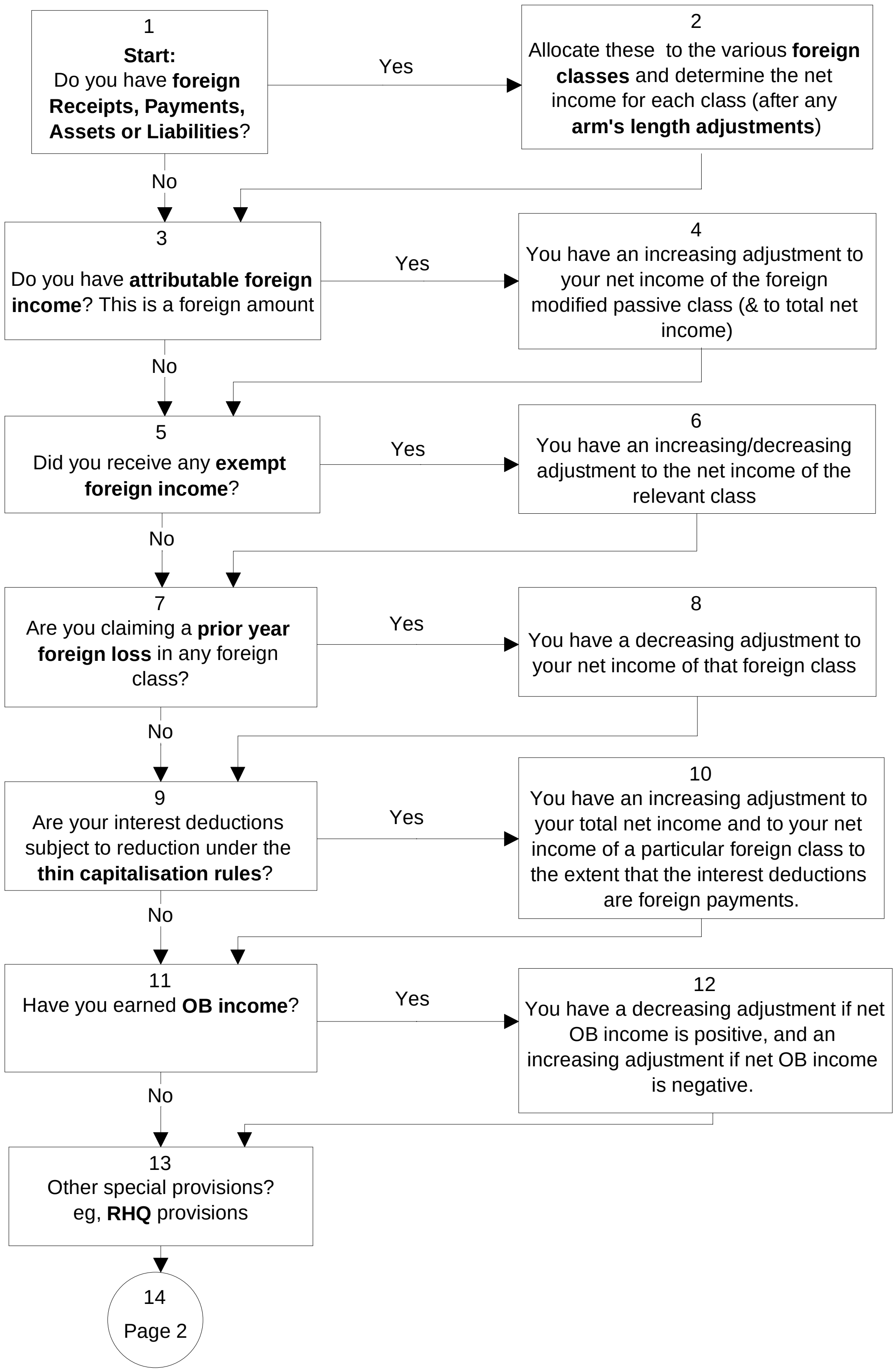


Non-residents – international aspects of the tax value method (continued)



Attachment F

Residents – international aspects of the tax value method



Residents – international aspects of the tax value method (continued)