
INVOLUNTARY RECEIPTS

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A case for reform

What are involuntary receipts?

- 13.1 Involuntary receipts arise in the following circumstances:
- governments or public authorities or private firms empowered by statute compulsorily acquire assets or rights over assets and compensate the affected owners; and
 - owners of assets are compensated for damage or loss of those assets — for example, damage or loss resulting from natural disasters.
- 13.2 Involuntary receipts can be characterised as follows:
- ‘pure’ compensation receipts for wrong or damage (for the loss or destruction of an underlying asset, or for permanent loss of value of, or damage to, an underlying asset), for example, physical damage to a property as a result of an earthquake;
 - receipts for the compulsory acquisition of an underlying asset, for example, the compulsory acquisition of land by a roads authority for an airport access; and
 - receipts for the compulsory acquisition of a right over an underlying asset, for example, the acquisition by an electricity authority of an easement over land, or the granting of a mining lease to a mining company over land.

How are involuntary receipts taxed at present?

- 13.3 In all involuntary receipt cases, the Australian Taxation Office (ATO), as a matter of administrative practice, identifies the most relevant asset to which the payment relates. Thus,
- if the relevant asset is the underlying asset, the ATO attributes the receipt to that asset:
 - if the transaction involves the actual disposal in whole, or in part, of the underlying asset, any receipt is attributed to that disposal; or
 - if the transaction involves permanent damage or reduction in value of the underlying asset, any receipt is treated under a cost base recoupment;
 - if the payment does not relate to an underlying asset, the relevant asset is the right to seek compensation.

13.4 The existing taxation treatment will vary according to the nature and form of the transaction.

13.5 If there has been a compulsory acquisition of an underlying asset, then any taxable gain may be rolled over to a replacement asset.

13.6 If the transaction does not involve any disposal of the underlying asset, the ATO treats as a recoupment of cost base so much of the receipt as is attributable to the loss in value of or damage to the underlying asset. Under the current interpretation of the law, if there is an excess recoupment (that is, if the receipt is more than the cost base of the underlying asset), taxpayers do not have to pay tax on this excess even if the asset is ultimately disposed of.

13.7 An involuntary easement results in an actual disposal of part of the landowner's interest in the land, and the tax treatment depends on whether the underlying land is a pre- or post- capital gains tax (CGT) asset.

13.8 The grant of a mining lease is generally negotiated between the Crown and the mining company, and results in a right to compensation to the landowner. It is treated for tax purposes as an involuntary arrangement with the compensation receipt being treated as a recoupment of cost base of the underlying asset (land).

What problems arise from current treatment?

13.9 Situations arise where taxpayers enter into involuntary disposals of assets and may then replace the asset in whole or in part. If an involuntary disposal were treated as a realisation for CGT purposes, taxpayers would be faced with a tax liability which might reduce their ability to buy a replacement asset.

13.10 While this situation arises in the case of a voluntary disposal, the fact that the problem arises through no choice of the taxpayer, in the case of involuntary disposals, has led to arguments that it is inequitable to apply CGT in such situations.

13.11 In economic terms, but not necessarily in cash flow terms, adequate compensation results in the taxpayer being no better or worse off as a result of the involuntary event. The basic common law principle of compensation is that it should put the aggrieved party back into the same position that he/she would have been in had the loss or damage not occurred.

13.12 In some instances, the taxpayer has the opportunity to put himself/herself back into the same or an equivalent asset holding position (as before the involuntary disposal) by repairing the damaged asset or acquiring a similar replacement asset.

13.13 The current taxation rules do not result in consistent treatment based on a common set of principles.

Reform options

13.14 In the pursuit of a simpler and more consistent treatment, two possible reform options are canvassed:

- Option 1 — treat involuntary disposals as a realisation event for taxation purposes with there being no distinction between voluntary and involuntary receipts; and
- Option 2 — distinguish between voluntary and involuntary receipts by deferring the tax liability on the latter in certain circumstances.

13.15 If it is decided that there are either practical reasons or an equity argument for taxing involuntary disposals differently from voluntary disposals then the boundary line should be clear and the arrangements for doing so as simple as possible.

Option 1: Make no distinction for tax purposes between voluntary and involuntary events

13.16 Under this option involuntary receipts would be treated the same as voluntary receipts so both gains and losses would be taxed at the time of receipt.

13.17 This approach has the following advantages:

- It would remove the need for, and boundary problems arising from, defining an involuntary event.
- It would also provide symmetry between gains and losses. Depending on how rollover relief for an involuntary disposal were structured, it is likely that a taxpayer facing a loss in this situation would elect to take the loss, whereas with a rollover, any gain would be deferred.

13.18 The disadvantages of this approach are potential cash flow problems and inequitable treatment.

Option 2: Tax gains and losses from involuntary receipts more consistently

13.19 Option 2 would retain a differential tax treatment for involuntary receipts where there are forced disposals or permanent damage or reduction in value of the asset. Appendix A summarises the current taxation treatment of involuntary receipts and the treatment under Option 2.

Key policy issues

What is the appropriate boundary line for determining whether a transaction is 'involuntary'?

13.20 If a government or public authority which has the power to compulsorily acquire an asset (or easement) chooses not to exercise that power but acquires the asset by agreement with the landowner, should the compensation received by the landowner attract the same taxation treatment as if the compulsory power of acquisition had been exercised?

13.21 If acquisitions acquired this way were treated less concessionally than those that were actually compulsorily acquired, a non-neutrality would be established between what would be very similar acquisitions. This would force landowners to pursue a course of action where public authorities exercised their statutory power to make acquisitions. There would seem to be little benefit in the taxation treatment forcing landowners and public authorities into a situation of exercising artificially the statutory power of acquisition when they could have reached a mutually acceptable agreement over the acquisition.

13.22 In the case of property potentially subject to a mining lease, property owners may prefer to sell their property to the mining company and acquire a replacement property rather than have it subject to a mining lease. Under these circumstances, there is an element of compulsion in the sale of the property so there may be a case for treating the entire sale proceeds as an involuntary disposal. To qualify for any concessional treatment the property owner would have to acquire a replacement asset.

How do the CGT and income tax provisions interact in relation to compensation receipts?

13.23 Some involuntary receipts for assets may be taxable wholly or partly as ordinary income. The treatment for involuntary receipts proposed under Option 2 would not be available for involuntary receipts (such as

compensation for loss of business profits) subject to ordinary income tax. Such involuntary receipts would be immediately taxable because the forgone income, for which the receipts are compensation, would have been taxed on the same basis.

Should pre-CGT status be maintained for replacement assets?

13.24 If it were accepted that there is an equity case for treating involuntary receipts differently from voluntary receipts, that case should apply to both preservation of the CGT exempt status of pre-CGT assets and preservation of tax deferral benefits for post-CGT assets.

13.25 If the pre-CGT status of compulsorily acquired assets were to be transferred to replacement assets, rules would be needed to ensure that taxpayers acquire replacement assets with a market value no higher than that of the compulsorily acquired assets. Alternatively, the cost base of a more expensive replacement asset could be apportioned between pre- and post-CGT status on the basis of the values of the original and replacement assets. The post-CGT proportion of the asset would be subject to CGT at the time of any future sale.

What treatment should apply to losses?

13.26 Where an involuntary disposal would give rise to a CGT loss, the appropriate treatment consistent with the treatment of gains would appear to be deferral of realisation of the loss and an increase in the cost base of the replacement asset. This would result in the replacement asset having a higher cost base than its purchase price. This would defer realisation of the loss until depreciation was claimed (in the case of a wasting asset) or the asset was disposed of.

13.27 In cases where the asset is only partially lost because of damage or the granting of an easement, the cost base would first be reduced in proportion and the loss realised added to that reduced cost base. For example, if the compensation received was one third of the value of the asset, the original cost base would be reduced by one third and the loss realised added to establish the new cost base of the asset.

13.28 This approach would also require rules to determine when a replacement asset was purchased as taxpayers would prefer to realise the loss immediately.

13.29 An alternative treatment would be to allow the loss at the time that the compensation is received. This would create uneven treatment between

gains and losses in that the taxpayer would be able to defer the gain but realise any loss.

Is there a need for anti-avoidance rules?

13.30 It is possible for related parties to be involved in value shifting arrangements where one entity over-compensates a related entity for an involuntary event, such as damage to an asset. The operation of general anti-avoidance provisions is examined in Chapter 24. In that context, it would be preferable — consistent with the principle stated in *A Strong Foundation* — to deal generally with such anti-avoidance concerns, possibly by means of generic rules to apply to value shifting between related parties.

What restrictions are necessary on the availability of Option 2 treatment?

13.31 Confining special treatment for receipts from involuntary disposals to cases where those receipts are used to purchase a replacement asset could be justified on the grounds that, where no replacement asset is purchased, there would be no later taxing point arising from a realisation. In some cases, such as easements, there is no realistic replacement asset. However, the original asset is retained and rollover relief can be provided by applying the amount of the compensation to reduce the cost base of the original asset.

13.32 Where a replacement asset is not purchased, any gain or loss would be subject to tax in the same way as under a voluntary disposal.

13.33 Where an asset is not disposed of but suffers a reduction in value, the taxation consequences would depend on whether the taxpayer chooses to repair the damage or make good the reduction in value, to acquire or identify another replacement asset, or to do nothing. If the taxpayer repairs the damage or incurs expenditure to alleviate the reduction in value of the underlying asset, the cost base of the asset would be adjusted downwards to reflect the compensation and upwards to reflect the expenditure. If the taxpayer acquires a replacement asset, rollover relief would be allowed. If it were a pre-CGT asset this status would be transferred to the replacement asset. If the taxpayer chooses to do nothing, the cost base of the original asset would be reduced, and any excess recoupment would produce an immediate tax effect.

13.34 The existing tax treatment would continue if the relevant asset is the right to seek compensation (for example, punitive damages).

Revenue implications

13.35 The nature of the reform options are such that the revenue implications are difficult to determine. There are no disaggregated CGT data that distinguish between CGT collected from involuntary and voluntary transactions. The disposal profile of the affected taxpayers would have to be assumed. However, Option 1 would be revenue positive in that tax would be brought forward, whereas Option 2 would be revenue negative as additional tax would be deferred (although it would have some relatively small tax positive effect because excess recoupment would be picked up under this option). In the short term the revenue impact of Option 2 is likely to be minimal whereas over the longer term it would increase.

Summary of current provisions and possible reform, Option 2

Table A.1: Involuntary receipts — summary of existing provisions and possible reform, Option 2

	Existing treatment			Proposed generic treatment Option 2
	Compulsory acquisition of asset, including loss/destruction (Subdivision 124-B, ITAA 1997)	'Pure' compensation receipts for loss or permanent damage (TR 95/35)	Involuntary easement (TR 97/3)	
Circumstances of involuntary receipt	For a compulsory acquisition, the acquisition must be by an Australian government agency.	The receipt arises from a right to seek compensation. For example as in the case of mining leases.	A public authority must take the easement, but the ATO extends this treatment to other bodies with a statutory power.	Recipient must have the right to seek compensation (under the general law, or a particular statute) and an underlying asset.
Underlying pre-CGT or other 'exempt' asset	Not taxed. Possible rollover of pre-CGT status onto replacement asset.	Not taxed	Not taxed	Not taxed. Rollover of pre-CGT status onto a replacement asset is an issue. If retained, it could apply to compulsory acquisition or loss or destruction cases (as under the current law) or extend to all involuntary receipt cases involving an underlying pre-CGT asset.
Underlying post-CGT asset	Not taxed to extent gain rolled over to a replacement asset.	Cost base reduction. No indexation available.	Under TR 97/3 a part-disposal approach applies. Cost base of the underlying asset is pro-rated against the compensation receipt, and a capital gain or loss may arise.	Rollover to a replacement asset or cost base reduction.

Table A.1: Involuntary receipts — summary of existing provisions and possible reform, Option 2 (cont)

	Existing treatment			Proposed generic treatment Option 2
Treatment of excess receipt over cost base of post-CGT underlying asset	Tax deferred to extent rolled over to a replacement asset. Excess over this taxed.	Not taxed	Under TR 97/3, it would be taxed as a gain.	Excess recoupment would produce an immediate tax effect.
Replacement asset rollover opportunity	Yes, but must be used for same purpose as original asset or in same business.	Not available	It is not clear under the existing law but probably not.	Rollover appears a suitable way of providing tax deferral.
Treatment of underlying post-CGT 'loss' asset (i.e. with value less than cost base)	Normal CGT rules apply. Capital loss may arise.	Cost base reduction as for gain assets.	Under TR 97/3, the part disposal approach applies as for gain assets. A capital loss may arise.	Cost base adjustment to parallel the treatment for gain assets.