4

CORE CONCEPTS AND PRINCIPLES

Determining taxable income using the cashflow/tax value approach	155
Assets and liabilities receiving a zero tax value	163
Assets and liabilities receiving a tax value determination	168
Assets receiving capital gains and loss-quarantining treatment	178
Clarifying the treatment of private receipts, expenditures and assets	181
Providing deductibility for blackhole expenditures	187
General deductibility of interest	191
Definition and valuation of trading stock	192
Definition of 'cost' for tax value purposes	196
More certain recognition of provisions	200
Appropriate tax recognition of accounting principles	203

Determining taxable income using the cashflow/tax value approach

Recommendation

4.1 Cashflow/tax value approach

Calculation of taxable income

(a) That to achieve a more robust and durable tax system, taxable income be calculated on the basis of cash flows and changing tax values of assets and liabilities — with increasing and decreasing adjustments to reflect tax policy effects.

Incorporation in tax law

(b) That the cashflow/tax value approach be reflected in the tax law:

(i) with expenditure — which is not of a private nature and does not relate to exempt income — being treated consistently with the accounting approach of classifying expenditure as attracting immediate write-off, amortisation or capitalisation according to whether or not it gives rise to an asset recognised as being on hand at the end of a year;

(ii) with the change in the tax values of all non-private assets and liabilities, unless specifically excluded or exempted, being reflected in the calculation of taxable income; and

(iii) with the tax value of assets and liabilities being determined at the end of the year in accordance with the relevant class of asset or liability.

Revenue-neutral implementation unless expressly varied

(c) That the cashflow/tax value approach be implemented in a revenue-neutral manner — except to the extent that other recommendations in this report expressly propose variations to the existing law.

Fundamental to the reforms of the business tax system recommended by the Review is a principle-based framework for a reformed income taxation system. The recommended framework is driven by the need to improve the structural integrity of the present system, to reduce complexity and uncertainty, to provide a basis for ongoing simplification and to align more closely taxation law with accounting principles wherever possible.

The need for a new approach

The existing law is based on legal concepts of income that have evolved over many years. Central to it are the concepts of ordinary income, statutory income including capital gains, and expenses and losses of either a 'revenue' or 'capital' nature.

As a consequence of the evolution of the existing law, assets may be taxed in a variety of ways depending on the purpose for which they are held. This creates uncertainty and complexity in the law, of the kind illustrated in the Review's first discussion paper, *A Strong Foundation*.

To distinguish expenses consumed in a tax year from expenses that essentially involve a conversion from one type of asset to another, the existing tax system uses the concept of capital expenditure. The absence of statutory principles guiding that differentiation has resulted in uncertainty and led to the mischaracterisation of some expenses.

Whether business expenditures are recognised for income tax purposes and, if recognised, the timing of their deductibility now depends more on the historical development of the law than on clearly enunciated principles. In particular, the treatment of the changing values of different categories of assets and liabilities has been grafted into the law in an uncoordinated and thus non-comprehensive way.

A range of expenditures — known as blackhole expenses by tax practitioners — either attract no deductions at all or are not deductible in a manner consistent with their declining value (see *A Platform for Consultation,* page 101). The lack of sound principles concerning the recognition of expenditure as well as assets and liabilities has influenced these outcomes — as has the *ad hoc* approach of adopting a multitude of amortisation regimes to recognise the decline in value of particular categories of assets. The lack of recognition, together with the mischaracterisation of some expenses, has led to distortions in the measurement of taxable income.

The Review is strongly of the view that a more coherent and durable legislative basis for determining taxable income is essential to reducing uncertainty and complexity in the present system. That redesigned tax law will underpin a more consistent, transparent and sustainable tax system. Having a structure which is more enduring and robust, and which can flexibly accommodate future changes, has much to commend it. Of itself, it will not imply a broadening of the tax base: variations to the base should occur only by express intention.

Features of the cashflow/tax value approach

Concept of taxable income

Determination of taxable income under the cashflow/tax value approach involves recognition of the two components of a taxpayer's income — the net annual cash flows from use of relevant assets and liabilities and the change in tax value of those assets and liabilities (see *A Platform for Consultation,* pages 27-34). Recognising the practical constraints in taxing the annual change in value of all assets and liabilities, the use of tax values ensures that taxpayers will generally continue not to be taxed on unrealised increases in balance sheet values.

Defining income in a manner structurally consistent with both economic and accounting approaches to income measurement — rather than relying on the current mix of statutory and judicial definitions of assessable income offset by an unstructured and highly differentiated set of deductions — supplies the high level unifying principle that cannot be found anywhere in the current income tax legislation. Application of that unifying principle will provide structural integrity and durability to the income tax law that the existing patchwork definitions simply cannot offer, however they might be amended.

Treatment of expenditure

An essential element of income measurement is the deduction of expenses consumed in the course of deriving gains. A treatment of expenditure which is consistent with the accounting approach of classifying expenditure by reference to the life of the benefit acquired is a fundamental feature of the cashflow/tax value approach.

All non-private expenditure, including existing blackhole expenses, will be recognised in the calculation of taxable income — unless specifically excluded by the law for policy reasons. The need to specify exclusions will result in greater certainty for taxpayers and administrators. As a general rule only individuals will be recognised as incurring private expenditure.

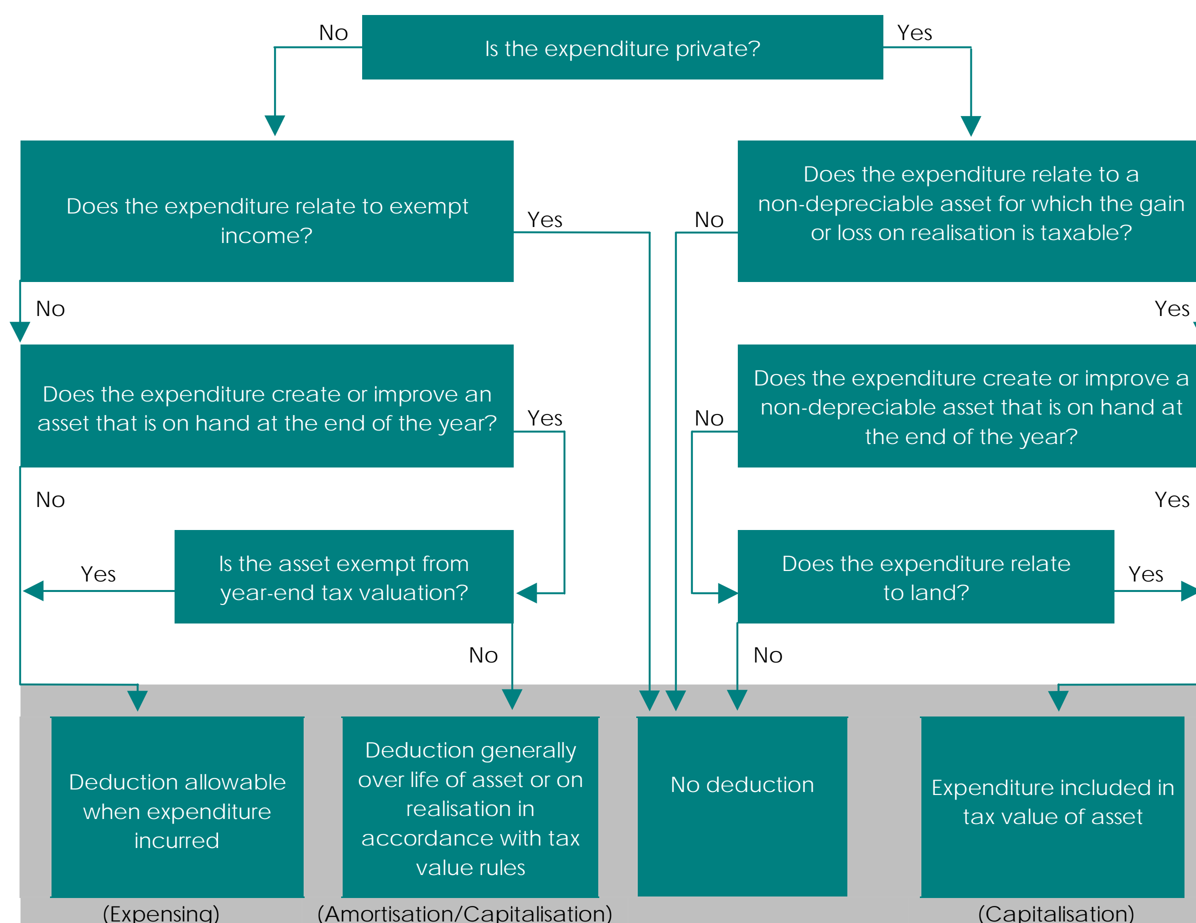
Where expenditure gives rise to an asset, and that asset is recognised for tax purposes at the end of a year, its tax value will be brought to account at that time unless specifically exempted. This is similar to the treatment of trading stock in the existing law. Under this approach, expenditure will be deductible over the period in which identifiable benefits are received from the expenditure.

Some transactions either will not be recognised or otherwise will be exempted from being treated as assets and liabilities (for example, most advertising expenditure). Some assets and liabilities will be exempted either because the compliance costs involved in valuation would not warrant their valuation or

for specific policy reasons (Recommendations 4.2 and 4.3). Exemption of certain assets and liabilities from end of year tax valuation will also provide the mechanism in the law for the calculation of taxable income under the simplified tax system applying to taxpayers operating small businesses (see Recommendation 17.1) and for certain other taxpayers (Recommendations 4.4 and 4.5).

Figure 4.1 depicts the treatment of expenditure under the recommended framework.

Figure 4.1 Treatment of expenditure under cashflow/tax value approach



Tax value of assets and liabilities

Critical features of the cashflow/tax value approach are the tax value rules for assets and liabilities and the meaning of 'asset' and 'liability'. As noted, the Review's recommended approach involves measurement of a taxpayer's income (or return on an investment) by taking into account changes in the tax value of assets and liabilities over a year.

The tax value of assets and liabilities on hand at the beginning and end of a year will be taken into account in the calculation of taxable income.

- Increases in the tax value of assets and reductions in the tax value of liabilities will add to taxable income.
- Decreases in the tax value of assets and increases in the tax value of liabilities will reduce taxable income.

Soundly based definitions of 'asset' and 'liability', and of their associated tax values in a range of circumstances, are required under this approach. A broad definition of an asset is required to protect the integrity of the tax base and to ensure that the tax law remains relevant in the face of asset innovation without the need for continual adjustment.

- The meaning of 'asset' will draw on, and be generally consistent with, the accounting definition of an asset. There is no general definition of asset in the existing tax law. An asset is defined for capital gains tax purposes but this definition is more narrowly focused than the accounting definition. Consistent with the accounting definition, an asset will be something that embodies future economic benefits. Where an asset is held by a taxpayer, the tax value of the asset will generally be taken into account in the calculation of taxable income — unless it is excluded or exempt from year-end tax valuation.
- The meaning of 'liability' will draw on the accounting definition of a liability. There is no definition of a liability in the existing tax law. In the new tax law, a liability will be an obligation that a taxpayer has incurred to provide future economic benefits. Consistent with the well understood meaning of 'incurred' in the existing law, there must be a present obligation to provide future benefits for there to be a liability. Some liabilities for accounting purposes, such as provisions for employee entitlements, will not be recognised as liabilities for taxation purposes, thereby effectively having a zero tax value (Recommendation 4.21). Where a liability is owed by a taxpayer, the tax value of the liability will generally be taken into account in calculating taxable income.

As noted earlier, some transactions will either not be recognised or will be specifically exempted from being treated as assets or liabilities often through the assignment of a zero tax value — whether for reasons of compliance cost or policy. In this regard, the Review emphasises (see Recommendation 4.1(c)) its intention that the cashflow/tax value approach be implemented in a revenue-neutral manner. Unless other recommendations in this report expressly propose variations to the existing law, the presumption should be that identifiable variations to existing policy will not be implemented by stealth. More generally, the benefits of a more robust and durable tax system should also be returned to taxpayers via lower tax rates.

Figure 4.1 illustrates that the proposed tax value rules for assets will determine the timing of the deduction of expenditure in calculating taxable income. An outline of the tax value of most types of assets is depicted in Figure 4.2.

Figure 4.2 Tax value of assets

Asset type				
Assets whose increase in value is only taxed upon realisation (most assets)	Trading stock	Depreciable assets subject to write-off at a specified rate for taxation purposes	Financial assets and rights whose annual change in value is calculated from associated benefits	Financial assets for which market value election has been made
↓	↓	↓	↓	↓
Cost	Lower of cost or net realisable value, or market selling value	Tax written down value	Accruals	Market value
Tax value				

As can be seen in Figure 4.2, taxpayers will generally not be taxed on unrealised gains. Gains on most assets will continue to be taxed on a realisation basis. The main departures from this are the accruals treatment for some financial assets and rights (Recommendation 9.2) and the market value election available for financial assets (Recommendation 9.1) or trading stock (Recommendation 4.17).

Critical to the cashflow/tax value approach is the tax value concept. It enables practical recognition of asset and liability values in the measurement of the components of a taxpayer's income.

The Review recognises that the proposed approach will impose some transitional costs on taxpayers and their advisors as well as the Australian Taxation Office as a result of the introduction of new concepts and newly defined terms such as 'asset' and 'liability'. These transitional costs can be justified because of the greater simplification, certainty, transparency and durability of the recommended framework. The new approach to structure will produce long-term benefits for Australia's tax system, which the Review believes will far outweigh the shorter-term costs.

Most taxpayers operating small businesses will feel little practical impact from the new approach because of the Review's recommendations allowing them to opt into the simplified tax system (STS) described in Recommendation 17.1. Similarly, there will be little impact on individuals, who will continue to attract a cash basis treatment on most income and expenditure (Recommendation 4.4).

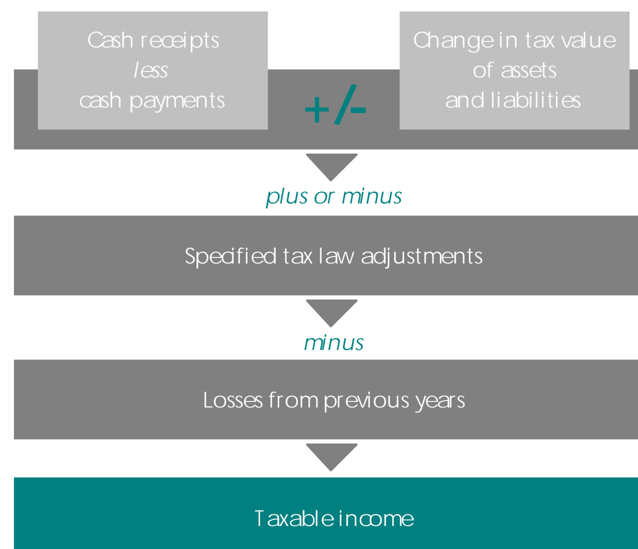
Calculation of taxable income

To determine a taxpayer's taxable income, adjustments will be required to the net income amount calculated under the recommended treatment of receipts, expenditure and changes in the tax values of assets and liabilities as explained above. These adjustments will be for specific policy reasons. For example, exempt income and the deduction for the extra 25 per cent of research and development expenditure will reduce taxable income. Examples of amounts which will increase taxable income, by requiring an addition to the net income amount, are non-deductible expenditures. These include payments of dividends and income tax, each of which will continue to be non-deductible.

Also, total spending initially having been taken into the calculation, expenditure relating to exempt income will be added back to increase taxable income by way of a specific adjustment.

After taking into account these specific policy adjustments and the carry-forward of unused losses, taxable income will be determined as shown in Figure 4.3.

Figure 4.3 Calculation of taxable income



Under the existing system, the timing of deductibility of expenditure depends on whether the expenditure is of a capital nature. In accounting terms a capital expense is essentially a conversion from one asset (for example, cash) to another asset. In other words, expenditure is of a capital nature when it is used to acquire, create or improve an asset. The Review believes that reflecting this approach in the structure of the tax system will reduce uncertainty and remedy the mischaracterisation of some expenses in the present law.

A key objective of the cashflow/tax value approach is to classify expenditure as attracting immediate write-off, amortisation or capitalisation by reference to

the life of the benefit acquired from the incurring of the expenditure. This is based on the notion of whether or not the expenditure gives rise to a recognisable asset on hand at year-end.

In *A Platform for Consultation* (pages 39-44), the Review discussed two options for determining taxable income under the framework incorporating changing tax values of assets and liabilities. One option maintains the existing assessable income and allowable deductions dichotomy. The other option adopts an approach based on cash flows and changing tax values of assets and liabilities. Both options are intended to, and would, produce the same outcome. They would also produce the same outcome that the current system is intended to do, under the same policy prescriptions.

The first option would involve the inclusion in assessable income of current receipts and earnings as well as the increase in the tax value of assets and the reduction in the tax value of liabilities. Deductions would include current expenditure as well as the reduction in the tax value of assets and the increase in the tax value of liabilities.

Some tax professionals seem to favour this option because it retains the existing concepts of assessable income and allowable deductions. However, as assessable income and expenditure include tax value changes for some assets and liabilities (for example, debtors and creditors), there would be a need for special rules under this option to remove the duplications. Removing duplication in the determination of assessable income and allowable deductions, however, underlines the equivalence between this option and the second option outlined in *A Platform for Consultation*.

It is this second option that the Review has concluded should be the approach to be taken in framing the legislation for the calculation of taxable income. It is based on cash flows (receipts less payments) and changing tax values of assets and liabilities. The Review does not see benefit in maintaining the existing terms of 'assessable income' and 'allowable deductions'. As noted, those terms would have significantly changed meanings if they were to be maintained in the new law.

As its primary advantage, this approach delivers structural integrity and durability of the resulting legislated framework. It is also consistent with the conceptual basis that has been developed for financial accounting. In addition, by minimising the number of specific rules required throughout the legislation (a problem that bedevils the current legislation), it will reduce the volume of tax legislation significantly as well as its complexity, thereby delivering lower compliance costs. The structural unification recommended will also provide a basis for ongoing simplification of the tax law.

Calculating taxable income will be conceptually consistent with accounting and economic approaches to income measurement — although, importantly, tax values will often be different, and less dependent on legal concepts, from

values in the financial balance sheet because they will be derived from the treatment incorporated in the tax law. In particular, because realisation is adopted as the basis for taxing gains for most asset categories and because expenditures will usually be recognised when incurred rather than when provided for in accounts, tax values will differ from financial balance sheet values. For example, depreciable assets will be included at tax written down value and most provisions, such as employee entitlements, will have a nil tax value. As noted, including depreciable assets at tax written down values and most other assets and liabilities at cost ensures that related gains are only brought to account on realisation.

Impact of the cashflow/tax value approach

The recommended approach is not a revolutionary way of calculating taxable income that departs from all established processes. It does not result in radically different outcomes, such as bringing to tax unrealised gains. Substantively, the same calculations need to be made under the existing law and the proposed approach.

It has been suggested by some that changing from the current system of taxation to the recommended approach will add substantially to compliance costs and require major modifications to existing computer systems currently used to calculate taxable income. This is not the case.

Adoption of the cashflow/tax value approach will not, of itself, require taxpayers to change the way they currently calculate their taxable income and they can continue to use their current computer programs. Attachment A demonstrates how the approach can be applied in practice. Modifications to existing systems will, of course, be required to reflect policy changes resulting from the implementation of reform measures by the Parliament. This would be the case whichever legislative structure were to be adopted.

Assets and liabilities receiving a zero tax value

Recommendation

4.2 Exemption principles for tax values

That classes of assets and liabilities not be recognised, or be exempted from the general requirement for year-end tax valuation (effectively receiving a zero tax value) if:

(i) it would be unreasonably costly — relative to the likely effect on tax assessments — to ascribe a tax value to the asset or liability; or

(ii) specifically identified policy reasons require such exemption.

In Chapter 3 of *A Platform for Consultation*, the Review identified a range of business assets that taxpayers currently do not need to bring to account at year-end, even though their cost is generally immediately deductible. The range was not exhaustive. In the absence of specific exemptions, taxpayers would need to bring such assets to account under the cashflow/tax value approach for determining taxable income.

In principle, the year-end tax value of business assets and liabilities of taxpayers would be brought to account. Nevertheless, the Review considers that a balance needs to be struck between that principle and the compliance costs related to that recognition. There may also be particular policy reasons for not requiring certain assets and liabilities to be brought to account at year-end for tax purposes.

In selecting those assets and liabilities recommended for exemption, the Review has balanced the following factors:

- the need to protect the integrity of the law — exceptions can create opportunities for manipulation and can lead to disputation about the precise meaning of the exception;
- the cost to taxpayers of recording the tax value of assets — some assets can be difficult to value (for example, professional work in progress) and the inclusion of the tax values of some other assets and liabilities would have little or no impact on taxpayers' tax liabilities (for example, the net value of the assets and liabilities associated with a 20 year lease over property subject to regular commercial lease rentals); and
- the degree of distortion (or impact on revenue) — some of the identified assets are usually realised within 12 months and so exemption under the current treatment is not particularly distortionary.

Simply exempting all short-term assets from being brought to account at year-end would not be appropriate. A rule as broad as that would cover assets such as trade debts and trading stock. Those assets often represent a significant portion of the assets of a business and excluding their value from the income tax base would be unacceptable. Accordingly, the Review has recommended general principles as well as specifying particular assets for exemption. Beyond the specific exemptions covered here, exclusions from asset/liability treatment are incorporated within a range of other recommendations — for example, in relation to 'routine' leases and rights (recognising, though, that a lease rental paid in one year for benefits in the next reflects an asset (prepayment) which would be brought to account in the first year and extinguished in the next).

Recommendation
4.3 Specific exemptions producing zero tax values

That, consistent with the exemption principles, taxpayers not be required to determine tax values for the following types of assets at year-end:

(i) consumable stores and spare parts, whose cost is not already absorbed in the tax value of other assets, and whose aggregate tax value does not exceed $25,000;

(ii) office supplies, unless trading stock;

(iii) standing crops and timber established by the taxpayer either for resale or for environmental works on rural land;

(iv) non-billable work in progress of providers of services for a fee — such as professionals, tradesmen and building contractors — where there is a reasonable expectation that the service will be billed within 12 months of the year in which the service was performed;

(v) results of exploration and prospecting activities from mining and quarrying; and

(vi) expenditure on advertising, except that which gives rise to:

- **a depreciable asset, or an improvement to a depreciable asset, used for advertising purposes; or**
- **an advertising service or product to be provided after the end of the year (consistent with other prepayments).**

Consumable stores and spare parts

Consumable stores and spare parts do not generally constitute trading stock under the existing law and so currently do not have to be valued at year-end.

The current treatment of consumables and spares is not entirely appropriate. Some taxpayers carry significant levels of such assets and deductions ought be allowed only as they are consumed. On the other hand, it would not be appropriate to require taxpayers to account for values below a certain limit.

A reasonable limit would seem to be $25,000. That will ensure that most businesses do not have to incur unnecessary compliance costs. Even where the $25,000 limit is exceeded, consumables and spares will not have to be separately accounted for if their cost has been absorbed in the tax value of other assets, such as in trading stock values.

Office supplies

Taxpayers currently do not have to account for the value of consumables and spares to be consumed, or used in machines, in a taxpayer's office. Usually, significant sums are not involved.

Requiring taxpayers to value annually stores of such relatively minor assets would impose additional compliance costs which cannot be justified in terms of tax law integrity or design. Accordingly, taxpayers will not be required to value these assets.

Standing crops and timber

Generally, taxpayers currently do not have to determine tax values for standing crops and timber established by them either for purposes of sale or, broadly, for environmental works on rural land. Establishment costs and development costs are deductible rather than added to the year-end tax value of these assets.

The current taxation treatment of short-term crops does not represent a significant distortion. The crops are harvested in the year following the incurring of the expenditures. Moreover, requiring their valuation for taxation purposes each year could be difficult, particularly for small farmers. The Review's principles would exempt these assets from year-end tax valuation.

Considerably more distortionary, however, is the current treatment of the costs of establishing and developing standing timber — because immediate deductions are granted even though a long-term appreciating asset is created as a result. In principle, the cost of establishing and developing plantation timber should be capitalised until the plantation is harvested.

Although that would be the outcome under the cashflow/tax value approach, the resultant lower after-tax returns would be likely to reduce investment in forestry, with undesirable environmental consequences. The Review notes that denying immediate deductions for the establishment costs of plantation timber would be inconsistent with the existing policy of encouraging planting of trees — important because of the associated environmental benefits.

In view of the existing policy, and consistent with the policy-based principle for exemption, the Review is not recommending a change to the current treatment of allowing immediate deductions for plantation establishment costs other than to the extent of any prepayments in accordance with Recommendation 4.4(ii).

The Review notes, nevertheless, that the current treatment has encouraged some end-of-year tax minimisation schemes. Some of the structural improvements to the law recommended by the Review should address, for the most part, the aggressive features of tax minimisation schemes — see the discussion under Recommendation 4.4.

Work in progress of service providers

Under the current law, providers of services for a fee (such as professionals, building contractors, tradesmen and the like) are not required to value their work in progress at year end to the extent that they are not entitled to bill for that work. Generally, that is not particularly distortionary as most service contracts tend to be of a short-term nature, so the income deferral is short. Indeed, the longer the contract, the more likely that the contract would be subject to periodic payments.

Work in progress of that nature can be difficult to value and to require taxpayers to do so could impose considerable compliance costs. However, providing a complete exclusion for such assets would not be appropriate as it could encourage taxpayers to enter into long-term arrangements for the provision of services on a deferred payments basis. Therefore, an exclusion will only apply if the work can reasonably be expected to be billed within 12 months.

Mining and quarrying exploration and prospecting expenditure

Applying the recommended treatment of expenditure and assets without recognising the valuation difficulties associated with the results of exploration and prospecting expenditure would mean that the tax treatment of this expenditure would depend on the results of the exploration or prospecting activity. Unsuccessful expenditure would be deductible at the time the activity was abandoned, while successful expenditure would enter the cost base of the project. That is the accounting approach.

It has been a longstanding feature of the current law to allow an immediate deduction for exploration and prospecting expenditure. Allowing continuation of immediate deductibility is justified on the basis that the value of the associated asset cannot be reliably measured.

Assets produced by expenditure on advertising

Most advertising expenditure is deductible immediately under the current law. The following are exceptions to that general rule.

- Where the expenditure is for the acquisition of, or improvement to, an asset used for advertising purposes — for example, an advertising sign or hoarding. In such cases, the asset would be depreciable.
- Prepayments of services to be rendered by another person where the service will not be completed within a period of 13 months. In that case, the expenditure is deductible over the period of time during which the service is to be rendered.

In many situations advertising expenditure may provide the dual benefit of enhancing both immediate sales and the value of future sales or goodwill. In practice, it would be extremely difficult to determine the extent to which expenditure on advertising that has been 'put to air' results in ongoing benefits beyond the period in which the advertising occurs.

The Review therefore believes that, consistent with accounting practice, there should be no attempt to recognise the value of an asset for tax purposes in respect of the end-benefits flowing from advertising. However, consistent with the treatment of expenditure and the proposed removal of the 13 months prepayments rule (see Recommendations 4.1 and 4.6), assets will be recognised where expenditure relates to:

- the cost of a depreciable asset used for the purpose of advertising, such as an advertising sign; or
- an advertising service or product to be provided or developed, at least partly, after the end of the year, such as a series of television advertisements.

Assets and liabilities receiving a tax value determination

Recommendation

4.4 Determining tax values for individual taxpayers

That individual taxpayers be required to determine tax values for the following assets and liabilities:

(i) depreciable assets subject to write-off for taxation purposes;

(ii) all assets and liabilities (including prepayments) relating to participation in a project or arrangement, managed by another person or entity, in which a number of taxpayers individually participate;

(iii) prepayments where the payment relates to the provision of services or products over a period:

- **exceeding twelve months; or**
- **ending after the next income year;**

(iv) assets in which a gain or loss is taxed on realisation;

(v) financial assets and liabilities that would be taxed on an accruals basis in accordance with Recommendation 9.2 and that have a term of one year or more where the rate of return applicable to any effective discount or premium is more than 1 per cent per annum, compounded annually;

(vi) financial assets and liabilities subject to market value election in accordance with Recommendation 9.1;

(vii) non-routine leases and rights (see Recommendations 10.1 to 10.13);

(viii) trading stock as specified in Recommendation 17.2 relating to small business taxpayers; and

(ix) business assets and liabilities of small business taxpayers who do not elect to use the simplified tax system in accordance with Recommendation 17.1.

Cash basis accounting for individuals

Under the current law, a cash basis of accounting has been applied for income derived by individuals primarily in receipt of employment-related income and/or ordinary interest and dividends.

Under the cashflow/tax value approach, the change in tax value of some assets and liabilities would have to be taken into account by some such individuals unless specifically excluded. The Review considers that individual taxpayers should continue to be taxed on a cash basis as a general rule. Some assets and liabilities will be valued for tax purposes and these are specifically listed.

Prepayments

In the case of prepayments, there will be no requirement to generally value such assets provided the payment does not relate to the provision of services or products over more than 12 months and the payment does not relate to a period which ends beyond the next income year. Typical prepayments which will be covered by this 12 month rule are annual subscriptions to professional or trade associations and for magazines and journals. This measure ensures, for example, that payments made in June to cover services over the following year of income will continue to be deductible in the year of payment.

Tax shelter arrangements

An exception to the 12-month prepayment rule will apply to advance expenditure incurred ('prepayments') in respect of participation or investment in arrangements or projects sometimes referred to as 'tax shelter schemes'. The type of arrangements intended to be covered include those that are the subject of product rulings issued by the Australian Taxation Office.

These types of arrangements generally involve participants incurring expenditure towards the end of an income year in respect of services to be provided over the following year. Income from such arrangements is not usually derived, if at all, for a number of years. In some cases, expenditure is partly financed by non-recourse loans — which means the investor is only liable to repay the loan from, and to the extent of, any proceeds from the sale of the product of the underlying asset.

Broadly speaking, under the current law these prepayments of up to 13 months are immediately deductible if they are not characterised as capital expenditure and provided the general anti-avoidance provisions do not apply. The current treatment of immediate deductibility and delayed income has encouraged some end-of-year tax minimisation schemes.

Under the Review's recommended treatment of expenditure and assets, some expenditure (including prepaid expenses) in respect of these types of investment arrangements will give rise to an asset, for example, a grapevine. In such cases, the expenditure will be included in the tax value of the asset and be written off in accordance with the write-off rules for the relevant class of asset. Whether expenditure gives rise to an asset on hand at year-end will depend on the facts in each case. The Review believes that such assets should be brought to account by individual taxpayers. Similarly, where expenditure such as management fees relating to these investment arrangements is prepaid, the prepayment should be allocated over the income years to which the payment relates (Recommendation 4.6).

The exception to the 12 month rule for prepayments relating to these arrangements or projects will affect the treatment of management fees paid at the end of the income year for services to be provided in the following year. The write-off of the expenditure for tax purposes will be allowed in the following year.

Where non-recourse funding results in expenditure on the investment scheme greater than identifiable project-related costs, such as management fees or development costs, the excess would appear to relate to an asset reflecting the future benefits from the project. That asset would not attract up-front deduction. It would fall in value to zero if no future benefits were, in the event, realised. If, in that event, the associated part of the non-recourse loan were also forgiven there would be no net tax effect under the recommended treatment of assets and liabilities (and under the matching arrangements involving debt forgiveness in Recommendation 6.8).

The structural improvements to the law recommended by the Review — including the treatment of prepayments — should address, for the most part, the key features of the tax minimisation schemes.

Financial assets and liabilities

Individuals will not be subject to accruals taxation unless the financial asset or liability provides significant tax deferral opportunities. These opportunities will exist where, to take the example of a financial asset that would be taxed on an accruals basis in accordance with Recommendation 9.2, the asset has a term of one year or more, and the return applicable to any effective discount is more than 1 per cent per annum, compounded annually. A similar accrual requirement under the existing tax law also applies to individuals. It means that, for example, if the annual return is wholly paid out during the income year, an individual does not have to apply accruals treatment to a loan.

The expression 'effective discount or premium' will cover deferred interest and similar situations (for example, where the capital is indexed to inflation). Subject to the 1 per cent and one year thresholds, the accruals rule will cover synthetic debt arrangements (see Recommendation 9.9).

Recommendation
4.5 Determining tax values for small business

That eligible taxpayers operating small businesses who elect to use the simplified tax system in accordance with Recommendation 17.1 be required to determine tax values for those assets and liabilities as specified in Recommendation 17.2.

Simplified tax system for small business

The Review is recommending a simplified optional treatment for taxpayers operating small businesses. The simplified tax system will involve the exclusion of certain assets and liabilities from year-end tax valuation (see Recommendation 17.1).

Recommendation
4.6 Prepayments

Repeal of 13-month rule

(a) That the existing provision allowing immediate deduction for advance expenditure relating to the provision of services within 13 months be removed from 1 July 2000.

Apportionment principle

(b) That, for taxpayers on both sides of the transaction, advance expenditure incurred ('prepayments') be allocated over the income years to which the expenditure relates.

New 12-month rule for taxpayers accounting on cash bases

(c) That most prepayments of no more than 12 months be brought to account in the year of payment or receipt for taxpayers calculating taxable income using:

(i) a cash basis treatment (Recommendation 4.4), or

(ii) the simplified tax system (Recommendation 17.2).

Transitional arrangements

(d) That, because of the changes to existing treatment, taxpayers be allowed to bring the initial tax value of prepayments (currently deducted as in paragraph (a)) to account evenly over five years — except those prepayments relating to projects or arrangements referred to at Recommendations 4.4(ii) and 17.2.

(e) That, to prevent exploitation of the transitional arrangement in paragraph (d), the initial tax value of prepayments to be brought to account over five years be limited to the lesser of:

(i) the prepayments incurred in the 2000-01 year; or

(ii) 110 per cent of the amount of prepayments incurred in the 1999-2000 year.

Under the existing law an immediate deduction is allowed for advance expenditure incurred ('prepayments') relating to the provision of services to be rendered within 13 months. This 13 month rule for prepayments allows an inappropriate bringing forward of annual deductions and is inconsistent with the accounting practice of bringing prepayments to account as assets at year-end. Because of its tax deferral advantages, the rule has been used by some taxpayers as a key feature of a number of schemes and arrangements to avoid tax.

The current treatment of allowing immediate deductibility for prepayments provides inconsistent treatment between payers and payees. As a general rule, a prepayment is not included in the income of the taxpayer in receipt of the payment until the services to which the payment relates have been provided. In other words, income is not derived until it has been earned.

The Review's recommendation will ensure consistent treatment for both the payments and receipts. Consistent with accounting, the tax value of

prepayments at the end of the year will be brought to account as an asset in the calculation of taxable income. The tax value of the services to be provided after the end of the year will be brought to account as a liability by the taxpayer receiving the prepayment.

In the case of individuals, and small business taxpayers who elect for the simplified tax system treatment, most prepaid expenses will only be treated as an asset at year-end if the prepayment relates to the provision of services or products over more than 12 months or extends beyond the end of the next year of income (see Recommendations 4.4 and 17.2). The existing 13 month rule is not appropriate because it allows the potential for immediate deductibility for expenses relating to services to be provided in three income years.

Transitional arrangements

Because of the potentially significant first year revenue impact on some taxpayers in having to account for prepayments as an asset, the Review is recommending a five year transitional rule in most cases. This means that taxpayers will be allowed to bring the tax value of the asset at 30 June 2001 evenly to account over five years.

The Review believes, however, that the five year transitional rule is not warranted for prepayments in respect of the tax shelter type projects or arrangements discussed at Recommendation 4.4.

Because of the recommended five year transitional measure combined with the reduction in the entity rate of taxation to 30 per cent in the 2001-02 year, some taxpayers might seek to exploit the transitional measure by inflating the amount of prepayments in the 2000-01 year. To prevent such exploitation and its resulting impact on revenue, the Review believes a further transitional measure is warranted.

The recommended measure will restrict the tax value of prepayments qualifying to be spread over five years to no more than an increase of 10 per cent over the amount of the deductions allowed for prepayments in the 1999-2000 income year.

Recommendation
4.7 Tax values of trade debtors and creditors

That, provided the terms of payment are within six months, the tax value of trade debtors and creditors be the nominal value of the amount to be received or paid.

Taxpayers will be required to account for the tax value of debtors and creditors at year-end unless they are calculating taxable income using a cash basis treatment (Recommendation 4.4) or the simplified tax system (Recommendation 17.2). Terms of payment are generally within six months and hence the recommendation will ensure that the current treatment for bringing debts to account will continue in most cases.

Recommendation 4.8 Certain assets now to be valued at year-end

Valuation of specific assets

(a) That taxpayers be required to bring to account the year-end tax value of the following classes of assets:

(i) non-billable deliveries of products that are capable of reasonable estimation; and

(ii) consumable stores and spare parts whose aggregate tax value at year-end exceeds $25,000 and whose cost has not already been absorbed into the tax value of other assets.

Transitional arrangements for specific assets

(b) That, because of the change to existing treatment, taxpayers be allowed to bring the initial tax value of the assets in paragraph (a) to account evenly over five years.

Assets to be brought to account for the first time

The Review has identified some assets with trading stock characteristics that taxpayers currently do not have to bring to account at year-end even though expenditure in respect of the asset is deductible when incurred. Those assets can represent a significant part of the income base of some taxpayers so their current treatment is particularly distortionary.

Non-billable deliveries of products capable of reasonable estimation

Generally, providers of products such as gas and electricity are not entitled to bill customers until they have established the actual value of the product provided — that is, until they have read customers' meters. Under the existing law, the value of such assets (unbilled products) is not taxable until the asset matures into a recoverable debt. The value of such products, as well as the cost of providing them, is capable of being accurately estimated. Accounting principles also require that the non-billable portion of delivered products to be

brought to account. In this case, the tax treatment should be consistent with the accounting treatment.

Consumable stores and spare parts

As noted under Recommendation 4.3, stores of consumables and spare parts are not generally treated as trading stock under the existing law and so do not have to be brought to account at year-end. Accounting requires year-end stores of such assets to be brought to account where amounts are material.

The Review is recommending that taxpayers will not have to account for the year-end stocks of consumable stores and spare parts where the aggregate tax value does not exceed $25,000 (Recommendation 4.3). Taxpayers will have to account for those assets where their aggregate tax value exceeds that limit, unless the cost of the items has already been absorbed into the tax value of other assets, such as trading stock.

Transitional arrangements

Consistent with Recommendation 4.6(d) relating to prepayments, because of the potentially significant first year revenue impact on some taxpayers in having to account for the abovementioned assets, the Review recommends a five year transitional rule. This means that taxpayers will be allowed to bring the tax value of those assets at 30 June 2001 evenly to account over five years.

Recommendation 4.9 Assets and liabilities changing their character

Assets or liabilities commencing or ceasing to be private assets or liabilities

(a) That where a taxpayer continues to hold an asset or owe a liability after it becomes, or ceases to be, a private asset or liability, that asset or liability be brought into, or taken out of, the tax base at a tax value determined by its market value at the time.

Assets commencing or ceasing to be listed assets for capital gains and loss-quarantining treatment

(b) That a gain or loss on the disposal of an asset, which commences or ceases to be a listed asset for capital gains and loss-quarantining treatment (Recommendation 4.10), be apportioned between the period before and after the change on the basis of a tax value determined by the market value of the asset at the time of the change.

Assets and liabilities commencing or ceasing to be private assets

Private assets held or liabilities owed by individuals will be excluded from the tax base so that any gain or loss on their disposal will not be taxed (Recommendation 4.13).

Where a private asset held, or a private liability owed, by a taxpayer becomes a non-private asset or liability, there is a need to decide the tax value of the asset or liability at the time of the change. For example, if the tax value of an asset was its original cost, the resulting gain or loss on the eventual realisation of the asset would include any accrued gain or loss during the period the asset was held as a private asset. This is an inappropriate outcome.

Where a non-private asset changes to a private asset and therefore leaves the tax base, there is a corresponding need to ensure that any gain or loss on the asset to that time is brought to account.

To ensure the appropriate outcome in both situations, such assets and liabilities will be treated as entering or leaving the tax base at a tax value determined by their market value at the time of the change. This will provide a means of crystallising any gain or loss attributable to the private or non-private periods.

Assets commencing or ceasing to be listed assets for capital gains and loss-quarantining treatment

In some situations, non-private assets can commence or cease to be listed assets for capital gains and loss-quarantining purposes while continuing to be held by the same taxpayer. For example, where held by an individual or superannuation fund, land will be a capital gains asset unless it is trading stock (Recommendation 4.10).

Situations could arise where land is initially acquired for investment or other business purposes but converts to trading stock. For example, a taxpayer might acquire rural land for market-gardening purposes. As a result of urban growth, the taxpayer decides some years later that it would be more economic to put the land to residential use. Rather than simply selling the land for the best price, the taxpayer decides to develop the land into residential allotments and market the individual allotments. In that instance, the land is likely to become trading stock at the time of the decision to proceed with the development.

Correspondingly, land could be initially acquired as trading stock and subsequently converted into long-term investment. For example, a taxpayer could acquire land for the development of apartment buildings for re-sale. At that point, the land would be trading stock. Upon completion, the taxpayer

decides to keep some or all of the apartments for long-term investment. At that time, the asset would no longer be trading stock.

Given the different treatment to be applied to listed capital gains assets compared with other assets — particularly where held by individuals and superannuation funds — capital gains and loss-quarantining treatment ought to apply to so much of the gain or loss in the above situations that is referable to the period that the assets are held as listed capital gains assets. In the case of entities, a change in character of an asset will only have an impact for loss quarantining purposes.

The correct outcome can be achieved by requiring taxpayers to value the asset at the time of change in its character, so identifying the unrealised gain or loss at the time (to be brought to account at the time of ultimate disposal). In the case where an asset converts from a long-term investment asset to trading stock, for example, the asset will be treated as having a tax value equal to that market value for the purposes of determining the capital gain or loss referable to the period that the asset was held as a listed asset.

Current treatment

The recommended treatment differs from that under the current law. A taxpayer holding an asset that changes its character to trading stock is treated as disposing of the asset and immediately re-acquiring it either for its cost or market value, at the taxpayer's option. The current approach has two major disadvantages:

- it taxes unrealised gains if the taxpayer selects market value and that exceeds the asset's tax value at the time; and
- it can allow capital losses to be converted into revenue losses if the market value of the asset is less than its cost and the taxpayer elects to value the asset at cost.

A taxpayer holding trading stock that changes its character to non-trading stock is treated as disposing of the asset and immediately re-acquiring it at its cost. That approach has the disadvantage of converting unrealised revenue gains and losses into capital gains and losses unless the taxpayer has valued the trading stock at other than cost.

Assets receiving capital gains and loss-quarantining treatment

Recommendation

4.10 Assets receiving capital gains and loss-quarantining treatment

General principles

(a) That capital gains and loss-quarantining treatment apply only to nominated classes of assets taxed on a realisation basis.

Nominated asset classes eligible for capital gains treatment

(b) That the following asset classes receive capital gains treatment (Recommendations 18.2 and 18.3):

(i) shares and other membership interests — excluding ordinary partnerships — other than where held before 1 July 2000 as trading stock or a revenue asset;

(ii) land and buildings — other than where:

- **held as trading stock, or**
- **the building is subject to the new depreciation regime (Recommendations 8.12 and 8.13), in which case only the land will qualify;**

(iii) goodwill;

(iv) statutory licences, long-term crown leases on land and other rights which represent a permanent disposal of an underlying asset that would be taxed on a realisation basis;

(v) collectables and other non-depreciable tangible assets (other than land):

- **acquired for more than $10,000, and**
- **held at least partly for private use; and**

(vi) any other assets prescribed in the Income Tax Regulations.

Assets subject to loss-quarantining treatment

(c) That, subject to paragraph (d) and Recommendation 4.11,

- **losses on the assets listed in paragraph (b), and**

- **capital losses on assets acquired before 1 July 2000,**

be offset against gains on assets listed in paragraph (b).

(d) That losses on collectables and other non-depreciable tangible assets (other than land), held at least partly for private use, be offset only against gains on like assets.

Simplicity in the law will be served by the use of a common basis for defining assets which will receive capital gains treatment and for which losses will be quarantined. For those taxpayers receiving this treatment of gains (Recommendations 18.2 and 18.3), a common asset pool provides a balance against the ability to defer taxation through selective realisation of losses.

Significant reform to the existing quarantining provisions is limited by revenue considerations. The revenue consequences of abolishing quarantining of all capital losses would be prohibitive, due to both the accumulated value of existing capital losses and the ongoing incentive to realise assets selectively.

Assets where a change in value is taxed on a realisation basis would account for the majority of assets held by individuals and a significant proportion of assets held by superannuation funds. Defining access to capital gains treatment and quarantining of capital losses in terms of the assets described in the recommendation aligns, broadly, with the 'capital' asset distinction in the existing law. Nevertheless, there would be some notable differences. In particular, losses on shares and land would be quarantined in a wider range of circumstances due to the removal of the existing distinction between 'revenue' and 'capital' assets.

Given the broad correspondence with existing capital gains assets, the listed asset classes should also define the pool of capital gains against which existing capital losses and future losses on existing assets can be applied — subject to private asset losses being restricted to gains on like assets (paragraph (d)) and the transitional measure in Recommendation 4.11.

Trading stock

Trading stock will continue to be excluded from capital gains treatment on the basis that such treatment would be counter to the objectives of encouraging investment in longer term capital assets and be inconsistent with the existing concept of taxing income from trading activities. The inclusion of trading stock assets in loss quarantining would undermine the integrity of capital loss quarantining.

Shares

In the case of shares and other membership interests, there is little conceptual or practical basis upon which to distinguish assets held for trading or

investment purposes. Such assets are not included in the definition of trading stock, which is restricted to tangible assets (Recommendation 4.16).

One approach considered by the Review was to have an arbitrary time-based distinction between trading assets and investment assets. Allowing taxpayers the opportunity to realise losses on shares held for up to 12 months (after which time gains by certain taxpayers are subject to capital gains treatment) and not quarantining those losses would be likely to impose a significant cost to revenue. Even allowing a shorter period for loss quarantining purposes would provide adverse selection opportunities resulting in too great a revenue cost.

Rights

As a general rule, rights will be excluded from capital gains treatment, unless the granting of a right results in the permanent disposal of an underlying asset, or part of an underlying asset, that is eligible for such treatment. Capital gains treatment of rights would only apply where there is a permanent disposal of the underlying asset that is subject to the right.

Most depreciable assets would not qualify for capital gains treatment due to the annual deduction for their change in tax value. However, in the case of buildings not depreciable under the general depreciation regime for depreciable assets (Recommendations 8.12 and 8.13), both the building and the land would be classified as realisation assets and, hence, would continue to be subject to capital gains treatment and quarantining of losses.

Recommendation

4.11 Quarantining of losses on existing CGT assets

Quarantining principle for existing CGT assets

(a) That where a taxpayer on 30 June 2000 holds shares taxed as 'revenue' assets or trading stock under the existing law, losses on capital gains tax assets acquired before 1 July 2000 not be applied against:

(i) gains on such shares acquired before 1 July 2000; and

(ii) gains on shares acquired on or after 1 July 2000.

Transitional provision for unusable losses

(b) That if a taxpayer has not been able to absorb losses on capital gains tax assets affected by paragraph (a) by 30 June 2005, up to 20 per cent of those losses be allowed to be offset against gains on shares in any one year.

At present some taxpayers have realised capital losses which have not been absorbed. Where those taxpayers also have revenue assets such as shares, those capital losses cannot be applied against gains on the revenue assets. The proposed removal of the 'revenue' asset/'capital' asset distinction would allow those capital losses to be applied against gains on revenue assets. Any currently unrealised capital losses could also be applied when realised against revenue gains.

While the short term revenue impact of allowing the application of capital losses against revenue asset gains is difficult to measure precisely, it could be significant. The two main types of assets that are of relevance in this regard are shares and real estate. Of these, the principal source of potential revenue loss is likely to be from shares. The Review is therefore recommending that capital losses on assets acquired before 1 July 2000 will not be able to be offset against gains from existing shares held as revenue assets or trading stock and shares acquired on or after 1 July 2000. This recommendation will only apply to those taxpayers which have shares taxed as revenue assets or trading stock under the existing law.

If capital losses are prevented from being absorbed solely because of this recommendation, up to 20 per cent of those losses will be able to be utilised against gains on shares in any one year commencing from the 2005-06 year. For example, this transitional provision would apply if a taxpayer did not have capital gains assets other than shares.

Relatively few taxpayers are expected to be affected by this recommendation. The main impact would be on a few large companies. Further, the restrictions imposed under this measure are not likely to have a significant adverse impact on taxpayers relative to their treatment under the existing law.

Clarifying the treatment of private receipts, expenditures and assets

Recommendation 4.12 Private receipts and expenditures

General principle

(a) That the application of the concept of private receipts and expenditures be restricted to individuals on the proviso that benefits provided by entities to members and employees are either:

(i) generally included in the taxable income of individual recipients as distributions (Recommendation 12.1); or

(ii) generally subject to fringe benefits tax (or also treated as the recipient's income if Recommendation 5.1 is adopted).

Specific exceptions

(b) That specific exceptions apply in respect of:

(i) shareholder discounts (Recommendation 12.2); and

(ii) distributions related to personal assets held in entities (Recommendations 12.25 and 12.26).

An important design issue for business taxation is the business/private dividing line defined by the treatment of private receipts, expenses and assets. This dividing line was given only preliminary attention in *A Platform for Consultation*.

Private receipts and expenditures in concept apply to individuals only and not entities. Restricting private receipts and expenditures to individuals will mean that all expenditure undertaken by entities will reduce taxable income either immediately or in future years unless precluded by a specific adjustment in the tax law.

In order to achieve the correct treatment of expenditure by entities, benefits provided by entities to employees or members should be taxed as income received at fair market value. Hence, the broad definition of a distribution from an entity contained in Recommendation 12.1 and maintenance of comprehensive fringe benefits taxation — or its replacement as recommended by the Review (see Recommendation 5.1) — are crucial to the proposed restriction of private expenditures to individuals.

Under the cashflow/tax value approach, the resulting treatment of expenditure broadens the scope of expenses that could reduce taxable income. Specifically, it is intended to allow a wide range of blackhole expenses to be deductible as a matter of principle. However, individuals' expenditure which is essentially of a private nature will continue to be non-deductible. To avoid any doubt, the new law will ensure that particular expenses (such as normal travel to and from work and certain self education expenses) will continue to be treated as private expenditure.

There will be some inconsistencies in the treatment of benefits received by employees and members of entities. For example, largely for compliance cost reasons, benefits received in the form of employer provided car parking (Recommendation 5.3) and the use of a residence held by an entity (where the related expenses are not deducted — Recommendations 12.25 and 12.26) will not be taxed in the individual's hands.

Recommendation

4.13 Private use of assets

General principle

(a) That taxable income not recognise:

(i) the non-monetary income and any private receipts which reflect the private use of an asset; and

(ii) the corresponding proportion of expenses incurred in relation to the private use of the asset.

Depreciable assets

(b) That expenses (including depreciation and interest) incurred in respect of depreciable assets (other than collectables) be apportioned on the basis of private and non-private usage in the year incurred — with that part relating to private use not taken into account in calculating taxable income.

(c) That the balancing charge on disposal of a depreciable asset be apportioned on the basis of overall use of the asset — with that part relating to private use not taken into account in calculating taxable income.

Land and buildings (other than a taxpayer's main residence) held by an individual

(d) That, in respect of land and buildings, other than a taxpayer's main residence, held by an individual and acquired after 30 June 2000, the following treatment apply:

(i) include expenditure directly attributable to the land in the tax value of the land to the extent that the land is not used for income-producing purposes (other than the realisation of a capital gain);

(ii) apply the depreciable assets treatment in paragraphs (b) and (c) to any structures on the land; and

(iii) apportion interest expenses between the land and structures in accordance with the acquisition values of the land and structures.

(e) That, in respect of land and buildings held by an individual at 30 June 2000, the existing tax treatment continue to apply.

Collectables and other non-depreciable tangible assets (other than land) held by an individual at least partly for private use

(f) That, in respect of any collectable and other non-depreciable tangible asset (other than land) held by an individual, and including any such asset acquired before 1 July 2000, the following treatment apply:

- **(i) include in the calculation of taxable income, expenditure incurred in a year up to the extent of any income — excluding a gain on disposal of the asset — derived in that year from the asset;**
- **(ii) exclude from taxable income any gain or loss if the asset was acquired for $10,000 or less; and**
- **(iii) quarantine losses on any asset acquired for more than $10,000 to gains on like assets (Recommendation 4.10(d)).**

Taxation of assets used partly for private purposes

Assets can generate three types of income — capital gains, current income and non-monetary income, the latter component reflecting the market value of benefits derived from the private use of an asset. Both the current income and capital gains represent part of the monetary income of the asset. There is a compelling case — based on revenue and compliance grounds — for excluding from the tax base the non-monetary income (and any private receipts) that reflects the private use of an asset and the corresponding proportion of expenses incurred in relation to that use.

Difficulties in determining the annual value of the capital gain and non-monetary components of income for many assets preclude a single practical rule for apportioning expenses between the private and non-private use of an asset. Hence, different approaches are required to apportion expenses associated with different types of assets where they are held at least partly for private use.

Assets held for private purposes are taxed in a variety of ways under the present law, in terms of the treatment of both expenses and capital gains and losses. Assets held primarily for private purposes are taxed under different provisions from those held only partly for private purposes. The approach recommended by the Review will achieve a more consistent treatment of assets used for private purposes while replicating the existing treatment to a substantial extent.

Current treatment of assets used privately

Assets, other than a taxpayer's main residence, that are used for private purposes receive one of three separate tax treatments under the current law.

- Personal use assets — items other than land and buildings or collectables held *primarily* for the private use and enjoyment of the taxpayer — are subject to capital gains tax if their purchase value exceeds $10,000. There is no allowance for capital losses or expenses.
- Collectables — items such as artworks, antiques and collections — are subject to capital gains tax if their purchase value exceeds $500. Capital losses on collectables are quarantined to capital gains on collectables and there is no allowance for expenses related to those assets.
- Other assets held for private use, such as land and buildings, and other assets not held *primarily* for private use, are subject to capital gains tax and losses are treated as ordinary capital losses. If those assets were acquired after 20 August 1991, recurrent costs (including interest expenses) are capitalised into the cost base of the asset — or deducted as incurred against any recurrent income generated by the asset. Such costs cannot give rise to a capital loss.

A capital gain or loss in respect of an individual's main residence is generally ignored for tax purposes under the current law.

Proposed treatment of assets used privately

Under the proposed approach, the concept of a 'personal use asset' and the discontinuities between the treatment of assets used partly or primarily for private purposes will be removed. Broadly, an asset other than land will be a private asset if the asset is held and used by an individual solely for private or domestic purposes and, except if the asset is a depreciable asset that is not also a collectable, its cost is not more than $10,000.

Depreciable assets

Depreciable assets will be treated in a manner similar to the present treatment. Expenses and that part of the balancing adjustment relating to the private use of the asset will be excluded from the calculation of taxable income. The exclusion of expenses and any loss in value associated with the private use of a depreciable asset reflects the fact that the benefit derived from those costs is not taxed.

Land and buildings

For land and buildings acquired after 30 June 2000, the recommended approach requires for tax purposes the separation of the land from any

structures. The required information will be available for structures commenced to be constructed after 30 June 2000, as a consequence of the proposed separation of land and buildings for the purposes of a sounder treatment of building depreciation (Recommendation 8.12).

The treatment for land will be similar to that which currently applies, with directly attributable expenditures (including interest and rates) being added to the tax value of the asset to the extent that the land is not used for income producing purposes (other than a capital gain on realisation). One difference will be that expenses included in the tax value of land could give rise to a loss on disposal, whereas at present such costs can be used only to offset a gain.

Expenses associated with structures attached to the land will be apportioned on the basis of the private and non-private usage of those assets, as for other depreciable assets used partially for private purposes. This differs from the present treatment where all non-capital costs of ownership for land and buildings are included in the cost base of the combined asset. Costs attributable to the building will not be capitalised except for the capital costs of acquisition and improvement. This approach is consistent with the treatment for other depreciable assets. The changed approach will apply only to buildings acquired or constructed after 30 June 2000.

As an example, in the case of a residential property used one-third of the time for private purposes and two-thirds of the time for income producing purposes:

- two-thirds of the annual expenses attributable to the land (such as interest and rates) will be deducted in calculating taxable income in each year and one-third will be added to the tax value of the land; and
- two-thirds of the annual expenses associated with the building and use of the land (such as maintenance, variable costs and overheads) will be deducted with the remaining one-third not taken into account in calculating taxable income or the tax value of the building or land.

Collectables and other assets held at least partly for private use

Recommendation 4.13(f) will result in one regime for collectables and other non-depreciable assets held for private use. There will be only one threshold acquisition amount for capital gains treatment.

Collectables and other non-depreciable assets on hand on 1 July 2000 will be covered by the new regime. Therefore, existing collectables acquired for more than $500 but no more than $10,000 will no longer be subject to capital gains treatment when realised.

The treatment for collectables held by an individual (other than as trading stock) and other non-depreciable tangible assets held by an individual (other than land) will be different from the present treatment in several respects. For

collectables, the main difference is that the threshold acquisition value for capital gains taxation will be increased from $500 under the present law to $10,000. For other non-depreciable assets (apart from land), the main difference lies in having a single treatment for assets used at least partly for private purposes, rather than a separate treatment for assets used partly for private purposes and those used primarily for private purposes.

Limiting deductibility of annual expenses to the extent of recurrent income earned from the asset in the same year, though somewhat arbitrary, provides an objective test upon which to base the apportionment of expenses.

Recognising that losses on collectables and other non-depreciable assets held by individuals partly for private use could reflect, in part, the private use of the asset, losses on those assets will be quarantined to gains on like assets. Collectables held by an individual as trading stock will be excluded from this treatment.

Providing deductibility for blackhole expenditures

Recommendation

4.14 Deductibility provided for blackhole expenditures

General principle

(a) That blackhole expenditures under the current law be either expensed, amortised or capitalised where incurred after 30 June 2000.

(b) That, consistent with this principle, write-off be provided for assets such as lease premiums, franchise fees and the cost of acquiring indefeasible rights of use (see Section 10).

Statutory deeming of economic life

(c) That expenditure giving rise to assets of indeterminate, but finite, lives:

- **(i) be accorded statutory write-off over a period to be determined on a case-by-case basis; and**
- **(ii) be prescribed in the Income Tax Regulations as eligible for that statutory write-off.**

(d) That the costs of establishing an entity and all forms of capital raising expenses be prescribed according to paragraph (c) with a

5-year write-off period and a maximum 5-year write-off period, respectively.

A range of expenditures (blackhole expenditures) is treated inappropriately under current tax law in that the expenditures are either not deductible or not deductible in a manner consistent with their economic characteristics (see *A Platform for Consultation* at pages 100-102).

Under the cashflow/tax value approach to determining taxable income, blackhole expenditures will be treated in a manner consistent with their economic characteristics. Specifically, such expenditure will be either expensed, amortised or capitalised.

- If the expenditure does not form part of the tax value of an asset or does not reduce a liability, it will, in effect, be immediately deductible.
- Some blackhole expenditures will have the effect of improving a non-depreciable asset, in which case the expenditure will be added to the tax value of the asset. The tax effect would be to reduce the taxable gain (or increase the allowable loss) when the asset is disposed of.
- If the expenditure is related to a depreciable asset, the existing blackhole expenditure will be written off by reference to the effective life of the asset. In other cases, while the asset arising from the expenditure is a wasting asset ultimately having no value, it may not be obviously related to other assets of the taxpayer that are recognised for tax purposes. Statutory write-off is relevant in these cases.

Different treatments of blackhole expenditures

Immediate deduction

A range of blackhole expenditures do not have an enduring value or the enduring value cannot be reasonably estimated. Under the cashflow/tax value approach, such expenditures will be immediately deductible. Whether an item of expenditure fits within this category would depend on the particular facts and circumstances.

The following are examples of blackhole expenditure that generally will be immediately deductible because they would not form part of the tax value of an asset:

- costs of defending title to an asset (including native title claims) where claims over the title are lodged while the person owns the property;
- costs of defending a takeover, whether successful or not;
- costs of winding-up or closing a business;
- expenditures that contribute to the creation of business goodwill, such as business relocation costs and market development costs unless the expenditures give rise to, or improve, a recognisable asset;

- costs of an unsuccessful takeover (deductible at the time of abandonment of the action) such as the costs of preparing takeover documents to obtain a strategic stake in a target company (but not the costs of shares acquired and associated expenses); and
- costs of demolishing an asset which has been held by the taxpayer for the purposes of producing income other than a capital gain on the associated property.

Not deductible until asset is disposed of

Some blackhole expenditure has the effect of improving a non-depreciable asset, in which case the expenditure will be added to the tax value of the asset. In such cases, the tax effect would be to reduce the taxable gain (or increase the allowable loss) when the asset is disposed of. Expenditures falling into this category include:

- costs of demolition that have the effect of improving the underlying property beyond its condition at the time it was acquired;
- costs of landscaping and other earthworks to be maintained on an indefinite basis;
- costs of successful feasibility studies relating to non-wasting assets;
- costs of successful takeovers; and
- costs of defending title to an asset (including native title) if the asset was acquired with the knowledge that the title, or other rights over the asset, were in dispute — otherwise this expenditure would be immediately deductible.

Amortisation

Expenditures that will attract write-off according to the effective life of the associated depreciable asset include:

- costs of successful feasibility and environmental impact studies relating to depreciable assets;
- costs of ornamental trees and shrubs; and
- contributions to local or regional infrastructure as a condition for constructing depreciable assets.

Other write-off arrangements

The write-off arrangements for a range of other expenditures that might be considered to be blackhole expenditures are covered in the proposed treatment of leases and rights. These expenditures include lease premiums, franchise fees and the cost of acquiring indefeasible rights of use.

Some expenditures give rise to an asset which will cease to have value at some time but whose life is indeterminate and do not obviously relate to other relevant assets of the taxpayer that are recognised for tax purposes. Examples of such assets include business start-up costs, such as:

- costs of establishing an entity, including company pre-incorporation expenses such as legal expenses and statutory charges; and
- costs of raising equity and borrowings for an indefinite period (for example, prospectus and underwriting costs).

Under the existing law, the costs of borrowing are eligible for write-off over the lesser of five years or the duration of the borrowing. In contrast, the costs of equity raising are blackhole expenditures, despite the similarities of a borrowing to an equity raising. For example, a business can choose to raise additional capital either through a perpetual floating rate note or new equity. There is thus a strong case for applying the same taxation treatment to all forms of capital raising expenses.

The existing law treatment of a maximum 5-year statutory write-off for the borrowing costs would be an appropriate basis to write off the costs of raising equity.

Pre-incorporation expenses have similar attributes to capital raisings as they can be necessary prerequisites for commencing a business. The Review considers that these expenses should be accorded a 5-year statutory write-off.

The Review may not have identified all expenditures for which the statutory write-off would be appropriate. The recommendation to include other expenditures (and their write-off period) under the Income Tax Regulations, as they are identified, will facilitate the future operation of the law.

Feasibility and similar studies

In some cases, it is not evident at the time of incurring expenditure whether or not it will produce either an asset, or an improvement to an asset — for example, a feasibility, environmental impact or market study. If the study is abandoned, there would be no asset and its cost will become deductible at that time. If the project proceeds, the expenditure will be included in the tax value of the assets associated with the project.

General deductibility of interest

Recommendation

4.15 General deductibility of interest

General provisions

(a) That interest expenditure be viewed as the cost of maintaining access to the capital funds underlying a business and hence be deductible in calculating taxable income in the year incurred except:

(i) when incurred as a private or domestic expense;

(ii) when incurred to earn exempt income — other than exempt foreign source income (see Recommendations 22.5 and 22.6);

(iii) when the interest is prepaid (see Recommendation 4.6); or

(iv) in respect of borrowings relating to land which is held by an individual but not used for income-producing purposes (other than the realisation of a capital gain) — see Recommendation 4.13(d).

Payment of tax liability

(b) That interest in respect of borrowings to fund the payment of tax liabilities not be treated as a private expense.

The treatment of interest expenses under the current law differs depending upon whether the expense is incurred:

- before an income earning activity;
- in connection with the earning of capital gains; or
- as part of the process of earning recurrent income.

In practice, these principles of deductibility are difficult to apply consistently due to the fungible nature of debt. This results in uncertainty and increased compliance costs, such as in seeking rulings to clarify the treatment of interest in relation to major investment projects.

The recommended treatment will significantly reduce the current uncertainty surrounding interest deductibility. It will also result in more equitable treatment for taxpayers.

As noted in *A Platform for Consultation* (page 44), interest should not be viewed simply as a cost of earning recurrent income. It is better viewed as the cost of maintaining access to the capital funds underlying a business. The financial

liability base of a business can be viewed similarly to, but separately from, the real asset base of a taxpayer. Given that interest expenditure does not directly change the value of the asset base of the taxpayer, it is appropriately deductible in the year incurred — other than to the extent to which the interest is prepaid thereby resulting in an asset on hand at the end of a year.

Interest in respect of borrowings by entities to finance distributions of equity and dividends, or to finance tax liabilities, will not be private expenditure (Recommendation 4.12) and will therefore reduce taxable income in the year incurred. This measure will remove the need to identify the purpose and use of any borrowings by an entity, other than in connection with the earning of exempt income. In practice, many business taxpayers are currently able to arrange their affairs to ensure immediate deductibility of interest on borrowings essentially used to pay tax.

General deductibility for interest will not extend to borrowings by individuals against assets where the purpose or use of those borrowings is to finance private expenditure. In other words, the existing purpose or use tests will continue to apply for individuals.

The current treatment of interest on borrowings in respect of land held by individuals for private use — capitalisation of interest expenses — is also to continue (Recommendation 4.13(d)).

In the international arena, conditional on the Review's thin capitalisation proposals in relation to Australian multinational investors (Recommendation 22.6), interest deductibility will no longer be denied for interest expenses incurred in earning foreign source income.

To maintain equity with the treatment for entities, it is appropriate that interest in respect of borrowings undertaken by individuals to meet their tax liabilities not be treated as a private expense. In practice, most individual taxpayers do not need to borrow to pay tax liabilities because tax is generally deducted at source.

Definition and valuation of trading stock

Recommendation
4.16 Definition of trading stock

That trading stock be defined as:

(i) any tangible asset (or an interest in a tangible asset as a joint owner) which:

- **is produced, manufactured or acquired, and**
- **is held for the purposes of manufacture, sale or exchange in the ordinary course of a business; or**

(ii) livestock.

The possibility of removing the current arbitrary and uncertain differentiation between trading stock, 'revenue' assets and 'capital' assets was canvassed in the Overview of *A Platform for Consultation* (page 42). Options for valuing trading stock were canvassed in Chapter 3 of *A Platform for Consultation*.

The cost of purchasing or manufacturing trading stock during a year reduces taxable income — and the tax value of any of this trading stock held at the end of the year adds to taxable income. This treatment of expenditure on trading stock is the same in practice as that proposed under the cashflow/tax value approach. As such, the retention of the existing concept of trading stock is not required simply for the purposes of applying that approach.

Where the concept of trading stock, nevertheless, remains relevant is in defining the manner in which assets that are held by a business for trading purposes should be taxed. In particular, consistent with the treatment under existing law, gains on disposal of trading stock assets should not be eligible for capital gains tax treatment while losses on such assets should not be subject to quarantining (see Recommendation 4.10). Capital gains tax treatment is aimed at encouraging investment while quarantining of losses is designed to limit the consequences of selective realisation of capital gains and losses. Neither of these aspects of the treatment of capital gains and losses is relevant to trading stock assets.

As against the definition of trading stock in the current law, the proposed definition:

- excludes intangible assets, such as shares and other financial assets; and
- includes interests in trading stock, such as those held by joint venturers and partners.

In the case of financial assets, it is both conceptually and practically difficult to distinguish between individual items on the basis of whether they are held for trading or investment purposes — hence, the recommended targeting of the trading stock definition to tangible assets. Financial services entities often account for their trading activities on a mark-to-market basis and their investment activities on an accruals or realisation basis. The proposed elective market value regime for tax purposes (Recommendation 9.1) will allow

financial services entities to achieve a match between tax and accounting treatment.

Interests in trading stock of members of unincorporated joint ventures and ordinary partnerships will also be treated as trading stock. Under Recommendation 16.16, a fractional interest approach to computing taxable income will apply to such structures unless the members elect to apply a joint approach. Under the fractional interest approach, members will account separately for their interests in trading stock.

Trading stock will also include land (including land held under a long term or perpetual lease granted by the Crown) currently defined as trading stock and livestock held for the purpose of primary production.

Recommendation

4.17 Tax values of trading stock assets

Tax valuation methods

(a) That, subject to paragraph (b), trading stock be valued at the lower of cost or net realisable value.

(b) That a taxpayer have the option to make a generally irrevocable election, at any time on or after 1 July 2000, to value classes of trading stock assets at market selling value.

Asset classes

(c) That a taxpayer be able to define for tax purposes classes of trading stock assets on the basis of type of asset but not:

(i) the purpose for which an asset is held;

(ii) time; or

(iii) characteristics that might change while an asset is held.

Variation of election

(d) That if a taxpayer can satisfy the Commissioner of Taxation that a material change in commercial circumstances justifies a variation of the market valuation method elected under paragraph (b), the taxpayer be able to vary the election.

Tax valuation methods

Taxpayers can currently elect to value each item of trading stock on one of several bases at the end of each year. The method of valuation can change

from year to year for an individual item of stock, subject to the requirement that the opening value for an item is equal to its previous closing value. As discussed in *A Platform for Consultation* (page 127), this degree of flexibility provides the scope for taxpayers to manipulate the valuation of trading stock for tax minimisation purposes. Nevertheless, some flexibility in the valuation of trading stock is warranted where such assets would typically be expected to decline in value due to obsolescence or deterioration or where the use of cost would impose undue compliance costs on the taxpayer.

For trading stock the default valuation option will be the lower of cost or net realisable value, the accounting method of valuing inventories. This will allow for reductions in the value of trading stock assets due to obsolescence or deterioration.

The concept of net realisable value is the same as for accounting (Accounting Standard AASB 1019 'Inventories'). Broadly, it means the estimated proceeds of sale net of all further costs of completion (where applicable) and costs of selling.

Apart from the default treatment, taxpayers will also continue to have the option of valuing trading stock at market selling value.

Asset classes

Elective valuation on the basis of asset class allows flexibility yet limits the potential cost to revenue associated with selective valuation of assets on a transaction-by-transaction basis or on an annual basis. To achieve this, once an asset class is defined and a method of valuation other than the lower of cost or net realisable value elected, all such trading stock assets in that class held by a taxpayer will be required to be valued using the elected market valuation.

Taxpayers will be able to specify their own asset classes, subject to some restrictions. This approach will provide flexibility to taxpayers and avoid obvious difficulties associated with attempting to define classes of assets in legislation. An asset class will need to be defined on the basis of readily identifiable characteristics of the included assets.

It is anticipated that taxpayers will specify trading stock classes on the basis of assets with similar characteristics, such as shelf-life characteristics; similar market characteristics (for example, price volatility or prices subject to seasonal influence or fashion); or similar production characteristics. The purpose for which an asset is held will not be a suitable basis for specifying an asset class, since it would allow, in effect, the basis of valuation to be determined at the time of lodging a tax return rather than at the time of acquisition of an asset.

Characteristics that are time dependent will not be suitable as a basis for identifying asset classes. For example, identifying asset classes on the basis of the date of acquisition would allow the basis of valuation to be changed on an

annual basis in the case of frequently traded assets, such as occurs under the existing trading stock valuation rules. Similarly, it would not be appropriate to allow asset classes to be defined in respect of characteristics that could change during the period that the asset is held, as this would allow the basis of valuation of an individual asset to change.

Election

Making the election generally irrevocable reinforces the integrity of its use. Taxpayers will be inclined to make an election where there are clear ongoing benefits from doing so. Nevertheless, there is merit in providing some scope to vary an election for a class of assets where a taxpayer can satisfy the Commissioner of Taxation that a material change in commercial circumstances warrants a variation of an election.

Definition of 'cost' for tax value purposes

Recommendation

4.18 A single meaning of 'cost'

That, in determining the tax value of assets, 'cost' be defined to have a consistent meaning including all expenditure incurred in bringing an asset to its present condition and location — such as:

(i) the acquisition price of an asset in an arm's-length transaction;

(ii) incidental expenditure incurred to acquire the asset;

(iii) expenditure incurred in making an asset ready for use or sale;

(iv) expenditure incurred in the creation of a new asset; and

(v) expenditure incurred in improving an existing asset.

The meaning of cost is an important element of the current law — for example, to determine the cost for taxation purposes of depreciable plant and trading stock. Its meaning will be critical under the cashflow/tax value approach, as cost will be the basis from which the tax value of most assets will be determined.

Current meaning of cost

Except for capital gains tax (CGT) purposes, the current law is generally silent about the meaning of cost. However, its meaning is generally well understood and broadly consistent with accounting practice. The courts have clarified its meaning over time and have often adopted the accounting concept for determining the meaning of cost for taxation purposes. As well, the Australian Taxation Office (ATO) has issued guidelines and rulings on its application.

Under the present law, the cost base of an asset differs depending on the way in which the asset is characterised.

- The cost of a purchased asset includes not only its acquisition price but also all expenditures associated with its acquisition and making the asset ready for use — for example, stamp duties, commissions and costs of delivery and installation.
- The cost of manufactured assets, such as trading stock, includes materials, direct labour and an appropriate share of attributable indirect costs, such as factory overheads. That method of determining the cost of manufactured assets is known as (full) absorption costing.
- The cost of an asset also includes expenditure incurred in making improvements to the asset. For example, the cost of a depreciable asset would include the cost of extending its life or making it more efficient.
- The meaning of cost for CGT purposes is broadly consistent with the general understanding of the meaning of cost. Additionally, the cost base includes expenditure associated with establishing, preserving or defending the taxpayer's title to, or right over, the asset and, in the case of some personal use assets, costs that would ordinarily be deductible — such as interest and repairs.

Absorption cost

Consistency and simplicity argue for having a single method of determining the cost of an asset. The absorption cost principle used in accounting standards as the basis for valuing inventories includes in the cost of the asset all direct and indirect expenditures attributable to bringing an asset to its present state and location. Hence, it represents an appropriate basis upon which to frame a single approach to determining the cost of an asset.

A key issue in defining a general meaning of cost using the absorption principle is determining the point at which costs cease to be absorbed into the cost of the asset. Accounting Standard AASB 1019 includes all costs incurred in bringing the asset to its present location and condition. From the limited case law available on this issue, the application of the absorption principle for taxation purposes appears to parallel closely that applied for accounting purposes. The implication of the accounting approach is that all costs incurred

in bringing an asset to its 'final point of sale' would be absorbed into the cost of the asset.

Improvements to an asset

Another important aspect of determining cost for an asset is the delineation between expenditures that simply maintain the value of the asset and those that add to the value of the asset. In principle, expenditure that improves an asset — for example, by extending its effective life beyond that assessed at the time it was acquired — should be added to the tax value of that asset. However, in practice, it is not always easy to delineate the extent to which expenditure on an asset represents repairs and maintenance, an improvement to an existing asset or a new asset.

Existing case law provides guidance on when expenditure represents repairs or maintenance rather than an improvement. The existing treatment does not attempt to apportion expenditure between that which might represent maintenance and that which might represent an improvement. Under the proposed treatment of expenditure and assets, determining whether expenditure represents maintenance or an improvement will remain necessary.

Expenditures not part of cost of an asset

Expenditures that do not directly or indirectly contribute to the acquisition, creation or improvement of an asset will not be included in the tax value of the asset. For example, the following expenditures will not be included as part of the tax value of an asset on the basis that they are not reflected in a change in the value of the asset to the taxpayer:

- interest on money borrowed to finance the asset or the taxpayer's activities more generally (other than for land that is used privately);
- costs of maintaining, repairing or insuring the asset;
- rates and taxes levied in respect of the asset; and
- selling costs.

Recommendation

4.19 Assigning cost to individual assets

General provisions for identifying cost

(a) That where a taxpayer is using cost for determining tax value and can identify an individual asset, the taxpayer may use:

(i) actual cost; or

(ii) as a basis of determining the cost of homogeneous assets —

- **either the first-in-first-out (FIFO) method, or**
- **the weighted average method.**

Unidentifiable assets not subject to capital gains treatment

(b) That where a taxpayer cannot identify individual assets and the assets are not subject to capital gains treatment, the taxpayer determine cost by applying consistently:

(i) either the FIFO method; or

(ii) the weighted average method.

Assets subject to capital gains treatment

(c) That where an asset is subject to capital gains treatment (see Recommendations 4.10), the weighted average method of determining cost be applied only to purchases on the same day.

Different methods of determining the cost of an asset are currently allowable for both accounting and tax purposes. Identifying precisely the cost of each asset on hand at year-end can be extremely difficult, if not impossible, to do where the taxpayer holds a number of indistinguishable assets acquired at different costs. ATO administrative practice has been to allow taxpayers to assign costs under either the FIFO or the weighted average cost method — although the weighted average method has limited application for capital gains tax (CGT) purposes.

- The FIFO approach assumes that the oldest items are disposed of first. It is a reasonable assumption about the pattern of disposal of many indistinguishable assets subject to deterioration or obsolescence.
- Weighted average cost allows the cost of items on hand at the beginning of the year to be averaged with the cost of items acquired during the year.
- For CGT purposes, taxpayers need to know the actual date of acquisition so weighted average is acceptable only to the extent that it is used to derive an average cost of homogeneous assets acquired on a particular date for different prices.

The use of different methods for determining cost is generally applicable to trading stock assets and other assets where a gain is taxed on realisation. For the purposes of determining the cost of assets under the cashflow/tax value approach, taxpayers will have the option of identifying assets separately, even though they may be identical, if there is a reasonable basis upon which to do so. For example, taxpayers could nominate the specific shares being disposed of where they have a reasonable means of identifying individual purchases of shares. Nevertheless, some taxpayers might choose to utilise the FIFO or weighted average methods for homogeneous assets as a means of reducing

record keeping requirements — such as in the case of trading stock assets. Both the FIFO and weighted average methods are acceptable alternatives in valuing homogeneous inventories for accounting purposes. To prevent possible manipulation of taxable income, taxpayers will be required to use either method consistently for each type of homogeneous asset. For example, a consistent method must be used for shares in a particular company.

For the purpose of capital gains treatment, it will remain necessary to identify the date of acquisition of an asset, due to the 12 month holding rule (Recommendations 18.2 and 18.3). Accordingly, only the FIFO method of identifying homogeneous assets will normally be acceptable as an alternative to individual identification where those assets are subject to capital gains treatment. As an exception, the weighted average method will be allowable in determining the average cost of homogeneous assets acquired on a particular date for different prices in those circumstances where it is not possible to apply the FIFO rule to those acquisitions.

Recommendation
4.20 Existing livestock valuation option retained

That the current option for primary producers to value natural increase in livestock at statutory rates in lieu of actual cost be retained.

Livestock producers currently have the option of valuing natural increase at statutory rates in lieu of actual cost — for example, natural increases in cattle can be valued at $20 per head. That option will be retained.

More certain recognition of provisions

Recommendation
4.21 Tax recognition principle for provisions

That

- **where a liability has been incurred, and**
- **a reasonable estimate can be made of the amount,**

provisions be recognised for taxation purposes for the following items:

(i) employee entitlements, such as long service leave;

(ii) retirement of non-executive directors;

(iii) product liability;

(iv) warranties; and

(v) taxes other than income tax.

Provisions are a technique used in accounting to deal with uncertainty about the value now of future expected cash transactions. The recommendation allows taxpayers to put a tax value on a recognised liability at the end of a year whenever a reasonable estimate of the amount can be made.

How will the liability be calculated?

How the recommendation will be applied in practice may be illustrated for long service leave and warranties. Similar reasoning applies to the other provisions that will be allowed. The amounts allowed for taxation purposes will not be the same as those allowed for accounting purposes. For taxation purposes, a recognised liability must be a present obligation that has also been incurred. Some amounts that are recognised for accounting purposes will not be recognised for taxation purposes, and will therefore have a zero tax value.

Taxpayers will be allowed to recognise a provisional liability for the amount required to satisfy long service leave payments that have been claimed by employees but not paid out before the end of the taxation year. Accordingly, no liability will be recognised for a long service leave obligation that is contingent on an employee submitting a valid claim, even if previous experience suggests that some existing employees will claim a long service payment. In contrast, accounting practice allows a provision to be established for the reasonable estimate of the long service leave that will be paid to existing employees, even though the leave has not formally been accrued or claimed.

In relation to warranties, a taxpayer may have a warranty obligation in relation to items sold before the end of the year that are returned for repair or replacement within the warranty period. The recommendation will allow the taxpayer to recognise a liability for a reasonable estimate of the amount required to repair or replace the items that have failed before the end of the year but have not yet been returned for repair or replacement. The taxpayer might estimate this amount after surveying customers on the time it takes them to realise that a fault exists and to return the item for repair or replacement. In contrast, the corresponding accounting provision includes additional amounts that are contingent on an item being returned faulty before the warranty period expires, because it is more likely than not that an item will be returned.

Some provisions will not be recognised

Three categories of provisions found in some financial statements will not be allowed for taxation purposes.

Amounts that are not recognised liabilities

The first category arises because the financial statements of some companies include items described as provisions but which are not liabilities under the proposed taxation definition. The existence of a present obligation is a necessary element of the definition of a liability for tax purposes. There is the question whether taxpayers should be able to establish taxation provisions for self-insurance and plant overhaul. These items do not, however, involve a present obligation which has been incurred and therefore would not be recognised as liabilities for taxation purposes.

In the case of self-insurance, there is no present obligation until an insurable event occurs. If, however, a present obligation arises on the occurrence of an insurable event, taxpayers will be able to provide for the expected cost of insurable events that occur during the year.

In the case of plant overhaul, the taxpayer controlling the asset does not have a present obligation until the plant overhaul has been contracted for or performed. Thus, there is no present obligation and so no provision is recognised for tax purposes at an earlier time. The mere intention, necessity or expectation of the need to make a payment in the future is not sufficient to give rise to a present obligation.

Amounts that are not owed to an identifiable entity

The next category not to be recognised arises because, for taxation purposes, a liability must be owed to another taxpayer or person. In contrast, for accounting purposes, a liability may be owed to a group of taxpayers or to the public at large. Accordingly, accounting will recognise a provision made for a taxpayer's obligation to make a payment in the public interest. Items in this category that will not be recognised for taxation purposes include provisions for:

- environmental clean-up;
- mining rehabilitation;
- proposed dividends; and
- rationalisation, particularly on the acquisition of a new business.

Amounts conditional on future events

The third category arises because, for taxation purposes, a liability is not permitted to be conditional on the occurrence of a future event, even if the occurrence of the event is reasonably certain. Accounting practice allows the provision to be established if the occurrence of the event is more likely than not. Litigation damages exemplify an accounting provision that will not be recognised for taxation purposes.

Recommendation

4.22 Bad debts

Writing off bad debts by taxpayers generally

(a) That taxpayers continue to be able to write off a debt to the extent that it is bad.

Writing off bad debts by financial institutions

(b) That deposit-taking institutions be able to establish for taxation purposes a provision for bad debts that have already been incurred provided there is an actuarial basis for the amount.

This recommendation will generally preserve the existing position under the taxation law in relation to bad debts.

Accordingly, all taxpayers will continue to be able to write off a debt that is bad and to write off part of a debt where only some of the debt is bad.

The recommendation will also retain the existing capacity for financial institutions such as banks, credit unions and building societies that are prudentially regulated to establish a provision for bad debts that have already been incurred and for which there is an actuarial basis for the calculation.

Appropriate tax recognition of accounting principles

Recommendation

4.23 Reflecting accounting principles in the Integrated Tax Code

That appropriate regard be had to accounting principles in the development of taxation legislation for the Integrated Tax Code.

The Review noted in *A Platform for Consultation* (pages 45-47) that a substantial degree of correspondence can be recognised between the conceptual benchmark for an income tax base and income specified in accounting concepts and standards. For example, the accounting concepts focus on economic gains and losses regardless of the legal character they may have under judicial concepts of income.

Despite the correspondence between taxation and accounting concepts at the higher level, accounting profit cannot be used directly as the measure of taxable income.

Taxation and general purpose financial reporting are intended to serve different objectives.

Because income taxation is required to raise sufficient revenue to meet the needs of government it requires less flexibility than general purpose financial reporting presents in the recognition and measurement of income. Moreover, because taxpayers have an incentive to manage their taxation obligations strategically, restricting taxpayer choices in the measurement of income will sometimes be necessary in ways that are not required for accounting purposes.

In contrast, financial reporting explicitly allows greater subjectivity in the recognition and measurement of income through the selection of appropriate accounting policies, provided these are disclosed in the financial statements. The notion of materiality influences whether an item is required to be recognised for financial reporting purposes and also the margin of error that is acceptable in the amount attributed to an item. Materiality is a matter of professional judgment.

In more practical terms, not all taxpayers are required to prepare financial statements in accordance with accounting standards. In addition, the tax law could also not passively reflect continual changes in accounting standards in the measurement of taxable income. Accounting standards in Australia also differ from international standards. Moreover, accounting rules are insufficiently comprehensive in some areas to be used for taxation purposes — for example, in relation to financial assets and liabilities.

Nevertheless, the substantial correspondence between tax and accounting income at the conceptual level means that accounting concepts and standards should be able to assist in the development of rules specifying taxable income. A consequent greater matching of tax and accounting requirements should reduce compliance costs for many taxpayers.

The Review has drawn on accounting principles in developing the draft law accompanying this report. Most importantly, the cashflow/tax value regime draws heavily on accounting concepts in specifying the boundary lines between immediate write-off, amortisation or capitalisation of business expenditure. These boundary lines are based on economic concepts relating to the timing of the future benefits arising from the expenditure — replacing current inconsistencies and anomalies stemming from the distinction between recurrent and capital expenditure.

As a further example, the draft legislation for the single regime for depreciable assets also moves closer to the accounting treatment in many respects. The correspondence between the proposed consolidation regime for wholly owned groups and accounting standards should also help to provide early compliance benefits.

Drawing on accounting principle where possible in the development of future income tax law should see more convergence of accounting and tax treatment over time.

Recommendation

4.24 Towards convergence of tax and accounting treatments

That the Australian Taxation Office work with the accounting and tax professions to identify differences between the accounting and taxation treatments of profits with a view to better aligning these treatments where the differences are inappropriate.

As noted, certain of the Review's proposals will move tax and accounting treatments of income closer together. This will reduce compliance costs. However, the calculation of taxable income will not generally be the same as the calculation of profits under the accounting standards.

Identification and analysis of the differences between the calculation of accounting profits and taxable income will be of advantage to both taxpayers and tax administration. These differences will be highlighted and will have to be justified. This has the potential to move the accounting and taxation systems closer together, further reducing compliance costs.

Attachment A

Demonstration of cashflow/tax value approach

This Attachment presents a demonstration case study including five statements showing how the financial statements, the current calculation of taxable income and the cashflow/tax value approach interrelate.

Statement 3, entitled 'Statement of Taxable Income (working from tax values of assets and liabilities)', is a format which can be used in one of two ways to generate the same taxable income. It can be used as:

- the primary method to calculate the taxable income of the taxpaying entity, or
- a reconciliation statement to verify that the taxable income as calculated by other approaches is in accord with the proposed tax law.

The only information not currently used by most taxpayers in calculating taxable income is the gross amount of the receipts and payments for the taxpaying entity. This information will be readily available for entities that produce cash flow statements. For those taxpaying entities that are part of a group that only produces a consolidated funds statement, the consolidation worksheet should usually disclose the receipts and payments of each subsidiary in arriving at the consolidated totals. For simpler businesses the total of receipts and payments in the cash account would provide the necessary information.

Statement 3 provides the information necessary for the reconciliation between the actual and the *prima facie* Australian tax payable — as reported by listed companies when there is greater than a 15 per cent difference between the two amounts.

Following are five statements to illustrate how the financial and taxation statements interrelate.

Statement 1: Profit and Loss Statement

Statement 2: Taxable Income – typical current calculation basis.

Statement 3: Statement of Taxable Income — cashflow/tax value approach.

Statement 4: Cash Flow Statement

Statement 5: Notes accompanying Balance Sheet. This statement gives background information showing balance sheet values and tax values for incorporation in Statement 3 above.

The statements, as presented, allow the reader to correlate amounts derived from the profit and loss and cash flow statements. Not surprisingly the taxable income determined by both methods of calculation is identical (see Statements 2 and 3).

The statements that follow include balance sheet figures derived up to the stage of determining profit before tax. This is the point at which taxable income would be calculated using the Statement 3 method. Statement 3 can also be prepared using final balance sheet amounts – that is, after determination of net profit, provision for taxation (current, deferred and/or future tax benefits), provision for dividend, and the retained earnings balance.

The method used in Statement 3 works equally well at either stage and, naturally, the amount for taxable income that is calculated at either stage is the same.

If the method is used to reconcile the taxable income to the tax law, it is likely that the spreadsheet would start from the final balance sheet numbers.

If the Statement 3 method is adopted as the basic method of calculating taxable income, then naturally the taxpayer will start from profit before tax (as in the illustrative case study).

The illustrative study starts from profit before tax so that both Statements 2 and 3 are taken to the taxable income stage.

This demonstrates both the technique and the identical results for taxable income.

Some comments on the statements

The progression from the profit and loss statement (in Statement 1) to taxable income (in Statement 2) is readily discernible. Non-cash charges, such as the provision for doubtful debts, which are expensed in arriving at profit before tax, but not deductible for tax, are added back on Statement 2.

Non-deductible expenditures charged against earnings are added back and concessional amounts deductible for tax are subtracted in arriving at taxable income. These same adjustments are also required in Statement 3 and are described as 'Income Tax Law Adjustments' in the proposed tax law. They have been shown in boxes in Statements 2 and 3 to highlight the identical treatment required.

The sub-totals on both statements ($6,625,000) before the adjustments are, naturally, identical. The unifying principle — cash receipts less payments plus/minus changes in tax values — gives the same result for taxable income before the tax adjustments in the boxes, under both methods.

The results are identical because of the linkage between the two methods. For example, sales revenue expressed as sales made during the year comprising those paid for and those yet to be paid for (that is, debtors) gives the same result as cash receipts for sales received during the year plus/minus the change in the debtors account.

The method of calculating the tax value of assets and liabilities is referred to in the notes to Statement 3 and in the detail of Statement 5.

Taxpayers who continue to use their established computer software to calculate taxable income will have the information to readily complete a spreadsheet, in the format adopted for Statement 3, in a relatively short time frame. As stated earlier, the only additional information required is the aggregate receipts and payments for the tax year. It will not represent an additional significant increase in compliance costs.

The basis of calculation described in this paper will apply generally but the Review is recommending a simplified tax system approach for small businesses.

The important advantage is that the tax system, itself, will have greater durability and will be less complex. The resulting reduction in compliance costs should certainly prove greater than the effort required to produce the equivalent of Statement 3 to establish that the taxable income calculated by any other method is in accord with the tax law.

Statement 1

Profit and Loss Statement 1999 ($'000)

Sales revenue	See Note 1			65,300
Expenditure	See Note 2		58,100	
Depreciation			1,200	
Goodwill amortisation			230	
Provision for doubtful debts			1	
Employee entitlements				
- current		150		
- non-current		-10	140	
Other liabilities/provisions				
- current		200		
- non-current		10	210	
Reduction in prepayments			25	59,906
				5,394
Increase in stocks				1,000
Profit before tax				**6,394**

Memorandum information (for reconciliation purposes)

Note 1		
Sales revenue		
	Sales receipts	65,000
	Increases in debtors	100
		200
		65,300
Note 2		
Expenditure		
	Cash costs	57,000
	Increases in creditors	500
		600
		58,100

Statement 2

Taxable income — current calculation ($'000)

Profit before tax					6,394
	Add back	Book depreciation Plant		1,180	
	Deduct	Tax depreciation Plant		-1,495	-315
	Add back	Book depreciation Building		20	
	Deduct	Tax depreciation Building		-5	15
	Add back	Goodwill amortisation			230
					6,324
	Add back	Provision for doubtful debts		1	
		Provision for employee entitlements		140	
	Other liabilities/other provisions		Add Book	210	
			Deduct Tax	-50	301
					6,625
	Non-deductible expenditures				
		Entertainment		**53**	
		Subscriptions		**10**	
		Legal expenses		**75**	
		Other		**10**	148
					6,773
	Deduct	R&D concession		**-175**	-175
Taxable income					6,598

Note: Adjustments of the kind shown in the box are the same adjustments required as shown in the 'Tax Adjustments' column in Statement 3, 'Statement of Taxable Income — cashflow/tax value approach'.

Statement 3

Statement of taxable income — cashflow/tax value approach ($'000)

Statement of Taxable Income (working from tax values of assets and liabilities)		Book Values 1999	Book Values 1998	Tax Values 1999	Tax Values 1998	Net Change in Tax Value	Tax Adjust-ments	Taxable Income Calculation
Shareholders Funds								
Issued Capital		21,500	20,000	21,500	20,000	-1,500		-1,500
Other Reserves								
Retained earnings + profit before tax	1	8,894						
Retained Earnings	1		2,500					
Taxable Income balance	1			4,850	5,775			
Total Shareholders' Funds		**30,394**	**22,500**	**26,350**	**25,775**			
Non-current Liabilities								
Provn for Employee Entitlements - N/C	2	50	60	0	0			
Other Liabilities/Other Provisions - N/C	2	50	40	0	0			
Provision for Income Tax - N/C	2	1,191	1,191					
Current Liabilities								
Bank Overdrafts (Net)	3	600	700					
Inter-Group Loans - Current		0	0					
Trade Creditors - Current		5,300	4,700	5,300	4,700	-600		-600
Trade Bills Payable		100	110	100	110	10		10
Inter-Group Trade Bills Payable		0	0					
Lease Liabilities - Current		0	0					
Inter-Group Trade Accounts		3,500	3,000	3,500	3,000	-500		-500
Provn for Employee Entitlements	2	1,400	1,250	0	0			
Other Liabilities/Other Provns	5	1,700	1,500	250	200	-50		-50
Other Creditors		50	0	50		-50		-50
Provision for Income Tax - Current	2	0	1,400					
Proposed Dividend	2	0	1,500					
Total Liabilities & Equity		**44,335**	**37,951**	**35,550**	**33,785**			
Goodwill		4,170	4,200	4,800	4,600	200		200
Fixed Assets								
Land and Buildings		2,100	2,000	2,015	1,900	115		115
Plant		7,750	7,500	5,535	5,600	-65		-65
Buildings & Plant under Construction		500	260	500	260	240		240
Leased Assets								
Future Income Tax Benefits								
Non-Current Assets								
Other Debtors - N/C								
Current Assets								
Stock on Hand		11,000	10,000	11,000	10,000	1,000		1,000
Trade Debtors		7,000	6,800	7,000	6,800	200		200
Prov for Doubtful Debts	2	-101	-100					
Inter-Group Trade Accounts		4,100	4,000	4,100	4,000	100		100
Other Debtors - Current		250	250	250	250	0		0
Cash on Deposit	3	5,000	0					
Cash at Bank	3	2,216	2,666					
Prepayments	5	350	375	350	375	-25		-25
Total Assets		**44,335**	**37,951**	**35,550**	**33,785**	**-925**		
Receipts				66,500				
Payments				61,850			4,650	4,650
Non tax deductible payments								
- Dividends paid							1,500	1,500
- Income tax paid							1,400	1,400
								6,625
Non tax deductible expenditure								
- Entertainment - NTD	4						53	53
- Subscriptions - NTD	4						10	10
- Legal - NTD	4						75	75
- Other	4						10	10
Other Adjustments								
- R&D concession	4						-175	-175
Taxable Income								6,598
Less, Revenue losses transferred in								0
Income on which tax is payable								6,598

Notes
1 Retained earnings and non-cash additions to reserve accounts have no tax value.
2 Provisions balances have no tax value.
3 Cash balances (positive and negative) have no tax value.
4 The amounts in the box in 'Taxable Income' column are the same adjustments as appear in the current conventional calculation of taxable income.
5 Adjusted for non-deductible amounts.

Statement 4

Cash Flow Statement 1999 ($'000)

Sales receipts			65,000
Issued capital			1,500
			66,500
Cash costs		57,000	
Purchase of assets	1,500		
Assets under construction	240		
Goodwill acquired	200	1,940	
Repayment of trade bills	10		
Dividends paid	1,500		
Taxation paid	1,400	2,910	61,850
Cash generated			4,650
Overdraft - Opening balance		700	
- Closing balance		600	100
Increase in cash			4,550
Opening balance			2,666
			7,216
Cash on deposit			5,000
Cash at bank			2,216

Statement 5

Notes accompanying balance sheet 1999 ($'000)

			Financial Accounts	Tax Values
Retained Earnings + profit before tax				
Opening balance			2,500	
Profit before tax	per P&L		6,394	
Closing balance			8,894	
Fixed Assets				
Land and buildings				
Opening balance			2,000	1,900
Additions			120	120
			2,120	2,020
Depreciation			20	5
Closing balance			2,100	2,015
Plant				
Opening balance			7,500	5,600
Additions - cash		1,380		
- creditors		50	1,430	1,430
			8,930	7,030
Depreciation			1,180	1,495
Closing balance			7,750	5,535
Buildings and plant under construction				
Opening balance			260	260
Additions			240	240
Closing balance			500	500
Goodwill				
Cost			4,600	4,600
Accumulated amortisation to beginning of year			400	0
Opening balance			4,200	4,600
Acquired during year			200	200
Amortisation			230	0
Closing balance			4,170	4,800
Issued Capital				
Opening balance			20,000	20,000
Increase			1,500	1,500
Closing balance			21,500	21,500

Movements in Provisions	Provision for employee entitlements current	Provision for employee entitlements non-current	Other liabilities/ provisions current	Other liabilities/ provisions non-current
Book values				
Opening balance	1,250	60	1,500	40
Profit and Loss	150	-10	200	10
Amounts paid	0	0	0	0
Closing balance	**1,400**	**50**	**1,700**	**50**
Tax values				
Opening balance	0	0	200	0
Movement	0	0	50	0
Amounts paid	0	0	0	0
Closing balance	**0**	**0**	**250**	**0**