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Glossary

The following acronyms and abbreviations are used extensively in these explanatory notes:

ATO	Australian Taxation Office
CGT	Capital Gains Tax
CIV	Collective investment vehicle
Commissioner	The Commissioner of Taxation
CPI	Consumer Price Index
Dictionary	Dictionary starting at section 995-1
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
PDP	Project Development Pool
Recommendations	*A Tax System Redesigned: Overview, Recommendations, Estimated Impacts*
Review	Review of Business Taxation

Board of Taxation Bill 1999

Establishment of the Board of Taxation

Outline

1. The draft legislation establishes a Board of Taxation (the Board) to advise the Treasurer on how to improve the taxation system as far as it affects business.

2. The Board will play a pivotal role in:

- monitoring the effectiveness of the integrated design process set out in the Government's Charter of Business Taxation (the Charter) to be used in the development of taxation policy and legislation;

- fostering compliance with the defined national taxation objectives and taxation design principles also set out in the Charter;

- reviewing annually the application of the policy framework and processes relating to the anti-avoidance rules; and

- reinforcing the need for wide consultation with parties likely to be affected by a proposed policy change at the earliest possible stage of development of the proposed change.

3. The Board will be the guardian of the Charter and will advise the Treasurer on its operation and effectiveness. It also will recommend to the Treasurer any changes to the Charter needed to ensure that it adequately deals with contemporary conditions.

4. Other functions of the Board will include:

- providing the Treasurer with an avenue for ongoing independent and timely advice on Australia's business taxation system, including advice:

  – in relation to new policies to be added to the Government's forward work program for business taxation matters;

  – on the development and implementation of policy initiatives already on the Government's forward work program or on such other matters referred to the Board by the Treasurer; and

  - on appropriate consultation mechanisms for those measures; and

- providing a means for research to be carried out on matters referred by the Treasurer to the Board.

Context of Reform

5. The Review of Business Taxation in its discussion paper *A Strong Foundation* highlighted shortcomings in the processes for developing policy and legislation for, and administration of, the business tax system.

6. The major shortcomings are:

- the development of policy without a sound conceptual framework of national objectives and taxation design principles;
- no integrated approach to policy change;
- a lack of specific accountabilities for the overall performance of the business taxation system; and
- the minimal consultation that takes place with the ultimate users of the system, the private sector, when policy is being developed.

7. The establishment of the Board was recommended in the report for *A Tax System Redesigned* as part of a package of measures designed to address these shortcomings. The other main elements of the package are the establishment of an Integrated Taxation Design Process and the adoption of a Charter of Business Taxation.

The Integrated Taxation Design Process

8. The Integrated Taxation Design Process is given prominence in the Charter. In accordance with this process staff from the Department of the Treasury, the ATO and the Office of Parliamentary Counsel, as the 3 agencies most involved in taxation design, will work in integrated cross-functional project teams with, where appropriate and possible, representatives from the private sector.

9. This integrated arrangement enables the involvement of policy, legislation and administrative and private sector expertise throughout the design process. Such arrangements should ensure that:

- administrative and compliance implications are at the fore when policies and consequential legislative provisions are drafted;
- the policy intent is reflected accurately in the legislation and its administration (recognising that legislation is the practical expression of policy); and
- more generally, the feedback loops are strengthened between policy formulation, legislative drafting and administration.

10. The Board will monitor the effectiveness of this integrated process, and report on it in its annual report to the Treasurer.

The Charter of Business Taxation

11. The Charter will set out a sound conceptual framework for policy development, enactment and implementation. The Charter as adopted by the Treasurer will be published in the Gazette.

12. A significant component of the Charter is the national taxation objectives and the policy, legislative and administrative design principles that will guide the development of the law. The Charter, and the Integrated Taxation Design Process contained in it, gives structure and transparency to the consultation and legislative design process, and sets out who is accountable for it.

13. As guardian of the Charter, the Board is responsible for monitoring and reporting on the processes set out in the Charter, and for recommending improvements to it so that it remains current.

14. Using the national objectives and principles contained in the Charter as benchmarks, the Board will give the business sector an enhanced, more formal and timely role in the development and maintenance of the business taxation system. The Board presents the private sector with a greatly improved opportunity to consult with Government and thereby to have an earlier and more effective input into the development of business taxation policy and legislation.

15. The Board may raise any concerns it has about compliance with the national objectives and taxation design principles. This capacity will have the effect of keeping the national objectives and principles at the fore when tax design matters are being considered by the Treasury, the ATO and the Office of Parliamentary Counsel.

16. The Board will report annually to the Treasurer, for tabling in the Parliament, on how the Board has discharged its functions. This requirement will strengthen and support the accountabilities within the design processes set out in the Charter and achieve a more open,

consultative, accountable and systematic approach to business taxation matters.

Summary of new law

17. The Board is established to advise the Treasurer how to improve the Commonwealth taxation system as far as it affects business. The draft legislation sets out the Board's functions, its membership and operation, and the ethical responsibilities of the members and provides for the Board to be supported by a Secretary who will have both technical and administrative assistance.

Detailed explanation of new law

18. The draft legislation establishes the Board of Taxation.

19. The draft legislation is divided into the following Parts:

Part 1 – Preliminary

Part 2 – Board of Taxation

Part 3 – Members

Part 4 – Secretariat

Part 5 – Using information and position as officer

Part 6 – Miscellaneous

Part 7 – Rules for interpreting this Act

Board of Taxation

Preliminary

20. The Act will commence on a day to be fixed by proclamation or if a commencement day is not proclaimed 6 months and one day after Royal Assent ***[sections 1 and 2]***.

21. The object of the Act is to provide for a Board of Taxation to advise the Treasurer on the development and improvement of the Commonwealth's taxation system as far as it affects business. Included in this system are those taxes which are collected directly from business,

such as income tax, as well as other taxes, such as withholding taxes, where the collection mechanism impacts on business ***[section 3]***.

Functions of the Board

22. The draft legislation establishes the Board of Taxation ***[section 4]***. The Board's functions indicate the range of duties that the Board is able to perform ***[section 5]***.

23. A primary function of the Board is to monitor and report to the Treasurer on whether the processes, principles and objectives as set out in the Charter are being followed in developing and implementing new taxation policy ***[paragraph 5(1)(a)]***.

24. The Charter establishes a context within which Australian taxation laws affecting businesses can be consistently developed and readily maintained. The Charter serves as a benchmark against which proposed changes to taxation law, and the policy and administrative processes associated with their development and implementation, can be judged more transparently.

25. The Charter has at its core 3 national taxation objectives:

- optimising economic growth;
- promoting equity; and
- promoting simplification and certainty.

26. These national taxation objectives require, among other things, that the business taxation system encourage long-term economic development, treat all taxpayers fairly and be as simple, certain, and easy to comply with as possible.

27. The Charter sets out a regime of taxation design principles to promote achievement of these objectives and to provide a broad, robust framework for the development of business taxation policy and legislation. These principles are of 3 kinds:

- policy design;
- legislative design; and
- administrative design.

28. The Charter provides for an integrated approach to the design of the business taxation system, and sets out the accountabilities of those responsible for it. Under the Integrated Taxation Design Process, officers from the Department of the Treasury, the ATO and the Office of the

Parliamentary Counsel will work together in integrated teams, with a shared purpose and shared ownership of outcomes. Where appropriate and wherever possible, these integrated teams would contain representatives external to the public service and may also include representatives from other parts of the public sector.

29. A further function of the Board is to advise the Treasurer on improvements that may be made to the processes of developing, legislating and implementing policies for the business tax system having regard to the national objectives and the taxation design principles set out in the Charter ***[subparagraph 5(1)(b)(i)]***. The Board has the specific function of advising the Treasurer of any changes needed to keep the Charter current ***[subparagraph 5(1)(b)(ii)]***.

30. The Board will advise the Treasurer on the policies the Government may consider appropriate for inclusion in a forward work program in relation to the business tax system. This role consists of suggesting new policies, or changes to existing policies, including policies to overcome any current deficiencies in the system. In this role the Board has a specific function of advising on the consultative approach appropriate for a matter, including any consultations that the Treasury and the ATO should undertake on a particular policy matter ***[subparagraph 5(1)(b)(iii)]***.

31. A defined forward work program for business taxation policy, with appropriate consultation, approved by the Treasurer, is to be established so as to ensure there is a visible, and public, agenda for business taxation policy.

32. Initially, a draft forward work program for business tax policy will be prepared by the Treasury, in conjunction with the ATO, for preliminary endorsement by the Treasurer. Program items will be supported by a project brief setting out policy objectives, resource requirements, timeframe and revenue implications. Project briefs will also include risk assessments, of the work not be undertaken and of not achieving satisfactory outcomes.

33. The Board will provide assistance to the Treasury portfolio and advice to the Treasurer on the development of the forward work program and on the need for further consultation in respect of new policies for business taxation. The Board will also be able to offer advice on the relative priorities given to various proposals in the work program and suggest areas of policy that have not been raised that need to be addressed.

34. Following initial consultation with the Board and others in the business community and elsewhere, as appropriate, the forward work program will be submitted by Treasury to the Treasurer for final approval.

35. The Board will present to the Treasurer for approval an annual work program for its own studies and research, and be able to request other specific references during the year.

36. The business experience and expertise of the Board members will be a valuable source of assistance to the Treasurer who can refer any matter to the Board for advice ***[subparagraph 5(1)(b)(iv)]***. The Board's expertise will be particularly relevant in the development of policies that affect business.

37. The Treasurer will also be able to refer any matter to the Board for research. The Board will be able to commission research from either the Board's Secretariat or from other sources, including the engaging of consultants to undertake the research ***[paragraph 5(1)(c)]***.

38. The Board will also conduct an annual review of the application of the policy framework and processes relating to anti-avoidance rules. This review will cover the application of the general anti-avoidance rule (GAAR) as well as specific anti-avoidance rules. ***[Paragraph 5(1)(d)]***

39. The annual review will cover the application of the anti-avoidance rules at the assessment (or amendment) stage or in public and private rulings.

40. The Board's review will examine why it was necessary for the general or a specific anti-avoidance provision to be applied and whether any structural defect in the law was highlighted by that application. The Board will also monitor the progress of reforms to address any structural defect that requires alteration. If no structural defects are involved, the Board will examine whether the current method of dealing with the tax avoidance (i.e. the GAAR or a specific anti-avoidance provision) is the most appropriate.

41. In conducting its annual review the Board will monitor the policy guiding the implementation of the anti-avoidance provisions and may advise the Treasurer concerning any amendments to the GAAR. This may involve public consultation if authorised by the Treasurer.

42. While the Board's review may clarify the circumstances in which the GAAR or a specific anti-avoidance provision applies and therefore improve certainty for taxpayers, the Board will not 'map the minefield' for taxpayers. The Board's review will not examine the application of anti-avoidance provisions on a case by case basis.

43. The review will be covered in the Board's annual report, but without disclosing the particular circumstances in which anti-avoidance provisions apply ***[subsection 35(3)]*.**

Work requiring Treasurer's approval

44. Public consultation by the Board is restricted to that approved by the Treasurer ***[paragraph 5(2)(a)]***. This provision is designed to limit instances where public expectations are raised before the Government has had an opportunity to examine a proposal.

45. This provision in no way limits the informal consultation that Board members will constantly have with the business community. Such consultation will be invaluable in the Board's role of advising on how to maintain and improve the business tax system.

46. The Board may, without prior approval of the Treasurer, undertake some preliminary feasibility work in preparing advice on policies it may suggest to the Treasurer for the forward work program for the Commonwealth taxation system. However, before any substantive work in developing those policies could be undertaken the approval of the Treasurer must be obtained ***[paragraph 5(2)(b)]***.

47. The requirement for approval will ensure that any substantive work undertaken by or on behalf of the Board on new policies accords with the Government's priorities. The Board should not be able to expend significant public resources on developing policies that have no prospect of being adopted.

48. The Treasurer can provide guidelines as to what constitutes substantial work ***[subsection 5(3)]***.

Membership

49. The Board will consist of 10 members – 7 private sector members (one of whom will be the Chair) and 3 public sector members ***[subsection 6(1)]***. All members, including the Chair, hold office on a part-time basis ***[section 12]***.

50. The draft legislation sets out a number of terms and conditions of a member's appointment. The Governor-General may determine other terms and conditions not covered by the draft legislation ***[section 18]***.

Public sector

51. Two of the public sector members will be members by virtue of the office they hold: the Secretary to the Treasury and the Commissioner will be permanent members. The third public sector member will be a person who is a Secretary of a Commonwealth Department or who has the powers of a Secretary of a Department ***[subsection 6(1)]***. The Governor-General on the advice of the Executive Council will appoint the third public sector member in writing ***[subsection 11(1)]***.

52. The provision for the third member to be appointed and be able to resign or be replaced provides flexibility, and makes it possible to vary the public sector membership in accordance with changing needs. The provisions also provide flexibility as to who is eligible to be appointed as the third public sector member. Any person who is a Secretary of a Commonwealth Department or equivalent level of an agency or similar part of the Australian Public Service can be appointed to the Board ***[paragraph 6(1)(d)]***.

53. Public sector members are able to appoint a person to act as the public sector member on a meeting by meeting basis ***[subsection 19(1)]***. Such appointments should be rare and usually would only be at the next highest level of the Department or Agency.

54. Anything done in relation to a person purporting to be an acting public sector member is not invalid merely because the appointment was ineffective or had ceased ***[subsection 19(2)]***.

55. This provision covers situations where the public sector member appoints someone to act for an upcoming meeting on a particular date and the date of the meeting is changed or an extra meeting called which the acting public sector member attends. The acting member's actions or that of the Board should not automatically be void because of a technical deficiency.

Private sector

56. The private sector members will be eminent people appointed for their personal attributes, business, professional or academic expertise and experience, without regard to any political affiliation. Private sector members will not serve in a representative capacity, nor will they be able to appoint anyone to act for them in their absence.

57. The private sector members will bring to the Board a national interest perspective, and a range of relevant skills and experience. The capabilities of the private sector members will provide the Board with a mix of expertise and experience in business (large or small), a strong taxation practice or taxation policy background from either a legal or accounting viewpoint in a professional or academic field together with a broad community perspective.

58. The Governor-General on the advice of the Executive Council will appoint the private sector members ***[subsection 11(1)]***. Generally the appointment will be for a term of 4 years. However, the initial appointments of private sector members will be staggered to ensure there is continuity of membership when new members are appointed. The initial membership will be appointed as follows: 2 members for 5 years; 3 members for 4 years and 2 members for 3 years ***[subsections 11(2) and (4)]***.

59. Private sector members will receive an appropriate rate of remuneration to be determined by the Remuneration Tribunal, and allowances as prescribed ***[section 14]***. As the Chair has additional responsibilities, it is expected he or she will receive more remuneration than the other private sector members.

60. To ensure that the private sector maintains the majority of the membership on the Board public servants or full time statutory office holders are not eligible to be appointed as private sector members of the Board ***[subsection 6(2)]***.

Ethical Responsibilities

Disclosing conflicts of interest

61. The people of most benefit to the Board are likely often to have pecuniary or other interests in matters that come before the Board, due to their involvement in business or the taxation profession. However, as the Board is an advisory body and not a decision making body this is not seen as a difficulty. In any event the Treasurer will be aware of the background and interests that Board members (members) have when receiving their advice.

62. Disruptions to the Board from having members constantly declaring minor interests and removing themselves from deliberations and decision making should be minimised. The standard of conflict necessary for an interest to be disclosed will be different than if the Board was a decision making body.

63. This standard takes into account the advisory nature of the Board. The proper performance of that advisory function requires the member to take account of their experience and perspective of the business taxation system. Minor interests will not conflict with the proper performance of a member’s duty.

64. Members will be required to disclose an interest that could conflict with the proper performance of the members’ functions in relation to a matter being considered by the Board ***[subsection 10(1)]***.

65. The detail of any disclosure of an interest and what needs to be recorded in the minutes of the meeting are likely to vary and will be left to the Board. If a member discloses that he or she has an interest and does not want to participate further, only the general nature of the interest would need to be disclosed and recorded. If however, the member wants the Board to make a determination, discussed below, so that he or she can participate in deliberations and decisions then the nature of the interest will need to be spelt out so that an informed determination can be made ***[subsection 10(2)]***.

66. For example, if the Board was examining a proposal to change aspects of the petroleum resource rent tax (which affects very few taxpayers) a member who is a director of one of the taxpayers affected should disclose that he or she has an interest. However, it is likely that the Board would benefit from the views of that member on the issue, provided in the context of having that interest.

67. Conversely if the proposal concerned an aspect of dividend imputation that affects companies and shareholders generally, members would not need to disclose their shareholdings. The members' shareholdings in those circumstances would not amount to a conflict. It would be reasonable for the Treasurer, when receiving advice, to assume that the members hold shares in companies.

68. If a member discloses an interest that could conflict with the proper performance of his or her functions in relation to a matter being considered by the Board, he or she must not be present during any deliberation nor take part in any decision of the Board on the matter unless the Board or the Treasurer determines that he or she can be present ***[subsection 10(3)]***.

69. Members who have disclosed an interest in a matter must not be present during the deliberations of, or take part in the making of a determination by the Board on whether a member can participate in the substantive deliberations or decision on that matter ***[subsection 10(4)]***.

70. The Treasurer has the power to determine that a member can participate in deliberations and decisions of the Board despite a conflict being declared.

Duty of confidentiality

71. Members have a duty not to disclose a document or information about the Board's deliberations or decisions that came into their possession or knowledge because of their membership or was provided to the Board in confidence ***[subsection 31(1)]***.

72. Some matters the Treasurer may refer to the Board for advice may be strictly confidential. Other matters may need input from a wider section of the business community. Communication of non-confidential information for that consultation will be for the purposes of carrying out their functions as members and within the performance of their duties as members ***[subsection 31(2)]***.

73. A public sector member may disclose a document or information to another person in the course of the performance of the duties of their full-time office. Such disclosure will not be a breach of his or her duty of confidentiality ***[subsection 31(3)]***.

74. The Commissioner should not be prevented from acting on any information that he obtains from being a Board member to prevent or rectify any risk to the revenue.

Prohibition on improper use of position or insider information

75. Two further obligations are imposed on members. Members are not to improperly use either their position as a member, or information obtained because of their position as a member, to gain an advantage for any person or to cause detriment to the Board or another person. There are both criminal ***[section 32]*** and civil ***[section 33]*** offences for breaching these obligations.

76. There may be occasions when members receive information not generally available to the public which could be used for personal advantage, either for themselves or for their clients or for associated entities. An unfair advantage may be obtained even if no document or information is disclosed to another person (disclosure of information to another person is a separate offence (see section 31)).

77. Examples of advantages gained include:

- contract dates being brought forward so that they are entered into before certain provisions that have an adverse effect are announced;
- decisions being deferred to take advantage of a concession not yet announced; or
- selling certain assets before an announcement that will decrease in value after the announcement.

Criminal penalties

78. It is a criminal offence for a member of the Board or the Board Secretary to dishonestly misuse information ***[subsection 32(1)]*** or his or her position ***[subsection 32(2)]*** to advantage themselves or someone else or to cause detriment to the Commonwealth or someone else. The information in question must have been obtained because of his or her position.

79. This provision is based on the proposed subsections 26(2) and (3) of the *Commonwealth Authorities and Companies Act 1997* adjusted to comply with the requirements of the Criminal Code. Chapter 2 of the Criminal Code applies to offences in the draft legislation ***[section 36]***.

80. Whether a Board member's or the Board Secretary's use of information or position is dishonest is determined on the basis of whether ordinary people would consider the use dishonest and the member or Board Secretary knows the use to be dishonest according to the standards

of ordinary people ***[subsection 32(3)]***. It would be difficult for a member or Board Secretary to maintain that they did not know that the use of the information or their position was dishonest if ordinary people would have considered it dishonest.

81. In a prosecution the trier of fact, that is, the judge or magistrate or justice of the peace, will determine whether the use was dishonest ***[subsection 32(5)]***.

82. The penalty for a Board member or the Board Secretary being convicted of dishonestly using information or their position is imprisonment for up to 5 years ***[subsection 32(4)]***. The *Crimes Act 1914* lets a court fine the convicted person as well as or instead of imposing a gaol term.

83. Anything done by a public sector member in the course of the performance of the duties of their full time office is not to be regarded as a misuse of their Board position or of information obtained because of their membership ***[subsection 32(6)]***.

84. This provision ensures that the public sector members are not exposed to criminal actions if they use information they obtain because of their membership of the Board in discharging the duties of their office. If the Commissioner receives information on tax avoidance because of his or her membership of the Board, he or she can use that information in discharging the duties of his or her office.

85. This provision is based on the proposed section 26 of the *Commonwealth Authorities and Companies Act 1997*.

Civil Penalties

86. The improper use by a Board member or the Board Secretary of information obtained because of their membership or position or the improper use of their position is subject to civil penalties. The improper use must be to either gain an advantage or cause detriment to a person. The detailed civil penalty provisions in sections 24, 25 and 27A and Schedule 2 of the *Commonwealth Authorities and Companies Act 1997* are incorporated with adjustments ***[section 33]***.

87. This provision provides the deterrent of civil penalties without the need to establish the relevant mental elements necessary for the criminal offences.

88. The criminal and civil penalty provisions apply in addition to any other rule of law relating to Board members' or the Board Secretary's duty or liability arising from their membership of, or position with, the Board. Those provisions do not prevent proceedings being commenced for a

breach of any duty or in respect of a liability arising from being a member or Board Secretary or in relation to the Board ***[section 34]***.

Meetings

Frequency

89. The Board must meet at least 4 times a year ***[subsection 7(1)]***. Usually the Chair will give reasonable notice of meetings although there may be occasions when the Chair convenes a meeting at very short notice ***[subsection 7(2)]***. This arrangement will enable the Board to provide timely advice to the Treasurer.

Quorum

90. A meeting of the Board needs 6 members for a quorum ***[subsection 7(5)]***. This provision ensures the public sector members will be unable to be in a majority at any meeting. Decisions of the Board will be made by a majority of the votes of members 'present' at a meeting ***[subsection 7(6)]***. The *Acts Interpretation Act 1901* allows a member to participate in a meeting by telecommunications and that member is taken to be 'present' in those circumstances. A tied vote will mean that no decision is made.

91. The Board will determine its own procedures subject to the draft legislation ***[section 9]***. It must keep minutes of all its meetings and provide a copy to the Treasurer ***[section 8]***.

Chair

92. The Chair will be appointed in writing by the Governor-General on recommendation from the Executive Council, from the seven private sector members ***[subsection 11(3)]***. The Chair will preside at all meetings at which he or she is present ***[subsection 7(3)]***.

93. During an absence or vacancy in the office of the Chair, an acting Chair may be appointed by the Treasurer from the private sector members ***[subsection 13(1)]***. The acting Chair will preside at a meeting if the Chair is not present, or if the Chair and acting Chair are not present at a meeting the members present will elect a private sector member to preside at the meeting ***[subsection 7(4)]***.

94. Anything done in relation to a person purporting to be acting as the Chair is not invalid merely because the appointment was ineffective, had not arisen or had ceased ***[subsection 13(2)]***. This provision would apply, for example, where the Treasurer appoints someone to act as Chair when the Chair was proposing to be absent from Australia and subsequently the Chair cancels the overseas trip. A meeting called by the Acting Chair would not be invalid because the Chair is not absent overseas.

95. The Chair's powers include establishing specific committees to report to the Board.

96. The Chair will remain as Chair for the length of his/her term.

Leaving the Board

Resignation

97. An appointed member is able to resign from the Board by giving the Governor-General a written resignation ***[section 16]***. The third public sector member, as an appointed member, is able to resign. This gives the flexibility of having the most appropriate membership as needs change over time.

Termination

98. The Governor-General may terminate the appointment of appointed members for reasons such as misbehaviour, physical or mental incapacity or bankruptcy. The misbehaviour needs to either relate to the member's ability to discharge his or her duties as a Board member, or be of a serious nature. It would include such matters as a conviction for serious criminal offence, or a tax offence or an offence involving dishonesty ***[subsection 17(1) and paragraph 17(2)(a)]***.

99. Another ground for termination is if the Board member is absent, except on leave of absence, from 3 consecutive meetings of the Board ***[paragraph 17(2)(b)]***. The exercise of the discretion under this ground would take into account the notice provided for the meetings and how closely together the meetings were held. For example, if a very important issue arose as a matter of urgency, the Chair may call 3 meetings within a week at very little notice. Those circumstances would not warrant the termination of a member's appointment for non-attendance.

100. The Treasurer may grant a member a leave of absence on terms and conditions he or she determines. It is envisaged that the leave of absence granted would only be for relatively short periods of say 2 to 3 months or on a meeting by meeting basis ***[section 15]***.

101. A members' appointment could also be terminated if he or she:

- fails to disclose an interest that could conflict with the proper performance of his or her functions ***[paragraph 17(2)(c)]***; or
- makes improper use, of his or her position as a member of the Board, or of information obtained because of his or her position as a member of the Board, to gain advantage or cause detriment ***[paragraph 17(2)(d)]***.

Secretariat

102. The Board will be judged by its contribution to the development of Australia's business taxation system and its capacity to relieve the tensions in the current system between the public and private sectors. To provide every opportunity for the Board to achieve its goals an independent Secretariat will be established.

Secretary – statutory office holder

103. The Board Secretary will be a statutory office holder whose role will be to help the Board perform its functions ***[section 20]***.

104. The Treasurer will appoint the Board Secretary after considering the Board's recommendation. The appointment will be in writing, on a full time basis for up to 4 years. ***[Section 21]*** As the position of Board Secretary is a full-time position he or she will be unable to engage in any outside paid employment without the Treasurer's approval ***[section 24]***.

105. The Board Secretary is appointed on the terms and conditions set out in the draft legislation and on other terms and conditions the Treasurer determines ***[section 27]***.

106. The Board Secretary will be paid remuneration as determined by the Remuneration Tribunal, or if no determination is made, remuneration as prescribed, and allowances as prescribed ***[section 22]***.

107. The Board Secretary will have the recreation leave entitlements that the Remuneration Tribunal determines, subject to section 87E of the *Public Service Act 1922*. With the Treasurer able to grant other leave of absences on the terms and conditions he or she determines ***[section 23]***.

108. During an absence from duty or vacancy in the office of the Board Secretary, the Treasurer may appoint a person to act as the Board Secretary ***[subsection 29(1)]***.

109. Anything done in relation to a person purporting to be acting as the Board Secretary is not invalid merely because the appointment was ineffective, had not arisen or had ceased ***[subsection 29(2)]***. This provision would cover, for example, situations where the Treasurer appoints someone to act for an upcoming period of recreation leave for the Board Secretary but the Board Secretary cancels their leave part way through.

Ethical Responsibilities

110. The Board Secretary will have the same ethical responsibilities as the members of the Board.

Disclosing conflicts of interest

111. The Board Secretary must disclose in writing to the Treasurer all the direct or indirect pecuniary interests that he or she has or acquires, that could conflict with the proper performance of his or her functions ***[subsection 28(1)]***.

112. The Board Secretary must disclose in writing to the Chair any direct or indirect pecuniary interests that he or she has in a matter being considered or about to be considered by the Board as soon as possible after he or she becomes aware of it ***[subsection 28(2)]***. This is because the Board Secretary may prepare papers or recommendations for the Board. The Board should be made aware of any potential conflict of interest the Board Secretary may have in weighing up the information or recommendation.

Duty of confidentiality

113. The Board Secretary will have the same duty of confidentiality as the members of the Board ***[section 31]***.

Prohibition on improper use of position or insider information

114. The Board Secretary will have the same prohibitions on dishonestly or improperly using information or his or her position as apply to the members of the Board ***[sections 32 and 33]***.

115. Examples of advantages to be gained by the Board Secretary are the same as set out for Board members.

116. The criminal penalty provision ***[section 32]*** is based on section 26 of the *Commonwealth Authorities and Companies Act 1997*. The detailed civil penalty provisions in sections 24, 25 and 27A and Schedule 2 to the *Commonwealth Authorities and Companies Act 1997* are incorporated with adjustments ***[section 33]***.

Resignation

117. The Board Secretary can resign from the office by giving the Treasurer a written resignation ***[section 25]***.

Termination

118. The Treasurer may terminate the appointment of the Board Secretary for reasons such as misbehaviour, physical or mental incapacity or bankruptcy. The misbehaviour needs either to relate to the Board Secretary's ability to discharge his or her duties, or be serious in nature. It would include such matters as a conviction for a serious criminal offence, a tax offence or an offence involving dishonesty ***[subsection 26(1) and paragraph 26(2)(a)]***.

119. Another ground for termination would be if the Board Secretary is absent, except on leave of absence, for 14 consecutive days or for 28 days in any 12 months ***[paragraph 26(2)(b)]***.

120. The Board Secretary's appointment could also be terminated if he or she:

- engages in paid employment apart from being the Board Secretary without the Treasurer's approval ***[paragraph 26(2)(c)]***;
- fails to disclose an interest that could conflict with the proper performance of his or her functions ***[paragraph 26(2)(d)]***; or
- makes improper use, of his or her position as Board Secretary, or of information obtained because of his or her position as Board Secretary, to gain advantage or cause detriment ***[paragraph 26(2)(e)].***

Independent Secretariat

121. The Board will have its own budget, funded by the Commonwealth to pay for its operations and its Secretariat. The Secretariat may consist of both professional and administrative staff engaged by the Board Secretary.

122. Having the Board Secretary as a statutory office holder with all the powers of a Secretary of a Commonwealth Department provides the flexibility of being able to employ public servants without them having to resign from the public service. This capability for employment with the Board, rather than secondment from a home Department or Agency, will ensure that independence from a former employer, such as the Treasury or the ATO, is maintained. ***[section 30]***

123. Further, this approach removes any possibility of perceptions of inappropriate influence if the Board Secretary and the Secretariat had been housed within an existing Department or Agency.

Annual Report

124. The Board must provide an annual report to the Treasurer who will lay a copy before each House of Parliament. The report will cover matters pertaining to the operations of the Board but will not disclose the substance of any of the advice or reports the Board provides to the Treasurer. The report may indicate that advice was provided on particular areas of the law and how other functions of the Board were discharged ***[section 35]***.

Regulations

125. The Governor-General may make regulations to give effect to the draft legislation ***[section 37]***.

Rules for interpreting this Act

126. The draft legislation will form part of an Integrated Tax Code which when complete will have common rules of interpretation, with consistent definitions and drafted in a consistent style.

127. These common rules for interpretation set out:

- when defined terms are identified ***[section 38]***;
- when defined terms are not identified ***[section 39]***;
- how to identify the defined term in a definition ***[section 40]***;
- what forms part of the Bill ***[section 41]***;
- what does not form part of the Bill ***[section 42]***.

Dictionary

128. The Dictionary section sets out the defined terms used in the draft legislation ***[section 43]***.

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A New Tax System (Income Tax Assessment) Bill 1999

Chapter 1
How to use the Act

Outline of Chapter

1.1 This Chapter explains the structure of the draft legislation and some of the important concepts that run through it.

Context of Reform

1.2 Division 2 will be a very broad Guide to the entire income tax system. Division 3 will provide details about the draft legislation and explain how it all fits together.

Summary of new law

1.3 Division 2 will be a non-operative Guide to the income tax law at the broadest level. It will list the main questions that the income tax law answers and outline the obligations it imposes.

1.4 Division 3 will also be a non-operative Guide that explains in plain English how the income tax law fits together. It will also introduce some of the important concepts in the law, such as the marking of defined terms, the numbering system and the status of non-operative material.

Comparison of key features of new law and current law

1.5 Division 2 will largely replicate Division 3 of the ITAA 1997. Division 3 will not be materially different from Division 2 of the ITAA 1997.

Detailed explanation of new law

What the Act is about [Division 2]

1.6 Division 2 will be a Guide. In the draft legislation, a Guide contains information that is useful to readers but is not an operative part of the law (see paragraphs 1.28 to 1.33). Division 2 will not be a detailed Guide – it will simply introduce some of the broad concepts in the law, list a few of the key questions that could be asked about them and signpost the main places where the answers can be found.

1.7 It will explain that income tax must be paid for each year and that most taxpayers will do so in instalments ***[subsections 2-5(1) and (2)]***. How much tax, by when it must be paid, and when a refund can be obtained are some of the key questions that the income tax law answers ***[subsection 2-5(3)]***.

1.8 The Division will end by listing the other main obligations the draft legislation imposes ***[sections 2-10 and 2-15]***.

How to use the Act [Division 3]

1.9 Division 3 will be a Guide. It will cover:

- how readers will find their way around the draft legislation, using the navigation tools and other techniques supplied to assist them;
- how the draft legislation is arranged in a logical structure that conceptually resembles a pyramid;
- how to identify defined concepts and terms, and find definitions;
- how to follow the numbering system; and
- what legal status Guides and other explanatory features have.

How readers will find their way around [Subdivision 3-A]

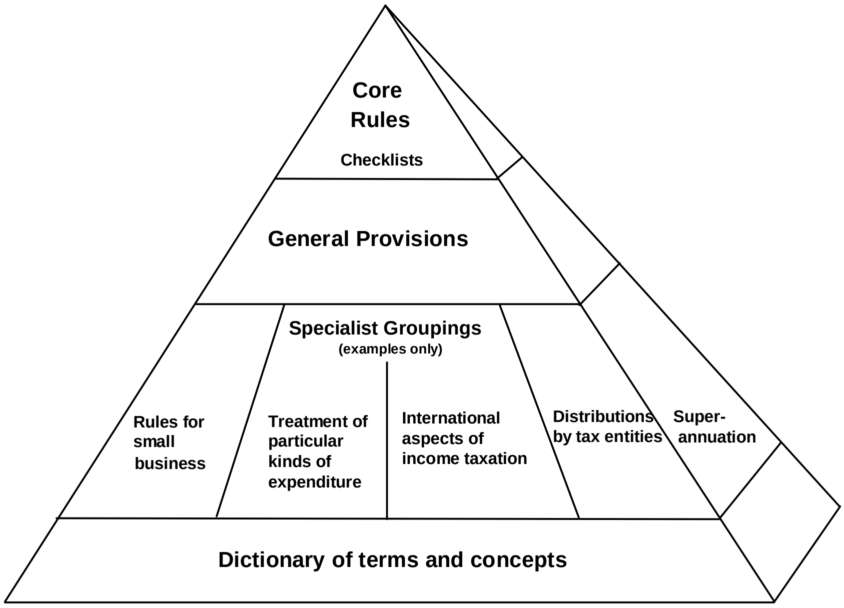
1.10 The draft legislation is designed so that readers can start at the front and navigate quickly to the area of the law that interests them ***[section 3-1]***. It does this by setting out the main rules (called 'the Core rules') near the beginning and providing signposts to the other areas that relate to those main rules. Each of those other areas itself signposts further related areas with more detailed rules, and so on.

1.11 There is usually a Guide in each area to explain what the area is about and how it fits into the overall scheme.

Structure [Subdivision 3-B]

1.12 The draft legislation is structured like a pyramid ***[section 3-5]***. At the top of the pyramid are the main rules explaining that there is a liability to pay income tax and how, in broad terms, it is worked out.

Diagram 1.1 The pyramid structure of the draft legislation



1.13 Below those core rules are provisions that explain how the core rules work in a range of common cases. Below them there are similar provisions that are of interest only to specialist groups (e.g. small businesses).

1.14 Each area is usually structured like a smaller pyramid – the core rules for that area appear first and are followed by the more detailed rules that expand or modify those core rules.

How can defined terms be found [Subdivision 3-C]?

1.15 In the draft legislation, defined terms are usually asterisked (e.g. *business) ***[section 3-10(2)]***. The asterisk appears at the front of a defined term the first time that it appears in a subsection (except in non-operative material) ***[subsections 3-15(1) and (2)]***.

1.16 The asterisk links to a footnote on each page that directs readers to the Dictionary in section 995-1. The Dictionary lists every term or phrase defined in the draft legislation and either sets out the definition there or signposts the place where it is.

1.17 In the definition itself, the term or phrase that is defined will appear in ***bold italics*** ***[section 3-20]***.

1.18 The combination of these features makes it possible to know when a term is defined and provides a way to find that definition quickly.

1.19 A few defined terms will never be asterisked ***[subsection 3-15(3)]***. These will fall into 2 broad categories:

- key participants in the income tax system (e.g. the Commissioner) ***[subsection 3-15(4)]***; and
- core concepts in the system (e.g. taxable income) ***[subsection 3-15(5)]***.

The draft legislation lists all these non-asterisked terms.

1.20 The reason for not asterisking these concepts is that they occur so frequently that it would be distracting to asterisk them each time. Because they are so commonly encountered, readers will always be aware that they are defined.

What is the numbering system [Subdivision 3-D]?

1.21 The draft legislation uses a numbering system that has 2 stages separated by a hyphen. In a section, the first stage of the number identifies the Division the section comes from (e.g. section 70-30 is in Division 70) and the second stage identifies the section's order within the Division.

1.22 In a Part, the first stage of the number identifies the Chapter the Part comes from (e.g. Part 2-15 is in Chapter 2) and the second stage identifies the Part's order within the Chapter.

1.23 Gaps will usually be left between Division numbers to accommodate additions ***[section 3-30]***. Gaps will also be left between section numbers for the same reason.

1.24 Usually, the gaps will be 4 Division or section numbers. If a gap is not regular, there will be a link note to refer to the next number in the sequence. For example:

[The next Division is Division 34]

1.25 This numbering system meets several aims:

- each unit of law has a unique number to identify it;
- the numbers are easy to read;
- the order of any 2 numbers is obvious;
- they can be spoken aloud without being ambiguous;
- each number identifies the area of law it belongs to; and
- the system copes well with insertions of large amounts of new material.

Adding new material

1.26 The numbering system is designed to make it easier to insert new material into the law than the system used in the ITAA 1936 (which simply numbered sections consecutively from 1 to last). That system has led to a lot of alpha-numeric section numbers (e.g. section 159GZZZZA) that confuse readers.

1.27 The new system permits an entire Division (with any number of sections in it) to be inserted with only a single letter. For example, between Divisions 104 and 105, Division 104A could be inserted with an unlimited number of sections.

What is non-operative material [Subdivision 3-E]?

1.28 The final part of Division 3 will explain the status of non-operative material. Non-operative material will be part of the Act but will not actually contain operative rules. Rather, it is material designed to help readers both find their way around and better understand the operative rules. ***[Section 3-35]***

1.29 The most obvious type of non-operative material is the Guides. A Guide is a plain text statement at the front of a significant area of the draft legislation. Generally, they summarise that area but they can also explain its purpose or its place in the income tax scheme. Although Guides are still a part of the draft legislation, they can only be used to interpret it in a limited range of cases. Those cases are set out in section 950-150. ***[Section 3-40]***

1.30 Examples are also non-operative material ***[section 3-45]***. Some readers find that applying an abstract concept to a practical case crystallises the concept for them. Because they do that, examples can help those readers to understand the law sooner.

1.31 An example can aid in interpreting a provision but cannot override it (section 15AD of the *Acts Interpretation Act 1901*).

1.32 The other main type of non-operative material is notes ***[section 3-45]***. These are used to point readers to information relevant to the provision they are reading. For example, if there is an exception to a rule, a note is a good way to draw it to the reader's attention. The exception could instead be included directly in the body of the rule but that can interrupt the flow of the provision and hinder comprehension.

1.33 Notes can provide information directly, like this:

> Note: Subdivision 165-A is about the conditions a company must satisfy before it can deduct a tax loss for an earlier income year.

or just signpost where the information is, like this:

For the same business test: see Subdivision 165-E.

Chapter 2
How to work out income tax liability

Outline of Chapter

2.1 This Chapter explains the core provisions of the income tax law dealing with the way in which income tax for an income year is worked out. ***[Part 1-3, Division 4 and section 5-10]***

Context of Reform

2.2 The core rules dealing with how to work out income tax liability largely replicate those presently found in Division 4 of the ITAA 1997. Some minor changes have been made, most of which do not affect the substance of the law.

2.3 Generally speaking, income tax liability is still based on the concept of taxable income. The major changes proposed by the draft legislation deal with the way in which taxable income is calculated. These changes are explained in Chapters 3 to 6.

Summary of new law

2.4 Individuals, tax entities and some other taxpayers are liable to income tax. While different rules will apply, the fact that a taxpayer is a foreign resident will not affect this basic liability to income tax.

2.5 Taxpayers work out their income tax for each income year. An income year is generally a period of 12 months ending on 30 June. However, with the Commissioner's approval, taxpayers can adopt another period of 12 months that does not end on 30 June.

2.6 Generally speaking, taxpayers work out their income tax by undertaking the following steps:

- they work out their taxable income for the income year;
- they apply the relevant income tax rate or rates to that taxable income, giving the taxpayer's 'basic income tax liability'; and
- they subtract their tax offsets from the basic income tax liability.

Income tax liability = Taxable income × Tax rate(s) – Tax offsets

Comparison of key features of new law and current law

2.7 The differences between Division 4, section 5-10 and the corresponding provisions in the current law are set out in the following table:

New Law	***Current Law***
Income tax is payable by individuals, tax entities and some other taxpayers. A *tax entity* is a company, a trust, an executor of a deceased estate, an arrangement entered into outside Australia that would be a trust if it had been entered into in Australia, or a limited partnership.	Income tax is payable by individuals, companies and some other entities listed in Division 9 of the ITAA 1997.
You covers any taxpayer, unless the term is used in an expressly limited way. There is no substantive change to the current law here as the definition of *taxpayer* is the same as that of *entity* in the ITAA 1997.	*You* covers any entity, unless the term is used in an expressly limited way.
Same as current law.	An *income year* is the year, the events of which will determine income tax payable for a *financial year*. A company's income year is generally the financial year prior to that in which income tax is being paid. For other taxpayers, the income year is generally the financial year in which income tax is being paid.
Same as current law.	A different period of 12 months can be adopted as an *income year*, with the Commissioner's approval.
A taxpayer that is an Australian resident may still be liable to income tax, however, there will be specific provisions dealing with different residency circumstances. The core provisions in the draft legislation that are concerned with working out taxable income only deal with a taxpayer that is an Australian resident throughout the year.	The effect of the assessable income provisions in the ITAA 1997 is that an individual or an entity that is not an Australian resident may still be liable to income tax.
Same as current law.	Tax liability depends upon taxable income, prevailing tax rates and entitlement to tax offsets.

Detailed explanation of changes

Who must pay income tax?

2.8 Every individual and tax entity is liable to pay income tax, as well as some other taxpayers ***[section 4-1]***. Division 14 contains a list of taxpayers by whom income tax is payable ***[section 14-1]***.

2.9 A ***tax entity*** is ***[section 960-105]***:

- a company (as defined in the draft legislation);
- a trust;
- an executor of a deceased estate;
- an arrangement entered into or arising outside Australia that would give rise to a trust if it had been entered into or had arisen in Australia; or
- a limited partnership (as defined in the draft legislation).

2.10 The term, ***taxpayer***, broadly covers all entities, including individuals. ***[Subsection 960-100(1)]***

2.11 Just because a taxpayer is liable to pay income tax does not mean that tax will necessarily be paid. For example, a taxpayer may have no taxable income, and will therefore not pay income tax.

2.12 Income tax may be payable even if a taxpayer is a foreign resident, either permanently or for just a period of time. The draft legislation contains a table which indicates where the different rules can be found, depending on the taxpayer's circumstances. ***[Section 4-15]***

The period over which income tax is worked out and paid

2.13 Liability to income tax is defined by references to years.

2.14 The draft legislation recognises 2 distinct years – the year, ending on 30 June, for which income tax is paid (called the ***financial year***) ***[subsection 4-10(1)]***, and the year the events of which determine the income tax to be paid for that financial year (called the ***income year***) ***[subsection 4-10(2)]***.

2.15 A company's income year is generally the financial year prior to that in which income tax is being paid. For other taxpayers, the income year is generally the financial year in which income tax is being paid.

2.16 With the Commissioner's approval, a taxpayer can adopt another accounting period of 12 months ending on another date as their ***income year***. ***[Paragraph 4-10(2)(b)]***

Meaning of 'you'

2.17 ***You*** refers to any taxpayer unless a specific exclusion is made ***[section 4-5]***. This is essentially the same meaning as the current law. Even though the current law refers to any 'entity' in the comparable provision, the draft legislation defines taxpayer in generally the same way as the ITAA 1997 defines entity ***[section 960-100]***.

2.18 Most of the draft legislation is drafted in the second person, using the term *you*. For example, the draft legislation would generally say 'you are liable to income tax' rather than 'a taxpayer is liable to income tax'.

2.19 The use of *you* simplifies the drafting and makes the law more accessible.

What is a taxpayer's income tax liability?

2.20 Generally, a taxpayer's income tax liability for an income year is the amount of tax that a taxpayer is liable to pay on their taxable income. It is generally calculated using this formula:

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

2.21 The draft legislation contains a method statement which provides a step by step approach for working out a taxpayer's income tax liability. ***[Subsection 5-10(1)]***

What is taxable income?

2.22 Chapter 3 explains the principles involved in working out taxable income.

Which rates apply?

2.23 The rates which are to be applied to work out a taxpayer's basic income tax liability are set out in the *Income Tax Rates Act 1986*. More than one rate may have to be applied.

2.24 For individuals who are Australian residents, a progressive rate system is used to determine income tax liability. That is:

- for taxable income up to a certain limit there is no rate of tax applied; and
- for income above that limit, progressive rates apply across particular taxable income bands.

2.25 On the other hand, income tax is imposed at a flat rate for most tax entities.

What are tax offsets?

2.26 A ***tax offset*** reduces the basic income tax liability directly ***[subsection 5-10(1), method statement, step 3]***. A tax offset encompasses what were previously referred to as rebates and credits.

2.27 Under the current law, if tax offsets exceed a taxpayer's basic income tax liability, there is no general entitlement to a refund. This is also generally the case under the draft legislation ***[subsection 5-10(3)]***.

2.28 However, some tax offsets, such as the private health insurance rebate, are refundable ***[subsection 5-10(2)]***. The Recommendations propose that excess imputation tax offsets for franked distributions made by a tax entity to an individual who is, or a complying superannuation fund that is a member of the entity, will also be refundable[1]. This means that where a taxpayer's income tax liability is reduced to zero, any remaining balance of these tax offsets will be refunded to the taxpayer.

2.29 Other tax offsets can be carried over to later years to reduce a tax liability of those years, even though they can not be refunded in the current year. An example of such a tax offset is a foreign tax credit.

[1] See Recommendation 11.7

Chapter 3
How to work out taxable income or tax loss

Outline of Chapter

3.1 The reformed income tax law will provide a new method[1] for calculating the taxable income or tax loss of resident taxpayers. The method looks at changing *tax values* of assets and liabilities as well as receipts and payments. Tax value is not, in many cases, linked to economic value. Gains on most assets are not brought into the tax net until they are disposed of.

3.2 This Chapter discusses the new method, which is set out in Divisions 5, 6, 12 and 36 of the draft legislation. Many of the provisions in these Divisions are discussed in outline in this Chapter, with other Chapters of these explanatory notes dealing with those provisions in more detail.

Context of Reform

3.3 The revised method links the calculation of taxable income and tax loss more closely to accounting concepts. The draft legislation, however, is necessarily formulated in its own terms recognising tax policy or administrative considerations.

3.4 The revised method also refocusses key questions about how amounts are to be included in, or excluded from, taxable income. In particular, the expenditure that is to reduce taxable income is identified by reference to whether, first, it is private or domestic and then, if it is not, whether it is made to acquire or improve an asset. This is in contrast to the current law where questions of deductibility revolve around whether the expenditure is to derive assessable income and whether it is of a capital or private or domestic nature.

What is the existing method for working out taxable income or tax loss?

3.5 The existing method for working out the taxable income or tax loss of a taxpayer basically involves determining assessable income and subtracting allowable deductions. Diagram 3.1 summarises the existing method.

---

1 Sometimes called the 'cash flow/tax value approach'.

Diagram 3.1 The current approach for working out taxable income or tax loss

Taxable income (loss) =

Assessable income	minus	**Allowable deductions**
Ordinary income e.g. trading receipts, reward for personal services		**Expenses linked to production of income but not capital or private or domestic expenses**
Statutory income e.g. some accrued gains, capital gains, anti-avoidance rules		**Incentives and concessions** e.g. deductions for accelerated depreciation, research and development

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

What is wrong with the current approach?

3.7 As illustrated by Diagram 3.1, the current law revolves around pivotal concepts of ordinary income, capital and expenses linked to the production of income. The boundaries of these concepts have been, and continue to be, the subject of much disputation.

3.8 In addition, the income tax system has, over the years, been modified to provide for the taxation of forms of income that are not recognised by the ordinary income concept. Examples are rules dealing with deferred interest securities[2] and capital gains tax.

3.9 Another feature of the current law is the large number of anti-avoidance rules that have been added over the years. These rules have often been added to deal with particular tax avoidance schemes that have arisen, often because of the lack of a sound structural framework in the law.

3.10 These add-ons to the income tax system, together with the difficult concepts of ordinary income, capital and allowable deductions, have made the current law detailed and complex. The proposed new method for working out taxable income or tax loss seeks, as far as possible, to overcome these difficulties.

2 Division 16E of the ITAA 1936.

Summary of new law

3.11 Diagram 3.2 summarises the new method for working out a taxpayer's taxable income or tax loss.

Diagram 3.2 New method for working out taxable income or tax loss[3]

Taxable income (loss) =

<table>
<tr><th>Net income</th><th>plus</th><th>Income tax law adjustment</th></tr>
<tr><td>Net receipts
i.e. receipts minus payments (both revenue and capital)</td><td rowspan="2"></td><td rowspan="2">Increasing adjustments
e.g. an adjustment under the general anti-avoidance rule</td></tr>
<tr><td>adjust for
Net change in tax value of assets (other than money)</td></tr>
<tr><td>adjust for
Net change in tax value of liabilities (other than a debit balance in a money account)</td><td rowspan="2"></td><td rowspan="2">minus
Decreasing adjustments
e.g. the reduction in the taxable part of some capital gains</td></tr>
<tr><td>Excludes private or domestic amounts</td></tr>
</table>

3.12 Unused tax losses of previous years are normally subtracted from the above result to the extent that it is positive. This gives the taxpayer's final taxable income.

3.13 In considering the new method, the points set out below should be noted.

- If the result of the above formula is positive, it is the taxpayer's taxable income. If the result is negative, it is the taxpayer's tax loss.
- The new method will apply to resident taxpayers, and non-residents for much of their Australian sourced income. It will not apply to bodies that are entirely exempt from income tax (e.g. religious and charitable institutions).
- Receipts and payments will include constructive receipts and payments.
- The ***tax value*** of assets will not, in many cases, equate to economic value. For example, the tax value of real property will be the cost of the asset to the taxpayer, meaning that any

3 Paragraph 3.23 sets out how changes in the tax value of assets and liabilities affect net income.

'paper' gains will not be taxed. The tax value of a depreciating asset will be the written down value of the asset.[4]

- Capital gains and losses are brought into taxable income/loss as part of net income. However, capital gains treatment will apply to certain capital gains under the Review's recommendations.[5]

- Modifications will be made to the way taxable income is worked out for those taxpayers who are to be taxed on a cash basis.

Why a new approach?

3.14 The new approach aims to provide a more logical structure for the income tax law while keeping the same outcomes the current approach would give with the RBT reforms added-on. In this sense it could be expected to better place the income tax law to deal with the future. The following table briefly sets out the main anticipated benefits from the new method.

Table 3.1 Advantages of new approach

Review objective	***Explanation***
Simplification	The net income concept provides one unifying principle for calculating taxable income/loss. The whole law will flow from this principle. It is anticipated that many special rules under the current law will disappear into this general principle.
Certainty	The new method is more structurally sound than the current law and, therefore, more certain. For example, under the net income formula, tax relief would be given for all business expenditure unless Parliament enacts special rules to prevent that.
Durability	Future change is less likely under the new method because outcomes are, as far as possible, determined by a unifying principle rather than many special rules. Also, the new method provides a clear structure for future policy changes via the income tax law adjustment regime.
Transparency	Policy incentives and concessions, and anti-avoidance rules, are more transparently identified through the new method's tax value and income tax law adjustment rules.

4 The concept of tax value of assets and liabilities is explained in general terms at paragraphs 3.48 to 3.52, and in some detail in Chapters 5 and 8.

5 The effect of the capital gains treatment is discussed in more detail at paragraphs 3.69 to 3.71.

3.15 The various objects provisions in the Divisions dealing with the new method broadly recognise these ideas and other relevant objects of the draft legislation. ***[Sections 5-50, 6-1, 12-1 and 36-1]***

Comparison of key features of new law and current law

3.16 This table compares the key features of the new method for working out taxable income or tax loss with the method under the current law.

Table 3.2 Comparison of key features of new law and current law

New Law	***Current Law***
Expenditure to acquire an asset does not normally immediately reduce taxable income.	Capital expenditure is not normally immediately deductible.
Private or domestic expenditure does not reduce taxable income.	Expenditure without a link to derivation of income is not deductible. Capital and private or domestic expenditure is not deductible.
Non-private non-domestic receipts included in working out taxable income.	Ordinary income assessable.
All capital receipts reflected in working out taxable income unless counter-balanced by an asset or liability or cancelled by an adjustment.	Some capital receipts are not assessable.

Detailed explanation of new law

How is taxable income worked out?

3.17 A taxpayer's taxable income will be calculated using this method ***[subsection 5-15(1)]***:

Net income + Income tax law adjustment – Unused tax losses

3.18 If the result is a positive amount, there is taxable income equal to that amount ***[subsection 5-15(2)]***. If the result is zero or negative, the taxpayer does not have a taxable income.

How to work out if there is a tax loss

3.19 A taxpayer will have a tax loss for an income year if the result of the formula set out below is negative (the amount of the tax loss is the amount worked out under this formula expressed as a positive amount) ***[subsections 36-10(1) and (3)]***:

Net income + Income tax law adjustment

3.20 The amount of the tax loss will be reduced if the taxpayer has a net exempt income for the income year that is positive. In this case the taxpayer will have a tax loss for the income year if the result of this formula is negative (the amount of the tax loss is the result of the formula expressed as a postive amount) ***[subsections 36-10(2) and (3)]***:

Net income + Income tax law adjustment + Net exempt income

3.21 The tax loss for an income year is added to any unused tax losses and may be able to be used in future income years to reduce taxable income.

Who has to apply the new method for working out taxable income or tax loss?

3.22 The new method will apply to residents, and to non-residents for their Australian sourced income and gains that are not subject to a final withholding tax. It will not otherwise apply to non-residents and it will not apply to entities that are entirely exempt from income tax. Specific rules for non-residents are anticipated but are not included in the draft legislation. Cash basis treatment will apply to individuals, and to small businesses choosing a simplified system.[6]

How is 'net income' worked out?

3.23 'Net income' has 3 components, as follows ***[section 5-55]***:

- Net receipts (i.e. receipts minus payments).[7]
- Adjust for net change in the *tax value* of assets (other than money). Net increases in tax value will add to net income, while net decreases will reduce net income.[8]
- Adjust for net change in the *tax value* of liabilities (other than a debit balance in a money account). Net increases in tax value will reduce net income, while net decreases will add to net income.[9]

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6 See Section 17 of *A Tax System Redesigned*

7 Steps 1 and 2 from the method statement set out at paragraph 3.25.

8 Steps 3 and 4 from the method statement set out at paragraph 3.25.

9 Steps 5 and 6 from the method statement set out at paragraph 3.25.

How is the net change in the tax value of assets and liabilities worked out?

3.24 The net change in the tax value of assets is worked out by subtracting the opening tax value of all assets held at the start of the income year from the closing tax value of all assets held at the end of the income year. The same process would be used to determine the net change in the tax value of liabilities. This is illustrated at paragraphs 3.25 and 3.26.

The draft legislation includes a 6 step method statement to work out net income

3.25 The draft legislation includes a 6 step method statement to work out net income (net income may be positive, negative or zero) ***[section 5-55]***. That method statement is set out below.

Method statement

Step 1. Add up all the amounts you received during the income year.

Step 2. Subtract from the step 1 result all amounts you paid during the income year.

Step 3. Add to the step 2 result the closing tax value of each asset (other than money) that you held at the *end* of the income year.

Step 4. Subtract from the step 3 result the opening tax value of each asset (other than money) that you held at the *start* of the income year.

Step 5. Subtract from the step 4 result the closing tax value of each liability that you owed at the *end* of the income year.

Step 6. Add to the step 5 result the opening tax value of each liability that you owed at the *start* of the income year.

3.26 This method can be expressed as a mathematical formula in the following manner:[10]

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

10 The assets considered exclude money. The liabilities considered exclude a debit balance in a money account (see paragraph 3.28). Relevant private or domestic items are also excluded (see paragraph 3.27).

Most private or domestic amounts are not counted in working out the net income of individuals

3.27 For individuals, most private or domestic amounts are excluded from the calculation of net income ***[Division 12]***. Private or domestic payments would include, as under the current law, those for most clothing, child care and travel between home and work. Certain private or domestic assets will be included in the calculation so that capital gains in respect of them can be included in taxable income. Chapter 4 provides a detailed explanation of the private or domestic amounts that are not included in working out net income.

Money and money accounts are excluded from assets and liabilities used to work out net income

3.28 Money is excluded from the assets that are taken into account in working out net income (see steps 3 and 4 of the net income method statement). Also, a debit balance in a money account is excluded from the liabilities that are taken into account in working out net income ***[subsection 5-60(3)]***.

What is money?

3.29 Money is defined to include the things set out in this table.[11] ***[Subsection 995-1(1), definition of 'money']***

Table 3.3 Meaning of money

Things that are money	*Comments*
Money in hand.	This covers money over which a taxpayer has immediate legal control. An example is cash physically held by the taxpayer. It also covers money in any currency, whether Australian or otherwise.
Any credit balance in any money account.	An example is a current account at a bank which the taxpayer uses in their day-to-day business activities. The balance can be denominated in any currency.

11 A rule will be included later to provide for money denominated in a foreign currency to be converted to Australian dollars. Also, rules covering foreign exchange gains and losses are being developed. These matters are discussed in *A Tax System Redesigned: Overview, Recommendations, Estimated Impacts* (see section 9).

What is a money account?

3.30 An account is a 'money account' for an income year if it has all the characteristics set out in the table ***[subsections 5-60(4) and (5)]***:

Table 3.4 Requirements for an account to be a money account

Requirement	***Comments***
The account must be held at an authorised deposit taking institution (as defined in the *Banking Act 1959*), or a similar institution in a foreign country.	This includes banks, credit unions and building societies. The foreign institutions covered would be those that are similar in nature to these.
The taxpayer must choose for the account to be treated as a money account for the income year. For the convenience of the taxpayer, the choice can be made after the end of the income year, such as when the taxpayer's income tax return is being prepared.	Money accounts are intended to cover transaction accounts that a taxpayer uses in their day-to-day business or investment activities. The money account rules are designed to give a taxpayer choice, as far as is reasonable, about whether they want the account treated as an asset or liability, or as part of their 'cash book'.
The balance in the account must not be a financial asset or financial liability subject to accruals or market value tax value rules (see Table 3.5).	Gains or losses on these assets and liabilities are intended to be taxed on an accruals or market value basis. Treating them as money accounts would defeat this intention.

3.31 Examples of money accounts are a savings account or an overdraft account. Some taxpayers may carry out their business transactions using credit cards. This may be their equivalent to a record of receipts and payments. In these circumstances, their credit card account could also be a money account, if that is how they want to treat it. A debit balance in any money account is excluded from the liabilities taken into account in working out net income.

Receipts and payments to or from money accounts are receipts and payments of the taxpayer

3.32 To simplify the treatment of accounts that are money accounts, the draft legislation includes a provision to the effect that amounts received into, or paid from, a money account are taken to be receipts and payments of the account holder ***[subsections 5-60(1) and (2)]***. This carries the implication that any money transfer between the taxpayer (cash in hand) and their accounts, or between their accounts, will always involve both a receipt by, and a payment to, the taxpayer, and so can be ignored.

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

3.33 Assets and liabilities that are money, or in money accounts, do not need to be considered under steps 3 to 6 of the method statement because steps 1 and 2 take account of the net change in a taxpayer's money assets and liabilities. It is necessary to keep track of all receipts and payments because it may be necessary to examine each of them to determine their effect on taxable income. For example, as discussed above, it is necessary to determine which receipts and payments are of a private or domestic nature, because they do not come into the calculation of taxable income except to the extent they relate to a CGT asset.

What receipts and payments are included in net income?

3.34 The amounts covered by steps 1 and 2 will include all money received, and all payments made, by a taxpayer in the income year. The words 'receipts' and 'payments' (and their derivatives) will have their ordinary meaning. The legal principles that apply in determining whether a person has received or paid something will be relevant to steps 1 and 2.

Constructive receipts are explicitly included in net income under step 1

3.35 The new method explicitly includes constructive receipts as amounts that are received for the purposes of working out net income ***[subsection 5-65(1)]***. This constructive receipts rule is intended to supplement, and not displace, general legal principles on when a person has received something.

3.36 A generally accepted principle of current tax accounting is that an amount accountable on a receipts basis can be income, even if it has not actually been received, as soon as it is applied or dealt with in any way on the taxpayer's behalf, or as they direct. In other words, an amount is treated as received as soon as the taxpayer gets benefit from it (this is referred to as a constructive receipt). However, this rule will not apply to amounts credited to a money account ***[subsection 5-65(1)]***.[12]

3.37 Although the concept of ordinary income is not relevant under the new method for working out net income, the same principle is to be applied in working out whether an amount has been received. The draft legislation will explicitly state this principle, confirming what is generally accepted as one of the ordinary principles of tax accounting.

3.38 The constructive receipts rule is based on the rule under the current law (see subsections 6-5(4) and 6-10(3) of the ITAA 1997).

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12 Paragraph 3.32 explains how amounts credited to a money account are treated as receipts.

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

3.39 The new method also explicitly treats certain constructive payments as amounts that are paid for the purposes of working out net income ***[subsection 5-65(2)]***. This constructive payments rule will apply where a taxpayer has a constructive receipt. The taxpayer will be taken to have paid, to the person who actually receives the amount, an amount equal to the constructive receipt.

3.40 This constructive payments rule is intended to supplement, and not displace, general legal principles on when a person has paid something.

Examples of constructive receipts and constructive payments

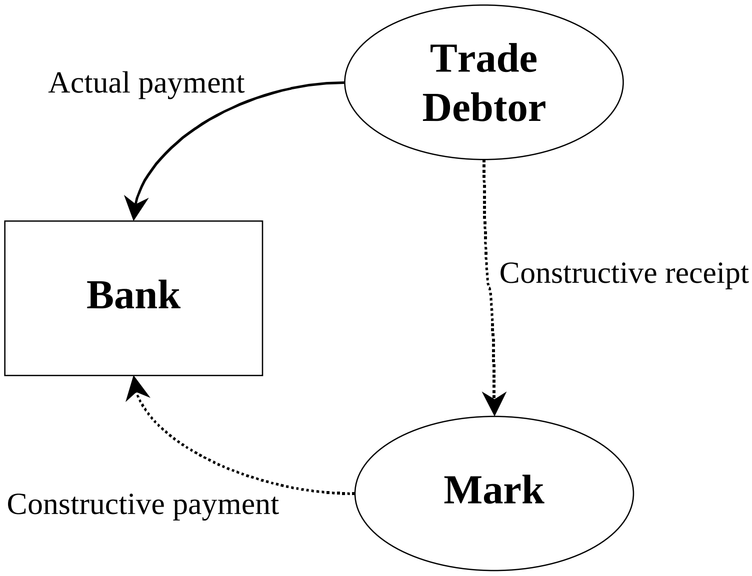
3.41 The following are examples of constructive receipts and constructive payments included under steps 1 and 2.

Example 3.1 Money credited to a loan account

> In carrying on his business, Mark has an outstanding loan account with his bank (this account is not a money account).[13] In paying amounts it owes, one of Mark's trade debtors credits amounts to his loan account. These amounts reduce the amount he owes to the bank and are, therefore, amounts he is taken to have received for the purposes of step 1.
>
> In this case Mark is also taken to have paid to the bank, for the purposes of step 2, the amount credited to his loan account. Diagram 3.3 illustrates this example.

13 See paragraphs 3.30 and 3.31 for an explanation of the accounts that are treated as money accounts.

Diagram 3.3 Illustration of Example 3.1



Example 3.2 Wages directed to a private health fund

On Homer's instructions, his employer sends part of his after tax wages to a health fund to meet his liability to pay health insurance contributions to the fund for the benefit of him and his family. He is taken to receive the amount when his employer pays it to the fund.

In addition to the receipt, Homer is taken to have paid the amount to the private health fund. However, because the payment is private or domestic in nature, it is not actually included as a payment under step 2.

Example 3.3 Dividends credited to an account in a taxpayer's name

A company, of which Margarita is a shareholder, credits a dividend to an account held in her name with the company. The amount of the dividend is a constructive receipt to her. Margarita is also taken to have paid the amount of the dividend to the company (the person with whom the account is held). Additionally, the account will be an asset to Margarita.

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

3.42 Whether a particular receipt or payment is revenue or capital is irrelevant to the calculations under step 1. This means that all receipts and payments (except those of a private or domestic nature) are included in working out net receipts.

What is the effect of including receipts and payments under steps 1 and 2?

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

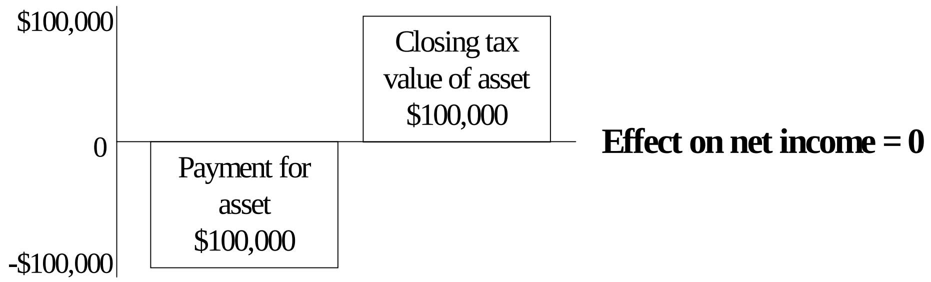
Example 3.4 The purchase of an asset

Hassan buys an asset at a cost of $100,000 (the asset's tax value is equal to its cost).[14] The effect on net income is zero because the payment is matched by the closing tax value of the asset. This is illustrated as follows (see Diagram 3.4):

- net receipts are –$100,000 under steps 1 and 2 (i.e. zero (receipts) minus $100,000 (payments));

- the net change in the tax value of assets is $100,000 under steps 3 and 4 (i.e. $100,000 (closing tax value of assets) minus zero (opening tax value of assets)).

Diagram 3.4 Effect on net income of purchase of an asset



Example 3.5 A loan is taken out

Fishton borrows $100,000. The effect on net income is zero because the receipt is matched by a liability to repay the $100,000. This is illustrated as follows (see Diagram 3.5):

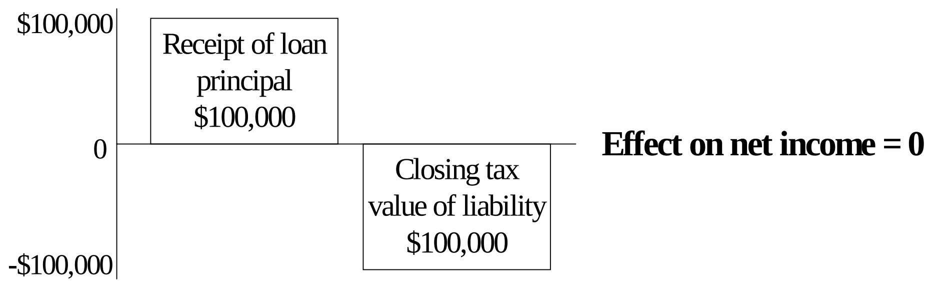
- net receipts are $100,000 under steps 1 and 2 (i.e. $100,000 (receipts) minus zero (payments));

- the change in the net income is –$100,000 under steps 5 and 6 (i.e. $100,000 (closing tax value of liabilities) minus zero (opening tax value of liabilities)).

The value of the liability will decline as the loan principal is repaid to match the deduction Fishton gets for the repayments.

14 The concept of tax value is discussed at paragraphs 3.48 to 3.52 and in Chapters 5 and 8.

Diagram 3.5 Effect on net income if loan is taken out



What is an asset?

3.44 An asset is a thing (such as land, chattels or a right) that embodies future economic benefits ***[subsection 6-15(1)]***. An asset usually has economic benefits because it can be used or sold. Money is an asset but is excluded in working out the net change in the tax value of a taxpayer's assets (see steps 3 and 4 of the method statement).

When does a taxpayer hold an asset?

3.45 Normally, a taxpayer holds an asset if they own it. However, other rules will apply to determine who holds certain kinds of assets for the purposes of the income tax law. ***[Subsection 6-15(3)]***

3.46 Chapter 5 contains a detailed explanation of what an asset is and by whom an asset is held.

What is a liability?

3.47 A liability is normally a present obligation to provide future economic benefits ***[section 6-20]***.[15] So, it would include an obligation to pay money, or to provide another kind of asset or a service. Chapter 8 contains a detailed explanation of what a liability is.

What is the tax value of an asset or liability?

3.48 The draft legislation contains rules to determine the tax value of assets and liabilities ***[sections 6-40 and 6-75]***. The tax value of assets will, in many cases, differ from their economic value. For example, the tax value of many assets will be their cost, so that gains will only be taxed when the asset is disposed of.

3.49 Chapters 5, 7, 8, 9, 10 and 11 contain a detailed explanation of how the tax value is determined for particular types of assets and liabilities. However, Table 3.5 briefly sets out the tax value of the main kinds of assets.

15 However, a liability that has not been incurred has a zero tax value (see section 6-75).

Table 3.5 Tax value of assets

Kind of asset	*Tax value*
An asset whose increase in value is to be taxed only upon realisation. This covers many assets capable of ownership (such as real property and some legally enforceable rights). It also covers some other assets not capable of ownership, such as knowledge acquired from someone else.	The asset's cost.[16] (The main components of an asset's cost are its original cost plus the cost of any improvements).
Certain rights to receive an amount (e.g. trade debtors where the terms for payment are 6 months or less and entitlements to receive an amount on demand).	The amount to be received.
Depreciating assets (e.g. items of plant, equipment and fixtures).	Written down value based on effective life or relevant depreciation or amortisation schedules (see Chapter 9).
Trading stock.	The lower of cost or net realisable value. A taxpayer can also make a generally irrevocable election to have the tax value of a class of trading stock set as market selling value (see Chapter 10).
Goodwill (e.g. the goodwill component of brand names and mastheads).	If the goodwill is acquired from someone else (i.e. when a business or franchise is bought), its tax value is its cost at that time. Otherwise the tax value is zero.
Assets whose annual increase in value is to be taxed using an accruals system (some financial assets).	The value worked out using the appropriate accruals methodology (see Chapter 7).

16 The draft legislation defines 'cost' – see Subdivision 6-E and Chapter 5.

Kind of asset	***Tax value***
Assets for which an election has been made to value the asset at market value. (This election can only be made for some financial assets.)	The market value of the asset.
Assets that should not, for policy or pragmatic reasons, be recognised by the income tax system. Examples are: • certain rights (such as some of those arising under routine leases);[17] • intangible advantages not capable of ownership (such as the market penetration that may arise from a successful advertising campaign).	Zero.

What is the closing tax value of an asset or liability?

3.50 The closing tax value of an asset or liability will be the tax value of the asset or liability at the end of the income year. ***[Subsection 5-70(1)]***

What is the opening tax value of an asset or liability?

3.51 The opening tax value of an asset or liability will always be the same as the closing tax value of the asset or liability brought to account in working out net income in the preceding income year. Thus, if there was no closing tax value brought to account at the end of the preceding year, the opening tax value of the asset is zero. ***[Subsection 5-70(2)]***

3.52 This opening tax value rule does not, however, apply to a balance in a money account that ceases to be a money account for the next income year and, therefore, becomes an asset or liability. In this case, the opening tax value of the relevant asset or liability is the balance in the account at the end of the income year when the account stopped being a money account ***[subsection 5-70(3)]***. This is illustrated in this example.

Example 3.6 Henry changes the way he treats one of his accounts

> Henry operates an overdraft account, which is invariably in debit, in the course of carrying on his business. In Year 1 he chose to treat the account as a money account, and at the end of that year it had a debit balance of $5,000. However, at the start of Year 2 he decides to rearrange his finances and, in so doing, decides not to treat the account as a money account in that year.

17 See Division 96 of the draft legislation.

The opening tax value for Year 2 of the liability that is in the account is $5,000. If the opening tax value of the liability was instead zero (as it would be in the absence of subsection 5-70(3)), Henry would effectively get a 'double deduction' for his expenditure.

What is the 'income tax law adjustment'?

3.53 The 'income tax law adjustment' is intended to adjust the net income to arrive at a taxable income for the taxpayers for whom adjustments to net income are to be made. These adjustments will mainly be necessary for policy or anti-avoidance reasons.

How is a taxpayer's income tax law adjustment worked out?

3.54 A taxpayer's income tax law adjustment is worked out as ***[subsection 5-90(1)]***:

Increasing adjustments – Decreasing adjustments

3.55 An increasing adjustment will add to taxable income while a decreasing adjustment will reduce taxable income.

3.56 The income tax law adjustment can, as a result of the application of the above formula, be a positive or negative amount ***[subsection 5-90(2)]***. If the result of the formula is zero, there is no income tax law adjustment.

What are the increasing and decreasing adjustments?

3.57 Various provisions throughout the draft legislation will specify when an increasing adjustment or decreasing adjustment arises. The rules dealing with the calculation of taxable income or tax loss provide tables that:

- set out some of the key adjustments ***[section 5-95]***; and
- direct the reader to where in the draft legislation these various provisions can be found ***[section 5-100]***.

3.58 Table 3.6 sets out some of the key increasing adjustments while Table 3.7 sets out some of the key decreasing adjustments.

Table 3.6 Key increasing adjustments

Increasing adjustment	*Rationale for the adjustment*
If the taxpayer has a negative net exempt income, an increasing adjustment for the amount by which it is negative. For example, a taxpayer with a net	Because exempt amounts are not taxable (see Table 3.7), any expenses that arise in respect of them should not usually reduce taxable income. This is the position under the current law.[18]

18 See section 8-1 of the ITAA 1997.

Increasing adjustment	***Rationale for the adjustment***
exempt income of –\$100 has an increasing adjustment of \$100. The meaning of the term 'net exempt income' is set out at paragraphs 3.65 to 3.67. ***[Subsection 5-95(1), item 5 of the table]***	A taxpayer will have a negative net exempt income if any such expenses exceed the exempt amounts. These expenses will have reduced net income (as either payments or liabilities) and, therefore, must be added-back to ensure the correct outcome.
An increasing adjustment equal to the amount of any gift or contribution (except to the extent that it is covered by Division 30 of the ITAA 1997) from which the taxpayer did *not* intend to gain an economic benefit. This adjustment will not cover a gift or contribution that is not taken into account in working out net income (i.e. as a payment or change in the tax value of an asset or liability). An example is a gift that is private or domestic in nature. ***[Subsection 5-95(1), item 10 of the table]***	Under the current law, gifts may be deductible under section 8-1 of the ITAA 1997 (e.g. because they are necessarily incurred in carrying on a business for the purpose of producing assessable income). Alternatively, they may be deductible under Division 30. Under the new approach, all non-private non-domestic gifts will have reduced net income (as either payments or liabilities). However, maintaining the approach under the current law, only these gifts are intended to reduce net income: • gifts that are made to obtain a benefit; or • gifts to bodies that qualify for deduction under the tax law (these are set out in Division 30). Accordingly, it is necessary to add back gifts not meeting these criteria.

Increasing adjustment	***Rationale for the adjustment***
An increasing adjustment equal to the amount of any *payment* of income tax, but only to the extent the payment is not characterised as private or domestic. ***[Subsection 5-95(1), item 20 of the table and subsection 5-95(2)]***	Payments of income tax (which may reduce net income under step 2) are not themselves intended to reduce taxable income (this is the position under the current law).[19] It is therefore necessary to add them back.
An increasing adjustment equal to the amount of any: • increase in the income year of any *liability* to pay tax imposed by an Australian law; or • decrease in the income year of any right to a refund of tax imposed by an Australian law. However, this adjustment will only apply to the extent the liability or right cannot be characterised as private or domestic. ***[Subsection 5-95(1), items 30 and 35 of the table and subsection 5-95(2)]***	Payments of tax (other than income tax) are intended to reduce taxable income, except to the extent they can be characterised as private or domestic. However, they are not intended to reduce taxable income when the liability to pay them arises. This is also true of liabilities to pay income tax. The reverse is true of refunds of tax. These increasing adjustments achieve the intended outcome.
An increasing adjustment to reflect apportionment for the private or domestic part of amounts that have *reduced* net income. An example is the decline in tax value of a depreciating asset that is used partly for private or domestic purposes. ***[Subsection 5-95(1), item 1 of the table; section 5-100, items 7 and 8 of the table]***	It is the intention that losses or outgoings that are private or domestic should not reduce taxable income. To achieve this outcome, it is necessary to add-back the portion of any loss or outgoing that is private or domestic. This is required because sometimes only wholly private or domestic amounts are excluded from net income. Chapter 4 explains these issues in detail.
An increasing adjustment when the general anti-avoidance rules apply. ***[Section 5-100, item 13 of the table]***	Taxpayers may enter into schemes to reduce or defer their tax liability. The general anti-avoidance rules are intended to address these schemes. Where the general anti-avoidance rule applies to address this problem, an increasing adjustment may be necessary to restore the taxpayer's tax position to what it would have been in the absence of the scheme.

19 See section 25-5 of the ITAA 1997.

Increasing adjustment	***Rationale for the adjustment***
An increasing adjustment equal to the amount of any distribution of profits (this would only apply where the taxpayer was a company or trust (called a 'tax entity')). ***[Section 5-100, item 3 of the table]***	Under the new entity taxation arrangements, tax entities are to pay income tax, at the entity tax rate, on their taxable profits. This includes those profits that they eventually distribute to members. Since such distributions will reduce net income (as payments), it is necessary to add them back to achieve this policy outcome.

Table 3.7 Key decreasing adjustments

Decreasing adjustment	***Rationale for the adjustment***
If the taxpayer has a positive net exempt income, a decreasing adjustment for the amount by which it is positive. For example, a taxpayer with a net exempt income of $100 has a decreasing adjustment of $100. The meaning of the term 'net exempt income' is set out at paragraphs 3.65 to 3.67. ***[Subsection 5-95(1), item 5 of the table]***	Exempt amounts are not intended to be taxable. Such amounts will be included in net income as either a receipt, increase in the tax value of assets or a decrease in the tax value of liabilities. Consequently, there needs to be a decreasing adjustment to ensure that the exempt amounts are not taxable.
A decreasing adjustment equal to the amount of any gift or contribution that: • is not taken into account in working out net income (e.g. a gift that is private or domestic in nature); and • covered by Division 30 of the ITAA 1997. ***[Subsection 5-95(1), item 15 of the table]***	A gift not included in working out net income (e.g. a private or domestic gift) will not reduce net income. This is appropriate unless the gift is made to a body listed in the gift provisions of Division 30. In these cases it is intended that a taxpayer be able to reduce their taxable income by the amount of the gift. This adjustment achieves that outcome.
A decreasing adjustment to reflect apportionment for the private or domestic part of amounts included in working out net income that have *increased* that net income. An example is a gain on disposal of a depreciating asset that has been used partly for private purposes. ***[Subsection 5-95(1), item 1 of the table; section 5-100, item 7 and 8 of the table]***	It is intended that amounts that are private or domestic should not be taxable. This adjustment will ensure that outcome. Chapter 4 explains these issues in detail.

Decreasing adjustment	***Rationale for the adjustment***
A decreasing adjustment equal to the amount of any receipt that is a refund of income tax. However, this adjustment will only apply to the extent the receipt cannot be characterised as private or domestic. ***[Subsection 5-95(1), item 25 of the table]***	These amounts are not intended to be taxable.
A decreasing adjustment equal to the amount of any: • decrease in the income year of any *liability* to pay tax imposed by an Australian law; or • increase in the income year of any right to a refund of tax imposed by an Australian law. However, this adjustment will only apply to the extent the liability or right cannot be characterised as private or domestic. ***[Subsection 5-95(1), items 30 and 35 of the table and subsection 5-95(2)]***	These adjustments deal with the same issues as discussed in the fourth row of Table 3.6 (dealing with increasing adjustments). A decreasing adjustment is necessary so that a decrease in a liability to pay tax, or an increase in a right to a refund of tax, does not affect a taxpayer's taxable income.
A decreasing adjustment for an application of the general anti-avoidance rules. ***[Section 5-100(2), item 13 of the table]***	The general anti-avoidance rules may operate to increase the taxable income, or reduce the tax loss, of a taxpayer. Where this is the case, it may be necessary to reduce the taxable income, or increase the tax loss, of one or more other taxpayers. This decreasing adjustment will achieve that outcome, if necessary.
A decreasing adjustment for expenditure concessions.	For policy reasons, the Parliament may provide for a taxpayer's expenditure on an asset, or an inflated proportion of a taxpayer's expenditure, to immediately reduce taxable income. Decreasing adjustments will achieve this outcome. For example, a decreasing adjustment will be needed to fully achieve the tax incentives for research and development expenditure. ***[Section 5-100, item 6 of the table]***

Unused tax losses reduce taxable income

3.59 All or part of a taxpayer's tax losses from earlier years may be used in an income year if the taxpayer's 'net income' plus their 'income tax law adjustment' is positive. The draft legislation is not complete in its treatment of losses. Accordingly, the paragraphs that follow discuss the anticipated treatment of prior year losses.

3.60 It is intended that only a taxpayer's prior year losses meeting the relevant tests[20] can be carried-forward to reduce taxable income in future years. Also, a tax loss will first reduce the amount of a taxpayer's net exempt income[21] (if positive) before it is used to reduce taxable income. If a taxpayer's net exempt income is negative, it is not relevant to working out how much of a tax loss is used-up.

What will 'unused tax losses' be?

3.61 The 'unused tax losses' will be:

- the sum of all the taxpayer's allowable tax losses from earlier income years that have not previously been used;

less

- the amount of a taxpayer's net exempt income (if positive).

How much of a tax loss will be used in an income year?

3.62 Some of a taxpayer's unused tax losses may be left over for use in future years. The amount of the unused tax losses used-up in an income year is set out in Table 3.8. However, tax entities subject to entity taxation will be able to elect whether or not to use a tax loss in an income year.[22]

Table 3.8 Amount of unused tax losses used-up in an income year

If the result of [net income + income tax law adjustment] is:	*The amount of the tax loss used-up is:*
Equal to or greater than the tax loss	The whole amount of the tax loss
Less than the tax loss	An amount of the tax loss equal to [net income + income tax law adjustment]

In what order will tax losses be used if there is more than one?

3.63 A taxpayer may have a tax loss from each of 2 or more earlier income years. In this case, the tax losses are used up in the order in which they are incurred. This is also the position under the current law. This means that:

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

21 The meaning of the term 'net exempt income' is set out at paragraphs 3.65 to 3.67.

22 See Recommendation 11.5.

- net exempt income (if positive) first reduces tax losses in the order in which they arose; then
- the amount of [net income + income tax law adjustment] reduces tax losses in the same order.

3.64 Example 3.7 illustrates how unused tax losses are used.

Example 3.7 A taxpayer has a tax loss from each of the previous two income years

Jacob is preparing his tax return for the 2004-2005 income year. For that income year he has:

- net income of $50,000;
- an income tax law adjustment of –$10,000; and
- net exempt income of $30,000.

Jacob also had a tax loss of $40,000 in each of the 2002-2003 and 2003-2004 income years.

Jacob does not have a taxable income. This outcome is worked out in the manner set out below.

- [Net income + income tax law adjustment] is $40,000 (i.e. $50,000 + (–10,000));
- Unused tax losses are $50,000 (i.e. $80,000 (tax losses) –$30,000 (net exempt income))
- The $40,000 [net income + income tax law adjustment] is reduced by the $50,000 unused tax losses, resulting in –$10,000.
- Jacob does not have a taxable income because the result of this process is not positive.[23]

All of Jacob’s 2002-2003 tax loss has been used-up. He has $10,000 of his tax loss from 2003-2004 left over to be carried-forward to future income years.

A ‘net exempt income’ may need to be worked out

3.65 A taxpayer may have to work out whether they have a ‘net exempt income’. This is relevant to whether they have an increasing adjustment or decreasing adjustment (see Tables 3.6 and 3.7) and to the amount of their unused tax losses that may reduce taxable income (see paragraph 3.61). The draft legislation does not set out the provisions for

23 See paragraph 3.18.

working out net exempt income. Accordingly, the paragraphs that follow discuss the anticipated framework for doing that.

3.66 There is a variety of areas throughout the income tax law that make various amounts exempt. Examples are the exemption of some social security benefits and the exemption of distributions that have been subject to family trust distribution tax.

How will net exempt income be worked out?

3.67 Net exempt income will be worked out using the same method used to work out net income (see the method statement at paragraph 3.25). However, only certain receipts, payments, assets and liabilities will be taken into account in applying the method statement. These are as set out below.

- Only receipts (called ***exempt receipts***) that the income tax law defines to be exempt will be included. Examples are exempt social security benefits and distributions subject to family trust distribution tax.

- Only payments made, and liabilities taken on, in order to get an exempt receipt will be included.

- Only assets and other liabilities that the income tax law says to include in working out net exempt income for an income year will be included. For example, if a gain on the disposal of an asset is intended to be exempt, the receipt for the disposal would be included in working out net exempt income, as would the opening tax value of the asset.

What is the treatment of non-cash transactions?

3.68 The draft legislation does not contain comprehensive rules to deal with arrangements involving the exchange or giving (without consideration) of non-cash benefits (e.g. a barter transaction). Consideration is being given to the development of these rules. They will be important to ensure that taxpayers are properly taxed on all their income, and that all their expenses are properly recognised.

How will capital gains be treated under the new method?

3.69 The draft legislation does not deal with capital gains treatment. The paragraphs that follow discuss the anticipated framework for dealing with gains subject to capital gains treatment in the context of the cash flow/tax value approach. Full details of the capital gains treatment proposals are discussed in *A Tax System Redesigned: Overview, Recommendations, Estimated Impacts*.[24]

3.70 Capital gains and losses will be brought into taxable income/loss as part of net income. In order to maintain the appropriate treatment for capital gains and capital losses, it will be necessary for a taxpayer to determine whether they have a net capital gain or loss for an income year. A taxpayer will need to do this in any income year in which one or more capital gains events occur (such as the disposal of an asset subject to capital gains treatment).

3.71 Table 3.9 sets out, in general terms, the anticipated effect capital gains treatment will have in working out taxable income or tax loss for these cases:

- where a portion of a gain is not to be included in taxable income;[25] and
- where capital loss quarantining applies.

Table 3.9 Effect of capital gains treatment on calculation of taxable income/tax loss

If there is a net capital gain:	***If there is a net capital loss:***
There would be a decreasing adjustment equal to the portion of any net capital gain that is not to be taxed.	There would be an increasing adjustment equal to the amount of the net capital loss (this would achieve quarantining). Any net capital loss could be carried forward to offset future capital gains as set out in the Recommendations.[26]

How are cash basis taxpayers affected?

3.72 The method for calculating taxable income will need to be modified to accommodate those taxpayers who, for policy reasons, will be taxed on a cash basis.

24 See Recommendations 4.10 and 4.11 and Section 18.

25 See Recommendations 18.2(a) and 18.3(i)

26 See Recommendation 18.4.

Chapter 4
Excluding private or domestic items

Outline of Chapter

4.1 This Chapter describes the circumstances in which the concept of 'private or domestic' is relevant in calculating an individual's income tax, and explains the meaning of the expression in the different contexts in which it arises. The relevant part of the proposed legislation is Division 12. This concept is not relevant to taxpayers other than individuals.

Context of Reform

4.2 The draft legislation introduces a new formula for working out how much income tax is payable by an Australian resident. It replaces the old method, which uses the expressions 'assessable income' and 'allowable deductions', with one that embraces 'receipts', 'payments', 'assets' and 'liabilities'.

4.3 However, some classes of these new items will be excluded from the formula. In the case of individual taxpayers, an exclusion will most commonly turn upon whether the expression 'private or domestic' could be said to apply in the particular circumstance.

4.4 Under the new system, a taxpayer's income comprises the excess of money receipts over money payments plus the change in tax value of net assets and liabilities over the year. Such a system attracts a number of advantages, including the extension of tax relief to business related expenditure that is 'preliminary' and therefore not 'incurred in deriving the assessable income' (often called 'blackhole expenditure').

4.5 Such a simple system is not suitable for individuals without some modification. For individuals, some receipts, such as gifts, and many payments, such as expenditure on food, clearly should fall outside the tax calculation. In a similar vein some liabilities, such as certain debts to a parent, and the falling tax value of assets used up through personal enjoyment should also be excluded.

4.6 The present law makes these kinds of exclusions by applying the notions of 'income', 'capital', 'private or domestic' and 'incurred in deriving the assessable income'. Under the draft legislation all receipts, payments, assets and liabilities are included unless they are specifically excluded.

4.7 In making these kinds of exclusions the draft legislation will rely solely upon the idea of 'private or domestic'. This test will have a role to play in accounting for receipts, payments, liabilities and some assets.

Summary of new law

4.8 The process of working out the tax liability of an Australian resident will comprise a number of steps:

- the tax liability for any year is worked out by applying the tax rates to the taxpayer's taxable income and then subtracting tax offsets ***[section 5-10]***;
- taxable income is worked out by determining net income, adding the income tax law adjustment and subtracting unused tax losses ***[section 5-15]***;
- net income is worked out by subtracting receipts from payments and adding (or subtracting) the net change in the tax value of assets and liabilities ***[section 5-55]***; and
- the income tax law adjustment is worked out by subtracting decreasing adjustments from increasing adjustments ***[section 5-90]***. Increasing adjustments and decreasing adjustments are specifically listed ***[sections 5-95 and 5-100]***;

4.9 For individuals, considerations of 'private or domestic' will arise in the process of working out both the net income and the income tax law adjustment.

'Private or domestic' and net income

4.10 The draft legislation excludes items from the net income calculation if they contain private or domestic features:

- receipts and payments will be excluded to the extent to which they are of a private or domestic nature ***[section 12-10]***;
- liabilities will be excluded if they are wholly of a private or domestic nature ***[section 12-15 and subsection 12-20(2)]***; and
- some assets will be excluded if they are for private or domestic purposes ***[section 12-15 and subsection 12-20(1)]***.

4.11 Some assets, such as a main residence and decorations for valour, that have private or domestic aspects are subject to special treatment ***[section 12-50]***.

'Private or domestic' and the income tax law adjustment

4.12 Increasing or decreasing adjustments will arise where ***[sections 5-95 and 5-100]***:

- there has been a change in the tax value of a liability that is associated with some private or domestic advantage;
- in the case of certain kinds of assets, there has been a change in the tax value of an asset partly used or intended for use for private or domestic purposes; and
- assets are disposed of, and liabilities are satisfied or disposed of, when some use or intention for private or domestic purposes has occurred.

Comparison of key features of new law and current law

4.13 The following table highlights the key features which can have the effect of excluding items from the tax calculation:

New Law	*Current Law*
Receipts are generally included in taxable income, but private or domestic receipts are excepted.	Income according to ordinary concepts forms the basis of taxable income.
Payments generally reduce taxable income, but private or domestic payments do not. Payments that result in an asset that remains at the end of an income year do not qualify for immediate deduction.	In order to reduce taxable income, outgoings must be: • incurred in the course of deriving the income; and not be: • private or domestic; or • capital.

Detailed explanation of new law

4.14 Basic to the process of calculating a person's income tax under the new method is the concept of net income. Under the statutory formula, the net income is worked out by subtracting receipts from payments and adding (or subtracting) the net change in the tax value of assets and liabilities (see Chapter 3).

4.15 For individuals the application of this formula is modified in order to take into account private and domestic considerations. Without such modifications, individuals would be subject to taxation on family gifts and would obtain tax relief for their expenditure on food and entertainment.

4.16 In order to avoid such results, the law provides that in the case of individuals all receipts, payments, liabilities and some kinds of assets will be excluded from the tax calculation to the extent that they have a private or domestic character or use. Furthermore, many individuals will have their incomes calculated on a cash basis. As such, many assets and liabilities will not need to be brought to account at all.

4.17 There are 3 mechanisms by which the taxable income can be modified to take into account private or domestic considerations:

- generally speaking, where an item of the net income formula could be described as 'wholly private or domestic', that item is excluded altogether from the net income formula ***[sections 12-10 and 12-15]***;
- generally speaking, in those cases where a receipt or payment is partly of a private or domestic nature, it will be excluded to the extent that it has this nature ***[section 12-10]***; and
- in those cases where liabilities and certain assets are used or intended for private or domestic purposes, there will often arise an increasing or decreasing adjustment ***[sections 5-95 and 5-100]***.

What does 'private' mean?

4.18 'Private' is a word that can carry a number of shades of meaning. The meaning that it carries in the context of taxation laws is one that can be contrasted with 'income earning' or 'commercial' or 'business'. A transaction of a private character and a private use of an asset or liability are typically associated with the enjoyment or sharing of wealth in contrast to its creation or growth. 'Private' does not carry the shade of meaning that can be contrasted with 'public', being the meaning it bears in, for example, 'private property' and 'a private income'.

What does 'domestic' mean?

4.19 'Domestic' can be used to describe those things that are of or pertaining to the household. Its meaning is similar to, though less general than, 'private'.

4.20 Further explanation about the meanings of 'private' or 'domestic' is best done in the various contexts in which they arise.

Applying 'private or domestic' to receipts and payments

What are receipts and payments?

4.21 The vast majority of cases will, as one would expect, involve the passing of money from one party to another.

4.22 However, under the new system of taxation there are provisions that deem a receipt or payment even if there has been no money changing hands.

The 'on behalf of' rule

4.23 Receipts and payments are taken to occur where there is a transaction not directly involving the taxpayer, but which occurs on the taxpayer's behalf. It is taken to involve both a receipt and a payment by the taxpayer. ***[Section 5-65]***

Example 4.1

> Thomas conducts a car dealership business and Lydia is an accountant. She decides to extend him some credit. Over a period she provides him with $80,000 worth of accounting services. Instead of asking him to settle up with a direct payment, she asks him to pay the money to one of her creditors in partial satisfaction of a debt. Upon payment, Lydia is taken to have received a payment of $80,000 in satisfaction of Thomas's debt, and is taken to have spent the money in reducing her own liabilities.

Special treatment of receipts and payments of individuals

4.24 For individuals, there is a general rule that receipts and payments are not taken into account to the extent that they are private or domestic in nature ***[section 12-10]***.

Example 4.2

> Thomas pays the newsagent $120, half of which covers newspapers for personal use and the other half is for stationery items that he will use in his business. The payment is private to the extent of $60.

4.25 However there is a major exception to this general rule. Where a payment is made to acquire or improve an asset, or an amount is received upon a sale of the asset, the payment or receipt will be wholly included or wholly excluded, depending entirely upon whether the asset itself will be or has been included ***[subsections 12-25(2) and (3)]***. All assets are included unless they are intended to be used for private or domestic purposes, and even then only if they fall into certain categories (see paragraphs 4.65 to 4.75).

Example 4.3

> Lydia buys a computer costing $8,000 for her accountancy business but she intends to use it partly for private purposes. The whole of the $8,000 is included as a payment.

4.26 Liabilities are treated in a symmetrical way. ***[Subsections 12-25(4) and (5)]***

Example 4.4

> Lydia borrows the $8,000 from a financial institution. Even though the funds will provide some private advantage, the resulting liability is included and the whole of the $8,000 loan principal is included as a receipt.

4.27 It will be necessary for individuals to examine their transactions to determine to what extent they are of a private or domestic nature.

4.28 Of course in a vast number of cases this will be so simple that taxpayers would not turn their minds to the matter at all. The tax implications of such obviously private payments as those for family groceries will not concern the taxpayer at the time of purchase or at the time of preparing an income tax return.

4.29 Indeed the system countenances such behaviour by deliberately excluding wholly private or domestic transactions from the net income formula in order that individuals are released from any requirement to record and account for these innumerable transactions.

Which kinds of <u>receipts</u> are private or domestic?

4.30 Generally speaking, the kinds of receipts that are presently taxed because they constitute ‘income’ within the ordinary meaning of that word would not be expected to be excluded under the proposed regime on the basis that they could be considered to be private or domestic. This is because it has always been inherent in the notion of ‘income’ that the expression tends not to embrace non-commercial, private or domestic affairs. That is, the meaning of ‘income’ already tends to exclude private or domestic receipts.

Example 4.5

> A father provides $10,000 to help his daughter in carrying on her meals-on-wheels business. The decision to make the payment has little to do with the nature of the business and much to do with the family relationship. As such, the receipt would be private and would not constitute income.
>
> On the other hand, if the daughter was entitled to a subsidy of $10,000 because of the nature of her business, the receipt would not be private and would constitute income.

4.31 The converse does not apply. There will be many receipts which are not income but which the new method will now bring to account – while ‘income’ does not include capital amounts, there is no such exclusion inherent in ‘receipts’.

Example 4.6

> Phoebe decides to buy a new tractor and borrows $20,000 for that purpose. Of course the amount does not constitute income, but at the time the funds are handed to her there will arise a ‘receipt’ (the resulting liability to the lender ensures that Phoebe is not taxed on her receipts).

Windfalls and gifts

4.32 Windfall receipts, such as lottery wins, would have a private nature and the same would generally apply to gifts. However amounts received in relation to income earning activities, such as tips or bonuses, would not be excluded from the net income formula.

Example 4.7

> Phillip is a talented footballer and wins the official fairest and best award. A television station rewards him with a payment of $20,000. The receipt is not private.

Wages etc.

4.33 Salaries, wages and fees for services provided would rarely be private, although the situation might arise in a purely domestic situation. For example, a child might be paid an allowance for performing household chores. This would not give rise to taxable income. In providing services, if a receipt is not for the services themselves (say, the painting of a room), but is merely a reimbursement of costs incurred in performance (the cost of the paint), then the receipt may well be private.

Inherently non-private receipts

4.34 Interest, rent, company dividend and trust distribution receipts would not be expected to have a private or domestic nature.

Receipts on disposal of assets

4.35 Receipts that are for the disposal of assets are subject to specified treatment ***[subsection 12-25(3)]***. As such, there is no need to determine whether the receipt itself is wholly or partially of a private or domestic nature. Instead, the rule is that the receipt will be included only if the asset is included. All assets are included in the net income formula, and then a range of specific exclusions, sharing a private or domestic theme, are provided for in sections 12-15, 12-20 and 12-50 (see paragraphs 4.65 to 4.75).

4.36 Even though the receipts upon disposal attract no 'private or domestic' scrutiny, the disposal itself may give rise to an increasing or decreasing adjustment, and the notion of 'private or domestic purpose' may well have a part to play in determining the existence and extent of these adjustments. The interplay between assets and 'private or domestic' is discussed later in this Chapter.

Borrowed principal

4.37 Similarly, it is not necessary to determine whether a receipt of borrowed funds from a lender, being a receipt giving rise to a liability, is private or domestic. This is because, in a way that mirrors the treatment of assets, the receipt will be included if and only if the liability is to be included ***[subsection 12-25(4)]***. Liabilities generally are included in the net income formula, with the exception of those liabilities that are wholly of a private or domestic nature ***[section 12-15 and subsection 12-20(2)]***.

Debt defeasance receipt

4.38 A receipt which constitutes consideration for taking over someone else's liability (a debt defeasance receipt) would be treated in the same way as the borrowings in the paragraph 4.37.

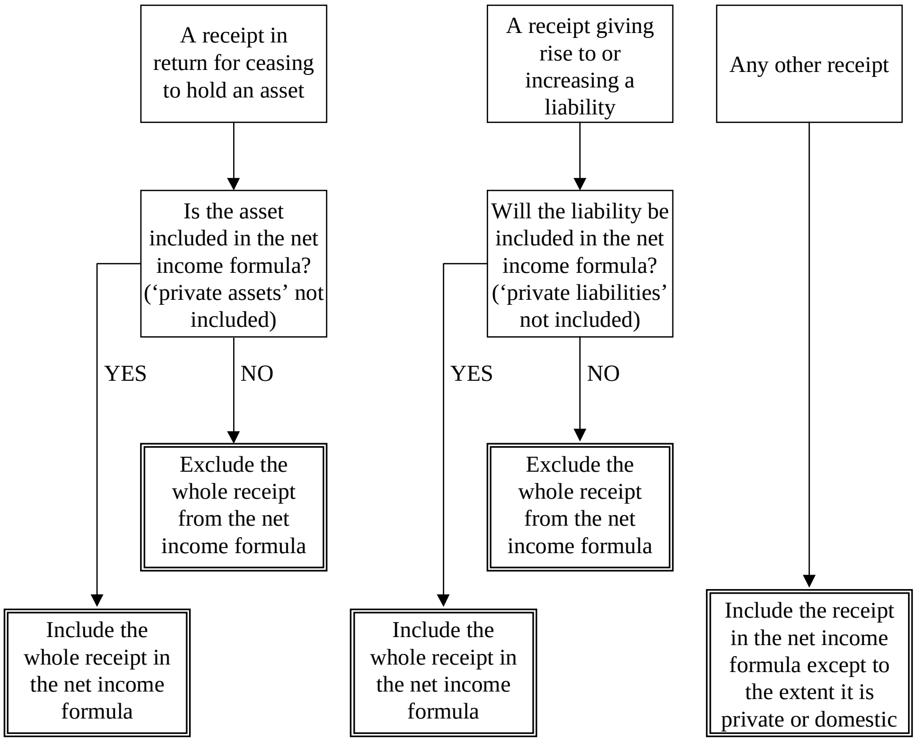
Repayment receipt

4.39 It is not necessary to determine whether a receipt which constitutes the repayment of a loan previously made by the taxpayer is private. The right to be repaid is an asset and, as is generally the case with assets, proceeds upon disposal will be included in receipts only if the asset is included in the formula. ***[Subection 12-25(3)]***

Categories of treatment for receipts

4.40 This diagram shows the different kinds of treatment that can apply to receipts.

Diagram 4.1



What kinds of payments are private or domestic?

4.41 There will be many more payments of a private or domestic nature than there will be receipts of this kind. This is not surprising when one bears in mind that a vast array of consumption transactions – purchases by non-business consumers of goods and services – involve a business receipt on one side but a private payment on the other.

4.42 Under the current law, expenditure comes within the general deduction provision (section 8-1 of the ITAA 1997) if it fulfils a number of requirements, including the requirement that it not be of a private or domestic nature. As such, all expenditure that currently qualifies as deductible under that section will not fail to provide tax relief under the new law solely on the basis that it is private or domestic in nature.

4.43 Payments will be of a private or domestic nature if they are calculated to achieve a private or domestic purpose. For the avoidance of doubt, the law will provide that some types of expenditure are private, for example, certain self education expenses.[1].

Gifts

4.44 A gift would usually be of a private or domestic nature, although there would regularly be occasions where a gift is not private because it is

1 See Recommendation 4.12.

made by a business to further its reputation and so sustain or improve its profitability.

Example 4.8

> Leong voluntarily contributes to the construction costs of a bypass road so that heavy vehicles do not detract from the amenity of a small town. Such a payment would not be private if it was to secure the favour of the local community in respect of Leong's business interests.

Food and drink

4.45 Normally an individual's payments for food and drink would be of a private nature, and this is the case even where an employer has prescribed the type and amount to be consumed.

Example 4.9

> Matthew is a professional footballer who would be a more effective player if he was bigger. His coach tells him to build himself up by eating lots of steak and potatoes and drinking more beer. The payments for the food are private.

4.46 On the other hand, expenditure on such items may not be private if it is made in the context of work related travel.

Example 4.10

> Nicholas conducts a rice exporting business and regularly travels to Japan to maintain contacts. During these trips his payments for food and accomodation would not be private.

4.47 Clearly such expenditure is not private if the food and drink constitutes trading stock or is consumed by one's employees in a work context.

4.48 It can be seen that whether or not a payment is private is to be determined not primarily by reference to the nature of the item or service that has been purchased, but by the nature of the advantage that the item or service will procure.

Child minding

4.49 Payments to obtain child minding services provide another example of this proposition. Such payments would normally be private even in the case where it is necessary to make such payments in order to earn one's income.

Example 4.11

> Timothy is the sole parent of a 3 year old boy. It would not be possible for him to continue his employment in a department store unless he uses child care facilities. The cost of this care is private.

4.50 However, if an individual carrying on business makes payments to secure child minding benefits for his or her employees, those payments would not be private or domestic.

Travel to and from work

4.51 Travel payments, too, illustrate the proposition. Costs of travel to and from work are normally private, even in the case where relatively expensive taxis are necessary because of the absence of public transport. However, if a person is required to transport to and from work bulky items associated with his or her income earning activities, payments in respect of that travel may not be private or domestic.

Example 4.12

> Freya plays in a symphony orchestra and is paid for doing so. Her instrument is the double bass and she is required to transport it to and from performances. It is so bulky that she needs to use a station wagon. The travel has a business flavour and so would not be private.

4.52 It is not intended that the new law would set up a departure from the current tax treatment of travel to and from work. Indeed many kinds of expenses would be expected to have their tax treatment remain the same.

Wages, rent etc.

4.53 Payments of wages will be private where a private or domestic advantage accrues. This will apply for example to payments to a cleaner in respect of service at the employer’s own residence.

4.54 Payments for rent, hire and leasing will be private to the extent to which the property is used for private purposes.

Interest

4.55 Interest is private, and so excluded, to the extent to which the borrowed funds are being used for a private purpose.

Example 4.13

> Benny borrowed $100,000 and used the funds to purchase 10 hectares. He uses half the land to operate a hobby farm, and leases out the other half. Each year he pays interest of $8,000. The liability for the $100,000 is included in the formula, but $4,000 of the interest payment is excluded as private.

Payments for assets

4.56 Payments that are consideration for the acquisition or improvement of assets are subject to special treatment. As such, there is no need to determine whether the payment itself is wholly or partially of a private or domestic nature. Instead, the rule is that the payment will be included if and only if the asset is to be included ***[subsection 12-25(2)]***. Assets generally are included in the net income formula, and then a range of specific exclusions, sharing a private or domestic theme, are provided for in sections 12-15, 12-20 and 12-50.

Extending loan funds

4.57 A payment that constitutes the extension of loan funds is effectively consideration for the acquisition of the resulting debt, which is an asset. As such the payment is subject to the special treatment discussed above.

Repaying a loan

4.58 Payments that are for the release from a liability are subject to special treatment ***[subsection 12-25(5)]***. As such, there is no need to determine whether the payment itself is wholly or partially of a private or domestic nature. Instead, the rule is that the payment will be included if and only if the liability was included. Liabilities generally are included in the formula under section 5-55, but those that are wholly private or domestic in nature are excluded by section 12-15.

4.59 However, even though the payments upon release attract no ‘private or domestic’ scrutiny, the release itself may give rise to an increasing or decreasing adjustment, and the notion of ‘private or domestic purpose’ may well have a part to play in determining the existence and extent of any such adjustment (see paragraphs 4.79 and 4.80).

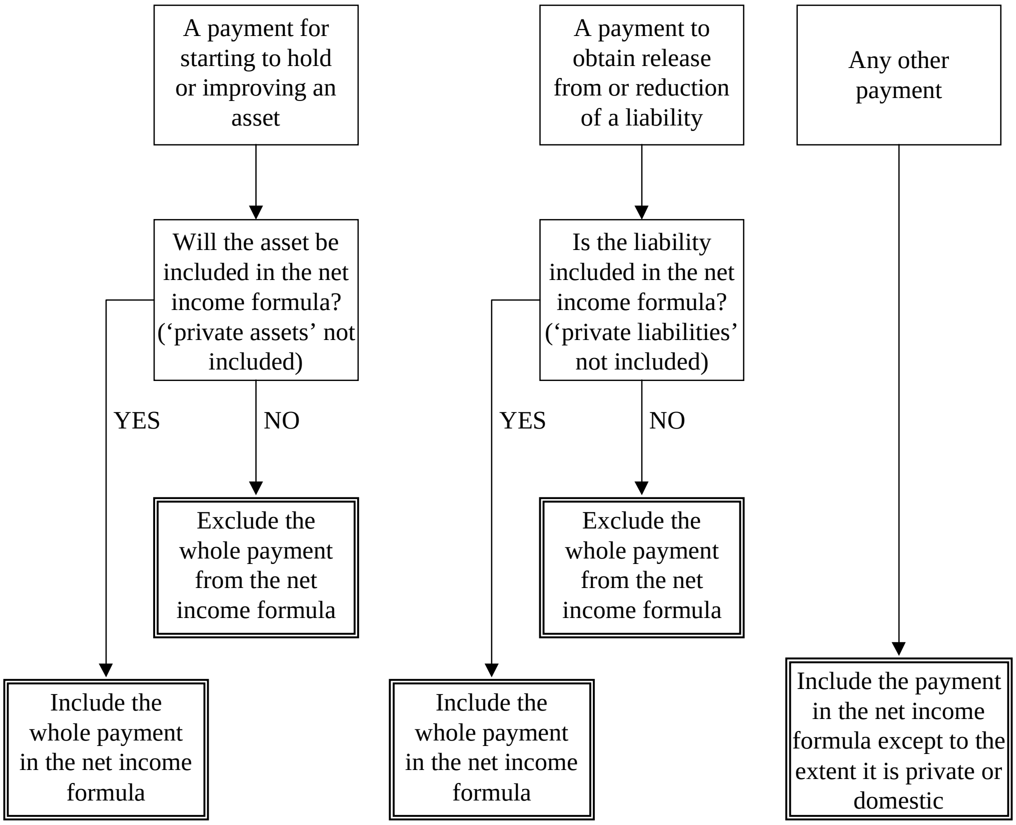
Debt defeasance payment

4.60 A payment made in order that another person will assume a liability (a debt defeasance payment) has the same effect as a repayment, and the treatment of such a payment is described in paragraph 4.59.

Categories of treatment for payments

4.61 Diagram 4.2 shows the different kinds of treatment that can apply to payments.

Diagram 4.2



Applying ‘private or domestic’ to assets and liabilities

4.62 As well as including the year’s receipts and payments, the net income formula requires that the tax value of assets and liabilities at the end of the year be taken into account ***[section 5-55]***. And as with receipts and payments, ‘private or domestic’ considerations can cause assets and liabilities to be excluded from the formula, and the ‘conversion rule’ means that assets and liabilities can move into and out of the formula even in the absence of a transaction. Such considerations can also cause assets and liabilities to give rise to increasing or decreasing adjustments.

The conversion rule

4.63 Conversion occurs where items, previously excluded from the net income formula because they are being used privately, are required to be included, and vice versa. In such a case it is taken that the taxpayer made or received a payment equal to the market value of the item. And even though that payment is not included as a ‘receipt’ or a ‘payment’, a tax adjustment will arise equal to the amount taken to be paid. ***[Sections 12-30, 12-35, 12-40 and 12-45]***

Example 4.14

Lydia had bought a room heater for $800 and has used it at home, but now decides to use it at her office. She could sell it for about $600. The heater will be brought into the taxing formula as an asset, and Lydia will be taken to have made a payment for it of $600. Even though the 'payment' is not included in the formula, a decreasing adjustment of that amount will apply.

4.64 The regime that applies 'private or domestic' considerations to assets differs substantially from that which applies such considerations to liabilities.

'Private or domestic' and assets

Exclusion from formula

4.65 Unlike the 3 other components of the net income formula – receipts, payments and liabilities – assets are not excluded from the calculation on the basis that they are wholly of a private or domestic nature. Assets generally are included in the formula, and then a range of specific exclusions, sharing a private or domestic theme, are provided for in section 12-15 and the definition of ***private asset*** in subsection 12-20(1).

4.66 Depreciating assets that are used or intended for use wholly for private or domestic purposes are excluded from the formula. However if a collectable depreciates, it will not fall within this exclusion ***[subsection 12-20(1), item 1 of the table]***.

Example 4.15

Robert is a professional portrait photographer and buys a small camera so that he can take it with him on his holidays. The asset is excluded.

4.67 All tangible assets, other than depreciating assets and land, costing $10,000 or less that are used or intended for use at least partially for private or domestic purposes are excluded ***[subsection 12-20(1), item 3 of the table]***.

Example 4.16

Jamila buys a painting for $9,000. She intends to usually hang it in her consulting rooms, but occasionally hangs it at home. The asset is excluded.

However if Jamila had no intention to hang the painting, and was holding it in safe storage with the intention to resell at a profit, it is included.

4.68 Some special classes of assets that have a measure of private or domestic character are subject to specialised treatment under other provisions. Such assets include an individual's main residence and a decoration for valour or brave conduct. ***[Section 12-50]***

4.69 The law provides that, generally speaking, a depreciating asset can be excluded only if it is used *wholly* for private or domestic purposes, and if not used, then intended to be used *wholly* for those purposes. On the other hand, non-depreciating assets are excluded as private on the basis of their initial cost and *partly* private usage.

What does 'used for a private or domestic purpose' mean?

4.70 As such, the meaning of the expression 'used for a private or domestic *purpose'* assumes an importance. And the terminology differs somewhat from 'private or domestic in *nature*'. However the differences between the 2 expressions should not be taken to reflect different ideas. Indeed payments will be of a private or domestic *nature* if they are calculated to achieve a private or domestic *purpose* (see paragraph 4.43 and following).

4.71 A private or domestic purpose, in respect of the use of an asset, is one which concerns the enjoyment or sharing of wealth rather than its creation or maintenance.

Example 4.17

> Adam is a travelling salesman and uses his car for these purposes. The use is not private – he is looking to earn money.
>
> Adam uses his car to inspect his rental properties. The use is not private – he is looking to protect his income earning assets.
>
> Adam uses his car to drive to the coast for a holiday. The use is private.
>
> Adam's friend Ellie needs a car in her catering business, but hers is temporarily off the road. Adam lets her use his car. The use is private – Adam is sharing his wealth.

Tax adjustments for end of year assets

4.72 The formula requires that the tax value of included assets be brought to account at the end of each year. This may give rise to tax adjustments on account of private or domestic considerations in the case of depreciating assets.

4.73 If a depreciating asset which is included in the formula has been used for a private or domestic purpose, an increasing adjustment will arise. The adjustment is equal to the part of the fall in tax value for the year that is attributable to private or domestic use or holding. Section 40-80 provides for an increasing adjustment where a depreciating asset is used for non-taxable purposes, and subsection 40-25(3) defines non-taxable purposes as including private or domestic purposes.

Example 4.18

> Lydia's computer had an opening tax value of $3,000 and a tax value at year end of $2,500. It was used half the time for private purposes, so an increasing adjustment of $250 will arise.

4.74 There is no provision for other kinds of end of year assets that are used for private or domestic purposes to give rise to tax adjustments. This is because their tax values will not change over the year, even if their market values do.

Tax adjustments on disposal of assets

4.75 The disposal of a depreciating asset that has been held both for private or domestic purposes and otherwise than for those purposes will ordinarily give rise to an adjustment amount, and it may be either increasing or decreasing ***[section 40-85]***. The adjustment copes with the private use of the asset for the whole of the time during which it was held by taking into account, amongst other things, previous year increasing adjustments. This is fully explained at Chapter 9 which deals specifically with wasting assets.

'Private or domestic' and liabilities

Exclusion from formula

4.76 Liabilities are excluded from the calculation if they are wholly private or domestic in nature ***[section 12-15 and subsection 12-20(2)]***. The nature of a liability is determined by the nature of the advantage its existence provides. In the case of a liability constituted by a borrowing, its nature would usually be determined by an examination of the use of the borrowed funds. Just as the use of borrowed funds can change, so can the nature of a liability.

Example 4.19

> Anna borrows $40,000 from the bank in January 2000 and uses the funds to buy a car for her private use. As a result the liability to the bank is wholly private.
>
> In March she sells the car for $40,000, buys a cheaper model for $20,000 and puts the other $20,000 in an interest bearing term deposit. The liability is no longer wholly private and as such the conversion rule applies. Anna is deemed to have received $40,000, but includes a matching liability of $40,000 in the tax calculation formula.
>
> Any interest paid in respect of the period after the sale would be private to the extent of 50%.

Tax adjustments for end of year liabilities

4.77 Liabilities can change their tax value over the course of a year. For example, a borrower's liability will increase if interest is capitalised. The increase in the tax value of the liability will lower the borrower's taxable income for the year by just the same amount as interest payments would have done if the interest was not capitalised.

4.78 If the loan funds were used to some extent for private purposes, interest payments would be excluded from providing tax relief to that extent. The same ultimate effect is expected to be achieved in the case of capitalised interest by means of a tax adjustment ***[subsection 5-95(1), item 1 of the table]***.

Example 4.20

> At the end of June 2000, Anna arranges that the interest not be paid but instead be added onto the outstanding balance (capitalised). On 30 June 2001 the balance of the loan has grown from $40,000 to $44,000. An increasing adjustment of $2,000 will arise, reflecting the proportion of private use of the borrowed funds.

Tax adjustments upon release from liabilities

4.79 For liabilities there is no equivalent to depreciation, which is estimated in advance and then adjusted (corrected) upon asset disposal with the advantage of hindsight. Because the kind of liability held for private purposes is typically a borrowing, which has a value that can be determined at any time (i.e. the amount owing), there is no need to adjust for prior year estimations at the time of release. As such, the procedure for adjustment upon release is expected to be similar to that applying to end of year adjustments.

4.80 An increasing or decreasing adjustment is expected to arise upon release from a liability where there is a variation between the tax value at the beginning of the year and the payments to obtain release, to the extent that the liability has been held for private or domestic purposes. ***[Subsection 5-95(1), item 1 of the table]***.

Example 4.21

> In December 2001 Anna repays the loan, which by this time has further increased from $44,000 to $46,000. Her payment is, of course, $46,000 which is $2,000 in excess of the opening balance. An increasing adjustment of $1,000 will arise reflecting the proportion of private use.

Chapter 5
Assets and tax values

Outline of Chapter

5.1 This Chapter explains:

- what an *asset* is;
- who *holds* an asset;
- the rules for working out an asset's *tax value*; and
- the rules for working out an asset's *cost*.

Context of Reform

5.2 While much of the current law seeks to assess changes in asset values, it is not clearly expressed in those terms.

5.3 In particular, the current law fails to *define* a concept of asset that can be used consistently throughout the law. For example:

- the general deduction provision in the current law (i.e. section 8-1) applies the asset concept by referring to outgoings of a 'capital' nature – expenditures that provide an *enduring* benefit – whereas, the capital gains and losses provisions (i.e. Parts 3-1 and 3-3) apply that concept using, in part, the notion of legal property.

5.4 As a result, assets are *treated* in different and, often, inconsistent ways. For example:

- some expenditures that give rise to items of a capital nature may be deducted over time (e.g. plant and equipment), whereas others cannot be deducted at all (e.g. takeover defence costs).

5.5 Contributing to the inconsistent treatment of assets is the current law's *prescriptive approach*. For example, the current law allows taxpayers that own assets, which decline in value over time, to write-off their cost over time, but only if the assets are specifically listed. As a result, plant and equipment may be depreciated (as it is listed), but a right for a fixed period cannot (as it is *not* listed) even though they both have a limited useful life and both will decline in value over time. The current law's prescriptive approach in this area means that the law must regularly be amended to include assets that were not previously listed. The latest example of this type of amendment is the capital allowance provisions for spectrum licences.

5.6 The new law will define an *asset* for the whole law. It draws on the meaning of asset for accounting purposes. This definition will help make clear the scheme of the income tax law, making it easier to comply with.

5.7 The current law taxes different taxpayers on the gains and losses of an asset depending on what kind of asset it is. As a result, the taxpayer who has to take into account the gains or losses of an asset could be the asset's legal owner, equitable owner or the taxpayer that paid for the asset. The new law will set out in one place the provisions relating to who owns or holds particular assets.

5.8 Under the new law, gains and losses from assets are included in taxable income by means of changes in the tax value of those assets. An important element in working out the tax value of most assets will be their cost. The current law does not consistently define cost. The capital gains and losses provisions refer to 'cost base', the trading stock provisions refer to 'cost price' and other provisions refer to 'cost'. Each of these terms can involve different components. The new law will provide a single meaning of cost.

Summary of new law

What will Division 6 do?	Division 6 of Part 1-3 of the new law deals with assets and liabilities and the concept of tax values. This Chapter explains the concept of asset and Chapter 8 explains the concept of a liability.
What is an asset?	An ***asset*** is something that embodies future economic benefits.
Who holds an asset?	In general, a taxpayer ***holds*** an asset if it owns the asset. But, there are special rules for some cases (e.g. tenant's fixtures and assets that are not capable of ownership).
What is tax value of an asset?	The ***tax value*** of an asset is the asset's value for income tax purposes.

How is an asset's tax value worked out?

The new law sets out rules for working out an asset's tax value. Very broadly, those rules are summed up in these general approaches:

- cost – the cost of creating or acquiring an asset plus the cost of any improvements;
- estimated value – the cost of an asset plus or minus an amount by which the asset is estimated to increase or decrease in value each year; and
- market value.

How is an asset's cost worked out?

The cost of an asset is comprised of 2 elements:

- costs in coming to hold the asset; and
- costs that bring the asset to its present condition and location.

Comparison of key features of new law and current law

New Law	***Current law***
The concept of an *asset* is defined and consistently used throughout the entire law.	The concept of an *asset* is not consistently applied. As a result, a single concept of asset does not emerge.
An asset is defined in commercial and economic terms.	An asset is generally defined in legal terms.
A taxpayer will be taxed on the gains and losses from an asset if they *hold* it. The principle underlying the concept of holding an asset will be clear: a taxpayer holds an asset if it economically owns the asset.	It is not always clear who is taxed on the gains and losses from an asset. Sometimes it is the legal owner, sometimes the equitable owner and sometimes the taxpayer that pays for the asset. The principle that connects these situations is not clear.
The tax treatment of an asset's gains and losses will be principled. Normally, gains and losses will be subject to taxation when they are realised. In some cases, unrealised gains and losses are subject to tax if they are relatively certain.	The tax treatment of an asset's gains and losses is by way of prescription. In general, the treatment that an asset's gains or losses get depends on whether the asset is singled out for a tax treatment.
The *cost* of an asset is defined and consistently used throughout the law.	The *cost* of an asset is not consistently defined. For example, the capital gains and losses provisions use 'cost base' and the trading stock provisions use 'cost price'. These terms include different elements.

Detailed explanation of new law

5.9 A taxpayer's taxable income for an income year will include any change in the *tax value* of an *asset* that it *holds* ***[section 5-55]***.

5.10 An increase in the tax value of an asset will increase taxable income, conversely a decrease will reduce taxable income.

5.11 A taxpayer will *hold* an asset if it is the asset's economic owner; that is, if the taxpayer is able to access the future economic benefits of the asset while stopping others from accessing those benefits. In most cases, the legal owner of an asset will be its economic owner. ***[Subsection 6-15(3)]***

5.12 The new law sets out rules for working out the *tax value* of assets ***[section 6-40]***. The result of these rules is that an asset's gains are *not* taxed, in most cases, until the asset is disposed of. This is achieved by giving most assets a tax value equal to their cost.

5.13 Broadly, the *cost* of an asset is equal to the cost of creating or acquiring an asset (including any incidental costs) plus any costs of improving the asset. ***[Subdivision 6-E]***

What is an asset?

5.14 An ***asset*** is a thing that is able to provide economic benefits in the future ***[subsection 6-15(1)]***. Assets embody future economic benefits in that they are the source of those benefits. Put another way, assets are things of *positive* economic value.

5.15 Assets can take any number and manner of forms. They can be tangible, or objects, such as motor vehicles, or intangible. Intangible assets include rights, such as the right of access to someone else's asset for a period, as well as things that are *not* rights, such as knowledge and other advantages.

5.16 Some things that meet the asset definition are not taken into account in working out taxable income because they are given a tax value of zero (see paragraph 5.42).

5.17 The asset definition does not require the precise measurement of a thing's economic value. It is sufficient in meeting the definition that a thing has some positive economic value even if it is not ascertained or brought to account.

Identifying the *asset*

5.18 Most assets have constituent parts. In some cases, the question will arise whether *the* asset is:

- a set of things; or

- each of the things.

5.19 That question is one of fact and degree. It must be determined in the light of all the circumstances of the particular case. Nevertheless, as a general principle, a set of things that is functionally and structurally complete usually constitutes a single asset. Therefore, it is necessary to consider if a set of things is linked in a way that creates a single item with its own function ***[subsection 6-15(2)]***.

5.20 For example:

- a working motor vehicle is made up of a number of parts, but the motor vehicle is *the* asset; and

- a share in a company is made up of a number of rights (e.g. the right to vote, and the rights to share in dividends and returns of capital), but the share is *the* asset.

5.21 In some cases the new law sets out special rules that help make clear the identity of an asset ***[section 6-25].*** For example, land is an asset that is separate from any capital improvements made to it ***[item 1 of the table in section 6-25]***.

5.22 The function and structure of assets can change over time. An asset can be split into a number of assets ***[section 6-130]***. For example, a car wrecker can split a motor vehicle into a number of assets by stripping the vehicle of its parts and selling them separately.

5.23 Also, assets can merge into a single asset ***[section 6-135]***. For example, components such as a keyboard, hard-disk drive and motherboard can be assembled to form a computer.

5.24 The identity of an asset is generally taken from the *thing* that constitutes the asset. As a result, a tangible asset is identified by an object. The identity and existence of a tangible asset may be confirmed by viewing it (e.g. stock-take of trading stock).

5.25 An intangible asset is usually identified by a right. The identity and existence of intangible assets cannot be confirmed by *directly* viewing them. However, their identity and existence can be confirmed by considering the transactions that gave rise to the rights. For example, the right to use business premises into the future, which arises out of a prepayment, may be identified on the basis of a tenancy agreement and expenditures made (as ascertained from business and accounting records). Rights recognised by the legal system (e.g. rights arising under contract) are capable of ownership.

5.26 Intangible assets that are *not* rights can be more difficult to identify. They will include knowledge and other advantages. Like rights, they cannot be physically identified. However, unlike most rights, they do not generally result from agreements with others. Generally, the existence of such assets can only be confirmed by examining the object sought in making certain expenditures.

5.27 Assets that are knowledge or other advantages are often identified or labelled by the object of the expenditure.

What is an economic benefit?

5.28 An economic benefit is a benefit that can be measured in money. However, the benefit does *not* need to be capable of being converted into money (see paragraph 5.32).

5.29 Economic value is a different way of looking at future economic benefits: a thing will have an economic value *now* if it is able to provide economic benefits in the *future*. Thus, assets may be considered from 2 perspectives:

- as a stock of future economic benefits; or
- as a store of economic value.

5.30 Economic benefits come in 2 forms:

- cash inflows (e.g. a debt owed to a taxpayer will give rise to cash receipts); and
- service or use (e.g. plant and equipment can be used to produce goods or services).

5.31 Most assets provide both types of economic benefit. For example, a computer can be used to run a program (providing a service benefit) *and* it can be sold for cash (providing a cash inflow benefit). Therefore, the computer has economic value because of what it can do (i.e. value-in-use) and what it can be sold for (i.e. value-in-exchange).

5.32 A thing may still be an asset even if it cannot be sold. This will be the case where the asset has value-in-use but does *not* have value-in-exchange. For example, an item of specialised equipment may not have a disposal value if nobody other than its current owner can operate it. Nevertheless, the equipment would still constitute an asset if its owner could use it to provide economic benefits.

Who holds an asset?

5.33 The change in the tax value of an asset is included in the taxable income of the taxpayer that *holds* the asset ***[steps 3 and 4 of section 5-55]***. In this way only the holder of an asset accounts for the asset’s changes in tax value.

5.34 The new law sets out a table identifying the holder of different kinds of assets ***[subsection 6-15(3)]***. Broadly, applying that table results in the economic owner of an asset holding that asset; that is, the taxpayer that is able to access the asset's economic benefits *while* stopping other taxpayers from doing the same. New items may need to be added to the table as the legislation is further developed.

5.35 In most cases, the economic owner of property is also its legal owner. In the case of assets which are property, an owner's ability to use or exchange the asset and deny others from doing the same is protected by the courts. On this basis, the new law recognises the legal owner of an asset as holding that asset. ***[Item 6 of the table in subsection 6-15(3)]***

5.36 In some cases, however, the legal owner of an asset is *not* its economic owner. This is most commonly the case with assets that a taxpayer affixes to another's land.

5.37 Assets affixed to land become part of land. Therefore, they are owned by the land's legal owner. For example, if a taxpayer refits the premises that it rents, the office fittings become part of the land (especially if they cannot be removed without damaging the premises). Therefore, the fittings are legally owned by the landlord. However, the economic owner of the asset is the taxpayer. It is the taxpayer that suffers the cost of the fittings. It is the taxpayer that is able, during the rental period, to use the fittings as well as being able to stop others from doing the same. In such cases, the new law treats the taxpayer that incurs the cost of the fittings as holding the asset, at least, for the period of the lease. ***[Item 4 of the table in subsection 6-15(3)]***.

5.38 Some assets cannot be legally owned. For example, knowledge may be an asset, but it cannot be legally owned unless it is patented. Nevertheless, such assets can have an economic owner.

5.39 A taxpayer ***holds*** such an asset if it is able to:

- use the asset; and
- deny other taxpayers from using or accessing the asset's economic benefits. ***[Item 7 of the table in subsection 6-15(3)]***

Example 5.1 Client lists

Charities Inc. Pty Ltd is a profit seeking company that is used by a number of charities to help raise funds. Charities Inc. keeps a record of any entity that has ever made a donation. Each time a new fund raising campaign begins Charities Inc. first approaches those entities that have previously donated. Those entities are more likely than others to contribute.

That list of clients is an asset, but it is not property. Charity Inc. holds the list because it can use it and by keeping it confidential can stop others from using it.

What is an asset's tax value?

5.40 While economic value is important in applying the asset definition, it is generally not used in working out taxable income.

5.41 Instead, the new law contains special rules for calculating the values of assets that are used in working out taxable income. That value is called the ***tax value*** ***[Subdivision 6-C]***. The new law explains how to work out the tax value of assets ***[section 6-40]***.

'Nil' tax values

5.42 Some assets will not be recognised for tax purposes and will therefore have a zero tax value. A zero tax value may be given to an asset for policy or pragmatic reasons. The new law may also specify a zero tax value to remove uncertainty. For example, an advertising campaign may provide economic benefits into the future. However, given the difficulty in determining the extent of benefits beyond a year in which the advertising occurs this type of asset will be given a tax value of zero ***[item 14 of the table in section 6-40]***.

5.43 Similarly, while knowledge that is not a form of property may constitute an asset in that it embodies future economic benefits, it is given a tax value of zero. The rules dealing with research and development will give the appropriate tax treatment to knowledge acquired through research and development.

How is an asset's tax value worked out?

5.44 An asset's tax value will be worked out using *rules* set out in the new law ***[section 6-40]***.

5.45 Different rules will apply to different kinds of assets. For example, the tax value of:

- trading stock is worked out using the rules in Division 38 ***[item 1 of the table in section 6-40]***;
- depreciating assets are worked out using the rules in Division 40 ***[item 2 of the table in section 6-40]***; and
- financial assets are generally worked out using the rules in Division 45 ***[item 7 of the table in section 6-40]***.

5.46 In very broad terms, each of the *rules* for determining the tax values of assets can be categorised into one of these general *approaches*:

- cost;
- estimated value; and
- market value.

Cost

5.47 Where the tax value of an asset is set at its cost, gains or losses will only be included in a taxpayer's taxable income when the asset is disposed of.

Example 5.2 How gains and losses are treated if the tax value of an asset is its cost

On 1 May 2003, Kathy pays $150,000 for a vacant block of land. Kathy holds the land as an investment.

The local council announces plans, on 15 June 2003, to redevelop the local shopping centre. As a result, local property values improve. At 30 June 2003, the land is worth $180,000.

Kathy's taxable income for the income year ending 30 June 2003 does *not* include her unrealised gain on the land of $30,000. This is because the land's tax value is its cost and *not* its market value. As a result, Kathy's payment for the land of $150,000 is balanced by the land's tax value of $150,000.

On 1 August 2003, the local council announces that it is abandoning its plans to redevelop the local shopping centre. As a result, local property values decline. Kathy sells the land on 1 March 2004 for $130,000.

Kathy's taxable income for the income year ending 30 June 2004 will take into account a loss of $20,000: Kathy has a receipt of $130,000 (the sale price of the land) and a decrease in the tax value of her assets of $150,000 (the tax value of the land that she no longer holds).

5.48 Tax value will be calculated by reference to cost for:

- trading stock if ***[item 1 of the table in section 6-40 and section 38-20]***:
  - a taxpayer does not choose market selling value; and
  - the cost of the trading stock is lower than its net realisable value;
- some financial assets ***[item 7 of the table in section 6-40 and items 3 and 5 of the table in section 45-15]***;
- membership interests, such as ordinary shares in a company ***[item 5 of the table in section 6-40]***;

- rights:
  - to receive an amount that has become due and payable ***[item 3 of the table in section 6-40]***;
  - to receive an amount for a supply on terms that require payment within 6 months ***[item 4 of the table in section 6-40]***; and
  - to have an amount applied in discharging a taxpayer's liability to income tax ***[item 10 of the table in section 6-40]***;
- goodwill if it is acquired from another taxpayer ***[item 12 of the table in section 6-40]***;
- assets that can be owned (which are not given an estimated or market value, or covered above), such as land ***[item 11 of the table in section 6-40]***; and
- assets that cannot be owned which have been acquired from another taxpayer, such as a secret formula ***[item 13 of the table in section 4-50]***.

Estimated value

5.49 Under this approach, an asset's expected gains or losses are spread over time. This approach is appropriate if the amount and timing of an asset's gains or losses are relatively certain or can be reliably estimated.

5.50 However, depending on the kind of asset, different techniques will be used in spreading an asset's gains or losses:

- losses on depreciating assets will be spread according to Division 40 ***[item 2 of the table in section 6-40]***. In some cases, this will involve *estimating* the effective life of a depreciating asset. (See Chapter 9).
- gains and losses on many financial assets will usually be spread according to Division 45 ***[item 7 of the table in section 6-40]***. (See Chapter 7).

Example 5.3 How losses from a depreciating asset are treated

Scotty's Design Pty Ltd buys a computer that is to be used in some graphic design work. The computer is purchased on 1 July 2001 and is ready for use from that date. The computer costs $12,000. Scotty's estimate that the computer will have an effective life of 2 years.

Using the straight-line method of depreciation for depreciating assets in Division 40, the tax value of the computer will decrease from its cost of $12,000 to $6,000 at 30 June 2002 and $0 at 30 June 2003. As a result, Scotty's taxable income will be reduced by $6,000 in each of 2002 and 2003.

Example 5.4 How gains from a financial asset are treated

On 1 July 2000, Finco Pty Ltd issues Simone with a promissory note. The face value of the note is $121 and date of payment is 30 June 2002. The note costs $100.

Subject to the risk of default, Simone is certain to make a $21 gain from the promissory note when it is paid on 30 June 2002. As the amount and timing of the gain are relatively certain, it can be spread over the life of the note.

Using the formula for financial assets in Division 45, the tax value of the note will increase from its cost of $100 to $110 at 30 June 2001 and $121 at 30 June 2002. As a result Simone will be taxed on a $10 gain in 2001 and an $11 gain in 2002.

5.51 Under this approach, the tax value of an asset at any time will be made up of two components:

- its *cost*; and
- the amount of the expected gain or loss which has accrued up to that time.

5.52 For example, in Example 5.4, the promissory note's tax value as at 30 June 2001 is $110, being made up of its cost ($100) and the gain which has accrued up to that time ($10).

Market value

5.53 Taxpayers can work out the tax value of trading stock and some financial assets using market value ***[items 1 and 7 of the table in section 6-40]***.

5.54 However, this method will not apply automatically. Taxpayers must make a choice to apply it to a particular class of assets.

5.55 The *rules* which refer to market value in working out the tax value of trading stock are set out in Division 38 (see Chapter 10).

5.56 The rules that allow the tax value of some financial assets to be worked out using their market value are set out in Division 45 (see Chapter 7).

How is an asset's *cost* worked out?

5.57 The general rules about working out the cost of an asset are explained in Subdivision 6-E. For some assets, further rules replace or vary the general rules. A table in Subdivision 6-E lists those assets and signposts the provisions where the special rules can be found ***[section***

6-140]. Those special rules are explained in the appropriate Chapters of these explanatory notes.

5.58 In general, there are 2 elements to the cost of an asset ***[section 6-100]***. The first element broadly deals with what it cost the taxpayer to start to hold the asset. That element will be part of the cost of every asset. The second element is about what it cost the taxpayer to bring the asset to its current condition and location. That element will only apply to some assets.

5.59 The first element is *always* worked out as at the time when the taxpayer began to hold the asset ***[subsection 6-105(1)]***. If the taxpayer has held the asset more than once (e.g. because it was sold, then repurchased later), the relevant time is when the taxpayer *most recently* began to hold it.

5.60 The second element is worked out at a particular moment ***[subsection 6-110(1)]***. When taxpayers need to know the asset's cost, they work out what it has cost them *to that point* to bring the asset to its current condition and location.

First element of cost

5.61 The first element of the asset's cost (essentially, what was paid to start holding it) is explained by a table ***[subsections 6-105(2) and (3)]***. The table lists the cases and identifies the amount of the first element for each case. The cases are listed in a deliberate order. If more than one case applies, only the last case is used ***[subsection 6-105(3)]***.

Payment cases

5.62 The main case is simply paying money to hold the asset, in which case the first element is that amount ***[subsection 6-105(3), item 1 of the table]***. This would cover money paid to *create* an asset (e.g. labour and materials) as well as simple purchase prices. It would also cover payments incidental to starting to hold the asset (e.g. stamp duty).

5.63 A similar case is incurring a *liability* to pay money (or increasing an existing liability to pay money) in order to hold the asset. In that case, the first element is the liability's tax value (or the increase in its tax value) when the taxpayer began to hold the asset ***[subsection 6-105(3), item 2 of the table]***. If the taxpayer both paid money *and* incurred (or increased) a liability to pay money, the first element is the sum of the first 2 cases ***[subsection 6-105(3), item 3 of the table]***.

5.64 If a single payment is for several non-cash benefits, only the reasonable part of it is treated as being for each of the assets it covers ***[section 6-120]***. What is reasonable will depend on the circumstances of each case but a good guide will often be the market values of the various things the payment was made for.

Non-cash benefit cases

5.65 If the taxpayer provides a non-cash benefit (except a liability to pay money) to hold the asset, the first element of the asset's cost is the asset's market value just before the taxpayer started holding it ***[subsection 6-105(3), item 4 of the table]***. Because this item is later in the table than the payment cases, it also covers cases where the taxpayer also made a payment, or created a liability, as well as providing the non-cash benefit. What is a non-cash benefit is explained at paragraphs 5.82 to 5.85.

Financial assets

5.66 The first element of the cost of most financial assets that a taxpayer acquires by providing a non-cash benefit (except incurring or increasing a liability to pay money) and nothing else, is the market value of the non-cash benefit at the time it was provided ***[subsection 6-105(3), item 5 and section 45-70]***.

Hire purchase and leased luxury cars

5.67 If the taxpayer holds the asset because of the special rule in subsection 6-15(3) about assets taken on hire purchase, the first element of the asset's cost is its market value when the contract was entered into ***[subsection 6-105(3), item 6 of the table]***. Similarly, if the taxpayer holds the asset because of the special rule in subsection 6-15(3) about leased luxury cars, the first element of the car's cost is its market value when the lease was granted ***[subsection 6-105(3), item 7 of the table]***.

Split and merged assets

5.68 Sometimes an asset will be split into 2 or more assets and the cost of each of those new assets will have to be worked out. The rule will be that the first element of the cost of each new asset is a reasonable share of the original asset's tax value just before it was split into the new assets ***[subsection 6-105(3), item 8 of the table; subsection 6-130(2)]***.

5.69 Similarly, assets are sometimes merged into a single asset. The first element of the cost of the merged asset will be the sum of the original assets' tax values just before they were merged ***[subsection 6-105(3), item 9 of the table; subsection 6-135(2)]***.

Other cases

5.70 The final case is the default case if nothing else applies. The first element of the asset's cost will be its market value just before the taxpayer began to hold it ***[subsection 6-105(3), item 10 of the table]***. This case would mainly cover taxpayers who receive an asset as a gift.

Second element of cost

5.71 The second element of an asset's cost (essentially, what was paid to bring it to its present condition and location) is also explained by a table ***[subsection 6-110(2)]***. The table lists the cases and identifies the amount of the second element for each case.

5.72 The cases all deal with economic benefits that have contributed to the asset's present condition and location (e.g. bolting a machine to the factory floor so that it could be used would be such an economic benefit). The economic benefits could be assets, services or some combination of both. So, first, taxpayers have to identify those economic benefits.

5.73 If a taxpayer paid money for economic benefits that contributed to an asset's present condition and location, the second element of the asset's cost includes that amount ***[subsection 6-110(2), item 1 of the table]***.

Example 5.5 Paying for an economic benefit

> Radius and Ulna Pty Ltd decides to add a new wing to the private fracture clinic it operates. The materials and the labour that go into the addition are economic benefits that contribute to the present condition of the clinic. The payments the company makes for those economic benefits would be included in the second element of the clinic's cost.

5.74 If the economic benefit is only one of the things that a single payment was for, only a reasonable part of the payment is treated as being for the benefit ***[section 6-120]***.

5.75 A similar case is incurring a liability to pay money (or increasing an existing liability to pay money). In that case, the second element includes the liability's tax value (or the increase in its tax value) when the taxpayer received the benefit ***[subsection 6-110(2), item 2 of the table]***. If the taxpayer *both* paid money *and* incurred (or increased) a liability to pay money, the second element includes the sum of the first 2 cases ***[subsection 6-110(2), item 3 of the table]***.

5.76 If the taxpayer provides a non-cash benefit (except a liability to pay money) for the economic benefit, the second element of the asset's cost includes the economic benefit's market value when the taxpayer received it ***[subsection 6-110(2), item 4 of the table]***. This item covers cases where the taxpayer also made a payment, or created a liability, as well as providing a non-cash benefit.

5.77 The final case is the default case for when nothing else applies. In such cases, the second element of the asset's cost will include the market value of the economic benefit when the taxpayer received it ***[subsection 6-110(2), item 5 of the table]***. Like the first element, this would mostly cover gift cases.

Double counting second elements

5.78 In theory, one amount could be counted towards the second element of an asset's cost more than once. For example, the tax value of a liability to make a payment for an economic benefit might have been counted already but would be counted again when the payment was actually made. In those cases, the amount can only be included once ***[subsection 6-110(3)]***.

Special rule for land

5.79 The second element of the cost of land specifically includes expenses directly attributable to the land (e.g. payments of rates, land tax, and interest on money borrowed to pay for the land), but only to the extent that the payments are private or domestic in nature ***[subsection 6-110(4)]***. This rule ensures that these payments, which would otherwise not be taken into account because of their private or domestic nature, will reduce a taxable gain made when the land is realised. It does that by making them part of the cost of the land, so that they will be taken into account in working out net income ***[subsection 12-25(2)]***.

What is not part of cost

5.80 An asset's cost will never include ***[section 6-115]***:

- interest;
- rates or land tax;
- amounts paid, or non-cash benefits provided, to maintain, repair or insure the asset. Whether something amounts to maintaining or repairing an asset will draw on the distinction the courts have drawn in the current law between repairs and improvements. So, for instance, whether the asset has merely been restored to its previous condition will be an important factor.

5.81 That rule ensures that those expenses reduce the taxpayer's net income *immediately* rather than only doing so when the asset is realised. However this does not apply to the private or domestic payments discussed in paragraph 5.79.

What is a non-cash benefit?

5.82 ***Non-cash benefit*** is the label for all assets or services that are not money ***[subsection 6-125(1)]***.

5.83 Further, a taxpayer who incurs a liability to another taxpayer, or who increases an existing liability to another taxpayer, provides that other taxpayer with a non-cash benefit ***[subsection 6-125(2)]***. So, for example, incurring a debt to a builder would be providing that builder with a non-cash benefit and later increasing that liability would be providing the builder with another non-cash benefit.

5.84 Similarly, a taxpayer who reduces all or part of a liability by *terminating* it, provides the taxpayer who owed that liability with a non-cash benefit ***[subsection 6-125(3)]***. Reducing the liability by actually satisfying the obligation would *not* be providing a non-cash benefit.

5.85 If a taxpayer doesn't directly receive a non-cash benefit, but it is dealt with on their behalf, or as they direct, that taxpayer is taken to have received the non-cash benefit. That rule mirrors the constructive receipt rule for money payments ***[section 5-65]***. It ensures that avoiding receiving the non-cash benefit doesn't mean that it won't be properly taken into account. However, this rule won't stop the benefit also being treated as provided to the taxpayer who directly received it. ***[Subsection 6-125(4)]***

Splitting and merging assets

Splitting an asset

5.86 When a taxpayer splits an asset into several assets (e.g. by cannibalising a car for spare parts), the new law will apply as if the taxpayer had stopped holding the original asset and started holding the new assets ***[subsection 6-130(1)]***.

5.87 The cost of the new assets is worked out by dividing the tax value of the original asset between the new assets (see paragraph 5.68).

Partial sales

5.88 The splitting rule applies when a taxpayer stops holding a *part* of an asset. The taxpayer will be treated as having split the original asset into the part (or parts) they stopped holding and the part they retained. ***[Subsection 6-130(3)]***

Merging assets

5.89 Similarly, when a taxpayer merges several assets into a single asset (e.g. by building a car from spare parts), the new law will apply as if the taxpayer had stopped holding the original assets and started holding the merged asset ***[subsection 6-135(1)]***.

5.90 The cost of the merged asset is worked out by adding up the tax values of the original assets just before they merged (see paragraph 5.69) ***[subsection 6-135(2)]***.

Chapter 6
Applying the new method for working out taxable income and tax loss

Outline of Chapter

6.1 This Chapter provides examples showing how, in practice, taxpayers can work out their taxable income under the new rules. This can be done by using accounting information which is prepared for financial reporting reasons. However adjustments must be made, where necessary, to ensure that the tax value of the assets and liabilities that are taken into account are in accordance with the tax law. These adjustments are the same as currently required in the differing treatment for financial and taxation purposes, subject to the reforms of the tax system proposed in the Recommendations.

How the new method can be applied in practice

6.2 In applying the process in the *current* law for working out taxable income, a business taxpayer is required to analyse items of revenues and expenditures and items affecting assets and liabilities, to check whether:

- the item was ordinary income or statutory income;
- an expenditure or liability item had the necessary connection to the derivation of assessable income to make it deductible;
- an expenditure or liability item was capital, or private or domestic, in nature.

6.3 In practice, the taxpayer will often take the net profit of the business for accounting purposes and adjust it upwards or downwards to achieve the outcome required by the tax law.

6.4 The requirements of the draft legislation will continue to allow a business taxpayer to start with the net profit of the business and make adjustments necessary for tax reasons. Indeed, the process for working out the taxable income or tax loss may become more straight-forward for some taxpayers (e.g. a trading business with a turnover above the $1 million threshold for the simplified tax system for small business or a small trader not opting into that system).

6.5 The normal items that trading businesses will have to consider in working out their taxable income or tax loss are found in the cash book, profit and loss statement and balance sheet. A small trader, who is ineligible or does not elect for the Simplified Tax System, will typically have to consider the assets and liabilities set out in Table 6.1.

Table 6.1 Assets and liabilities typically considered by a small trader

Assets	***Liabilities***
Land and buildings	Loan from bank
Plant and equipment	Other borrowings
Debtors	Trade creditors
Stock in trade	Creditors for expenses
Pre-paid items	
Cash assets at bank	
Cash in hand	

6.6 Most of these assets and liabilities are taken into account in preparing the profit and loss statement of the business. Generally they are assets or liabilities where the value at which the asset or liability is included in the accounts is the same as the tax value. The depreciation allowance deducted for plant and equipment for accounting purposes may differ from the tax depreciation. Similarly some liabilities for accounting purposes will not have a tax value.

6.7 The following examples illustrate how the new method for working out taxable income and tax loss can be applied in practice.

Example 6.1 A small business not electing into the Simplified Tax System

6.8 It is likely that most small businesses will elect to be taxed under the recommended simplified tax system which incorporates a cash basis of calculating taxable income. However, some may still use the current accrual basis of accounting, subject to the changes proposed in Section 4 of the Recommendations.

6.9 Sunshine runs a small retail business selling trinkets and pottery and prepares her accounts using accrual based accounting. The profit and loss statement in the first year of Sunshine's business is as follows:

	$	$	$
Sales			120,500
less Cost of Goods Sold			
Opening Stock	0		
add Purchases	71,000	71,000	
less Closing Stock		13,000	58,000
Gross Profit			62,500
less Operating Expenses			
Electricity		5,500	
Telephone		900	
Accounting		600	
Rent		20,000	27,000
Net Profit Before Tax			**$35,500**

6.10 In an example of this type where there are no income tax law adjustments, Sunshine simply has to return the net profit as her taxable income. It is assumed that all operating expenses are for business purposes.

Example 6.2 A medium sized company

6.11 This case study shows how to work out taxable income under the cashflow/tax value approach. While the cashflow/tax value approach provides a more logical and coherent framework, it involves the same information and the same kinds of calculations as under the current law.

6.12 This equivalence is illustrated in Section 4 of the Recommendations, using the accounts of a large sized company.

Crowbar Pty Ltd – factual situation

6.13 Crowbar Pty Ltd is a family owned company carrying on a hardware retail business, trading as The Paint Tin. The company started in the mid-1990s with one retail outlet and through innovative marketing and competitive pricing, has expanded to run 4 outlets across the metropolitan area. Crowbar owns the freehold for 2 of its outlets, and leases the others.

6.14 During the current financial year (Year 2), Crowbar trades profitably. The following transactions and events are relevant to the preparation of Crowbar's accounts and tax return:

- Crowbar's accounting period and income year both run from 1 July to 30 June;
- Crowbar uses the accrual system of accounting;
- Year 2 is the first income year in which the cashflow/tax value approach applies;
- Smokescreen Pty Ltd – one of Crowbar's best customers – was wound up with no possibility of making payment. Accordingly $50,000 was written off as a bad debt during Year 2;
- In Year 2 the company implemented a policy to accept deposits from customers to reserve the highly sought after 'Nomadic Toolman' range. As at the end of Year 2, $125,900 had been received;
- Crowbar makes provisions for employee entitlements, including accrued wages, annual leave and long service leave. It is assumed that, of these amounts, only the accrued wages are allowable deductions under the current or proposed law;
- Crowbar makes provisions for future warranty claims. It is assumed that the provisions made are not deductible under the current or proposed law;
- Freehold has a market value of $9.8 million as at the end of Year 2. This gain is not taxed as it is not a realised gain;
- On the last day of Year 2 Crowbar sold 2 trucks for $137,840. These vehicles had written down values of $100,000 and $80,000 for accounting and tax purposes respectively;
- Different depreciation rates are used for accounting and tax purposes. See Appendices 6.1 and 6.2 to this Chapter for further details;
- Crowbar makes a $11,000 donation to a registered charity;
- $9,000 is spent on non-deductible entertainment;
- Crowbar had acquired 'Who Cares Hardware?', a boutique hardware business for the Z-generation of hardware enthusiasts, in a previous year. The excess of the consideration over the fair value of net assets was $780,000. This is written off for accounting purposes over 20 years, or 5% per annum;

- Crowbar paid tax of $765,056 and paid dividends to its shareholders of $2,000,000;
- Crowbar paid $24,000 in research and development expenditure. The tax law permits an extra 25% write-off, that is, $6,000;
- In Year 2, Crowbar paid $400,000 for new equipment;
- Crowbar had made prepayments totalling $73,448 as at the end of Year 2.

Financial Statements

6.15 Crowbar prepares the following Cash Flow Statement (Figure 6.1) and Profit and Loss Statement (Figure 6.2) for Year 2. The Balance Sheet as at end of Year 1 (Figure 6.3) and the Balance Sheet as at end of Year 2 (Figure 6.4) are also provided.

Figure 6.1 Cash Flow Statement for Year 2

	$	$
Cash inflows		
Receipts from customers	53,630,000	
Deposits from customers	125,900	
Interest received	8,200	
Consideration for sale of trucks	137,840	
Dividends received	16,000	
Loans received	2,694,000	56,611,940
less cash outflows		
Payments to stock suppliers	34,285,490	
Payments to suppliers	7,448,957	
Interest paid	649,320	
Loans repaid	3,318,860	
Purchase of new equipment	400,000	
Payment of income tax	765,056	
Payment of dividends	2,000,000	48,867,683
Net increase in cash held		7,744,257
Add opening cash brought forward		183,736
Closing cash carried forward		7,927,993

Figure 6.2 Crowbar Pty Ltd (trading as The Paint Tin)

Profit and Loss Statement for Year 2

	$	$
Revenue		
Sales revenue	56,279,108	
Interest received	8,200	
Dividends received	16,000	
Profit on sale of trucks	37,840	
Total Operating Revenue		56,341,148
less expenses		
Cost of goods sold	31,666,743	
Bad debts expense	114,117	
Advertising	80,000	
Electricity	50,933	
Rent	3,750,600	
Donations	11,000	
Entertainment	9,000	
Salaries	1,635,583	
Postage and telephone	60,949	
Research and Development	24,000	
General operating	1,837,599	
Interest on loan	605,322	
Amortisation expense	39,000	
Depreciation expense	293,377	
Other employment expenses	214,291	
Warranty expense	20,000	40,412,514
Profit Before Income Tax		**15,928,634**
less income tax expense		5,845,967
Net Profit After Tax		**10,082,667**

Figure 6.3 Balance Sheet as at end of Year 1

Assets	$	$	**Liabilities**	$	$	**Shareholders' Funds**	$
Cash		183,736	Trade creditors		5,357,656	Contributed capital	4,000,000
Receivables	4,362,478		Accruals		1,902	Retained profits	1,516,387
less provision for Doubtful Debts	94,680	4,267,798	Borrowings		4,370,700		
Inventory		4,674,896					
Freehold		4,765,769	*Provisions*				
Plant and equipment	2,395,178		Employee	331,046			
less provision for Depreciation	760,130	1,635,048	Warranties	130,000			
Goodwill		702,000	Tax	765,056	1,226,102		
Investments		243,500					
TOTAL		**16,472,747**	**TOTAL**		**10,956,360**	**TOTAL**	**5,516,387**

Net assets **$ 5,516,387**

Shareholders' funds **$ 5,516,387**

Figure 6.4 Balance Sheet as at end of Year 2

Assets	$	$	**Liabilities**	$	$	**Shareholders' Funds**	$
Cash		7,927,993	Customer deposits		125,900	Contributed capital	4,000,000
Receivables	6,961,586		Trade creditors		4,101,480	Retained profits	9,599,054
less provision for Doubtful Debts	158,797	6,802,789	Accruals		10,155		
Inventory		6,037,467	Borrowings		3,745,840		
Prepayments		73,448					
Freehold		4,765,769	*Provisions*				
Plant and equipment	2,595,178		Employee	577,241			
less provision for Depreciation	953,507	1,641,671	Warranties	150,000			
Goodwill		663,000	Tax	5,845,967	6,573,208		
Investments		243,500					
TOTAL		**28,155,637**	**TOTAL**		**14,556,583**	**TOTAL**	**13,599,054**

Net assets **$13,599,054**

Shareholders' funds **$13,599,054**

How does Crowbar prepare its tax return?

6.16 Crowbar could prepare its tax return using either the cashflow/tax value approach or the current method. If the assets and liabilities are accounted for correctly, the calculations will give the same result. Even if the accounts do not recognise assets and liabilities in the way required by the tax law, adjustments could be made to either calculation to arrive at the taxable income.

Cashflow/tax value approach

6.17 Crowbar's taxable income for the Year 2 income year is worked out using the formula in subsection 5-15(1):

Net income + Income tax law adjustment – Unused tax losses

Crowbar works out its net income

6.18 Net income is worked out by using the 6 step method statement in section 5-55. This formula broadly comprises 3 elements: receipts minus payments, change in tax value of assets and change in tax value of liabilities.

Step 1 (Receipts) less step 2 (Payments)

6.19 All receipts not of a private or domestic character are included under step 1.

Customers	53,755,900
Interest	8,200
Proceeds from sale of trucks	137,840
Loans	2,694,000
Dividends	16,000
TOTAL	**56,611,940**

6.20 All payments not of a private or domestic character are included under step 2.

Suppliers	41,734,447
Interest	649,320
Income tax	765,056
Loan repayments	3,318,860
Dividends paid	2,000,000
Purchase of equipment	400,000
TOTAL	**48,867,683**

6.21 These items are readily identifiable from Crowbar's cash book or bank statements. They represent the Cash Flow Statement for Crowbar during the period. (See Figure 6.1)

Add step 3 (Closing assets) minus step 4 (Opening assets)

6.22 Steps 3 and 4 seek to measure the change in *tax value* of assets held by Crowbar at the end of the income year.

6.23 The assets held by Crowbar as at the end of Year 2 (Closing assets) and their tax values are:

Receivables	6,961,586
Inventory	6,037,467
Prepayments	73,448
Freehold	4,765,769
Plant and equipment	1,434,635
Goodwill	780,000
Investments	243,500
TOTAL	**20,296,405**

6.24 The assets held by Crowbar as at the beginning of Year 2 (Opening assets) and their tax values are:

Receivables	4,362,478
Inventory	4,674,896
Freehold	4,765,769
Plant and equipment	1,458,256
Goodwill	780,000
Investments	243,500
TOTAL	**16,284,899**

6.25 The cashflow/tax value approach requires Cash at bank to be excluded from closing and opening assets to avoid the double counting that would otherwise arise. The relevant change in cash balances over the year is captured by taking into account receipts and payments in steps 1 and 2.

Less step 5 (Closing liabilities) add step 6 (Opening liabilities)

6.26 Steps 5 and 6 seek to measure the change in *tax value* of liabilities held by Crowbar at the end of the income year.

6.27 Liabilities owed by Crowbar as at the end of Year 2 (Closing liabilities) that affect taxable income are:

Customer deposits	125,900
Trade creditors	4,101,480
Accruals	10,155
Borrowings	3,745,840
Provision for employee entitlements	130,278
Contributed capital	4,000,000
TOTAL	**12,113,653**

6.28 Liabilities owed by Crowbar as at the beginning of Year 2 (Opening liabilities) with positive tax values are:

Trade creditors	5,357,656
Accruals	1,902
Borrowings	4,370,700
Provision for employee entitlements	98,374
Contributed capital	4,000,000
TOTAL	**13,828,632**

Income tax law adjustment

6.29 Some receipts and payments are not intended to affect taxable income and so must be reversed out from the calculation. Furthermore sometimes specific policy decisions are made that affect taxable income. This is achieved by an income tax law adjustment, which is explained in Subdivision 5-C.

6.30 An income tax law adjustment is the net effect of increasing and decreasing adjustments. ***[Subsection 5-90(1)]***

Increasing adjustments

6.31 Crowbar’s increasing adjustments for the income year are:

Income tax paid	765,056
Dividends paid	2,000,000
Entertainment	9,000
TOTAL	**2,774,056**

Deceasing adjustments

6.32 Crowbar's decreasing adjustments for the income year are:

Research and development (extra 25%)	6,000
TOTAL	**6,000**

6.33 This gives rise to an income tax law adjustment of $2,768,056.

What is Crowbar's taxable income under the cashflow/tax value approach?

6.34 The new method can be summarised as follows:

Step 1: Receipts		56,611,940
Step 2: Less Payments		48,867,683
		7,744,257
Step 3: Add Closing Assets		20,296,405
		28,040,662
Step 4: Less Opening Assets		16,284,899
		11,755,763
Step 5: Less Closing Liabilities		12,113,653
		–357,890
Step 6: Add Opening Liabilities		13,828,632
Net Income		13,470,742
Income Tax Law adjustment (s. 5-90)		
Increasing adjustments	2,774,056	
Less Decreasing adjustments	6,000	2,768,056
Taxable income		**16,238,798**

Same result as under the current method

6.35 Under the current approach, Crowbar would prepare a Statement of Income Tax Reconciliation showing the adjustments required to accounting profit to reveal taxable income.

Accounting Profit Before Income Tax			**15,928,634**
Add-back items			
Accounting depreciation	293,377		
Balancing charge on sale of trucks	57,840		
Goodwill amortisation	39,000	390,217	
Movements in non-allowable provisions			
Doubtful debts	64,117		
Employee entitlements	214,291		
Warranty	20,000	298,408	
Non-deductible expenditure			
Entertainment		9,000	697,625
			16,626,259
Less depreciation deducted			
Tax Depreciation			343,621
			16,282,638
Less Non-Syndicated Research and Development			
Additional deduction – R&D			6,000
			16,276,638
Less Other Subtraction Items			
Profit on sale of trucks (accounting)			37,840
Taxable income			**16,238,798**

6.36 The same amount of taxable income is worked out under each method.

6.37 Further supporting calculations are shown in the appendices to this Chapter.

Appendix 6.1 Accounting depreciation schedules

Plant and equipment	Cost	Additions Year 2	WDV Disposals Year 2	Effective life	Year 1 Dep'n	Year 2 Dep'n
Buildings	600,000			25	24,000	24,000
Trucks	560,000		100,000	8	70,000	70,000
Computers	358,590			5	71,718	71,718
Equipment	876,588	400,000		10	87,659	127,659
	2,395,178	400,000	100,000		253,377	293,377

Buildings	Year 2	Year 1
Cost	600,000	600,000
less Prov for Dep'n	96,000	72,000
	504,000	528,000

Computers	Year 2	Year 1
Cost	358,590	358,590
less Prov for Dep'n	286,872	215,154
	71,718	143,436

Trucks	Year 2	Year 1
Cost	360,000*	560,000
less Prov for Dep'n	180,000	210,000
	180,000	350,000

*Sold 2 trucks at end of Year 2 with cost of $200,000 for $137,840.

Equipment	Year 2	Year 1
Cost	1,276,588	876,588
less Prov for Dep'n	390,635	262,976
	885,953	613,612

Plant & equipment	Year 2	Year 1
Assets	2,595,178	2,395,178
less Prov for Dep'n	953,507	760,130
	1,641,671	1,635,048

Sale of Trucks	
Consideration	137,840
less written down value	100,000
Profit on sale of trucks	37,840

Appendix 6.2 Tax depreciation schedules

Plant and equipment	Cost	Additions Year 2	WDV Disposals – Year 2	Rate	Year 1 Depreciation	Year 2 Depreciation
Buildings	600,000			N/A	0	0
Trucks	560,000		80,000	15%	84,000	84,000
Computers	358,590			27%	96,819	68,133
Equipment	876,588	400,000		15%	131,488	191,488
	2,395,178	400,000	80,000		312,307	343,621

Sale of Trucks	
Consideration	137,840
less written down value	80,000
Balancing charge	57,840

Appendix 6.3 Prepayments and Accruals

Payments	Cash	Prepaid (Year 1)	Prepaid (Year 2)	Accrued (Year 1)	Accrued (Year 2)	Expense (Year 2)
Advertising	75,000				5,000	80,000
Electricity	48,256				2,677	50,933
Rent	3,750,600					3,750,600
Donations	11,000					11,000
Entertainment	9,000					9,000
Research and Development	24,000					24,000
Salaries	1,603,679			98,374	130,278	1,635,583
Postage and telephone	60,373			1,902	2,478	60,949
General operating	1,867,049		29,450			1,837,599
Interest	649,320		43,998			605,322
	8,098,277	0	73,448	100,276	140,433	8,064,986

Chapter 7
Tax value of financial assets taxed on an accruals basis

Outline of Chapter

7.1 This Chapter explains how to work out the tax value of financial assets – including bonds and indexed securities – to which the accruals rules of Subdivision 45-C apply. The tax values of these and other assets (and liabilities) are used, along with receipts and payments, in section 5-55 as a component of a formula used to calculate the taxable income of a taxpayer (section 5-15), and ultimately to determine the taxpayer's income tax for the purposes of section 5-10.

7.2 The Chapter explains how, because of the way their tax values are calculated, these financial assets are taxed on an accruals basis (subject to an exemption for individuals and small businesses). This means that their returns are subject to tax as they accrue rather than as and when they are received. It also explains which financial assets are not subject to accruals taxation treatment (including options and ordinary shares in companies).

Context of Reform

7.3 Under the current law, the gains on most financial assets are taxed only when they are realised.

7.4 The distortions and deferral opportunities arising from this have been spelt out in some detail in Chapter 5 of *A Platform for Consultation*, and previous discussion papers put out by Treasury and the ATO in past years for consultation.

7.5 Financial assets and liabilities providing the same before-tax return can produce very different after-tax returns just because of the deficiencies in the current law. By driving wedges between tax values and commercial values, these deficiencies:

- inhibit commercial financial innovation;
- distort pricing, risk allocation and the timing and magnitude of investment and finance decisions; and
- provide scope for exploitation of the law.

7.6 The Review's recommendations for reform will place the taxation of financial assets on a more consistent and neutral basis.

Summary of new law

7.7 Under Subdivision 45-C, the gain or loss on a financial asset that is certain is brought to account for tax purposes as it accrues. This is achieved by making appropriate adjustments to the tax value of the asset.

7.8 The tax value of financial assets to which the Subdivision applies is worked out by reference to 3 components which comprise the total return on a financial asset, namely:

- the regular coupon or interest payment (if any);
- any discount or premium in relation to the asset (i.e. the difference between its acquisition cost and its face, or nominal, value); and
- any return linked to the value of an index (e.g. the CPI or All Ordinaries Index).

7.9 Subdivision 45-C does not apply to:

- rights to receive payment within 6 months for the supply of goods or services (and interest thereon);
- membership interests like ordinary shares in a company;
- options; or
- assets arising from the relationship between a tax entity and its members.

These assets are taxed on a realisation basis. Nor does the Subdivision apply to assets for which a mark-to-market election is made under Subdivision 45-D. The tax value of Subdivision 45-D assets is their market value.

Individuals will generally be able to adopt (Recommendation 4.4), and small business will be able to choose through the *Simplified Tax System* (Recommendation 17.2), a cash basis to account for most of their business income and day-to-day expenditure, rather than be subject to accruals taxation. Rules are being developed to give effect to these recommendations.

Comparison of key features of new law and current law

7.10 The adoption of accruals taxation for Subdivision 45-C financial assets within the framework of the new method for calculating the taxable income of a taxpayer provides a more coherent, certain and robust approach than the current law. The key differences between the new law and the current law are outlined in the table below.

Table 7.1 Comparison of new and current law

New Law	*Current Law*
Gains and losses on financial assets that are certain are systematically brought to account for tax purposes as they accrue.	There is no coherent system for determining when gains and losses on financial assets are brought to account for tax purposes.
Tax arbitrage opportunities are minimised.	Taxpayers can exploit the asymmetry between the timing of deductions in respect of certain liabilities and the income of corresponding assets.
Neutrality is enhanced by providing the same tax treatment for equivalent financial assets.	Financial assets with the same before-tax returns but different forms can have very different after-tax returns.

Detailed explanation of new law

What are financial assets?

7.11 An asset is any thing (tangible or intangible) that embodies future economic benefits. See Chapter 5 for a full explanation of these terms. ***[Section 6-15]***

7.12 A ***financial asset*** is to be defined in section 45-10.

What is the tax value of a financial asset used for?

7.13 The tax value of all assets and liabilities, including financial assets and liabilities, is used in calculating the taxable income or tax loss of a taxpayer. This is because the taxable income or tax loss of taxpayers depends on their net income, and the calculation of net income uses a formula that takes into account the tax value of their assets and liabilities. The relevant formulas for these calculations, which are set out in sections 5-15 and 5-55 and explained in Chapter 3, are as follows:

Taxable income = Net income + Income tax law adjustment – Unused tax losses

Net income = Receipts – Payments ± Net change in tax value of assets and liabilities

7.14 The tax value of a particular asset or liability is not necessarily its market value. In fact, the market value and the tax value will usually be different, except at the time the asset is first held or where the mark-to-market election applies to the asset. See Chapter 5 for a general explanation of tax values of assets.

7.15 The tax value of a financial asset to which Subdivision 45-C applies is worked out in the ways described below.

Which provisions govern the tax value of a financial asset?

7.16 The principal provision governing the tax value of all assets is section 6-40, which is explained in Chapter 5. The table in that section identifies assets which are taxed on:

- a market value basis (where the holder has elected to use the asset's market value as the relevant tax value at a particular time);
- a realisation basis (i.e. at the time a gain or loss is actually realised); or
- an accruals basis (i.e. as gains and losses accrue).

7.17 Subdivision 45-C applies to financial assets which are taxed on an accruals basis. Subdivision 45-C applies to all financial assets other than:

- rights to receive payment within six months for the supply of goods or services (and interest thereon) ***[item 1 of the table in section 45-15]***;
- membership interests (as defined in section 960-120 – for example, ordinary shares in a company) ***[item 3 of the table in section 45-15]***;
- options ***[item 5 of the table in section 45-15]***;
- assets arising from the relationship between a tax entity and its members ***[item 4 of the table in section 45-15]***; and
- assets for which a mark-to-market election is made under Subdivision 45-D (i.e. assets for which the taxpayer has elected to use market value as their tax value) ***[item 6 of the table in section 45-15]***.

When is the tax value of a financial asset calculated?

7.18 There are 2 types of occasions on which the tax value of a financial asset to which Subdivision 45-C applies has to be ascertained:

- when the taxpayer begins to hold the asset (i.e. when it is acquired) – the tax value at this time is determined by section 45-65; and
- at a later time when certain events happen – the tax value at this time is determined by section 45-75 or 45-80, as appropriate.

7.19 The person who holds an asset is identified by the table in subsection 6-15(3). Apart from cases involving certain leasing or hire purchase arrangements, the legal owner of an asset is usually the person who holds the asset for the purposes of the new law. Chapter 5 provides an explanation of who is the holder of a particular asset.

What is the tax value of a financial asset taxed on an accruals basis when a taxpayer begins to hold it?

7.20 When a taxpayer begins to hold a financial asset to which Subdivision 45-C applies, its tax value is the cost of the asset at that time, reduced by any amount the taxpayer received in respect of the asset at or before that time. ***[Section 45-65]***

7.21 Amounts received at or before the time a taxpayer begins to hold an asset would include, for example, interest that is pre-paid by a borrower to a lender at the time a loan is drawn down.

7.22 The cost of an asset when a taxpayer begins to hold it is defined in section 6-105, which is explained in Chapter 5. As a general rule, it is the amount, or amounts, paid in order to hold the asset. It would include, for example, the asset's purchase price, and payments incidental to acquiring it. If the amount paid to acquire the asset is a non-cash benefit (e.g. the provision of goods or services), the cost of the asset is generally the market value of the asset immediately before it was acquired.

7.23 The cost of an asset does not include the payment of interest on a loan taken out to acquire the asset, nor the other amounts listed in section 6-115.

Cost of a financial asset in certain cases

7.24 If a taxpayer provides only a non-cash benefit to acquire a financial asset (other than by incurring or increasing a liability to pay money) then section 45-70 prescribes the method for calculating the cost of the asset (which is used in calculating its tax value under section 45-65). An example of a non-cash benefit is the provision of goods or services. ***[Subsection 45-70(1)]***

7.25 In these cases the cost of the financial asset is taken to be the market value of the non-cash benefit. ***[Subsection 45-70(2)]***

7.26 In many cases the market value of a non-cash benefit would be readily apparent. In other cases it may be necessary to calculate market value (and hence the cost of the financial asset) by reference to the present value of future benefits.

Example 7.1 Using present value of future benefits to calculate market value of a non-cash benefit

Ahmed buys an antique vase from Zena on terms that require no down-payment but, starting in one year, payment by instalments of $100,000 a year for 4 years.

Zena has a financial asset, representing her right to receive $100,000 a year for 4 years starting one year after the purchase date, for which she provided a non-cash benefit (the vase). The tax value of her financial asset at the time she begins to hold it is its cost – that is, the market value of the vase.

There is no ready market for antique vases of the kind Zena sold to Ahmed and its market value is difficult to ascertain. However, because Zena and Ahmed dealt with each other at arm's length, it is reasonable to determine the market value of the vase by reference to the present value of the future benefits to be provided.

Under this present value calculation the future value of the payments will be discounted by an appropriate discount rate. For these purposes, an appropriate discount rate may be the average of the buy and sell yields on a fixed-coupon, 4-year Commonwealth Treasury bond (perhaps with a specified percentage loading added).

Rules for determining the appropriate discount rate are to be developed.

Assuming that this discount rate is 6%, compounded annually, the present value of the amounts Zena will receive is the sum of:

- $\frac{\$100{,}000}{1 + 6\%}$ (the present value of the first instalment, to be paid in a year's time);
- $\frac{\$100{,}000}{(1 + 6\%)^2}$ (the present value of the second instalment, to be paid in 2 years' time);
- $\frac{\$100{,}000}{(1 + 6\%)^3}$ (the present value of the third instalment, to be paid in 3 years' time); and
- $\frac{\$100{,}000}{(1 + 6\%)^4}$ (the present value of the fourth instalment, to be paid in 4 years' time).

The sum of these amounts, $346,510.56, is taken to be the market value of the vase and therefore the cost of the financial asset.

What is the tax value at a later time?

7.27 After the acquisition of a financial asset it is necessary to calculate its tax value at certain specified times.

7.28 As explained above in paragraph 7.13, a taxpayer’s taxable income for an income year depends on net income for the year, which in turn depends in part, on the net change during the year of the tax value of the taxpayer’s assets and liabilities. To determine this it is necessary to calculate the tax value of assets held at the end of the income year (the closing value) and compare that value with the tax value of assets held at the beginning of the year (the opening value). Therefore the tax value of financial assets has to be determined at the end of each year of income.

7.29 The tax value, at a time after it is acquired, of a financial asset to which Subdivision 45-C applies is calculated under one of 2 formulas:

- the first formula (in section 45-75) caters for cases where all the future amounts to be received in respect of the asset are certain;

- the second formula (in section 45-80) handles cases where future amounts to be received are linked to variables determined in advance (e.g. variable interest rates or the CPI).

These formulas, which are explained below, are therefore used to calculate the tax value of an asset which a taxpayer holds at the end of an income year.

7.30 The formulas are also used in certain circumstances to calculate the tax value of an asset at other times. These circumstances are where:

- an amount is received in respect of the asset during the year (e.g. an interest payment); or

- there is a change in one of the components comprising the total return on the asset (namely, the interest rate or face value of the asset).

Calculation of tax value by reference to 3 types of return

7.31 The tax value of a financial asset to which the formula in section 45-80 in Subdivision 45-C applies is worked out by reference to 3 types of return which comprise the total return on a financial asset. These are:

- the regular coupon or interest payment (if any);

- any discount or premium in relation to the asset (i.e. the difference between its acquisition cost and its face, or nominal, value); and

- any return linked to the value of an index (e.g. the CPI or All Ordinaries Index).

7.32 Where there is no index or variable amount involved, the formula in section 45-75 provides a convenient basis on which to determine the tax value of a financial asset whose annual return derives from a series of known future receipts. In this case, the regular coupon or interest payment is reflected in the internal rate of return of the financial asset when it is first held by the taxpayer.

7.33 The part of the returns attributable to the period for which the tax value of the asset is being calculated will be added to the previous tax value of such assets, resulting in that part being taxed even if it is not yet received. In other words, that part will be taxed on an accruals basis.

7.34 The following table provides examples of financial assets exhibiting these 3 types of return.

Table 7.2 Examples of types of return on financial assets

Description of asset	***Type(s) of return on asset***	***Example***
An asset with known future payments.	• Agreed payment schedule.	• An agreement by a debtor to pay over time for the acquisition of a tangible asset.
An asset whose only returns comprise regular payments calculated by applying a specified rate to its face value.	• Regular coupon or interest payment.	• Bond acquired at par (i.e. a bond with a face value equal to its acquisition or issue price – there being no discount or premium).
An asset which provides a single fixed return on maturity.	• Discount.	• Zero coupon bond.
An asset acquired at a discount or premium which provides regular payments calculated by applying a specified rate to its face value.	• Regular coupon or interest payment. • Discount or premium.	• Interest-bearing bond acquired at a discount or premium.

Description of asset	***Type(s) of return on asset***	***Example***
An asset which provides a single fixed return on maturity based on the level of, or change in, a specified index.	• Return linked to index.	• Non-interest bearing equity-linked bond (i.e. a bond whose returns are linked to the value of a specified share index). • Non-interest bearing CPI-indexed bond (i.e. a bond whose returns are linked to the CPI).
An asset acquired at a discount or premium which provides regular payments calculated by applying a specified rate to its face value and which provides an additional return on maturity based on the level of, or change in, a specified index.	• Regular coupon or interest payment. • Discount or premium. • Return linked to index.	• Interest-bearing bond acquired at a discount or premium which provides a return linked to the CPI.

Application of the tax value formula where all of the returns are certain

7.35 The formula in section 45-75 applies to a financial asset, all of whose returns are certain. Therefore it applies, for example, to fixed-rate bonds.

7.36 The formula represents a simplified version of the formula in section 45-80, which is explained below. In effect, the internal rate of return is calculated up-front from the cost of the asset (the initial tax value) and the ‘certain’ future receipts. The tax value at successive later times is then determined by adjusting the previous tax value by reference to the internal rate of return (‘interest %’) and any receipts received at that time. Thus the tax value formula is:

$$\left[\text{Last tax value} \times (1 + \text{Interest \%})\right] - \text{Receipts at the test time}$$

7.37 Even though amounts received in respect of an asset reduce its tax value, this does not mean that taxable income is reduced – the amount received is a receipt which will increase net income.

7.38 Each of the components of the formula is explained below.

What is the 'last tax value'?

7.39 The ***last tax value*** of an asset is defined in subsection 45-75(2) as its tax value when it last had to be calculated, namely:

- when the taxpayer received an amount in respect of the asset for a period ***[paragraph 45-75(2)(a)]***;
- the end of an income year ***[paragraph 45-75(2)(b)]***; or
- the time the taxpayer began to hold the asset ***[paragraph 45-75(2)(c)]***.

What is the 'interest %'?

7.40 Basically, the ***interest %*** in subsection 45-75(3) is the internal rate of return on the asset.

7.41 If the only returns on a financial asset are paid at least annually, then the internal rate of return is simply that annual rate. This would be the case, for example, for fixed rate bonds acquired at par (i.e. neither at a discount nor a premium). In other cases, the internal rate of return will be different from the rate at which annual payments are made.

7.42 Subsection 45-75(3) provides that the interest % is the annual compounded rate of return (expressed as a percentage) that, if used to calculate the net present value of the following at the time the taxpayer began to hold the asset, would result in that net present value equalling zero:

- an amount equal to the cost of the asset at that time; and
- the amounts to be received after that time in respect of the asset, on the assumptions that they will be received at the earliest time that the taxpayer will become entitled to them and that the asset is held for the rest of its life.

7.43 If the period starting at the previous time and ending at the test time is less than a year, then the rate of return calculated above is apportioned by multiplying it by:

$$\frac{\text{Number of days in that period}}{365}$$

[Subsection 45-75(3)]

7.44 Examples 7.4(ii) and (iii) below show how the 'interest %' component of the tax value formula in section 45-75 is calculated.

What are 'receipts at the test time'?

7.45 ***Receipts at the test time*** is defined in subsection 45-75(5) as the total of all the amounts received in respect of the asset at the test time. If no amounts are received at that time then the value of this component is zero.

7.46 There will be an amount included in the **'**receipts at the test time**'** component of the formula if the reason for calculating the tax value of an asset is because an amount is received in respect of the asset in respect of a period (e.g. if an annual interest payment is made). At other test times 'receipts at the test time' would generally be zero unless, for example, the test time is the end of the taxpayer's income year and the asset provides a return at that time.

7.47 Even though a receipt will reduce the tax value of an asset, there is not a corresponding reduction in taxable income of the taxpayer. This is because the receipt itself would be included as the first component in the net income formula in section 5-55.

Application of the tax value formula where a predetermined variable is involved

7.48 In essence, the formula in section 45-80, which applies if not all the amounts to be received in respect of the financial asset are certain when the asset is first held, determines the tax value of a financial asset at a particular time after it is first held by:

- adding to (or subtracting from) its previous tax value amounts relating to the relevant period that are attributable to the interest rate, indexation component, discount or premium; and
- reducing the result by any amount received in respect of the asset at that time.

7.49 The formula is as follows:

Last tax value	+	[Last face value × (Interest % + Index %)]	+	Amortisation of discount or premium	–	Receipts at the test time

7.50 For example, suppose the tax value (and face value) of a financial asset at the beginning of a year of income is $100. If at the end of the year it provides a 10% interest payment plus a change to its face value of 5% by reference to an index, then its tax value at the end of the year will be:

$100 + [$100 × (10% + 5%)] – $10 = $105

Therefore there is a net increase of $5 in the tax value of the asset over the income year.

7.51 Each of the components of the formula is explained below.

What is the 'last tax value'?

7.52 The ***last tax value*** of an asset is defined in subsection 45-80(2) as its tax value when it last had to be calculated. In addition to the times mentioned above in relation to subsection 45-75(2) (see paragraph 7.39), the tax value of a financial liability to which the formula in section 45-80 applies has to be calculated when there is a change in the components of the formula. Therefore the tax value has to be calculated:

- when the taxpayer received an amount in respect of the asset during the year ***[paragraph 45-80(2)(a)]***;
- when the relevant interest rate changed ***[paragraph 45-80(2)(b)]***;
- when the face value of the asset changed by reference to an index number ***[paragraph 45-80(2)(c)]***;
- the end of an income year ***[paragraph 45-80(2)(d)]***; or
- the time the taxpayer first began to hold the asset ***[paragraph 45-80(2)(e)]***.

What is the 'last face value'?

7.53 The ***last face value*** of an asset is defined in subsection 45-80(3) as the face value of the asset at the time its tax value was last calculated.

7.54 The ***face value*** of an asset is its stated, or nominal, value. For example, a 5-year bond may have a face value of, $100, which means that, 5 years after its issue, the issuer will pay the holder $100. Because financial instruments may be issued at a discount or a premium to the face value, the face value of a financial instrument may differ from its issue price.

7.55 The face value of an instrument is also the amount to which a specified percentage is applied to determine a return on the instrument. For example, if the 5-year bond described above paid an annual return of 5%, the annual return would be $5 (i.e. 5% of its $100 face value).

7.56 Therefore section 45-80(4) defines the face value of an asset as whichever of the following is appropriate:

- the amount on the basis of which a return on the asset is calculated ***[paragraph 45-80(4)(a)]***; or
- the amount paid at the end of the asset's life ***[paragraph 45-80(4)(b)]***.

What are the 'interest %' and 'index %'?

7.57 In calculating the tax value of a financial asset, the formula in subsection 45-80(1) requires the application of the sum of the ***interest %*** (defined in subsection 45-80(5)) and the ***index %*** (defined in subsection 45-80(7)) to the last face value of the asset.

7.58 The interest % is defined in detail in paragraphs 7.60 to 7.64 – it is not the same as the interest % referred to in the simplified tax value formula in subsection 45-75. In essence, it is the annual coupon rate of return on the last face value of the asset (not necessarily in the form of interest) for the period between the time the tax value was last calculated (the 'previous time') and the time the tax value is currently being calculated (the 'test time'). This period is called the test period.

7.59 The index % is defined in paragraphs 7.65 to 7.67. If the face value of the asset is changed at the test time by reference to the change in an index (e.g. the CPI) then the index % is the change in the index expressed as a percentage. In all other cases it is zero.

Example 7.2 Use of interest % and index %

> Suppose a bond issued for $100 pays a fixed annual rate of 5% of the last (indexed) face value plus any increase in the CPI over the year. Assuming the last face value of the bond is $100, if there is a 2% annual rise in the CPI then the component of the tax value attributable to the interest % and the index % is:
>
> $100 × (5% + 2%) = $7

<u>Detailed explanation of Interest %</u>

7.60 Interest % is defined in subsection 45-80(5) as the interest rate (defined in subsection 45-80(6) – see below) applicable during the test period to the financial asset being tested. It is to be expressed as a percentage. The interest rate represents an annual return – therefore, if the test period is less than a year, the interest % will be reduced by an appropriate amount. The reduction is made by multiplying the (annual) interest rate by the following factor:

$$\frac{\text{Number of days in the test period}}{365}$$

7.61 For example, a bond may pay interest at the annual rate of 6% twice a year. When the first instalment of interest is paid half-way through the year the bond's tax value needs to be calculated. The relevant interest % used in calculating the tax value at that time will be half the annual rate, namely 3%.

7.62 ***Interest rate*** is defined in subsection 45-80(6). It is the annual rate of return which applies to the face value of an asset to calculate the amount paid on the asset in respect of a certain period. For example, if an asset with a face value of $100 pays $5 twice a year, the relevant interest rate is 10%. A return can be an interest rate within this definition notwithstanding that it may not be 'interest' in legal form.

7.63 The annual rate of return is compounded as appropriate. This means that, where a return relates to a period in excess of one year, the annual rate of return is not the simple interest rate (calculated as the total return expressed as a percentage and divided by the number of years in respect of which it is paid), but is the compound rate.

7.64 For example, a bond with a face value of $100 pays a return of $21 after 2 years. The annual rate of return for the purposes of calculating its tax value at the end of each year is 10%. This is because the application of a 10% annual interest rate on a compounding basis results in a $21 return after 2 years.

Detailed explanation of Index %

7.65 Index % is defined in subsection 45-80(7) as zero unless the test time is an ***indexation time***. The indexation time for an asset is defined in subsection 45-80(8) as:

- the time when the face value of the asset changes by reference to an index number; and

- the time when the asset came into existence.

7.66 If the test time is an indexation time, the index % is the following amount expressed as a percentage:

$$\frac{\text{Index at test time} - \text{Index at previous indexation time}}{\text{Index at previous indexation time}}$$

7.67 ***Index*** is defined in subsection 45-80(9) as the index number by reference to which the face value of the financial asset changes. This may, for example, be the CPI or the All Ordinaries Index. If the index number relates to a particular period, the relevant number is the index number for the last period that ends before the index time. For example, if the relevant index is determined quarterly, the index number at a particular test time that occurs within a quarterly period will be the index number at the end of the previous quarter.

Example 7.3 Calculation of the index % for a financial asset

A financial asset is issued on 1 August 2000 with a face value of $100. At the end of each financial year (1 July to 30 June) the face value of the asset increases by an amount equal to the change in the CPI over the year. Assume that the CPI for the quarter ending on 30 June 2000 is 125, and on 30 June 2001 it is 128.

The taxpayer's income year ends on 30 June. Therefore it is a test time for the asset (i.e. its tax value has to be calculated at that time). It is also an indexation time, as is the issue date. To calculate the tax value it is necessary to determine the index % in relation to the asset.

The relevant index % is calculated under subsection 45-80(7) as follows:

$$\frac{128 \; - \; 125}{125} \; = \; 2.4\%$$

This percentage will be applied to the last face value of the asset (i.e. $100) in accordance with the formula in subsection 45-80(1) to determine the tax value of the asset at the end of the taxpayer's income year.

What is the 'amortisation of discount or premium'?

7.68 Another component of the tax value formula in subsection 45-80(1) is the ***amortisation of discount or premium*** (defined in subsection 45-80(10)). Basically, this is the amount of the discount or premium on an asset amortised, or spread, over the test period.

7.69 A discount is the amount by which the issue price or purchase price of an asset is less than its face value; a premium is the amount by which that price exceeds its face value. For example, a one-year bond with a $100 face value issued for $95 is issued at a 5% discount. If it is issued for $105 then it is issued at a 5% premium.

7.70 'Amortisation of discount or premium' is defined in subsection 45-80(10) as:

Adjusted cost – Last adjusted cost

7.71 The ***adjusted cost*** is defined in subsection 45-80(11) as the last adjusted cost increased by the amortisation rate (defined in subsection 45-80(13) – see below). The ***last adjusted cost*** is defined in subsection 45-80(12) as:

- the cost of the asset at the time the taxpayer began to hold the asset, if that time was the last time the tax value of the asset was calculated (the 'previous time'); or
- in any other case, the adjusted cost of the asset at the previous time.

7.72 The ***amortisation rate*** is, in effect, the internal rate of return on the asset which is attributable to the discount or premium. This rate is to be calculated as an annual rate where the test period is the whole year, and a part-year rate if the test period is less than a year. The part-year rate is calculated by multiplying the annual rate by the following factor:

$$\frac{\text{Number of days in the test period}}{365}$$

[Subsection 45-80(14)]

7.73 More specifically, the amortisation rate is defined in subsection 45-80(13) as the rate – expressed as a percentage – that, if applied on an annual compounding basis to calculate the net present value of the following at the time the taxpayer began to hold the asset, would result in that net present value equalling zero:

- a payment by the taxpayer at that time of an amount equal to the cost of the asset at that time; and

- a receipt by the taxpayer, at the earliest time that the taxpayer will become entitled to it, of an amount equal to the face value of the asset at the time of its acquisition, on the assumption that the asset is held for the rest of its life (the face value in this case is the amount paid to the holder of a financial asset at the time it terminates or expires).

7.74 Example 7.4(iv) below shows how the 'amortisation of discount or premium' component of the tax value formula is calculated.

What are 'receipts at the test time'?

7.75 The final component of the tax value formula in subsection 45-80(1), which reduces the tax value of the asset being tested, is ***receipts at the test time*** defined in subsection 45-80(15). It is defined in the same way as that component is defined for the purposes of section 45-75 (see paragraphs 7.45 to 7.47).

Example 7.4 Calculating the tax value of various financial assets

The following examples show how the tax value of various financial assets is calculated.

(i) Ordinary share

This example shows that ordinary shares are taxed on a realisation basis (as are options).

<u>Facts</u>

On 30 June 2001 ABC Co. buys a parcel of ordinary shares in a company for $1,000. No mark-to-market election is made in respect of the shares. At the end of the 2001-2002 income year (30 June 2002) the shares are worth $1,200. On 1 July 2002 ABC Co. sells the shares for that amount.

Calculation of tax value

On 30 June 2001 the tax value of the shares is $1,000.

At the end of the 2001-2002 income year the shares have increased in value by $200. However, their tax value remains unchanged. This is because gains and losses on ordinary shares are not subject to tax on an accruals basis under Subdivision 45-C, but are taxed on a realisation basis in accordance with item 3 of the table in section 45-15. At the end of the 2002-2003 income year, ABC Co. no longer holds the shares, resulting in a $1,000 reduction in tax value. During that income year it received $1,200 as proceeds from sale of the shares. Accordingly, its net income for that year in respect of the shares is $200 ($0 – $1,000 + $1,200).

(ii) Bond acquired at par

This example shows that, for a simple financial instrument like a bond acquired at par which pays interest on an annual basis at the end of a year of income, the tax value at the end of a year of income under Subdivision 45-C will be the same as the tax value at the beginning of the year, provided the bond is held for the whole of the income year.

Facts

Bruce acquires a 5-year, fixed-rate bond with a face value of $100 for $100 on 30 June 2000. On 30 June 2001 the bond pays interest for the year (calculated at 5%) of $5. Assume that the tax value of the bond at the beginning of the 2000-2001 income year is $100.

Application of tax value formula

All the returns on the bond are fixed. Therefore, at the time Bruce acquires it, all the amounts to be received are known and section 45-75 applies.

The payment of interest is an event which requires the calculation of the bond's tax value under section 45-75. The tax value of the bond under that section is calculated in accordance with the following formula:

$$\left[\text{Last tax value} \times (1 + \text{Interest \%})\right] - \text{Receipts at the test time}$$

- The last tax value of the bond is $100.
- The interest %, calculated under subsection 45-75(3), is the rate of return that, if used in working out the net present value of the following cash flows on 30 June 2000, results in the net present value equalling zero:
    - $100 paid at that time; and
    - the sum of the following amounts:

– \$5 in one year's time;

– \$5 in 2 years' time;

– \$5 in 3 years' time;

– \$5 in 4 years' time; and

– \$105 in 5 years' time.

It is not necessary to calculate this rate of return – since the only return on the bond is 5% paid annually, the rate of return is 5%. This can be demonstrated by applying a 5% discount rate to the annual returns as follows:

- $\dfrac{\$5}{1 + 5\%}$

- $\dfrac{\$5}{(1 + 5\%)^2}$

- $\dfrac{\$5}{(1 + 5\%)^3}$

- $\dfrac{\$5}{(1 + 5\%)^4}$

- $\dfrac{\$5}{(1 + 5\%)^5}$

The sum of these amounts is \$100.

Therefore, the tax value of Bruce's bond on 30 June 2001 is:

$$[\$100 \times (1 + 5\%)] - \$5 = \$100$$

Because 30 June is the end of Bruce's year of income, the tax value of his bond at the end of the income year (the 'closing value') is \$100. This is the same as its tax value at the beginning of the year (the 'opening value'). Therefore, in calculating his net income for the year under section 5-55, the change in tax value of his bond is zero. However, the \$5 interest payment he received is a receipt which will be included in his net income.

(iii) Bond acquired at a discount

<u>Facts</u>

Suppose Bruce sells the bond described in the above example to Cynthia on 30 June 2001 for \$80. It is sold at a discount to its face value because, since its issue, variable interest rates have risen and therefore the fixed rate of 5% on the bond is less valuable.

Application of tax value formula

The tax value of the bond when Cynthia buys it is its cost, namely $80 (section 45-65). This is also the opening tax value of the bond for the 2001-2002 income year. On 30 June 2002 it pays $5 interest, so its tax value has to be calculated at that time using the formula in section 45-75.

The last tax value of the bond is $80, so the interest % is worked out under subsection 45-75(3) as the rate of return that, if used in working out the net present value of the following on 30 June 2001, results in the net present value equalling zero:

- $80 paid on 30 June 2001; and
- the sum of the following:
  - $5 in one year’s time;
  - $5 in 2 years’ time;
  - $5 in 3 years’ time; and
  - $105 in 4 years’ time.

In other words, what is the annual rate of return that would produce a net present value of $80 for the given cash receipts? Using a financial calculator, the relevant rate is 11.5180%.

Inserting these components into the tax value formula in section 45-75, the tax value of the bond as at 30 June 2002 is:

$$[\$80 \times (1 + 11.52\%)] - \$5 = \$84.21$$

Therefore, at the end of the 2001-2002 income year, the tax value of the bond is $84.21. Consequently, there has been a net change in the tax value of the bond over the year of:

$$\$84.21 - \$80 = \$4.21$$

Cynthia will include this amount, together with the $5 interest receipt, in her net income under section 5-55.

(iv) Indexed-linked bond issued at a premium

Facts

On 15 April 2001 Duke Co., an investment company, acquires a 4-year indexed bond with a face value of $100,000 for $105,000 on the secondary market (i.e. at a 5% premium). The bond pays 5% annual interest in arrears calculated on the indexed face value, and a return of the indexed face value at maturity (which is in 3 years and 290 days' time). The face value is indexed according to changes in a broadly-based share index.

<u>Application of tax value formula</u>

Duke Co.'s 2000-2001 income year ends on 30 June 2001. It needs to calculate the tax value of the bond at that time to determine its net income for the year. Because some of the returns on the bond depend on a predetermined variable (the indexation component), the tax value is calculated according to the following formula in subsection 45-80(1):

$$\text{Last tax value} + [\text{Last face value} \times (\text{Interest \%} + \text{Index \%})] + \text{Amortisation of discount or premium} - \text{Receipts at the test time}$$

- The last tax value of the bond is its cost at the time of acquisition, namely $105,000 (section 45-65).

- Its face value at that time is $100,000.

- Under subsection 45-80(5) the interest % is the interest rate during the period from 15 April to 30 June multiplied by:

$$\frac{\text{Number of days in the test period}}{365} = \frac{76}{365}$$

  (Note that, in calculating the number of days in the test period (76), the day of acquisition is not counted.)

  Under subsection 45-80(6) the interest rate is the annual rate of return (5%) compounded as appropriate. In this case the rate is paid annually and therefore no compounding is required. Therefore the interest % is:

$$5 \times \frac{76}{365} = 1.041\%$$

- The index % is calculated under subsection 45-80(7) as:

$$\frac{\text{Index at test time} - \text{Index at previous indexation time}}{\text{Index at previous indexation time}}$$

  Assuming the relevant index at 30 June (the test time) is 103 as compared to 100 at 15 April (the previous indexation time), the index % is:

$$\frac{103-100}{100} = 3\%$$

- The 'amortisation of discount or premium' component of the formula is calculated under subsections 45-80 (10) and (11) as follows:

  Adjusted cost – Last adjusted cost

  = [$105,000 × (1 + Amortisation rate)] – $105,000

  The amortisation rate calculated under subsection 45-80(13) is the annual compounded rate of return that would result in the net present value of the following equalling zero:

- $105,000 paid on 15 April 2001; and

- $100,000 received in $3\frac{290}{365}$ years' time.

  In other words, what is the annual rate attributable to the premium paid on acquisition that, when applied on a compounding basis, would decrease $105,000 to $100,000 in $3\frac{290}{365}$ years? This is calculated as follows:

$$\left(\sqrt[3\frac{290}{365}]{\frac{100{,}000}{105{,}000}}-1\right)\times 100=-1.2776\%$$

  The 'amortisation of discount or premium' component is therefore:

  [$105,000 × (1 + (–1.2776%))] – $105,000 = –$1,341.48

  Inserting these components into the tax value formula in section 45-80, the tax value of the bond as at 30 June 2002 is:

  $105,000 + [$100,000 × (1.041% + 3%)] + (–$1,341.48) – 0

  = $107,699.52

Therefore, at the end of the 2000-2001 income year, the tax value of the bond is $107,699.52. The net income of Duke Co. from the bond for that income year is:

$107,699.52 – $105,000.00 = $2,699.52

How do the accruals rules affect individuals and small businesses?

Pursuant to Recommendation 4.4, there is a general exclusion from accruals tax treatment for individuals. The exclusion also applies, under Recommendation 17.2, to small businesses, conducted by an individual or an entity, that elect to be taxed under the Simplified Tax System.

Under this exclusion, accruals taxation treatment will not apply to financial assets and liabilities, subject to certain specified exceptions. For these purposes, a small business is one that has an annual turnover or annual receipts of less than $1 million, and whose leasing activities do not provide more than 5% of the business's turnover.

The exclusion allows eligible taxpayers to use a cash basis to account for business income and day-to-day expenditure in most circumstances. Under the cash basis of taxation, income is recognised for tax purposes when it is actually received, and, in most circumstances, expenses are recognised when they are actually paid.

There are exceptions to this general exclusion, which are listed in Recommendation 17.2. The main exceptions relate to where a financial asset or liability provides significant taxation deferral opportunities. These significant deferral opportunities are considered to exist where a financial asset or liability has a term of at least one year, and the rate of return applicable to any effective discount or premium is more than 1% a year, compounded annually. (The term 'effective discount or premium' includes not just the discount or premium at which a security is issued, but also covers deferred interest and similar situations.)

Similarly, the exclusion will not apply to 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. These projects or arrangements are generally referred to as 'tax shelter' schemes.

Chapter 8
Liabilities and tax values

Outline of Chapter

8.1 This Chapter explains how to work out the tax value of a liability held by a taxpayer (e.g. a liability to repay a loan or to pay for services rendered) using the tables in section 6-75 and subsection 45-40(1). The tax values of liabilities and assets, along with receipts and payments, are used in section 5-55 as a component of a formula used to calculate the taxable income of a taxpayer (section 5-15), and ultimately to determine the taxpayer's income tax under section 5-10.

8.2 The Chapter explains the effect that changes in the tax value of a liability of the taxpayer has on the tax payable, and compares this with the timing of tax deductions for liabilities under the current law.

8.3 The Chapter also explains that liabilities which have not yet been incurred have a tax value of nil and therefore have no immediate effect on tax payable.

Context of Reform

8.4 Under the current law, the calculation of a taxpayer's taxable income or tax loss can involve difficult questions relating to the characterisation of receipts and payments as capital or not. This can lead to uncertainty and inappropriate results.

8.5 Chapter 3 describes the proposed new approach for a more coherent and comprehensive method for calculating a taxpayer's taxable income or tax loss on the basis of receipts less payments plus the change in tax value of assets and liabilities. This approach focuses on the question whether payments and receipts give rise to assets or liabilities for tax purposes and the specification of the tax values of those assets and liabilities.

8.6 The proposed methods described in this Chapter underpin the effectiveness of the new approach through the specification of appropriate tax values for liabilities. These tax values reflect, with greater certainty and coherency than the current law, the commercial position of the taxpayer by taking into account the time value of money where appropriate and practicable.

Summary of new law

8.7 The tables in section 6-75 and subsection 45-40(1) prescribe the methods for calculating the tax value of the different types of liabilities a taxpayer may have.

8.8 The new law identifies the following types of liabilities:

- liabilities that have not yet been incurred;
- liabilities which have been incurred but are not financial liabilities (i.e. incurred liabilities that do not entail a monetary obligation – for example, a liability to supply goods or services);
- financial liabilities which have been incurred and which involve an underlying physical transaction (i.e. liabilities to pay for goods or services – performance by way of the supply of those goods or services represents a physical transaction, as compared to a purely monetary transaction under which only money changes hands, as in a loan transaction); and
- other financial liabilities which have been incurred (e.g. a liability to pay money in the future in exchange for money provided today).

8.9 The tax value of liabilities that have not yet been incurred is nil ***[item 9 of the table in section 6-75]***. As a result, such liabilities have no immediate effect on taxable income.

8.10 The tax value of other liabilities is, wherever practicable, calculated in the same way as the tax value of corresponding assets. This ensures symmetrical tax timing treatment between liabilities and assets that have equivalent characteristics.

8.11 The general principle governing the tax values of incurred liabilities is that they should be determined on an 'accruals' basis, based on the present value of the obligation to pay in the future. This reflects the time value of money where there is a period of time between performance (including payment) by one party and the requirement to perform (including to make a payment) by the obligated party. Accruals tax treatment recognises the fact that an obligation to pay an amount or to provide benefits in the future is equivalent to an obligation to pay a lesser amount, or to provide benefits of a lower value, immediately. Therefore, the true cost of an obligation to pay money in the future is not the nominal amount of money owed but a lesser amount, namely the present value of the nominal amount.

8.12 There are 2 broad exceptions to the general principle. First, many transactions involve a liability to pay money immediately on performance

– in these cases there is no time period between performance and payment. Second, there are many liabilities involving physical transactions where the time period between performance on one side and performance on the other is relatively short. The compliance costs involved in applying accruals tax treatment in respect of these transactions are not justified. For such liabilities their tax value simply reflects the nominal amount of the money owed.

8.13 The new law also:

- enables the market value of eligible financial liabilities held by a taxpayer who makes a mark-to-market election to be their tax value (i.e. taxation on a 'market value' basis); and
- ensures that the tax value of financial liabilities that correspond to a financial asset taxed on a realisation basis is also determined on a realisation basis.

> Recommendation 9.3 lists options and forwards as examples of financial liabilities and assets that are generally being taxed on a realisation basis. Rules giving effect to this recommendation are being developed.

> Individuals will generally be able to adopt (Recommendation 4.4), and small business will be able to choose through the Simplified Tax System (Recommendation 17.2), a cash basis to account for most of their business income and day-to-day expenditure, rather than be subject to accruals taxation. Rules are being developed to give effect to these recommendations.

Comparison of key features of new law and current law

8.14 The new law is designed to provide a coherent, certain and robust system for enabling the liabilities of a taxpayer to be recognised for tax purposes. The key design features of the new law as compared to the current law are outlined in the table below.

Table 8.1 Comparison of new and current law

New Law	***Current Law***
The accruals tax treatment of liabilities, which applies for most financial and long-term liabilities, recognises the time value of money.	The general provisions governing tax deductibility of losses and outgoings do not explicitly take into account the time value of money.

New Law	***Current Law***
A liability to pay an amount (or to provide an asset or services) reduces a taxpayer's taxable income (subject to any offsetting adjustment – for example, a receipt) at the time the liability is entered into by: • that amount, if the payment is to be made immediately or, if it is for the supply of goods or services, within six months; or • the present value of that amount in other cases, unless the liability corresponds to an asset taxed on a realisation basis.	As a general rule, the courts have not interpreted the general deductibility provisions of the current tax law as permitting present value discounting of deductible payments. However, the nominal amount of a deductible payment does not represent the true cost of the obligation, which is the present value of that amount.
The tax value of liabilities generally corresponds to the tax value of corresponding assets (i.e. assets comprising the rights which arise from the obligations imposed by particular liabilities). This promotes symmetrical tax treatment for the issuer and holder of financial assets and liabilities, thereby promoting neutrality and minimising opportunities for tax arbitrage.	Asymmetrical tax treatment can apply between the issuer of a financial asset and its holder so that tax deductions are available for the issuer's liability before income is taxed to the holder of the asset.

Detailed explanation of new law

What is a liability?

8.15 A ***liability*** is defined in section 6-20 as a present obligation to provide future economic benefits. ***[Subsection 6-20(1)]***

8.16 This definition draws on the accounting definition of a liability. It also specifically includes the balance of the contributed capital account of a tax entity which is subject to the new entity tax rules. ***[Subsection 6-20(3)]***

What is an obligation?

8.17 An obligation is a requirement to do something (or *not* to do something). To be a liability for tax purposes, it does not need not be a legally binding obligation. ***[Subsection 6-20(2)]***

8.18 An obligation involves at least two parties: one party owing the obligation to another. Therefore, a taxpayer's unilateral decision or mere intention to do something is not an obligation. For example, the mere decision of a taxpayer to spend money does not give rise to an obligation, even if the taxpayer creates an accounting provision for the planned expenditure. In such a case there is no obligation to an external party.

8.19 Ordinarily, the obligation will be owed to the taxpayer to whom the future economic benefits will be provided. However, this does not have to be the case. For example if, under a liability assumption or an in-substance defeasance arrangement, A enters into a contract with B to pay C a fixed amount at a specified time in the future, A has a liability within the meaning of section 6-20. This is the case even though A's obligation is owed to B but the relevant payment is made to C. ***[Subsection 6-20(2)]***

8.20 Obligations can arise voluntarily (e.g. by contract or deed), or they may be imposed on the taxpayer (e.g. by legislation).

What is a present obligation?

8.21 An obligation must be a present obligation if it is to constitute a liability. That is, it must presently exist. Therefore a future obligation cannot constitute a liability, even if it is certain to arise.

8.22 If an obligation is a contingent obligation, it will not become a present obligation until the contingency occurs. For example, the obligation of an insurance company to pay an amount under an insurance policy becomes a present obligation only when an event occurs which allows a claim to be made under the policy.

Example 8.1 Provision for car warranties

Henry runs a car yard. He commenced business on 1 July 2001. Each car he sells is covered by a 3 year warranty. Henry keeps scrupulous accounting and business records and he is able to show that on average 1 out of every 10 cars he sells in a year is the subject of a warranty claim in that year, 2 in the following year and 3 in the year after that. His records also show that on average each claim costs $200 in parts and labour.

Henry has been in business for 2 years. He sold 10 cars in his first and second year.

Henry recognises a provision for warranty claims in his commercial accounts. In the year ended 30 June 2003, he recognises a provision for $2,200. This is based on his records that show that he will receive 11 warranty claims in the future (3 in the current year, 5 in the following year and 3 in the year after that) at an average cost of $200.

The provision can be separated into 2 parts. That part which relates to the claims for the current year ($600) and that which relates to claims in the next 2 years ($1,600).

The provision for $600 is a liability. The fact that Henry can show that 3 cars currently need to be fixed means that he is presently obliged under their warranties to repair them. However, the provision for

$1,600 is not a liability. Henry is not presently obliged to repair those vehicles because they do not yet need to be fixed.

What are economic benefits?

8.23 A liability entails an obligation to provide future economic benefits. This will be the case if the obligation involves transferring assets to, or performing services for, another taxpayer where a monetary value can be placed on the assets or services.

8.24 Natural love and affection is not an economic benefit.

What is a financial liability?

8.25 A ***financial liability*** is defined in section 45-35 as a liability to provide some or all of the future economic benefits that are embodied in a ***financial asset*** (to be defined in section 45-10) ***[section 45-35]***. This definition encompasses any liability to pay money.

8.26 This Chapter focuses primarily on the tax value of financial liabilities referred to in section 6-75 and Subdivision 45-B. Rules for the tax value of non-financial liabilities are being developed.

What is the tax value of a liability used for?

8.27 The tax value of assets and liabilities is used in calculating the taxable income or tax loss of a taxpayer. This is because the taxable income or tax loss of taxpayers depends on their net income, and the calculation of net income uses a formula that takes into account the tax value of their assets and liabilities. The relevant formulas for these calculations, which are set out in sections 5-15 and 5-55 and explained in Chapter 3, are as follows.

Taxable income = Net income + Income tax law adjustment – Unused tax losses

Net income = Receipts – Payments ± Net change in tax value of assets and liabilities

8.28 The tax value of a particular liability will usually not be its market value. Apart from the time that a liability is first owed, tax value will usually correspond with market value only where the market value election has been adopted.

8.29 The tax value of a liability is worked out in the ways described below.

What is the tax value of a liability which has not been incurred?

8.30 The tax value of a liability which has not been incurred is always nil. As a result, such liabilities will not affect taxable income until they are incurred. ***[Item 9 of the table in section 6-75]***

Meaning of 'incurred'

8.31 For these purposes, 'incurred' takes the meaning that the courts have given it in interpreting the general deduction provision of the current law (section 8-1 of the ITAA 1997).

8.32 Therefore, for a liability to be incurred, the taxpayer obligated to provide future economic benefits pursuant to the liability must be 'completely subjected' or 'definitively committed' to the obligation. A liability will not be incurred if the taxpayer has the discretion or option *not* to provide the benefits.

Example 8.2 Provision for annual leave

Theresa carries on a business in which she employs Sanjay and Kylie.

Sanjay and Kylie are employed under an award which entitles them to 4 weeks' annual leave after 12 months of service. Theresa is not required under the award to pay for annual leave until leave is taken.

Sanjay is entitled to 12 weeks' annual leave, having worked 3 years without taking a holiday. Sanjay would be entitled to a payment in lieu of his annual leave if his employment ceased.

Kylie has been employed for 6 months. Kylie is not entitled to annual leave; however, she would be entitled to a payment under the award equal to half a year's holiday pay if her employment ceased.

Theresa records a provision for annual leave in the accounts of the business. The balance in the provision equals the amount of wages Sanjay is entitled to be paid while on annual leave, and the payment that Kylie would be entitled to if her employment ceased.

The accounting provision is a liability for income tax purposes because Theresa is under a present obligation to pay either wages for annual leave or an amount in lieu of annual leave when the relevant event which leads to such an obligation (i.e. taking annual leave or ceasing employment) happens. However, the liability has not been *incurred* because Theresa is not 'completely subjected' or 'definitively committed' to making the payments until the relevant event occurs. Therefore it has a tax value of zero.

How is the tax value of a liability which has been incurred calculated?

8.33 As noted, the tax value of a liability which has been incurred is calculated on the basis of one of 3 general approaches: realisation, market value or accruals. To achieve greater symmetry of treatment between assets and liabilities, and to obviate the need for separate tax value rules for liabilities that duplicate tax value rules for assets, the tax value of a liability is calculated, wherever possible, by reference to the tax value of an identical asset that corresponds to the liability. In summary:

- tax value is calculated on a realisation basis by reference to the nominal amount of money to be paid for:
  - a liability to pay money immediately;
  - a short-term liability for the supply of goods or services; and
  - a financial liability that corresponds to a financial asset taxed on a realisation basis;
- the tax value of a financial liability for which a market value election has been made is the liability's market value; and
- the tax value of other liabilities is calculated on an accruals basis by reference to the tax value of the identical corresponding asset.

Liabilities taxed on a realisation basis

8.34 The table in section 6-75 provides that the tax value of a liability to pay money immediately, or a short-term liability for the supply of goods or services, is the (nominal) amount of money liable to be paid. This tax value applies from the time the liability is incurred to the time the taxpayer is no longer subject to it. ***[Items 1 and 2 of the table in section 6-75]***

8.35 For these purposes a short-term liability is one that requires performance within 6 months. Thus, a liability to pay in 6 months' time for services provided today is a short-term liability. ***[Item 2 of the table in section 6-75]***

8.36 Liabilities that relate to assets taxed on a realisation basis are also taxed on a realisation basis. This is implemented by means of the 'identical corresponding financial asset' concept that is further explained below in paragraphs 8.42 to 8.44. ***[Item 3 of the table in subsection 45-40(1)]***

Example 8.3 Tax value of a liability to pay for goods within 6 months

Smith delivers an asset to Jones on terms that require payment in 6 months' time. The asset is worth $95 but, because payment is deferred, Jones undertakes to pay $100. Assume that Jones's year of income ends 2 months after delivery, and that the asset has been consumed in Jones's business by that time.

The difference between the $100 paid for the asset and its $95 market value reflects the time value of money. Because the obligation to pay is within 6 months the tax value of the liability is simply the nominal amount of the money owed.

Therefore, disregarding any other transactions during the year, Jones's net income for the income year would be reduced by $100, because that is the increase in the tax value of her liabilities (there is no corresponding increase in the tax value of Jones's assets because the asset is not on hand at the end of the income year).

This outcome is equivalent to what occurs under the current law if the $100 is a deductible outgoing to which Jones is definitively committed or completely subjected.

Liabilities taxed on an accruals basis

8.37 Liabilities are taxed on an accruals basis if they:

- do not involve an underlying physical transaction to be paid for within 6 months;
- do not relate to assets taxed on a realisation basis; and
- are not the subject of a mark-to-market election.

8.38 Taxing liabilities on an accruals basis takes into account the time value of money.

8.39 A taxpayer's taxable income is reduced at the time the taxpayer incurs a liability. (The reduction could be offset by the receipt of money or by the acquisition of an asset.) If the liability is taxed on an accruals basis, the amount of the reduction is the present value of the amount to be paid in the future.

8.40 To implement this 'present value' approach, the table in subsection 45-40(1) relies on the concept of an identical financial asset corresponding to the liability whose tax value is being calculated. The tax value of the liability is the tax value of that corresponding financial asset. ***[Item 2 of the table in subsection 45-40(1)]***

8.41 As indicated, this concept also allows financial liabilities corresponding to financial assets which are taxed on a realisation basis to be taxed on the same (realisation) basis. ***[Item 3 of the table in subsection 45-40(1)]***

What is an identical financial asset corresponding to a liability?

8.42 A liability comprises an obligation, or obligations, to pay money or to do something other than pay money. Usually these obligations will be owed to a single person or entity. If so, that person or entity will hold an asset that corresponds to the liability – the obligations of the holder of the liability will constitute rights of the holder of the asset. For example, if A owes B $100, A has a liability representing the obligation to pay $100, and B has an asset representing the right to receive $100.

8.43 Even if the obligations are not owed to a single person or entity so that there is no single asset that corresponds to the liability, it is possible notionally to construct an asset that corresponds to the liability.

For example, if A has a single liability comprising an obligation to pay \$50 to B and \$50 to C, neither B nor C individually holds an asset that corresponds to A's liability. However, an asset could be constructed that does correspond to the liability, namely a right to receive \$100. This could be achieved by looking at what asset A would hold if, instead of having the liability, it was the party to whom the obligations were owed.

8.44 The table in subsection 45-40(2) explains how to identify a financial asset that corresponds to a particular financial liability. The table identifies 3 types of liability, namely:

- a liability to provide future economic benefits that are embodied in a single financial asset held by a taxpayer – in which case the corresponding financial asset is that single financial asset ***[Item 1 of the table in subsection 45-40(2)]***;

- a liability to provide future economic benefits that are embodied in two or more financial assets held by one or more taxpayers – in which case the corresponding financial asset is a notional financial asset that embodies all those future economic benefits ***[Item 2 of the table in subsection 45-40(2)]***; and

- any other financial liability (e.g. a liability to provide only some of the future economic benefits embodied in a single financial asset) – in which case the corresponding financial asset is a notional asset that embodies all the future economic benefits that are to be provided to discharge the liability ***[Item 3 of the table in subsection 45-40(2)]***.

Example 8.4 Constructing a notional financial asset

Giant Co. holds a single financial asset comprising:

- a right to the return of principal plus an indexation amount calculated by reference to changes in the All Ordinaries Index from Big Co.; and

- a right to receive a non-indexed, periodic return on the principal from Small Co.

Both Small Co. and Big Co. have financial liabilities. Item 3 in the table in subsection 45-40(2) provides that:

- the corresponding financial asset in relation to Small Co.'s liability is a right to receive the periodic return; and

- the corresponding financial asset in relation to Big Co.'s liability is a right to receive the principal plus the indexation amount.

How is the tax value of a liability calculated by reference to a corresponding financial asset?

8.45 If the financial asset corresponding to a financial liability is taxed on a realisation basis, the tax value of the liability at the time it is incurred is the cost, and will remain the cost, of that asset. ***[Item 3 of the table in subsection 45-40(1)]***

8.46 A financial liability described in item 2 of the table in subsection 45-40(1) is taxed on an accruals basis. Its tax value is the same as what the tax value of an identical financial asset corresponding to the liability would be if it were held by the holder of the liability. At the time it is incurred, the tax value of the liability is the tax value of the identical financial asset calculated under section 45-65. At a later time it is the tax value calculated under the formula in section 45-75 or 45-80. ***[Item 2 of the table in subsection 45-40(1)]***

8.47 Chapter 7 explains how to apply the formulas in sections 45-75 and 45-80. To apply the formula to a notional corresponding financial asset it is necessary to make an assumption as to that notional asset's cost. The assumed cost of the corresponding financial asset is what the cost of an asset of that kind would be, at the time the liability was entered into, if the asset were held by the holder of the liability. The cost of a financial asset is worked out under Subdivision 6-E. ***[Items 2 and 3 of the table in subsection 45-40(1)]***

8.48 Under the 'corresponding financial asset' approach to valuing liabilities, when working out the tax value of the corresponding financial asset (and thereby the tax value of the liability) any payments made pursuant to the liability will be taken to be receipts in relation to the asset. Therefore, whenever a payment of interest is made pursuant to the liability, the tax value of the liability will be the tax value of the corresponding financial asset, determined as if the payment made were a receipt in relation to the asset. Therefore, just as the receipt of interest on a financial asset reduces the asset's tax value, the payment of interest reduces the tax value of the liability.

Example 8.5 Tax value of a liability calculated on an accruals basis

Suppose that in Example 8.3, the liability was a financial liability under which Smith lends Jones $95 in return for a promise by Jones to pay $100 to Smith in 6 months, plus an additional amount if there is an increase in the CPI over that period.

The identical financial asset that corresponds to Jones's liability is the right to receive $100 in 6 months (i.e. Smith's asset).

The tax value of this corresponding asset under section 45-65 is its cost, namely the $95 paid for it (see item 1 of the table in subsection 6-105(3)).

Its tax value 2 months later (at the end of Jones's year of income) is calculated under the formula in section 45-80. This formula is used because some of the returns depend on a predetermined variable (the CPI). The formula is:

$$\text{Last tax value} + \left[\text{Last face value} \times (\text{Interest \%} + \text{Index \%})\right] + \text{Amortisation of discount or premium} - \text{Receipts at the test time}$$

Assume that there is no change in the CPI over the relevant period. Therefore the components of the formula are as follows:

- The last tax value is $95
- The last face value is $100
- The interest % is zero
- The index % is zero
- The amortisation of discount or premium is:

  Adjusted cost – Last adjusted cost

  = [$95 × (1 + Amortisation rate)] – $95

  The amortisation rate calculated under subsection 45-80(13) is 1.8%. This is the annual compounded rate of return, apportioned over the 2 month test period, that would result in the net present value of the following equalling zero:

  – $95 paid; and

  – $100 received in 6 months' time.

  The 'amortisation of discount or premium' component is therefore:

  [$95 × (1 + 1.8%)] – $95 = $1.71

Inserting these components into the tax value formula in section 45-80, the tax value of the notional financial asset at the end of Jones's year of income is:

$95 + [100 × 0] + $1.71 – 0 = $96.71

Therefore this is the tax value of Jones's liability at the end of her income year. Disregarding any other transactions during the year, Jones's taxable income would be reduced by $96.71, and increased by the $95 she received from Smith, resulting in a net reduction of $1.71.

In the following income year when Jones pays $100 to Smith, her liabilities will reduce to zero (resulting in $96.71 being added to taxable income, offset by the $100 payment she makes – a net reduction in taxable income of $3.29).

As the CPI component turned out to be zero, the same result would be obtained by applying instead section 45-75. The formula in that section is:

$$\left[\text{Last tax value} \times (1 + \text{Interest \%})\right] - \text{Receipts at the test time}$$

- The last tax value is $95.
- The internal rate of return (interest %), calculated under subsection 45-75(3), is the annual compounded rate of return that, if used in working out the net present value of the following at the time the loan is made, results in the net present value equalling zero:
  - $95 paid at that time; and
  - $100 received in six months' time.

  This rate, apportioned over the two month period, is, again, 1.8%.

Inserting these components into the tax value formula in section 45-75, the tax value of the notional financial asset at the end of Jones's year of income is:

$$\left[\$95 \times \left(1 + 1.8\%\right)\right] - 0 \quad = \quad \$96.71$$

Again, the corresponding increase in the tax value of Jones's liability is $1.71, reducing her taxable income in the income year by that amount.

Liabilities taxed on a market value basis

8.49 The new law will allow a taxpayer who uses market value to determine profit and loss from particular financial assets and liabilities for financial accounting purposes to elect to adopt the same basis for tax purposes, subject to satisfying certain criteria to be set out in Subdivision 45-D. The tax value of a financial liability for which a market value election has been made is the liability's market value. ***[Item 6 of the table in subsection 45-40(1)]***

Liabilities relating to shareholders etc.

8.50 A tax entity may have a liability (other than contributed capital) in relation to its members and certain other taxpayers. These liabilities are listed in the table in section 6-145. They include the obligation of a company to pay a declared dividend to its shareholders.

8.51 However, the tax value of a liability arising from the relationship between a tax entity and its members, and certain other taxpayers, is always taken to be nil. Therefore the taxable income of a tax entity is not affected by these liabilities. ***[Item 4 of the table in section 6-75; item 4 of the table in subsection 45-40(1)]***

How do the accruals rules affect individuals and small businesses?

Pursuant to Recommendation 4.4, there is a general exclusion from accruals tax treatment for individuals. The exclusion also applies, under Recommendation 17.2, to small businesses, conducted by an individual or entity, that elect to be taxed under the Simplified Tax System.

Under this exclusion, accruals taxation treatment will not apply to financial assets and liabilities, subject to certain specified exceptions. For these purposes, a small business is one that has an annual turnover or annual receipts of less than $1 million, and whose leasing activities do not provide more than 5% of the business's turnover.

The exclusion allows eligible taxpayers to use a cash basis to account for business income and day-to-day expenditure in most circumstances. Under the cash basis of taxation, income is recognised for tax purposes when it is actually received, and, in most circumstances, expenses are recognised when they are actually paid.

There are exceptions to this general exclusion, which are listed in Recommendation 17.2. The main exceptions relate to where a financial asset or liability provides significant taxation deferral opportunities. These significant deferral opportunities are considered to exist where a financial asset or liability has a term of at least one year, and the rate of return applicable to any effective discount or premium is more than 1% a year, compounded annually. (The term 'effective discount or premium' includes not just the discount or premium at which a security is issued, but also covers deferred interest and similar situations.)

Similarly, the exclusion will not apply to 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. These projects or arrangements are generally referred to as 'tax shelter' schemes.

Chapter 9
Depreciating assets

Outline of Chapter

9.1 Division 40 contains the rules for writing off the cost of depreciating assets for the purpose of working out the taxable income of an entity or individual which owns or controls the assets. It also consolidates within one Division the disparate capital allowances – including plant depreciation and mining, quarrying and primary producer allowances – of the current law.

Context of Reform

9.2 The methodology set out in Division 5 for working out taxable income requires a taxpayer to first work out the net income of an income year. A key component of net income is the measurement of change in the tax value of assets and liabilities ***[Subdivision 5-B]***. To work out the change in tax value, the method statement in section 5-55 requires that the closing tax value of assets be added to net receipts and the opening tax value of assets be deducted. As regards depreciating assets, the difference between opening and closing tax values – as calculated under new Division 40 – is effectively the amount that is written off for tax purposes in working out taxable income.

9.3 The decline in tax value of depreciating assets is recognised in the current law: it is reflected in the written down or depreciated value of these assets. However, current write-off arrangements are contained in many different provisions which do not have a consistent basis of deduction. Some, such as plant depreciation, provide deductions for the cost of an asset over its effective life. Some provide a statutory, straight-line basis of deduction of the specified cost (e.g. primary producers' telephone connections), while others allow write-off of the original cost on a straight-line basis over a statutory life (e.g. income producing buildings). Some, principally plant depreciation, provide for an adjustment of deductions on disposal of the asset; others do not.

9.4 To the greatest extent possible, Division 40 will standardise the basis for measuring the decline in tax value of depreciating assets. It will apply to most depreciating assets, including new income-producing buildings and other assets, such as an airport tarmac, which may not have qualified for deduction previously under the plant depreciation rules. It will apply whether a depreciating asset is a tangible asset or an intangible asset, and will allow write-off according to the decline in tax value of the asset – based on cost – over its effective life.

9.5 To be more specific, Division 40 will replace the following capital allowances contained in the ITAA 1997:

- plant depreciation under Division 42;
- capital works under Division 43;
- software depreciation under Division 46;
- exploration or prospecting under Subdivision 330-A;
- mine (quarry) development expenditure under Subdivision 330-C;
- transport expenditure under Subdivision 330-H;
- rehabilitation expenditure under Subdivision 330-I;
- intellectual property under Division 373;
- spectrum licences under Division 380;
- landcare operations under Subdivision 387-A;
- water facilities under Subdivision 387-B;
- horticultural plants under Subdivision 387-C;
- grapevines under Subdivision 387-D;
- forestry and timber operations under Subdivision 387-G;
- environmental impact assessment under Subdivision 400-A;
- environmental protection activities under Subdivision 400-B.

9.6 Certain capital allowances contained in the ITAA 1936 that have limited future operation are not covered. These are:

- development allowance under Subdivision B of Division 3 of Part III;
- drought investment allowance under Part XII; and
- special depreciation for Australian trading ships under section 57AM.

9.7 Buildings and other capital works that qualify by 30 June 2000 for write-off under Division 43 of the ITAA 1997, as well as any additions or improvements made after that time, will continue to be written off under that Division.

9.8 At this stage, the following capital allowances have not been incorporated into Division 40:

- Film licensed investment companies under Subdivision 375-H of the ITAA 1997;
- Australian films under Division 10BA of Part III of the ITAA 1936;
- Industrial property relating to copyright in an Australian film under Division 10B of Part III of the ITAA 1936; and
- Research and development under section 73B of the ITAA 1936.

The deduction entitlements currently available under these rules will be preserved by way of a 'decreasing adjustment' under the scheme of the draft legislation.

9.9 Proposed simplified depreciation arrangements, which are part of the Simplified Tax System for small business taxpayers, are not included in these legislative measures. Under the proposals, business taxpayers with annual turnover of less than $1,000,000 will be able to elect to be included in the System, which incorporates a cash basis for recognising business income and expenditure, and a depreciation regime which gives immediate write-off for assets costing less than $1,000 plus pooling of other depreciating assets with effective lives of less than 25 years.

9.10 Division 40 does not contain a specific rule to adjust the amount of write-down when a depreciating asset is disposed of for an amount greater or less than its tax value. That is because under the general rules in Division 5 for calculating net income, the disposal proceeds are brought to account as receipts while the asset itself would no longer be reflected in the closing tax value of assets. This provides an automatic balancing adjustment on disposal of a depreciating asset.

9.11 Some existing concessions are preserved, including certain primary production concessions, within the umbrella of Division 40. The statutory write-off regimes for telephone and electricity connections are also preserved under the amortisation rules in Subdivision 40-F.

9.12 Other specific categories of amortisable payments will also be covered by Subdivision 40-F. They can be characterised as expenditures for the establishment of a business or to enlarge a business structure – company incorporation costs and loan or equity raising costs. The current law permits write-off of loan raising expenditure over the lesser of 5 years or the loan term. However, the other expenditures are not deductible because, whilst incurred in connection with the production of income, they are capital in nature. They have a lasting value which adds to the business structure and therefore do not have the character of immediately deductible revenue expenditure. Consistent with Recommendation 4.14 dealing with blackhole expenditure, Subdivision 40-F will provide write-off over 5 years or, in the case of expenditure to obtain a loan, the lesser of 5 years or the loan term.

Summary of new law

What the Division will do	Division 40 provides a standard set of rules (in Subdivision 40-A) that can apply to all depreciating assets.
Link to higher level rules	The rules in Division 40 will measure the decline in tax value of depreciating assets over an income year. The amount of the decline is an essential element in working out net income. It reflects the difference between the opening and closing tax values of an asset.
What is a depreciating asset?	A ***depreciating asset*** is an asset that loses value because it is effectively used up to produce taxable income. Its useful lifespan is accounted for by writing down the value until it reaches zero or the asset is disposed of.
How is the decline in tax value calculated?	There is a formula that basically divides the cost of the asset by the number of years it is expected to be commercially useful.
What rate applies?	The rate used depends on whether a taxpayer chooses the straight line or the diminishing value method.
When does the decline in tax value start?	Usually, when the asset is able to be used to produce taxable income.
Adjustments	An adjustment reduces the decline in tax value if the asset is used for private, domestic or exempt purposes. A further adjustment may flow from this if the taxpayer stops holding the asset.
Pooling	Pooling can be used as an alternative to the separate write-off of assets which cost $1,000 or less, for assets that have been written down under the diminishing value method to $1,000 or less, for in-house software and for project costs that do not themselves produce separate assets.

Jointly held depreciating assets	Joint interests in an underlying depreciating asset will be taken as separate assets for write-off purposes.
Partially completed assets	A limited write-off is available for an incomplete asset where some part of it generates income before the overall asset is completed.
Landcare and primary producers	The write-off for landcare assets, water facilities, grapevines and other horticultural plants differs from other depreciating assets in 3 ways. These are: • accelerated rates apply; • write-off is always based on the cost of the first holder; and • only the prime cost rate is available.
Amortisable payments	These payments are treated as depreciating assets and written off over a statutory period.
Luxury cars	Special rules establish the upper limit for the cost of a car for the purposes of calculating the decline in tax value.

Comparison of key features of new law and current law

Comparison with Subdivision 40-A: Core Provisions

9.13 The following table sets out the important differences between the various capital allowances in the current law and the basic rules in Subdivision 40-A. Some of the key features of the new law are subject to exceptions as explained under later headings.

New Law	*Current Law*
The core provisions will apply to all depreciating assets.	The current law applies to depreciating assets that qualify as plant or articles, and to expenditure on assets covered by specific provisions e.g. mining, primary production, buildings. Some assets with a limited useful life are not covered by any provision, so no account is taken of expenditure on these assets ('blackhole expenditures').
The taxpayer *holding* a depreciating asset is entitled to write-off the asset.	Depending on the provision that applies, either the *owner* of the relevant asset or the entity that *incurs expenditure* on that asset is entitled to the capital allowance.

New Law	***Current Law***
A depreciating asset can be written off when: • it is first used or installed for a taxable purpose; or • construction of the asset is completed and it is used for a taxable purpose; or • a project commences operation for a taxable purpose and an asset is part of the project; or • if the asset is a right, when the right is first held.	When an asset starts to decline in value varies from regime to regime. The most common variations are when the expenditure is incurred and when the asset is first used.
The cost of a depreciating asset is generally the amount paid to hold it.	The amount on which the decline in value of an asset is based is either the expenditure incurred on the asset or its original cost.
There is a choice between the prime cost rate and the diminishing value rate for all depreciating assets.	Most capital allowances are a straight line deduction. For plant depreciation, there is a choice between the prime cost and diminishing value rates.

Comparison with Subdivision 40-B: Pooling

9.14 The following table sets out the differences between the new and the current law with regard to pooling.

New Law	***Current Law***
Certain 'blackhole' expenditure that does not form part of the cost of a depreciating asset may be written off over the life of the project to which it relates.	Capital expenditure that is not plant is not deductible under the current law unless specifically provided for.
Any items which have been written-down under the diminishing value rate to $1,000 or less can be pooled and written off over 4 years using the diminishing value rate.	The current law has no equivalent provision.
There are no rules to allow pooling of assets which have the same depreciation rate.	Items that have the same depreciation rate may be pooled.
Any items costing less than $1,000 may be pooled and written off over 4 years using the diminishing value rate.	There is an immediate write-off of small items costing less than $300.

Comparison with Subdivision 40-C: Jointly held depreciating assets

9.15 The following table sets out the difference between the new law and the current law for jointly held depreciating assets.

New Law	***Current Law***
The interests of joint holders are recognised and capable of separate write-off.	The current law is largely silent on jointly held assets, and it is unclear whether each holder's separate interests can be written off. This has been a particular problem with respect to depreciation allowances which are based on a 'unit of property'.

Comparison with Subdivision 40-D: Partially completed assets

9.16 The following table sets out the difference between the new law and the current law for incomplete assets.

New Law	***Current Law***
A limited write-off is available for that part of an asset that is used to generate income before the asset is fully completed.	Write-off commences when an asset is used or installed for a taxable purpose and, in relation to buildings, when the whole building is completed.

Comparison with Subdivision 40-E: Landcare and primary production

9.17 The following table sets out the differences in how the new and the current law deal with specific primary production depreciating assets.

New Law	***Current Law***
Assets used in landcare operations on any land in Australia will qualify for immediate write-off.	The deduction for landcare operations is limited to capital expenditure on rural land or land on which a primary production business is carried on.
The write-off for a water facility is only available while a taxpayer holds the facility. A later holder of a water facility can write it off provided there is still some amount available and it is used at least in part in a primary production business.	The deduction for expenditure on a water facility is available only to the person who originally incurs it.
The write-off is adjusted to the extent that the water facility is not used in a primary production business during and income year.	There is no reduction for non-primary production use.

Comparison with Subdivision 40-F: Amortisable payments

9.18 The following table sets out the important differences between these payments in the new law and the current law.

New Law	*Current Law*
A later land holder of land to which electricity and telephone lines have been extended can continue to write-off any remaining part of the original payment.	The deduction entitlement stays with the taxpayer incurring the expenditure. Subsequent owners have no write-off entitlement.
The write-off depends on the use of the electricity supply or telephone connection being for a taxable purpose year by year.	Although there must be a connection between the production of assessable income and incurring the expenditure, that connection only applies for the first income year of the write-off. Once that test is satisfied, the write-off continues until the original cost is exhausted – even if the land is sold.
The write-off reflects the number of days the taxpayer has access to the supply or connection in an income year.	There is no pro rating for part year use.
Specified types of expenditure will be written off in a straight line over 5 years.	Equivalent ‘blackhole expenditure’ (apart from borrowing costs) is not deductible because of its capital nature.

Detailed explanation of new law

Subdivision 40-A – The core provisions

9.19 Subdivision 40-A contains the core provisions for working out the decline in tax value of depreciating assets (the ‘write-off’) that are used for income producing purposes. A depreciating asset’s opening tax value for the year (or its cost when the asset was first held during the year) is reduced during the year by the rate of decline determined from its effective life and the selection of prime cost or diminishing value write-off ***[section 40-10]***. The closing tax value at the end of the year is the opening tax value for the next.

9.20 The current law contains various rules as to the person entitled to deductions under the different capital allowances. The primary rule under Division 40 is that the person who holds the depreciating asset may write-off its cost if it is used for a taxable purpose or is installed ready for use and held in reserve for such a purpose. Those tests generally reflect the tests for plant depreciation deduction under the current law.

9.21 The eligibility of the 'holder' of a depreciating asset to write-off the decline in its value under Division 40 reflects the broad economic notions of 'asset' and 'holding' an asset in Division 6. An asset is a thing such as property or a right that has economic value because it embodies future economic benefits. The future economic benefits embodied in the ownership of a motor vehicle, for example, are those that can be obtained from using it, letting others use it, or selling it.

9.22 Holding an asset is not necessarily the same as owning it, but in most cases the person who owns an asset would be the holder of that asset. That is the consequence of the rule in section 6-15 that the holder of an asset that is capable of being owned is the owner or, if there is both a legal owner and an equitable owner, the legal owner. For other assets generally, the holder is the person who uses the asset to gain economic benefits and is able to regulate or deny others' access to the future economic benefits inherent in the asset. In some specific instances, a person who is not the owner of an asset nevertheless will be treated as the holder of the asset, e.g. a hire purchaser, a lessee of a luxury car, a lessee who has affixed depreciating assets to leased premises.

9.23 Two or more persons who jointly hold a depreciating asset may each write-off the decline in their share of the cost. This is intended to give entitlement to each entity which has an economic interest in the asset and therefore stands to lose from any decline in its value. Subdivision 40-C contains the relevant rules.

9.24 Section 40-20 excludes from the general depreciating assets write-off rules the cost of assets used in landcare operations, water facilities, grapevines and horticultural plants. In accordance with the Government's commitment not to disturb primary producer concessions, the existing method of write-off for those assets is preserved by Subdivision 40-E. Landcare assets and water facilities are also excluded if a tax offset is claimed under Division 388 of the ITAA 1997.

What is a depreciating asset?

9.25 A depreciating asset is defined in section 40-15 as being an asset with a limited useful life. This covers assets of a wasting nature that decline in value because of physical deterioration or obsolescence and assets of an intangible kind such as copyrights and industrial designs that have a limited lifetime due to statutory or contractual limitations. Land is not ordinarily a depreciating asset – because it does not have a finite life – but items of plant such as motor vehicles or machinery are depreciating assets. A depreciating asset does not include:

- trading stock covered by Division 38;
- financial assets covered by Division 45;

- routine leases or routine rights covered by Subdivision 96-A;
- non-routine leases or non-routine rights covered by Subdivision 96-B; or
- an asset that is not capable of ownership.

9.26 The last of these exceptions would apply, for example, to an intangible asset created by expenditure which, under the current law, would be immediately deductible as a revenue outgoing, e.g. advertising expenses that produce benefits that extend across more than one income year.

9.27 The effect of subsection 6-15(2) is that taxpayers will have to exercise judgment in identifying the particular asset to be written off where the asset is made up of different parts and components. The 'unit of property' basis of identification used in the existing plant depreciation rules is being discontinued. However, in many instances the facts and circumstances of a particular case may produce a similar outcome because the functional separateness of a composite asset will lead to its being identified as the particular depreciating asset. The importance of identifying the asset rather than its constituent parts is that the life of the asset on which write-off is based may very well differ from the life of the component.

Is every depreciating asset covered by Subdivision 40-A?

9.28 As explained in Chapter 3 (How to work out taxable income or tax loss), the change in the tax value of a depreciating asset is taken into account in working out taxable income only if it is not used solely for private or domestic purposes. Wholly 'private or domestic' assets therefore are not covered by Division 40. Where an asset is used only partly for private or domestic purposes, section 40-80 adds an amount (an 'increasing adjustment') to the calculation of taxable income to reflect the degree of non-taxable use.

9.29 Some depreciating assets are given special write-off treatment and are therefore not covered by Subdivision 40-A. See, for example, the rules relating to landcare and other primary production assets contained in Subdivision 40-E.

When does the tax value of an asset start to decline?

Start time

9.30 Section 40-25 introduces the concept of 'start time', that is the time when the decline in tax value of a depreciating asset begins to be measured.

9.31 The general rule is that the write-off of a depreciating asset begins when the asset is first used for a taxable purpose, or is installed ready for use and held in reserve for such a purpose. That rule does not differ from the current law in relation to plant and equipment. The same rule applies if the asset is being constructed or created – write-off will not commence until the completed asset is used, or installed etc., for a taxable purpose. If the asset is a right – for example in copyright – its 'start time' is when the right is first obtained.

Completion

9.32 There are some special rules about when the write-off begins. Subdivision 40-D provides limited write-off for some partially completed assets that are used for a taxable purpose. Amounts allocated to an in-house software pool under Subdivision 40-B do not begin to be written off until the year following the expenditure.

9.33 Where the asset is being created or constructed as part of a larger project, write-off starts when it is first used for a taxable purpose once the construction or creation of the project is completed. For example, an access road to a mine site facilitates the development of the site and necessary infrastructure to enable mining operations to begin. Even though it is actually used in the business before extraction commences, its tax value stays at cost until that later time because the project has not commenced taxable operations ***[paragraph 40-25(2)(c)]***.

Taxable purpose

9.34 This is basically a use for the purpose of producing taxable income. In the case of leisure facilities and boats the particular taxable purpose required is stated specifically so that the asset has to be intrinsic to the income producing activities or its use must constitute a fringe benefit ***[subsections 40-25(3) and (4)]***.

How do you work out the change in tax value?

9.35 The effect of the formula in section 40-30 is that the tax value of a depreciating asset is written down in an income year by applying the relevant write-off rate to the asset's base value. The reduction in tax value is lower if the asset was not held by the taxpayer for the whole income year.

9.36 Thus there are 3 elements to the 'decline in tax value' formula:

- base value: this is the opening tax value to which the rate of write-off is applied. In the first year in which the asset is used or installed for taxable purposes, the base value is its cost. In later years, it is also cost if the prime cost (straight line) rate is used, but the opening tax value if the diminishing value (reducing balance) rate is used.

- rate: this is either the prime cost or diminishing value rate, based on effective life, that applies to the particular depreciating asset. (Section 40-50 provides a choice between the prime cost method and the diminishing value method.)

- days for which write-off applies: this is the period of the income year during which the asset was held by the taxpayer. (As explained above, section 6-15 defines the meaning of holding an asset.) This element of the formula reduces the full-year reduction in tax value if the asset was held for only part of the year. That would normally be because the asset was either acquired or disposed of part way through the year.

Example 9.1

A depreciating asset was purchased on the 101st day of the income year for $10,000 and was immediately used for taxable purposes. If the applicable prime cost rate was 10%, the asset's reduction in tax value for the year would be:

$$\frac{\$10{,}000 \times 10\% \times 265}{365} = \$726$$

Immediate write-off

9.37 For assets used in exploration or prospecting for minerals or quarry materials, the cost currently may be wholly written off in the first year in which they are used, or installed ready for use, for a taxable purpose (Subdivision 330-A of the ITAA 1997). Section 40-35 maintains this effect by specifying a zero tax value for such assets at the end of that year. The definition of 'exploration or prospecting' contained in the ITAA 1997 has been adopted in the new law ***[subsections 40-35(2) and (3)]***.

What is the cost of an asset?

9.38 Subdivision 6-E defines the cost of an asset (including a depreciating asset) on which the write-off under Subdivision 40-A is based. Cost is normally the amount paid, or required to be paid, to become the holder of the asset. For example, cost would include any deposit paid plus the value of any liability to make future payments. Cost also includes any later costs that increase the economic value of the asset ***[section 6-110]***. Where an amount is paid for an asset and other assets or benefits and no cost allocation is specified for particular assets, the cost of each asset is the proportion of the amount reasonably attributable to it ***[section 6-120]***.

9.39 Another component of cost is expenditure incurred to commission an asset. Because the commissioning process enables an asset to become fully functional, it is appropriate to write-off these costs over effective life. Initial production trials for a new item of manufacturing plant would be part of the commissioning process, and any amounts received from the sale of goods produced by the trial will directly reduce the commissioning cost of the plant ***[section 40-40]***.

9.40 If no amount is paid or payable for a depreciating asset, for example if the asset was received as a gift, the cost for write-off purposes is the asset's market value ***[item 10 of the table in subsection 6-105(3)]***. If an amount was paid or payable, but the asset was not at first used for taxable purposes, the cost is the asset's market value at the time it was first brought into taxable use ***[section 12-30]***.

9.41 A market value 'cost' rule also applies where a person who may not otherwise be the holder of a depreciating asset – for example, a hire purchaser or lessee of a luxury car – is treated as the holder for purposes of the write-off under Subdivision 40-A ***[items 6 and 7 of the table in subsection 6-105(3)]***.

Apportionment of receipts

9.42 Section 40-45 requires that a person must apportion on a reasonable basis undissected receipts only part of which relates to the disposal of a depreciating asset.

Rates

9.43 For each depreciating asset, either the prime cost or the diminishing value method must be chosen for the year for which the asset's decline in tax value is first calculated. The choice of method determines the rate of write-off that applies to the particular asset. The choice between prime cost or diminishing value, once made, cannot be changed ***[subsections 40-50(1) and (2)]***.

The prime cost rate

9.44 The prime cost rate assumes that a depreciating asset loses a set portion of its *original* value in each year. That is, it spreads the decline in the asset's tax value equally over each year of the asset's effective life. The ***prime cost rate*** is worked out like this ***[subsection 40-50(4)]***:

$$\frac{100\%}{\text{Effective (life in years)}}$$

Example 9.2

If an asset's effective life is 20 years, the prime cost rate will be:

$$\frac{100\%}{20} = 5\%$$

The diminishing value rate

9.45 The diminishing value rate assumes that an asset loses a set percentage of its *remaining* value in each year. That is, it weights the decline in an asset's tax value towards the start of the asset's effective life. The ***diminishing value rate*** is worked out like this ***[subsection 40-50(3)]***:

$$\frac{150\%}{\text{Effective (life in years)}}$$

Example 9. 3

Using the previous example of an asset with an effective life of 20 years, the diminishing value rate will be:

$$\frac{150\%}{20} = 7.5\%$$

What is an asset's effective life?

9.46 The effective life of a depreciating asset is the factor that determines the prime cost or diminishing value rate that applies to the asset.

9.47 For the first year in which the asset's decline in tax value is first calculated, it is necessary to either work out the effective life or use the effective life specified by the Commissioner in published schedules ***[subsections 40-55(1) and (2)]***.

9.48 In working out effective life – that is, how long (in years) it will be before its useful life ends – a taxpayer must take into account how it expects to use the asset ***[subsection 40-55(3)]***.

9.49 Subsection 40-55(4) provides that regulations may be made which prescribe guidelines to assist taxpayers to work out the effective life of a depreciating asset. In addition, subsection 40-55(5) authorises the Commissioner to make a determination specifying the effective life of depreciating assets. The Commissioner has published schedules of depreciation rates based on estimated effective lives under the current law.

9.50 The effective life rules in subsections 40-55(1) to (5) do not apply to in-house software. Subsection 40-55(6) specifies the effective life of in-house software as $2^1/_2$ years. This is the rate of write-off that has applied to in-house software under the current law (Divisions 42 and 46 of the ITAA 1997) from 11 May 1998. An in-house software project is computer software that has been developed or acquired principally for use within an organisation rather than for commercial exploitation by the software developer. It does not include software that can be wholly 'written off' in one year e.g. under section 40-35 as assets used in exploration or prospecting ***[subsection 40-55(7)]***.

Recalculating effective life

9.51 If in a later year the estimate is found to be no longer accurate, it is permissible to recalculate the effective life ***[subsection 40-60(1)]***. This could happen, for example, if the particular asset is used more intensively than originally anticipated or the asset is moved to another geographical location which accelerates its deterioration.

9.52 When effective life is revised the rate must also be adjusted to enable the tax value at that time to be written off over the remaining effective life ***[subsections 40-60(2), (3) and (4)]***.

Additions and improvements

9.53 Section 40-65 requires that amounts expended on a depreciating asset after it has been acquired, and which are added to the cost of the asset under section 6-110 because the expenditure increases the economic value of the asset, must also be added to the asset's closing tax value. This ensures the correct result in calculating net income. To correctly calculate the asset's future decline in tax value adjustments must be made to the base value of the asset in the calculation formula in section 40-30. Where a diminishing value method is being used, the base value must be increased by the amount of the additions. For the prime cost method the 'cost' is altered to become the sum of the opening tax value for the relevant income year and the amounts expended on the improvements. In addition, the asset's effective life must be recalculated, and the rate adjusted using the appropriate calculation in section 40-60.

Example 9.4

> A taxpayer pays $20,000 for a machine that has an estimated effective life of 10 years. Its decline in tax value is calculated under the diminishing value rate. At the start of the eighth year, its tax value is $6,411. Its capacity is upgraded at a cost of $5,000. The effective life is now 6 years. The base value is increased by $5,000 to $11,411.
> In year 8, the asset would decline in value by $2,852
> i.e. $11,411 × (1.5 ÷ 6). The closing tax value of $3,559
> i.e. $6,411 – $2,852 is increased by $5,000 to give a new closing value of $8,559.

Replacement statutory licences

9.54 Section 40-75 provides rules to cover a situation where a statutory licence – that is, one issued by a government agency – is replaced by one or more new licences that exactly replicate the rights conferred by the original licence.

9.55 Where a single new licence replaces an existing licence, the rules treat that new licence as if it were the original one ***[subsection 40-75(1)]***. In the situation where the original licence is replaced by 2 or more new licences, the rules treat this as if the original were split into the replacement licences ***[subsection 40-75(2)]***. These provisions give a neutral outcome under the rules that calculate net income to recognise that the substance of the taxpayer's affairs has not altered. In both situations, the taxpayer holds exactly the same rights after the replacement as were held before the replacement.

Accounting for non-taxable use

Adjusting the amount of the decline - General rule

9.56 If a depreciating asset is used to any extent for a private, domestic or exempt purpose, an increasing adjustment is made to cancel the part of the decline in the asset's tax value that relates to that use ***[section 40-80]***. This ensures that the decline in tax value of a depreciating asset is recognised only to the extent that the asset is used for taxable purposes.

Example 9.5

> An industrial cleaner purchased for $2,000 that has an effective life of 10 years would decline in value by $200 a year under the prime cost rate. If in one year 5% of the asset's use was to clean the taxpayer's own residence, there would be an increasing adjustment of 5% of the $200, or $10.

Specific rule where particular car expense methods apply

9.57 The 'private use' increasing adjustment is different where the depreciating asset is a car in respect of which the taxpayer has used simplified substantiation rules to prove the car expenses. Where the 'cents per kilometre' or '12% of original value' substantiation methods are used, the decline in the tax value of the car cannot be separately taken into account because those methods create a self-contained car expense allowance. Therefore, the increasing adjustment is the full decline in tax value of the car ***[Item 1 of the table in subsection 40-80(3)]***.

9.58 Where the 'one-third of actual expenses' substantiation method is used, the taxpayer's car expense allowance, including any decline in tax value of the car, is limited to one-third of the expenses. In that case the increasing adjustment is two-thirds of the decline in tax value of the car that has been taken into account ***[Item 2 of the table in subsection 40-80(3)]***.

Adjustments on disposal

9.59 Section 40-85 requires that either a decreasing adjustment or an increasing adjustment be made in working out a person's taxable income in a year in which a depreciating asset which has not been used wholly for taxable purposes ceases to be held by that person. It applies if the disposal proceeds of the asset are more or less than its tax value at that time.

9.60 The formula in subsection 40-85(4) calculates the portion of the nominal gain or loss on disposal of the asset that is attributable to the 'non-taxable' use of the asset while it was held by the taxpayer. If the amount so calculated is positive, there is an equivalent decreasing adjustment, and the reverse if the calculated amount is negative.

9.61 In effect, the adjustments reflect the fact that gains or losses on disposal of such assets are partly of a non-taxable nature.

Capital works

9.62 Section 40-90 makes clear that Division 40 will apply to buildings and other structures of the kind covered by existing Division 43 only if they commence to be constructed on or after 1 July 2000. Nor will the new write-off rules apply to extensions, alterations or improvements to those kinds of structures that commence to be constructed before 1 July 2000. Division 43 will continue to allow write-off for eligible capital works that commence to be constructed before that date.

Subdivision 40-B – Pooling

9.63 Subdivision 40-B provides a simplified write-off mechanism for depreciating assets which cost $1,000 or less or have a base value (under the diminishing value method) of $1,000 or less, for specified project expenditures that are not part of an identifiable depreciating asset, and for amounts paid to develop (or in having developed) in-house software. Under section 40-125 a pool is a grouping of expenditure or assets that is treated as a single depreciating asset the decline in which is taken into account under Subdivision 40-A.

9.64 The mechanism allows the decline in tax value of low cost depreciating assets to be calculated by including the cost of such assets in a single pool which is written down at a diminishing value rate of 37.5%. Assets added to the pool are written down at 18.75% in the first year. In-house software expenditure is allocated to a separate annual pool and written down over $2^1/_2$ years after the first year under the prime cost rate or at a diminishing value rate of 60%. Pooled project expenditures are written down at a prime cost or diminishing value rate as if the pool was a single depreciating asset which has an effective life equal to the expected life of the project.

Project development pools

What goes into a project pool?

9.65 Section 40-130 defines a PDP and lists the project amounts that are required to be included in such a pool so that the decline in the tax value of the pool may be taken into account in working out taxable income.

9.66 Project amounts are specified in subsection 40-130(3). They are amounts paid, as listed below, which are not included in the cost of a depreciating asset but are part of a project that has a construction or creation phase and which will be carried on for a taxable purpose after completion of that phase:

- to create or upgrade community infrastructure;
- for site preparation costs for mine or quarry development;
- for feasibility studies;
- for environmental assessments;
- for exploration, prospecting or mining information;
- for ornamental trees and shrubs; or
- for other expenses that are prescribed by regulation.

9.67 A project may have sub-projects if their expected lives are different from the expected life of the main project, and project amounts must be allocated between them on a reasonable basis ***[subsection 40-130(2)]***.

Calculating the decline in tax value of a project pool

9.68 The decline in tax value of a PDP starts when the construction or creation stage is finished and the project or sub-project begins to operate for a taxable purpose ***[section 40-145]***. In the year in which that 'start time' occurs, the tax value of the PDP is its cost less the decline in tax value using either a diminishing value or prime cost rate based on the expected life of the project. In later years, the relevant rate is applied to the PDP's opening tax value for the year. These are the same rules that apply generally to depreciating assets under Subdivision 40-A. However, to reflect the fact that a PDP is an aggregation of expenditures rather than an identifiable asset, the tax value reduces to zero in the year the project ends. This allows the opening tax value of the PDP to be wholly written down in that year ***[subsection 40-135(3)]***.

9.69 Section 40-140 establishes the cost of a PDP. In simple terms, it is the sum of the project amounts allocated to the PDP. The cost increases by any further amounts allocated after the project's start time. Any such increase will be added to the closing tax value for the year in which it is paid and cause an adjustment to the base value component of the diminishing value rate formula in section 40-30. The rate will have to be adjusted so that the increased cost of the PDP can be written off over the remaining expected life of the project.

Expected life of a project

9.70 The prime cost or diminishing value rate applicable to a PDP is based on an effective life equal to the expected life of the project or sub-project. The expected life is worked out by the taxpayer by estimating how long it will be before it ends. It is permissible to recalculate expected life if the estimate is no longer thought to be accurate ***[section 40-155]***.

Low-value asset pools

9.71 Section 40-160 sets out the conditions for allocating assets to a low value asset pool. A low cost asset that may be allocated to a low value asset pool is a depreciating asset which costs $1,000 or less. Once a choice is made to allocate a low cost asset to a pool, a taxpayer must similarly allocate all such low cost assets acquired thereafter. In addition, a taxpayer may allocate a depreciating asset to the pool if its opening tax value for the income year is $1,000 or less, and its decline in tax value has been calculated by the diminishing value method. (This option allows assets with a long diminishing value 'tail' to be merged with other small value assets and written off at the faster rate applicable to the low value asset pool.) Assets may not be so allocated, however, if they have been used to any extent for non-taxable purposes. Assets allocated to a low value asset pool may not be removed.

9.72 The diminishing value rate is used to calculate the write-off for a low value asset pool. There are 2 separate components. The first is 18.75 % of the cost of low cost assets allocated to the pool in the income year. The second is 37.5% of the opening tax value of the pool for the year, plus the opening tax values of any depreciated assets that are allocated during the year. In effect, the pool declines at the rate of 37.5% of the opening tax value each year plus 18.75% of the cost of low cost assets allocated for the year ***[section 40-170]***.

9.73 The tax value at any time during an income year of a low value asset pool is its opening tax value for the year, plus the cost of low cost assets allocated to the pool for the year, plus the opening tax values of allocated depreciated assets, minus the 18.75% and 37.5% write-off components ***[section 40-165]***.

9.74 Only part of the cost of a low value asset that is not to be used wholly for taxable purposes is allocated to the pool. The amount to be allocated is the cost of the asset reduced by the estimated non-taxable percentage. If an asset from the pool is disposed of, any disposal receipts are subtracted from the pool's closing tax value. However, if only a percentage of the asset's cost was allocated to the pool, the same percentage of the disposal receipts is deducted from the pool's closing tax value ***[section 40-175]***.

In-house software pools

9.75 Section 40-180 allows a taxpayer to write-off amounts paid to develop (or to get someone else to develop) in-house software by allocating the amounts to an in-house software pool. Amounts so allocated are the cost of the pool. It is not permissible to pool amounts paid unless the software will be used solely for a taxable purpose. Once a taxpayer chooses to create an in-house software pool in a year, all amounts paid in that year and in subsequent years to develop (or to get someone else to develop) in-house software must be pooled.

9.76 In-house software-as defined in subsection 40-55(7) – is computer software acquired or developed principally for the internal use of an organisation. It does not include:

- software obtained or developed for commercial exploitation; or
- software that can be written off immediately e.g. as an exploration asset.

9.77 A separate pool is created for each year's in-house software expenditure. No additional amounts can be added to the pool after the end of the income year. In the year of allocation the pool's tax value equals the total amounts allocated, and in later years it is the opening tax value less the decline in the pool's tax value as worked out under section 40-190 ***[section 40-185]***.

9.78 There is no write-off for an in-house software pool in the year the pool is created. The pool may be written down to zero over the next $2^1/_2$ years using the prime cost rates of 40%, 40% and 20%, or written off using the diminishing value rate of 60% ***[subsections 40-190(1) and (2)]***.

9.79 Items of software developed from amounts allocated to an in-house software pool have a zero tax value to take account of the fact that they are written off through the pool. This prevents double counting in calculating net income ***[subsection 40-190(3)]***.

Subdivision 40-C – Jointly held depreciating assets

9.80 Subdivision 40-C has special rules that apply to taxpayers holding an asset jointly. For example, a group of farmers who have their own separate farming businesses may nevertheless band together to purchase a harvester. The special rules will not apply to depreciating assets which the members of a partnership or joint venture have elected to treat as if held by one taxpayer rather than fractionally ***[section 40-250]***.

9.81 The major effect is that the taxpayer's interest in the depreciating asset is treated as if it were a depreciating asset. The underlying asset is absorbed into the interest held by a joint holder and receives no separate treatment under Division 40 ***[subsection 40-255(1)]***.

9.82 The effective life of the underlying asset is applied in working out the decline in tax value of an interest in it ***[subsection 40-255(2)]***.

Calculating the decline in tax value of an interest in a jointly held asset

9.83 A situation may arise where a taxpayer's interest in a depreciating asset is changed so that, after the change:

- the taxpayer holds a joint interest in the asset in which previously the interest was 100%; or
- the taxpayer's previous joint interest is reduced but not extinguished.

In either circumstance, it is necessary to work out the tax value of the previous holding immediately before the change. That value is apportioned between the interest retained and the interest disposed of. The tax value of the retained interest continues to be written off by the taxpayer ***[section 40-260]***.

9.84 Section 40-265 also covers the case where a taxpayer's interest in the underlying asset is augmented but without achieving a 100% holding. The amount paid for the additional interest is added to the opening tax value of the interest already held, and the total written off under prime cost or diminishing value rates – whichever applies – that are applicable to the remaining effective life of the combined interest.

Subdivision 40-D – Partially completed assets

9.85 Subdivision 40-D enables a taxpayer to begin to write-off the cost of a partially completed depreciating asset if it is being used for a taxable purpose ***[section 40-325]***.

9.86 To determine the cost of a partially completed asset on which the write-off is based, the direct costs paid for the section of the partially completed asset that is being used for taxable purposes are added to other costs that have been paid for the partially completed asset that reasonably relate to the section being used ***[subsection 40-330(1)]***.

9.87 The write-off is calculated by applying the prime cost or diminishing value rate that will apply based on the estimated effective life of the asset when it is completed ***[subsection 40-330(2)]***.

9.88 Section 40-335 limits the amount of write-off in an income year to the lesser of the decline in tax value of the partially completed asset and the receipts directly obtained from the use of the asset. This prevents substantial write-offs being available for partially completed assets which generate small or even token amounts of income.

9.89 To provide for an asset to be progressively brought into taxable use as it is progressively completed, section 40-340 stipulates that the tax value of a partially completed depreciating asset is the total cost from time to time less the total decline in tax value that has been taken into account previously.

Subdivision 40-E – Assets used for landcare and primary production

9.90 Subdivision 40-E preserves existing special rules for writing-off grapevines and other living plants, and assets used in landcare operations or water conservation. The structure of Subdivision 40-E is different from Subdivision 40-A because, unlike for depreciating assets generally, only the original cost of these assets is written off by the first and later holders using prime cost. As well, accelerated rates apply, giving a faster write-off than if the conventional effective life calculation in Subdivision 40-A applied. For assets used in landcare operations, the write-off will no longer be limited to rural or primary production land.

9.91 Because the write-off for all holders of such assets is based on the first holder's cost, there is an effect on tax value. The basic rule is as contained in section 40-10. However, in the first income year that a second or subsequent owner begins to hold a Subdivision 40-E asset its tax value is modified to take into account the decline in tax value of all previous owners. This ensures that the original cost of the first holder is written off once only, and within the specified time frame commencing at the original start time ***[subsection 40-410(1)]***. The tax value of such assets cannot fall below zero ***[subsection 40-410(2)]***.

9.92 A water facility can be written off if its use includes primary production. The write-off eligibility for horticultural plants and grapevines is that they must be used in a primary production business. In the case of a landcare asset, the use can be for any taxable purpose. The write-off for a landcare asset or water facility is forfeited if the alternative tax offset is claimed under Division 388 of the ITAA 1997 ***[section 40-405]***.

What is a landcare operation asset and an approved management plan?

9.93 Assets used in landcare operations are the same as those specified in Subdivision 387-A of the ITAA 1997. These include fences, levees and drainage works constructed to combat land degradation ***[subsection 40-415(1)]***.

9.94 An approved management plan for land is one prepared by a qualified person to show the location of fencing needed to separate land classes to prevent land degradation ***[subsection 40-415(2)]***. This reflects the definition contained in Subdivision 387-A of the ITAA 1997. A qualified person is one approved by the Department of Agriculture, Fisheries and Forestry ***[section 40-465]***. Should an individual's approval be revoked or denied that person can apply to the Administrative Appeals Tribunal to have the decision reviewed ***[section 40-470]***.

What is a water facility and what is a horticultural plant?

9.95 The definitions of a water facility and a horticultural plant correspond with the definitions contained in Subdivisions 387-B and C of the ITAA 1997. A water facility is either equipment or a structural improvement for conveying or conserving water for use in a primary production business ***[section 40-420]***. A horticultural plant is a plant or fungus grown in a primary production business for its products or parts ***[section 40-425]***.

When does the decline in tax value commence?

9.96 Section 40-430 stipulates the time when the write-off for landcare assets, water facilities and grapevines commences. The commencement time is the start time identified in subsection 40-430(2). For landcare assets and water facilities, the write-off commences when it is first used for a taxable purpose. For a grapevine the start time is when the vine is planted, even though it may not be productive for some years. The rule is slightly different for other horticultural plants, where the write-off is delayed until the income year in which the first expected commercial season commences.

How is the write-off worked?

9.97 Landcare assets can be fully written off – by giving them a zero tax value – in the year they are installed for a taxable purpose ***[paragraph 40-435(1)(a)]***. Similarly, horticultural plants can be fully written off – to zero – in the income year of their first expected commercial season if they have an effective life of less than 3 years ***[paragraph 40-435(1)(b)]***.

9.98 For longer life horticultural plants, water facilities and grapevines, the write-off is spread over a number of years ***[subsection 40-435(2)]***.

The calculation is according to this formula:

$$\frac{\text{Cost} \times \text{Rate} \times \text{Days you hold the asset in the income year}}{365}$$

The formula has 3 elements:

- cost;
- rate; and
- the period of the year the asset is held.

Cost

9.99 For the first holder of a water facility or a landcare asset, the cost is the amount paid to acquire or construct it ***[subsection 40-440(1)]***. This is the basic rule that applies for depreciating assets generally, but for a later holder of a water facility or a landcare asset the cost is the original holder's cost.

9.100 Similarly, for grapevines or horticultural plants the cost for the initial holder and any later holder will be the original establishment cost ***[subsection 40-440(2)]***. This includes the cost of the plant or vine itself and the cost of preparing the ground and planting. Amounts paid to clear or drain land do not form part of the cost ***[subsection 40-440(3)]***.

Rate

9.101 The rates of write-off are specified in subsection 40-435(2). Water facilities and grapevines are written off using rates of 33.33% and 25% respectively. Horticultural plants receive an accelerated rate that depends on their effective life. Effective life is the estimated period from the first to the last expected commercial season.

9.102 Alternatively, an effective life specified by the Commissioner may be adopted ***[subsection 40-445(1)]***. Once chosen, effective life cannot be changed.

Non taxable use

9.103 If the asset is used to any extent for a private, domestic or exempt purpose, an increasing adjustment is made to cancel the part of the decline in tax value that relates to that use ***[section 40-450]***. This ensures that the decline in tax value of one of these assets is recognised only to the extent that the asset is used for taxable purposes.

Adjustments on disposal

9.104 There are 2 related adjustments made when some of the original cost of the asset remains to be written off at the time the underlying land is disposed of. The first adjustment is an increasing adjustment in working out taxable income equal to the closing tax value of the asset at the time of disposal ***[subsection 40-455(1)]***.

9.105 The second adjustment includes this same amount in the tax value of the land. Therefore, to the extent that any of its cost has not been written off, it is reflected in a smaller gain or a larger loss on the sale of the land. This preserves the effect of the current law by ensuring that there is no separate balancing adjustment on the disposal of a landcare or primary production asset ***[subsection 40-455(2)].***

Information requirements

9.106 When an asset is sold, the new holder can require the previous holder to provide information about cost and when the write-off commenced. For horticultural plants this must also include information about effective life. The purchaser needs this information to calculate the write-off because its write-off is limited to what is left of the original cost based on original effective life ***[section 40-460]***.

Subdivision 40-F – Amortisable payments

9.107 Subdivision 40-F provides tax write-off for 2 broad categories of payments. Firstly, it preserves the treatment in the current law for the write-off of mains electricity and telephone connection expenditure. Secondly, it establishes a 5 year statutory write-off for various specified expenditures and for expenditures prescribed by regulation. The intention is to provide write-off for expenditures relating to assets which decline in value over time but the effective life of which cannot be calculated with reasonable certainty and which are not clearly related to other depreciating assets.

What payments are covered?

9.108 Subdivision 40-F will allow taxpayers to write-off, as depreciating assets, payments:

- for a telephone line brought onto land that the taxpayer uses in a primary production business;
- to make a connection to a mains electricity cable to the metering point or to upgrade a connection, provided the electricity is used for a taxable purpose;
- to incorporate a company;
- for borrowing money that is to be used for taxable purposes;
- to raise equity; or
- that are prescribed by regulation ***[section 40-525]***.

9.109 Because the specified amortisable payments are written off as if they were depreciating assets, any asset that is created by the payments is given a zero tax value. This prevents double counting in calculating net income ***[subsection 40-525(3)]***.

Tax value of amortisable payments

9.110 The tax value of amortisable payments follows the basic rule contained in section 40-10. However, in the first income year that a second or subsequent owner begins to hold land to which an electricity or telephone line has been extended, its tax value is modified to take into account the decline in tax value of all previous owners. This ensures that the original cost of the first holder is written off once only, and within the specified time frame commencing at the original start time. For a taxpayer who did not pay the amount but has acquired the telephone or electricity supply connection by buying the land, the write-off available is limited to that part of the original expenditure that has not been written off ***[section 40-530]***.

When does the write-off start?

9.111 The commencement of the write-off depends on the type of payment ***[subsection 40-535(1)]***.

9.112 The write-off for payments for electricity connections or telephone lines commences at the time of the first business usage. In the case of telephone lines, that business must be one of primary production ***[paragraph 40-535(2)(a) and subsection 40-535(3)]***.

9.113 For payments to incorporate a company, the write-off commences when the company is incorporated ***[paragraph 40-535(2)(b)]***.

9.114 For payments related to borrowing money or equity raising, write-off commencement is when the loan is obtained and the borrowed money is used for taxable purposes, or the equity is obtained ***[paragraphs 40-535(2)(c) and (d)]***.

9.115 As other amortisable payments are prescribed by regulation, the write-off commencement time will be specified in the regulations ***[paragraph 40-535(2)(e)]***.

Working out the write-off for electricity and telephone lines

9.116 A straight line method is used to calculate the amount of the write-off for amortisable payments for installing electricity and telephone line connections. The calculation is 10% of the amortisable payment, reduced to the extent that the taxpayer did not hold the asset for the whole of the income year. In the year when the start time occurs, the days of the year prior to the start time are not counted as days when the taxpayer held the asset. In a subsequent year, the taxpayer holds the asset for as long as the land to which the payment relates is held ***[section 40-540]***.

Working out the write-off for other amortisable payments

9.117 The same straight line method is also used to calculate the amount of the write-off of other amortisable payments, but a different rate of write-off applies. In effect, 20% of the amortisable payment is written off each year. However, for payments to obtain a loan with a term of less than 5 years, the write-off will be spread over the loan's term. For any amortisable payments that are prescribed by regulation, the rate of write-off will be as prescribed ***[section 40-540]***.

9.118 The write-off is adjusted in the first year to reflect the appropriate period of entitlement, measured from the relevant 'start time' e.g. the start time for payments to obtain a loan is when the taxpayer starts to use the borrowed money for taxable purposes – see section 40-535 and the amortisation formula in section 40-540.

Non-taxable use

9.119 If the electricity supply or telephone line is also used for a non-taxable purpose, an increasing adjustment is made to cancel the part of the write-off that relates to that purpose. A similar adjustment is made in relation to a telephone connection to the extent that the telephone line is used during the year otherwise than in carrying on a primary production business ***[subsections 40-550(1) and (2)]***. To cover the case where borrowed money may be used for a non-taxable purpose during an income year, an increasing adjustment to taxable income adds back the proportion of the write-off that relates to the non-taxable use ***[subsections 40-550(3) and (4)]***.

Adjustments on disposal

9.120 There are 2 related adjustments made when a taxpayer disposes of land to which a telephone line or electricity metering point is attached and some of the original amortisable payment is still to be written off. The first adjustment is an increasing adjustment in working out taxable income equal to the closing tax value of the payment at the time of disposal ***[subsection 40-555(1)]***.

9.121 The second adjustment includes this same amount in the tax value of the land ***[subsection 40-555(2)]***. This preserves the effect of the current law: there is no separate accounting for electricity connections or telephone lines on disposal of the land. Instead, any part of the amortisable payment that has not been written off forms part of the land's cost base just before the disposal. In turn, this will be reflected in a smaller capital gain or a larger capital loss on disposal of the land.

Information requirements

9.122 The purchaser of such land can require the vendor to provide information about any amortisable payment for electricity or telephone connections that relate to the land and when the write-off commenced. This enables the purchaser to work out any remaining write-off entitlement based on the original amortisable amount ***[section 40-560]***.

Subdivision 40-G – Luxury cars

9.123 Subdivision 40-G limits the cost of a luxury car for the purposes of measuring the annual write-off of its cost as a component of taxable income. It also provides for an increasing adjustment in the income year in which the cost is reduced, and a decreasing adjustment in the income year in which the car is disposed of, to reflect the fact that part of the cost is not taken into account in calculating taxable income.

What is the luxury car limit?

9.124 The luxury car limit is explained in section 40-625. It means that the cost of a car – as defined in section 995-1 of the ITAA 1997 – cannot exceed the luxury car limit that applies for the financial year in which a taxpayer first holds the car. If the car is not used for a taxable purpose until a later year, the cost in that later year cannot exceed either the car's market value or the luxury car limit for the year the car was first held, whichever is less.

9.125 However, there are 3 exceptions. The first is for a car that is used in a business of transporting paying passengers from place to place, for example taxi and limousine services where a vehicle and driver are provided. This exception would not cover in-house arrangements, for example, where a company group provides chauffeur driven cars for the use of senior executives ***[paragraph 40-625(2)(a)]***. The second exception is for a car used in a business of short-term hire to the public for hire periods of up to one month ***[paragraph 40-625(2)(b)]***. The third exception is for a vehicle that is modified so that a person with a disability can use it for taxable purposes. This third exception applies where the cost of the car would be under the limit but for the modifications ***[paragraph 40-625(2)(c)]***.

9.126 Subsection 40-625(6) prevents taxpayers exploiting the short-term hire car exception by continuously re-hiring a luxury car.

9.127 Under Subdivision 960-M of the ITAA 1997 the luxury car limit is indexed annually for inflation based on movements in the motor vehicle purchase sub-group of the CPI. For the financial year ending 30 June 2001, the limit will be determined in the same way. ***[Subsection 40-625(3)]***

Rules where the luxury car limit applies

9.128 The principal effect of the luxury car limit is that the write-off under Subdivision 40-A of a car that cost more than the luxury car limit is calculated on a cost reduced down to the limit. Where a car was previously held by an associate of the taxpayer the Commissioner may limit the cost to the associate's cost. This rule is designed to prevent arrangements to inflate the amount available for write-off beyond what would be available if the associate had not transferred the car ***[subsection 40-625(4)]***.

9.129 The part of the cost that exceeds the limit may not be written off. To allow for that effect in calculating net income, section 40-630 provides for adjustments in the first income year the car is held and in the income year it ceases to be held. In the first income year the car is held there is an increasing adjustment to taxable income equal to the difference between the actual cost of the car and the luxury car limit for that year ***[subsection 40-630(2)]***.

9.130 A decreasing adjustment is made in the year in which the luxury car is disposed of, to reflect the fact that the excess part of the cost has not been available for write-off. In effect, the adjustment equals the proportion of the disposal price which represents the portion of the cost for which no tax benefit is allowed. The formula in subsection 40-630(3) produces that result as follows:

$$\frac{\text{Disposal value} \times \text{Luxury car cost excess}}{\text{Actual cost}}$$

9.131 A similar adjustment is made where a lessee or hire purchaser of a luxury car has been treated as the holder of the car, but the car is returned to the financier on termination of the lease or hire purchase arrangement. The decreasing adjustment in that case is the proportion of the opening tax value of the taxpayer's liability under the lease or hire purchase which represents the portion of the cost for which no tax benefit is allowed. The formula in subsection 40-630(4) produces that result as follows:

$$\frac{\text{Opening tax value of liability} \times \text{Luxury car cost excess}}{\text{Actual cost}}$$

Division 43 – Deductions for capital works

Time limit on applying Division 43

9.132 Division 40 will apply to buildings and other structures of the type which are currently deductible under existing Division 43, provided those buildings or structures commence to be constructed after 30 June 2000. Division 43 will continue to apply to buildings and other structural improvements for which construction commenced before 1 July 2000. Extensions, alterations or improvements to capital works being written off under Division 43 will also continue to be written off under that Division ***[section 43-19]***.

Chapter 10
Trading stock

Outline of Chapter

10.1 This Chapter explains the revised definition of 'trading stock' and the options for valuing trading stock.

Context of Reform

10.2 Under the current law, the cost of purchasing or producing trading stock is generally deductible in the year in which it is incurred. An increase in the value of trading stock on hand at year-end from that on hand at the beginning of the year is assessable income while a reduction is an allowable deduction.

10.3 The current law provides taxpayers with a range of options for valuing trading stock, for the following reasons:

- to allow deductions for unrealised losses in recognition of the fact that trading stock, if it is not disposed of within a reasonable period of time, can often depreciate due to factors such as obsolescence; or

- to ease compliance by allowing taxpayers to choose the method of valuing trading stock that is easiest for them to apply.

10.4 The concept of trading stock remains relevant in the new law for determining the appropriate taxation treatment of assets held for trading purposes, compared with investment assets, which will be subject to capital gains and loss quarantining treatment. For example, land held by an individual will be subject to that treatment except where it is trading stock.

10.5 The current rules for valuing trading stock are extremely flexible. Taxpayers have the option of annually valuing each item at its cost, replacement price or market selling value. As well, where warranted by obsolescence or any other special circumstances, taxpayers may elect to adopt a lower value that is reasonable.

10.6 Because there is no requirement in the current law to value stock on a consistent basis each year, there is the opportunity to manipulate taxable incomes by adopting different values from year to year.

10.7 Accordingly, the new rules for valuing trading stock will be less flexible than the current rules and will therefore reduce opportunities for tax minimisation. However, some flexibility is retained to allow for stock declining in value due to obsolescence or deterioration or for compliance cost reasons.

Summary of new law

10.8 The default method of valuing trading stock is the lower of cost and net realisable value, the accounting method of valuing inventories. That method allows deductions for unrealised losses but does not tax unrealised gains.

10.9 Taxpayers will continue to be able to choose to value classes of trading stock assets at market selling value if that would make the valuation process easier.

10.10 The current special rules for valuing certain live stock remain unchanged.

Detailed explanation of new law

Definition of 'trading stock'

New definition is similar to definition in current law

10.11 The definition of ***trading stock*** is the same as under the current law except that it excludes intangible assets (e.g. shares and other financial assets). The definition is not exhaustive but includes any tangible asset produced, manufactured or acquired that a taxpayer holds for purposes of manufacture, sale or exchange in the ordinary course of a business. Also included is live stock, which has the same meaning as under the current law. Land will continue to be treated as trading stock where it is held for the requisite purpose. The meaning of ***business*** remains unchanged from that under the current law. ***[Section 38-10; definitions of 'business' and 'tangible asset' in subsection 995-1(1)]***

10.12 Intangible assets such as shares and other financial assets can be trading stock under the current law. They are excluded from the new law because of the difficulty in distinguishing between individual items on the basis of whether they are held for trading or investment purposes. Financial services entities often account for their trading activities on a mark-to-market basis and the proposed elective market value option will allow such entities to achieve a match between tax and accounting treatment.

Tax Value of trading stock

Lower of cost and net realisable value – the default method

10.13 The tax value of each item of trading stock is the lower of its cost and net realisable value unless the taxpayer has chosen to value that class of trading stock at market selling value ***[subsection 38-20(1)]***.

10.14 That default method of valuing trading stock is the same as the method of valuing inventories for accounting purposes – Australian Accounting Standard AASB 1019 'Inventories'. The cost of an item of trading stock is to be determined according to Subdivision 6-E, which specifies what constitutes the cost of an asset. Broadly, the cost of an asset includes the cost of acquiring it and all costs associated with bringing it to its present location and condition. That is consistent with the accounting meaning of cost.

10.15 The net realisable value of an item is the same as that for accounting. Broadly, the net realisable value of an asset is the estimated proceeds of sale, net of all further costs of completion and selling. ***[Subsection 38-20(2)]***

Option to value classes of trading stock at market selling value

10.16 Taxpayers will have the option of valuing classes of trading stock at market selling value ***[subsection 38-40(2)]***. The option recognises that some taxpayers might find it easier to determine market selling value than determining the cost and net realisable value of assets.

10.17 The option to switch to or from market selling value takes effect immediately unless the taxpayer nominates a later time ***[subsections 38-40(6) and (7)]***.

Option solely provided to ease compliance

10.18 The option is provided solely for the purpose of allowing taxpayers to ease the cost of complying with the law. It is not provided as a means of minimising tax liabilities. Accordingly, taxpayers will need to exercise the option in a manner consistent with that object. ***[Subsection 38-40(1)]***

10.19 What is an asset class is not defined. It is open to a taxpayer to specify a class that is consistent with the purpose of the provisions ***[subsections 38-40(3) and (4)]***. Specifying an asset class based on the time that the asset was acquired is not acceptable as it would enable identical assets acquired at different times to be valued differently ***[subsection 38-40(5)]***.

10.20 A taxpayer will be able to revoke or vary a market selling value election if the Commissioner is satisfied that there has been a material change in circumstances warranting the variation. The variation must be consistent with the purposes of the provision and must be in writing. ***[Subsection 38-40(7)]***

Tax Value of live stock

10.21 The special rules for valuing certain live stock remain unchanged from the current law.

Natural increase of live stock

10.22 Taxpayers can elect to value the natural increase of certain animals at specified amounts in lieu of the actual cost of the animal – for example, the natural increase of cattle and horses can be valued at $20 a head. However, a horse acquired as a result of artificial insemination is generally taken to have a cost equal to the service fees incurred in breeding the horse. ***[Section 385-55; definitions of 'live stock' and 'primary production business' in subsection 995-1(1)]***

Breeding horses

10.23 There is an option to adopt special tax values for breeding horses acquired under a contract if they are at least 3 years old before the end of the income year. Broadly, the cost of male horses can be evenly written off over 4 or more years. The write-off rate for female horses depends on the age of the horse at the time the taxpayer last began to hold it for breeding, but cannot exceed 33 1/3% of prime cost. ***[Sections 385-60 and 385-65]***

Chapter 11
Routine leases and rights

Outline of Chapter

11.1 Legislative rules relating to the taxation of routine leases and rights are currently being developed in accordance with Recommendations 10.2 and 10.7. This Chapter explains in outline form how that legislation is expected to apply.

11.2 The legislative rules will specify how to calculate the amount of gain or loss from a routine lease or right contract which a taxpayer must bring to account in working out taxable income under the general rules contained in Division 5.

Context of Reform

11.3 The methodology set out in Division 5 for working out taxable income requires a taxpayer to first work out net income of an income year. A key component of net income is the measurement of change in the tax value of assets and liabilities – see Subdivision 5-B. To work out the change in tax value, the method statement in section 5-55 requires that the closing tax value of assets be added to net receipts and the opening tax value of assets be deducted. The opening tax value of liabilities is also added, while the closing tax value of liabilities is subtracted.

11.4 Within that framework, a lessor of a depreciating asset would have to account for rental receipts under the lease, the change in tax value of the leased asset (under the depreciating asset rules in Division 40), the change in the tax value of the asset represented by the present value of future lease receivables under the contract, and the change in the tax value of the liability represented by the obligation to provide the leased asset to the lessee over the lease term.

11.5 Correspondingly, the lessee would have to account for lease payments, the change in the tax value of the asset represented by the rights under the lease, and the change in the tax value of the liability represented by the obligation to make future lease payments.

11.6 The current law does not provide a basis for taxing leases in a way that properly reflects the changing values of the parties' assets and liabilities under a lease. This provides some opportunity for tax deferral through uneven payments, and largely unrestricted capacity for transfer of the benefits of accelerated depreciation between taxable lessors and lessees.

11.7 It is proposed that a tax code for routine leases and rights will modify the application of Division 5 by providing a simpler calculation methodology where a lease or other right over a depreciating asset qualifies as a routine lease or right. It will also apply to routine leases and rights in respect of non-depreciating assets, for example a lease of land or a service contract where the periodic payments generally match the benefits being provided.

Comparison of key features of new law and current law

11.8 The treatment of routine leases and rights under the new law will not substantially differ from the treatment under the current law where the parties to the arrangement are taxable entities.

11.9 Under the current law, a lessor of depreciable assets is required to treat lease rentals as income in the year they are derived. For a business taxpayer, that would generally be on the basis of rentals that are due. Under the new law, a lessor will be required to include in the calculation of net income rentals received and rentals due but unpaid. The lessee would obtain a tax deduction under the current law for lease rentals incurred during the income year. The requirement under the new law to account for rentals paid and rentals due but unpaid is likely to produce a similar outcome.

11.10 There is no fundamental difference between the new law and current law in the treatment of the underlying leased asset. In either case, the lessor will bring to account the decline in tax value of the asset. Under Division 40, however, the decline in value is not accelerated by depreciation rate loadings or asset broadbanding.

11.11 There is unlikely to be significant practical difference in the tax treatment of routine leases or rights over non-depreciating assets as between the proposed new law and the current law. That is because, where regular payments are made which broadly match the timing and value of the benefits being provided, the income derived and expenditure incurred tests under the current law are likely to tax lessors or grantors on amounts that are due but unpaid and, for lessees or grantees, allow deductions for amounts payable but unpaid.

Explanation of new law

Routine leases and rights over depreciating assets

What is the tax treatment of a routine lease or right over depreciating assets?

11.12 The taxation treatment of routine leases or rights over depreciating assets will be modified by Division 96 from the treatment that would apply under Division 5 by taxing the lessor on the basis of lease rentals that are received or due, and the lessee in an equal and opposite manner.

11.13 The lessor will be treated as the holder of the leased depreciating asset ***[subsection 6-15(3)]***, and changes in its tax value will be measured under the effective life calculations in Division 40. The parties to a routine lease or right will not be required to account for the change in tax value of assets or liabilities such as the right to future receipts or the obligation to make future payments under the lease or right except to the extent they are amounts payable, prepayments or deferred payments in relation to the relevant income year.

11.14 The only asset (apart from the underlying leased asset) the lessor or grantor will have in relation to a routine lease or right at the end of an income year is the right to receive payments referable to a period ending on or before that date. The tax value of that asset at a particular time will be the amount of those receivables ***[sections 6-40 and 96-100]***.

11.15 Correspondingly, the only liability the lessee or grantee will have to account for in relation to a routine lease or right at the end of an income year is the obligation to make payments referable to a period ending on or before that date. The tax value of that liability at a particular time will be those amounts payable. ***[Sections 6-75 and 96-100]*** A lease rental paid in one year that relates to rental periods of the next year will be brought to account as an asset of the lessee or grantee in the first year but will have a zero tax value at the end of the next year.

What is a routine lease or right?

11.16 Consistent with Recommendation 10.7, routine leases and rights over depreciable assets will comprise:

- lease or rights contracts (other than hire purchase contracts and leases subject to the rules for leases of luxury cars) for an aggregate period of less than 12 months; or
- lease or rights contracts (other than hire purchase contracts and leases subject to the rules for leases of luxury cars) with specified equal periodic rental payments that:

– are payable at least every 12 months;

– are based on the market value of the asset at the beginning and end of the arrangement; and

– are for a period that is less than 90% of the effective life of the asset, provided that:

  - where the value of the leased asset is greater than $0.5 million and less than $1 million, the lease term is for 5 years or less; or

  - where the value of the leased asset is greater than $1 million and less than $5 million, the lease term is for 3 years or less; or

  - where the value of the leased asset is greater than $5 million, the lease term is for one year or less.

Routine leases and rights over non-depreciating assets

What is the tax treatment of a routine lease or right over a non-depreciating asset?

11.17 Similar taxation treatment will apply to routine leases and rights over non-depreciating assets. The lessor or grantor will bring to account actual receipts under the lease or right agreement, and amounts due but not received at the end of the income year. The lessee or grantee will bring to account actual amounts paid under the agreement, and amounts due but unpaid.

11.18 The only asset the lessor or grantor will have in relation to a routine lease or right over a non-depreciating asset at the end of an income year is the right to receive future payments that are referable to a period ending on or before that date. The tax value of that asset at the end of the income year will be the amount of those receivables ***[sections 6-40 and 96-200]***.

11.19 Correspondingly, the only liability the lessee or grantee will have in relation to a routine lease or right over a non-depreciating asset at the end of an income year is the obligation to make payments referable to a period ending on or before that date. The tax value of that liability at the end of the income year will be those amounts payable ***[sections 6-75 and 96-200]***.

What is a routine lease or right over a non-depreciating asset?

11.20 Routine leases and rights over non-depreciating assets will comprise:

- lease or rights contracts for an aggregate period of less than 12 months; and
- lease or rights contracts:
  - with regular periodic payments that are payable at least every twelve months;
  - where the amounts of the payments reflect the benefits received under the contract during the period to which the payments relate; and
  - reflect ordinary commercial practice in relation to such contracts.

Chapter 12
Overview of the consistent entity regime

Outline of Chapter

12.1 This Chapter gives an overview of Part 3-5. Divisions 150 to 156 in the Part apply a consistent tax treatment to companies, trusts and limited partnerships (*tax entities*). They also treat consistently dealings between those entities and their members. Division 150 provides an overview of the rules for tax entities. This Chapter introduces the new regime. Detailed discussion is contained in Chapters 18 to 21.

12.2 The balance of Part 3-5 contains other rules for tax entities. Some are not part of the consistent entity treatment rules because they are applicable both to tax entities that are excluded from those rules and to tax entities that are included in those rules. Division 158 is concerned with the mutuality exclusion; it has application to a range of tax entities both in and out of the consistent entity treatment rules. Division 161 is concerned with the application of the law to tax entities that are not legal persons; it has application to all tax entities, in or out of the consistent entity treatment rules.

12.3 Other Divisions include rules only for tax entities to which the consistent entity treatment rules do not apply. Division 157 contains the rules for the CIV regime. Division 159, not included in the draft legislation, will contain rules for trusts that are excluded from the consistent entity treatment rules.

Context of Reform

12.4 The aim of reforming the taxation of tax entities is to improve integrity and fairness, through a consistent treatment of profits earned by tax entities, and of transactions between tax entities and their members. Reform is intended to simplify the tax code by applying, as far as possible, common rules which apply alike to all entities, whatever their legal structure ***[section 150-5]***. A single set of rules will therefore be applied to tax entities. These rules include the treatment of gains distributed to members, contributions and returns of capital and rearrangements of member interests ***[section 150-1]***.

12.5 Paragraphs 150-15(2)(a) and (b) clarify that for the purpose of meeting the definitions of 'company' and 'dividends' in international tax agreements, limited partnerships and trusts – that is, all the tax entities receiving consistent entity treatment that are not companies – receive the same treatment as companies, and their distributions receive the same tax treatment as dividends.

12.6 In certain limited cases, specific rules apply only to a certain type of entity, having regard to its special characteristics. To provide ease of compliance with the common rules or greater certainty in administering the common rules, alternative rules, or additional clarifying rules, apply as well as the common rules in limited cases ***[section 150-20].*** There are, however, some additional rules that depart in some respects from the consistent entity treatment. This draft legislation deals with some, but not all, of these rules.

- CIVs receive special treatment to allow ordinary people to enjoy the same tax position as those who can invest directly in a broad portfolio of assets.

- Superannuation business (and superannuation business of life insurers) remains in the special retirement income investment regime designed to encourage savings for retirement.

- General partnerships, which do not confer limited liability and in which members are jointly concerned through mutual agency, are not tax entities and so are not subject to consistent entity treatment.

[Section 150-10]

What do the consistent entity rules do?

12.7 The consistent entity rules are based on the principle that income will be subject to the same overall level of taxation regardless of the type of entity that earns it ***[section 150-5].*** This principle recognises that investors (referred to as members) are the ultimate owners of an entity and benefit from the income generated by the entity.

12.8 The consistent entity rules about distributions from the entity to its members derive from the current full imputation arrangements applying to companies and their resident individual shareholders. They extend those arrangements through the provision of refunds of excess imputation credits. This will mean that the tax rate applying to the underlying income distributed by entities subject to entity taxation will be better aligned with the tax rates of individual resident members.

12.9 Members who hold an interest in an entity have access to its ongoing profits while they remain members. Thus, where a tax entity has available profits (realised or unrealised), distributions by the entity to ongoing members are treated as coming from those profits. Where there are no available profits a distribution is taken to be from contributed capital to that extent. This is the ‘profits first’ rule ***[subsections 150-25(3) and (4)].***

12.10 Where members get a distribution from the entity as consideration for giving up part of their relative interest in the entity, the distribution will be treated as coming from the contributed capital and taxed and untaxed profits attributable to the interest given up. This is the 'slice' rule ***[subsection 150-25(5)].*** (For on-market buy backs this treatment cannot be offered for practical reasons: a member selling on-market will not know if they are selling to the entity or a third party ***[subsection 150-25(6)].***)

12.11 Given the objectives of a consistent entity treatment, some of the dealings between entities and their members need to be treated differently from their dealings with other taxpayers. This reflects the special relationship between entities and their members. Key features of an entity tax system embodied in the consistent entity rules are:

- applying tax at the entity level on the taxable income of an entity (this is achieved by the core rules);
- recognising distributions from an entity to its members, including indirect distributions involving associates and third parties (this is achieved in the dictionary);
- recognising amounts contributed to an entity to create or increase membership value (contributed capital) and the return by the entity of those amounts to its members;
- recognising tax paid at the entity level when profits are distributed by an entity to its members (profits being any amount other than contributed capital, whether previously taxable to the entity or not);
- providing general objective rules to govern how much of a distribution from an entity to a member is from available profits and how much is from contributed capital; and
- ignoring certain assets and liabilities that arise for an entity and its members in respect of distributions by an entity to its members or contributions to an entity by its members (this is achieved by the core rules).

[Section 150-30]

Summary of new law

What the Divisions will do	Divisions 150 to 156 provide consistent tax treatment for most companies, trusts and limited partnerships and for the distributions they make to members (the ***consistent entity rules***).
Link to higher level rules	The core provisions contained in Part 1-3 of the ITAA 1997 impose a liability to tax on a tax entity. Taxable income of the entity and of its members is worked out under the core rules. The consistent entity rules supplement the core rules by setting out the tax treatment of distributions made by a tax entity.
Which entities does the new regime apply to?	Tax entities, which are companies (including co-operatives and unincorporated bodies), trusts (including executors of some deceased estates and foreign arrangements that would be trusts in Australia) and limited partnerships. But some tax entities will not be subject to the entity tax regime. Some are excluded from the regime altogether (e.g. complying superannuation funds) and some from the application of particular entity rules (e.g. CIVs).
Entity tax	The entity pays tax on its taxable income at the entity tax rate.
Member tax	A member pays tax on profit distributions received from a tax entity, with a credit for any tax paid on those profits at the entity level. A resident member (subject to some limitations) can offset the tax credits against their tax liability and resident taxable individuals and complying superannuation funds are entitled to a refund of any excess credits.

Who is a member?

A ***member*** of an entity has a particular kind of right in relation to the entity (a ***membership interest***), directly or through a nominee ***[section 960-115]***.

Types of membership interests are listed in subsection 960-120(1). They include a share in a company, the interest of a partner in a limited partnership, an interest in a registered managed investment scheme, a beneficial interest in the income or capital of a trust, and an interest in the proper administration of a trust because the person is an object of a discretion that can be exercised by the trustee of a non-fixed trust.

Membership interests also include:

- an interest that carries a right to a return from the entity that is contingent on the performance of the entity or on the discretion of the entity; interests carrying more than protective (specified) voting rights;
- interests issued by the entity that may or will convert into a membership interest (unless excluded by the debt test); and
- rights to participate in management or control of the entity.

A member of the management committee of an unincorporated association will be a member for the purpose of the consistent entity rules because they have a right to participate in the management or control of the entity.

No interest that is a debt under an intended debt test is a membership interest. Rules for this test are not included in the draft legislation, and are being developed in common with rules for the taxation of financial arrangements.

In a contract of employment, remuneration based on the employer's economic performance does not give a membership interest to the employee.

What is a distribution?

A ***distribution*** is the passing of value from the entity to the member (or to someone who has a membership connection) because they are a member. Rearrangements or membership interests that shift value between members are also distributions. So are indirect distributions involving associates or third parties.

A benefit can take any form such as money, property, services, or additional interests in the entity.

What is the amount of the distribution?	Its value less any consideration provided by the recipient.
How is the distribution treated?	For the entity, the distribution to a member will generally be a payment but an increasing adjustment is made where needed to ensure there is no overall effect on income. Where the distribution is of contributed capital, reducing a liability, but is not a payment, a decreasing adjustment may be needed for the same reason. For the recipient, a profit distribution is a receipt that increases net income. A distribution from contributed capital is also a receipt, but it will generally be offset by a reduction in the tax value of the member's interest in the entity.
What are available profits?	***Available profits*** are basically the *net market value of the entity's assets*. ***Net market value*** equals the market value of the entity's assets less its liabilities (which include its *contributed capital*).
How do you determine whether a distribution is from profits or contributed capital?	Generally, a distribution will be taken to have been made from ***available profits*** first and then contributed capital when profits are exhausted (the 'profits first' rule). A distribution connected with the cancellation of a member's interest in a tax entity (e.g. an off-market share buy back) will be taken to be a return to the member of the slice of the entity's contributed capital and profits attributable to the interest (the 'slice' rule). It will be first from the slice of contributed capital, any excess will be from the slice of taxed profits, and thereafter from untaxed profits.
What is contributed capital?	Broadly, ***contributed capital*** is the contributions made to an entity to secure, or in respect of, an interest in the entity, less any returns of such contributions.

Comparison of key features of new law and current law

12.12 The following table sets out the important differences between the current law and the consistent entity rules in Divisions 150-156. Some of the key features of the new law are subject to exceptions which are explained in all entity Chapters.

Table 12.1 Comparison of key features of new law and current law

New Law	***Current Law***
Trusts and their distributions will be taxed like companies and company distributions under the consistent entity rules.	Generally, the net income of a trust is taxed to the beneficiaries who are presently entitled. Trust income to which no beneficiary is presently entitled is taxed to the trustee. Corporate unit trusts and public trading trusts are already taxed like companies.
All co-operative companies will generally be taxed on the same basis as other tax entities subject to entity taxation.	Co-operative companies that satisfy the definition in section 117 of the ITAA 1936 are taxed on their retained profits only.
The term *member* is used to refer to taxpayers that invest in tax entities.	Investors are referred to in a way that depicts their membership of a particular entity type e.g. shareholder (company), beneficiary (trust), and partner (limited partnership).
The concepts of 'dividend' and 'deemed dividend' will be replaced by the global, and broadly defined, term *distribution*. It will apply to determine when value has shifted from a tax entity to a member, in their capacity as a member.	Shareholders are taxed on dividends received from companies. For a dividend to be income it must be paid out of the available profits. Some other payments by companies are deemed to be dividends (e.g. distributions by liquidators) and some are also deemed to be paid out of profits (e.g. excessive remuneration paid by a private company to a director). For trusts, beneficiaries are taxed on the share of trust net income to which they are presently entitled.
A tax entity is generally taken to make distributions to members out of profits first and then out of contributed capital when profits are exhausted (the 'profits first' rule).	Companies can choose the source of some of their distributions. However, various anti-avoidance provisions apply. For trusts, beneficiaries are taxed on their present entitlement to the net income of the trust.
Tax entities that may be subject to entity taxation must keep a contributed capital account, and sub-accounts for each separate class of membership.	There is no general requirement to keep a contributed capital account. There is a definition of share capital account for a company and special rules about the consequences of tainting it with other amounts.
The imputation system will apply to distributions by tax entities subject to entity taxation.	The imputation system only applies to company dividends and distributions made by other entities taxed like companies.

New Law	***Current Law***
Members that are resident individuals, complying superannuation funds, complying approved deposit funds or pooled development trusts will be entitled to a refund of excess tax credits.	Excess credits are lost.

Detailed explanation of new law

12.13 The consistent entity rules will apply to both some tax entities and their members and to certain transactions between them.

12.14 The types of transactions dealt with by the rules in this draft legislation are:

- the transfer of value from entities to members (for example, distributions of entity profits) in their capacity as members, and equivalent indirect transactions;
- transfers of value from members to entities (for example, contributions of capital by members to obtain a membership interest – such as shares – in the entity), and other transfers for membership interests; and
- the provision by a tax entity of additional membership interests to its members or a reduction in the number of interests (rearrangements).

12.15 Rules will also be required for dealings in membership interests between members and third parties – for example, when a member disposes of their share in a company or unit in a unit trust to someone other than the entity. These will largely be dealt with through the general tax value rules that have not been fully developed for this draft legislation.

Major building blocks of the consistent entity system

12.16 The consistent entity rules rely on several major building blocks. These are discussed in detail in Chapters 13 to 18. They include the following:

- tax entity (Chapter 13);
- member (Chapter 14);
- membership interest (Chapter 14);
- distributions (essentially from an entity to a member), rearrangements and unpaid entitlements (Chapters 15 and 16);

- ‘profits first’ and ‘slice’ rules (Chapter 17); and
- contributed capital (of the entity) (Chapter 18).

Key features of the consistent entity system

12.17 The key features outlined earlier in this Chapter use the basic building blocks as a foundation.

Applying tax at the entity level on the taxable income of an entity

12.18 An entity is liable for tax on its taxable income. The tax liability is calculated by reference to the core rules. Gains that have not been included in the entity’s taxable income – for example, because of the availability of a tax concession – will be taxed in the hands of members when distributed.

12.19 Undistributed profits retained in a tax entity are not allocated to the members for tax purposes. Income preferentially treated in a tax entity does not retain its tax-preferred character when distributed to members. As noted, members are taxed on such distributions. Special transitional measures (not included in this draft legislation) will prevent the inappropriate impact of this feature on trusts in existence at commencement of the consistent entity rules.

Recognising distributions to members of an entity, including indirect distributions involving associates and third parties

12.20 The dictionary contains comprehensive rules which ensure that all transfers of value to a member occurring because of membership of the entity are recognised and are taken into account in the consistent entity rules. It achieves this by:

- acknowledging that a transfer of value between an entity and a member can occur directly or indirectly via an associate or a third party; and
- recognising that a transfer of value can take any form.

Recognising amounts contributed to an entity for membership interests (contributed capital) and the return by the entity of those amounts to its members

12.21 Amounts contributed to a tax entity are not taxable to the entity. These amounts are not profits of the entity and so they are added to the entity’s contributed capital account.

12.22 By contributing capital, the member or contributor is investing in the entity, and this investment adds to the assets of the members. The treatment of returns by the entity of contributed capital is symmetrical with the contribution of capital to the entity. Contribution of capital generally gives rise to a tax value for the membership interest acquired, while a return of contributed capital reduces the tax value of the member's interest.

12.23 Where a member (or their associate) receives a distribution of contributed capital greater than the tax value of the relevant membership interest, the member's taxable income will increase by the excess amount, as that amount is a gain to the member on the investment. When members can deal in (that is, acquire or dispose of) existing membership interests, the tax value of their interests need not be the same as the contributed capital for these interests.

12.24 An exception is provided where the membership interest has never had a tax value. The exception covers those cases where the contribution of an amount to an entity did not give rise to a corresponding increase in the tax value of an asset that is a membership interest. For instance, a settlor could have contributed the capital of a trust on behalf of beneficiaries. The trust is a tax entity, and the beneficiaries are members, but as they have made no contribution and incurred no cost themselves they have never had a tax value for their membership interests.

Recognising tax paid at the entity level when profits are distributed by an entity to its members (profits being any amount other than contributed capital, whether taxable to the entity or not)

12.25 Entities pay tax on their taxable income. A member in receipt of a profit distribution from an entity is entitled to a credit for any tax already paid by the entity. To that extent, this treatment recognises the notion that entities can be considered extensions of their ultimate owners.

12.26 The extent of this integration of ownership interests will be increased by allowing resident individuals, complying superannuation funds, complying approved deposit funds and pooled superannuation trusts a refund of any credits they are not able to fully utilise. Overall, tax on entity profits will generally be imposed at the members' tax rates.

Providing general objective rules to govern the extent to which a distribution is from available profits or from contributed capital

12.27 The way in which a distribution is taxed depends on whether it is a gain or a return of contributed capital. The consistent entity tax regime contains general objective rules for working out the source of a distribution. In general, a distribution from an entity to a member will be taken to be a profit distribution to the extent that the entity has available profits. The distribution is sourced from contributed capital once entity profits have been exhausted. This is the 'profits first' rule.

12.28 Members' interests in an entity have an economic value that exceeds contributed capital by available profits. When the entity makes a distribution and the members maintain an ongoing interest, it is the excess of value over contributed capital that is reduced until no available profits remain.

12.29 Were entities to be allowed a discretion to distribute capital ahead of profits (as can happen under the current law) they could extend the period of tax deferral that may arise in respect of retained profits even after their value has been distributed to members. It would also allow greater scope to stream contributed capital and profit distributions to members depending on their tax circumstances.

12.30 The 'slice' approach will apply to distributions related to the extinguishment of a member's interest (for example, an off-market buy back or a final distribution by a liquidator). This approach allows entities to return contributed capital ahead of profits. It recognises that, on extinguishment of a membership interest, what is being returned to the member is the slice of the entity's profits and contributed capital relevant to their membership interest. Further, the order in which it is returned is:

- first, the member's share of the entity's contributed capital;
- second, their share of taxed profits; and
- third, their share of untaxed profits.

Ignoring certain assets and liabilities that arise for an entity and its members in respect of distributions by an entity to its members or contributions to an entity by its members

12.31 An entity and its members are treated separately for tax purposes. To prevent double counting and to reflect a level of integration of ownership, some entity/member transactions have no tax effect. For the entity, a membership-related distribution does not reduce the entity's taxable income because it is offset by an increasing adjustment under the core rules. Likewise, capital contributed to the entity by members (increasing the liability of the entity) is offset by a corresponding receipt so that the entity's taxable income is not increased.

12.32 Also, certain rights and liabilities for an entity and a member that arise because of their relationship have a nil tax value for the purpose of applying the net income formula. For example, the right to receive a distribution arising as a result of a company declaring a dividend would be ignored for the purposes of calculating the taxable income of the entity and the member ***[Subdivision 6-F]***.

Interaction with the core provisions

12.33 The core provisions are contained in Part 1-3 of the ITAA 1997 and explain how to work out a taxpayer's income tax liability. The new method for working out taxable income (see Chapter 3) is reflected in the drafting of the consistent entity provisions already explained.

12.34 The core provisions take care of the basics. They impose an income tax liability on both entity and member. They ensure that payments, receipts and changes in the tax value of their assets and liabilities are reflected in the formula for calculating net income. In some cases it has been necessary to override the effect of the net income formula for some entity/member transactions, see Subdivision 6-F.

12.35 The entity rules then supplement the core rules by, in some circumstances, adjusting the tax value of membership interests. For example, the tax value of a member interest is reduced to reflect a distribution of contributed capital. The entity rules also contain increasing and decreasing adjustments to the net income of entities and members to arrive at their correct taxable income. Tax law adjustments are mainly necessary for policy reasons.

Residency

12.36 The consistent entity rules, as currently drafted, apply regardless of the residency status of entities and their members. The rules are being reviewed for the purpose of determining whether any modifications should apply to non-residents. Changes will be made where needed to reflect the results of that review.

Where to find more detail

12.37 The following table shows you where to find a detailed explanation of the draft legislation. The draft explains which tax entities are covered by the new regime, how they are taxed and the tax consequences of dealings between those entities and their members.

Table 12.2 Consistent entities Chapters

No	***Chapter***
13	The entity
14	Entity members
15	Distributions
16	Unpaid trust entitlements and rearrangement of membership interests
17	Source of distributions
18	Contributed capital
19	Collective investment vehicles

What’s not included in the draft legislation?

12.38 The draft legislation is not complete. Some topics are not covered at all, for example:

- trusts excluded from the new regime (referred to as *excluded trusts*);
- transfer of a membership interest in an entity to someone other than the entity; and
- franking and imputation.

12.39 In places, the draft legislation foreshadows the inclusion of further rules on a particular topic (using italicised comments enclosed in boxes). Where the nature of those rules is sufficiently known, they are discussed in these explanatory notes.

Application and Transitional provisions

12.40 The consistent entity rules will apply to entities from 1 July 2000.

12.41 The Review has also recommended that they apply, from that date, to non-commercial loans from a member to a closely-held entity if the loan was in existence at the time of announcement by the Government of legislative action in this area (or made subsequently), see Recommendations 11.8 and 12.23.

12.42 Transitional measures will ensure the consistent entity rules do not impact inappropriately on existing trusts. In particular, the Government’s commitment to maintain existing tax treatment for assets held in trusts before the date of announcement will be met, both for capital gains realised on pre-CGT and on post-CGT assets. The amount of currently untaxed gain (subject to the recommended change to capital gains treatment) will be added to the contributed capital of the trust.

12.43 Also, measures will ensure that income that has been taxed in a trust prior to commencement will not be taxed again if distributed after commencement.

Consequential amendments

12.44 None of the amendments consequential on the consistent entity tax regime are included in the draft legislation. It is anticipated that the existing company tax provisions will be repealed and that Division 6 of the ITAA 1936 will be rationalised for the purpose of taxing excluded trusts.

12.45 Amendments will also be required to ensure that new concepts such as tax entity, membership interest, membership-related distribution and the profits first rule fit properly with the rest of the ITAA 1997 and the remaining provisions of the ITAA 1936.

Chapter 13
The entity

Outline of Chapter

13.1 Division 151 explains which tax entities are subject to the consistent entity rules.

13.2 Division 152 explains the effect on a tax entity's taxable income of capital contributions it receives and distributions it makes (including returns of contributed capital, and on-market buy backs of membership interests).

Context of reform

13.3 The consistent entity tax rules will apply to companies (including unincorporated associations but not partnerships), limited partnerships and most trusts (including executors and estate administrators) as announced by the Government in *A New Tax System*. These entities are all referred to in the legislation as *tax entities*. The concept of tax entity is one of the major building blocks of the new system. A single all embracing term has been used in the rules to simplify the legislation.

13.4 Two key features of the new regime are that a *tax entity* is recognised as a taxable entity and dealings by a tax entity with its members do not generally affect the entity's taxable income.

Summary of new law

What the Division will do	Division 151 explains that the new regime that applies to companies (including unincorporated associations but not partnerships), limited partnerships and most trusts (including executors and estate administrators).
Which entities are excluded?	Complying superannuation funds, complying approved deposit funds, pooled superannuation trusts, deceased estates (within a 2 year period for administration) and excluded trusts.
The rules are modified for:	Collective investment vehicles.

What the Division will do	Division 152 explains how dealings between an entity and its members are treated when an entity is working out its taxable income.
What is the effect on entity taxable income after there have been transactions with members?	There is no net effect on entity taxable income other than where there is an on-market buy back (for which special rules apply).

Detailed explanation of new law

13.5 The ***consistent entity rules*** apply to all tax entities unless specifically excluded ***[section 151-5]***. Some entities are excluded entirely from the system, while others are excluded from the application of some of the rules only.

13.6 Detailed rules have not been included in this draft legislation for the franking and imputation of distributions.

What is an 'tax entity'?

13.7 The term ***tax entity*** refers to a company, a trust, or a limited partnership ***[section 960-105]***. 'Company', for tax purposes, includes both corporate bodies and unincorporated associations ***[definition of 'company' in section 6(1) of the ITAA 1936 and subsection 995-1(1) of the ITAA 1997]***. *Tax entity* also covers a person acting in the capacity of executor administering a deceased estate and an arrangement or situation entered into or arising outside Australia which, had it been established in Australia, would have given rise to a trust. The definition does not include individuals or ordinary partnerships and so, in this regard, is narrower than the existing definition of 'entity' in the ITAA 1997.

Trusts

13.8 A person acting in the capacity of executor administering a deceased estate is specifically included because, under the rules of equity, this type of arrangement may not technically constitute a trust and the executor may not technically be a trustee. Under the current law, the existence of a trust arrangement is governed by the extended definition of trustee in subsection 6(1) of the ITAA 1936 which includes any executor or administrator. This existing definition of trustee will not be used for determining which trusts are covered by the new system. Rather the term 'trust' will take on its ordinary meaning so that only arrangements that come within the equitable concept of a trust relationship will be trusts for the consistent entity rules unless otherwise specified.

Co-operatives

13.9 The term *tax entity* includes *all* co-operative companies, including both co-operatives that meet the criteria in Division 9 of the

ITAA 1936 and co-operatives that do not meet those criteria. The consistent entity rules will not disturb retention of the special deduction (contained in paragraph 120(1)(c) of the ITAA 1936) that gives some co-operatives a deduction for capital repayments of certain government loans. Members of co-operatives with low marginal tax rates will also be eligible to obtain early refunds of excess imputation credits from the distributing tax entity.

Certain trusts not recognised as tax entities

13.10 A trustee may make a beneficiary presently entitled to an amount of income or capital of a trust, but not actually pay it to the beneficiary. The amount is held in the trust for the benefit of the beneficiary with the present entitlement. Under trust law the legal status of this retained money or property is unclear. Under one interpretation of the law it remains part of the existing trust. Under another interpretation the retained money or property is held under a separate trust.

13.11 It is necessary to remove any uncertainty as to how an unpaid trust amount should be treated for tax purposes, that is, whether it is money or property of the existing trust or the contributed capital of a separate tax entity. To achieve this subsection 960-105(2) provides that where a new trust is taken to arise under the law of equity in relation to the unpaid trust amount, and there is no express or implied agreement between the trustee and the beneficiary either to hold the amount on a new trust or to lend the amount to the trustee, then that new trust is disregarded for taxation purposes and the asset is taken to form part of the estate of the existing trust.

13.12 In such a case, the entity is not taken to have made a distribution to the member under subsection 960-145(1).

Which tax entities are excluded entirely?

Superannuation funds

13.13 The consistent entity rules do not apply to complying superannuation funds, pooled superannuation trusts or complying approved deposit funds ***[subsection 151-10(1)]***. These funds will continue to be subject to income tax under their own regime contained in Part IX of the ITAA 1936.

Deceased estates

13.14 A ***deceased estate*** is any trust for the administration of the estate of a deceased person ***[subsection 995-1(1)]***. Deceased estates will be excluded from the consistent entity rules for a period. The rules begin to apply to them only when their administration is finalised or at a time 2 years after the date of death, whichever occurs first ***[subsection 151-10(2)]***.

13.15 Generally, 2 years will be a sufficient length of time for the executor to wind-up the deceased person's affairs and distribute the estate's asset to beneficiaries. A time limit has been set for the exclusion to prevent executors of deceased estates delaying the finalising of administration and undertaking income producing activities. The 2 year period may be extended by the Commissioner for legitimate cases where a deceased estate cannot be wound up within the 2 year period; for example, as a result of a genuine dispute regarding the deceased person's will ***[subsection 151-10(3)]***.

Excluded trusts

13.16 Some other trusts will also be excluded from the consistent entity rules. Generally, these would be trusts that have been created or settled only as a legal requirement or subject to a legal test or sanction. This is designed to distinguish such trusts from trusts created at a settlor's direction. Other exclusions are justified for practical reasons, for example, trusts for an absolutely entitled beneficiary, constructive trusts, the bank accounts of minors and short-term stakeholder arrangements.

13.17 Detailed rules for excluded trusts have not been developed for this draft legislation (they are to be contained in Division 159). It is anticipated that most excluded trusts will be taxed under a rationalised Division 6 of the ITAA 1936.

Which entities are excluded from only some of the rules?

13.18 The consistent entity rules are modified for ***collective investment vehicles*** (CIVs). The modifications are contained in Division 156 and are explained in Chapter 19.

13.19 Broadly speaking, a CIV is a unit trust which invests in assets of a passive kind (although it could also trade in these assets) and distributes all, or virtually all, of its taxable income for an income year to its members in that year, or shortly afterwards (e.g. a cash management trust).

13.20 Taxable income of a CIV which flows through to its investors in this way, retains its source and character in investors' hands as if it had been received directly by them and will be taxed at the investor level only. Because of this, certain elements of the consistent entity source rules do not apply to CIVs.

Entities that may move in and out of the system

13.21 Excluded entities, such as deceased estates not wound up within 2 years of the date of death and complying superannuation funds that become non-complying, may move into the consistent entity system. Likewise, a non-complying superannuation fund that becomes complying may move out of the system. Detailed rules for movements of entities into and out of the system have generally not been included for the draft legislation.

13.22 Chapter 19 explains the circumstances in which the modified consistent entity rules for CIVs begin or cease to apply to an entity.

Applying the rules to entities that are not legal persons

13.23 The consistent entity rules include translator provisions ***[Division 161]***. These rules apply to tax entities that are not legal persons (trusts, limited partnerships and unincorporated associations). They create a standard set of equivalents for things done by or in relation to entities that are legal persons ***[section 161-1]***. They ensure that the actions of a person on behalf of a tax entity are recognised as actions undertaken by the entity and that the person's assets and liabilities on behalf of the entity are treated for tax purposes as being those of the entity. The rules also identify what assets are to be taken as assets of the entity.

13.24 This is achieved by the creation of the general category of 'representative' of such a tax entity ***[subsection 161-1(2)]***. The representatives are:

- a trustee or any of the trustees acting as the trustee of the trust;
- a partner acting in the affairs of the limited partnership; and
- a member of the management committee acting in the management of the association.

13.25 What such representatives do in their representative capacity is done by the entity, and what is done to or in relation to such representatives in their representative capacity is done, to or in relation to, the entity. This is so, even if the representatives act beyond their actual authority (but within their ostensible authority). ***[Subsection 161-1(1)]***

13.26 In working out their net income, representatives do not take account of anything that they do to or that happens to them in their capacity as representatives, as these things happen to the entity ***[section 161-5]***.

13.27 There can be more than one representative of an entity. Representatives are jointly and severably liable for the liabilities and obligations of an entity, including tax liabilities and obligations ***[subsection 161-1(3)]***.

Widely-held / Closely-held entities

13.28 The current law recognises a number of different systems for determining the extent of public control of an entity. In the case of companies, the tax law uses the terms 'public' and 'private'. But this is not the same distinction as exists under the *Corporations Law*. Nor can it be applied easily to trusts. The trust loss provisions of the current law use concepts such as 'very widely-held', 'widely-held' and 'closely-held'.

13.29 Under the new law, all entities will be treated as 'closely-held' or 'widely-held'. This will provide a simple, consistent method of classification as well as a comprehensive code which does not rely on other statutory rules, such as the *Corporations Law*.

13.30 ***Closely-held*** and ***widely-held*** are both defined in the new law ***[subsection 995-1(1)]***. The definition of 'widely-held' is linked to a detailed explanation of the term ***[section 960-110]***. A tax entity is defined as 'closely-held' if it is not widely-held.

Why is this distinction relevant?

13.31 Classification as widely-held or closely-held is important for several provisions in the new law, for example:

- there is a different treatment of non-commercial loans between an entity and member depending on whether the entity is widely-held or not;
- certain discounts provided by an entity to a member will not be treated as distributions if the entity is widely-held; and
- CGT rollovers for scrip-for-scrip takeovers between companies are allowed only where one of the entities involved is widely-held.

What is a 'widely-held entity'?

13.32 Generally, a *tax entity* is widely-held if it has at least 300 members. However, even if an entity satisfies this test, it will not be widely-held if it fails any one of 3 further concentration of ownership tests ***[subsection 960-110(1)]***.

13.33 These tests deal with control and entitlements that members have because of their membership interests. The tests ask whether 20 or fewer individuals have (or hold between them) directly or indirectly and for their own benefit membership interests carrying:

- fixed entitlements to 75% or more of the entity's income ***[subparagraph 960-110(2)(a)(i)]***; or
- fixed entitlements to 75% or more of the entity's capital ***[subparagraph 960-110(2)(a)(ii)]***; or
- 75% or more of the voting rights in the entity ***[paragraph 960-110(2)(b)]***.

13.34 If the answer to any of these questions is 'yes', the entity is closely-held. For the purposes of these tests one individual, regardless of whether a holder of a membership interest in the entity, will be counted together as one with the following other individuals:

- their associates; and
- their nominees who hold membership interests in that capacity; and
- nominees of the individual's associates where the nominees hold membership interests in that capacity.

[Subsection 960-110(4)]

13.35 In considering whether voting rights or fixed entitlements are 'directly or indirectly' held, account is also taken of the potential for rights attaching to any membership interests to be varied or abrogated, regardless of whether they actually are varied or abrogated. For this purpose, account may be taken of:

- any part of the entity's constituent document or of any contract, agreement or instrument authorising any change to the rights attaching to membership interests, or relating to changes to or termination of the membership interests themselves ***[paragraph 960-110(3)(a)]***;
- any contract, agreement, arrangement, option or instrument empowering a person to acquire the membership interests ***[paragraph 960-110(3)(b)]***; and
- any power, authority or discretion in a person in relation to rights attaching to the membership interests ***[subsection 960-110(3)]***.

13.36 Where an entity has a discretion as to which member is entitled to receive all or some of its income or capital, it will be treated as closely-held. This maintains the existing approach in the trust loss provisions, where any non-fixed trust is closely-held. Where a trustee has a discretion, it is not possible to determine who really controls the income or capital of the trust and the objects of the trust do not have an interest as such in either the profits or capital of the trust ***[subsection 960-110(5)]***.

13.37 Under the current law, any corporate limited partnership is taxed like a public company. The widely-held rules mean that some limited partnerships will not be widely held under the new law.

The entity's taxable income

13.38 The consistent entity rules supplement the core provisions for working out income tax liability contained in Part 1-3 of the ITAA 1997.

Effect of distributions of available profits or prior taxed amounts on the entity's taxable income

13.39 The consistent entity rules ensure that distributions of available profits and prior taxed amounts do not affect the taxable income of the entity. This is achieved by increasing adjustments to the entity to reverse the effect of these distributions, where otherwise the distribution would reduce the taxable income of the entity. This happens when a distribution is in the form of a payment or produces a decrease in the tax value of the entity's assets, or an increase in the tax value of the entity's liabilities ***[subsections 152-5(1) and (2)]***.

13.40 The amount of the increasing adjustment will only be the extent to which the distribution would otherwise reduce the taxable income of the entity. An example of a distribution that does not attract an increasing adjustment is a distribution in the form of an interest in a trust asset that vests in a discretionary beneficiary ***[subsection 960-145(2)]***. No adjustment is required because the distribution remains unpaid.

Effect of contributed capital distributions on the entity's taxable income

13.41 A distribution of contributed capital reduces the contributed capital of an entity. As contributed capital is taken to be a liability, a reduction in contributed capital of a tax entity reduces the tax value of the tax entity's liabilities; equivalent in effect to the increasing adjustments made for distributions of available profits or prior taxed amounts.

13.42 Where the contributed capital distribution does not result in either a payment, a reduction in tax value of the entity's assets or an increase in the tax value of the entities liabilities (other than contributed capital), then there is a decreasing adjustment made to ensure that the net effect on the entity's taxable income is zero. In these cases, the reduced tax value of a liability (contributed capital) is offset by the decreasing adjustment to achieve a result of zero net effect on the entity's taxable income. ***[Subsection 152-5(3)]***

Effect of receipts of contributed capital on the entity's taxable income

13.43 A capital contribution by a member to an entity is a receipt to the entity. The effect of this on the entity's taxable income is reversed as the contribution increases the contributed capital of the entity, and hence increases the tax value of the entity's liabilities. The receipt increases taxable income, and the increase in tax value of contributed capital reduces taxable income by the same amount, for no net effect. ***[Section 152-10]***

Effect of an on-market buy back on the entity's taxable income

13.44 A buy back by a tax entity of membership interests in itself will only be an ***on-market buy back*** if the interest is listed for quotation in the official list of a stock exchange in Australia or elsewhere and the transaction occurs in the ordinary course of trading on the stock exchange. A buy back transaction that is described as 'special' when reported to the stock exchange under the exchange's rules is not in the ordinary course of trading ***[definition of 'on-market buy back' in subsection 995-1(1)]***.

13.45 In principle, consideration for an on-market buy back is as much a distribution to the member as an off-market buy back or other redemption of a member interest for consideration**.** However, the general treatment is impractical because a member selling on-market will not know who is purchasing their share, and so should receive the same tax treatment regardless of whether the tax entity or a third party is the purchaser.

13.46 Consideration given by a tax entity for an on-market buy back is therefore not a distribution ***[subsection 960-150(5)]***. It is still, however, a payment by the entity which, under the core rules, reduces its net income. An increasing adjustment, equal to the amount or value of the consideration to the extent it is from available profits or prior taxed amounts, reverses the effect of the payment ***[paragraph 152-15(1)(a)]***. To the extent the consideration is from contributed capital, the resulting reduction in the tax value of a liability achieves the same outcome.

13.47 Where the consideration for the on-market buy back includes a component of taxed profit, there will also be a decreasing adjustment equal to the amount of the taxed profit component ***[paragraph 152-15(1)(b)]***. Without this adjustment, a second tier of taxation would arise in respect of the taxed profits of the entity. An evaluation of the provisions dealing with potential capital losses arising from the disposal of membership interests after the distribution for pre-acquisition profits is noted in Recommendation 6.6, and may have implications for this provision.

13.48 The amount of the taxed profit component is determined in the same way as it would be if the consideration were a distribution subject to the 'slice' rule ***[subsection 152-15(2)]***. The 'slice' rule is contained in Subdivision 154-D and explained in Chapter 17.

Core rules - assets and liabilities disregarded in entity's taxable income

13.49 The tax values of some assets and liabilities that arise from the relationship between the entity and the member are taken to be nil when calculating the net income of the entity under the core rules.

13.50 The entity's right to receive contributions of capital from members, for instance uncalled amounts in respect of a share issue price, is taken to be an asset with a nil tax value. The obligation of an entity to make distributions, for instance to pay a declared dividend, is a liability with a nil tax value. An obligation of an entity to repay a non-commercial loan (see discussion in Chapter 19 on what is a non-commercial loan) from a member is also a liability with a nil tax value ***[Subdivision 6-F]***. These assets and liabilities have a nil tax value for the purposes of calculating the net income of the entity to prevent double counting.

13.51 The right to enforce security in relation to any of these rights and obligations is not expressly dealt with under the Subdivision. This is to avoid the unnecessary inclusion of a series of linked provisions: it might otherwise be taken to be necessary to take the tax value of any security of the security to be nil, and so on and so on. The provision is considered adequate to obviate such circular inclusion of these rights and obligations. Moreover, even if security for such rights and obligations were not implicitly dealt with, its value under the core rules will be no greater than the excess over the value of the rights or organisations itself. Generally, this value would be small.

13.52 The core provisions ensure that an entity's dealings in relation to membership interests with its own members do not affect its taxable income. The consistent entity rules, to the extent they deal with the entity's taxable income, take the same approach.

Effect of the mutuality principle on the entity's taxable income

13.53 The mutuality principle provides that where a number of persons contribute to a common fund created and controlled by them for a common purpose, any surplus arising in the fund is not income for tax purposes. Receipts which do not arise from contribution to a common fund are income for tax purposes. Commercial dealings between an entity and non-members, and some such dealings between entities and members will produce income, not mutual accretions.

13.54 The new law maintains the current tax status of mutual gains of entities when working out the entity's taxable income. It does this by providing increasing or decreasing adjustments to neutralise the effects of net reductions or net accretions in the common fund of the entity for the income year ***[Division 158; section 158-1]***. This happens regardless of whether the consistent entity rules apply to the entity.

Chapter 14
Entity members

Outline of Chapter

14.1 This Chapter explains the special rules for members of entities.

14.2 Sections 960-115 and 960-120, in the dictionary, contain the rules for determining who is a member of an entity and the nature of their membership interest.

14.3 Division 153 contains special rules about how distributions from a tax entity are taxed to the recipient. Distributions of gains are taxed appropriately under the core rules without member-specific provisions. Imputation credits and refundability of excess imputation credits will be dealt with under provisions still to be drafted. The provisions of Division 153 are specifically concerned with distributions of contributed capital, distribution of prior taxed amounts, and the effect of rearrangements of membership interests. In each of these cases, special member rules are needed to adjust the general effect of the core rules.

Context of Reform

14.4 The current law refers to shareholders, beneficiaries and partners which reflects the separate treatment of the specific entities to which those terms attach. As part of the move towards more consistent treatment, it makes sense to have a common name for entity investors.

14.5 The identity of entity 'members' is relevant because:

- distributions received by them from the entity will be taken into account in working out their net income; and
- contributions they make to the entity in exchange for obtaining or enhancing a membership interest in the entity will become part of the entity's contributed capital.

14.6 A member's interest in an entity is, itself, an asset that is taken into account in working out the member's net income. The tax value of the membership interest is adjusted to reflect any return of capital by the entity, and any further contributions of capital on the interest.

Summary of new law

What the sections will do	Sections 960-115 and 960-120 explain who is a *member* of an entity and the nature of their *membership interest*.
Who is a member?	• A ***member*** of an entity is: • the holder of a prescribed interest, including: – a shareholder in a company; – a member of a registered managed investment scheme; – a partner in a limited partnership; – a person who has a beneficial interest in the assets of a trust estate; or – a person who has an interest in the proper administration of a trust because the person is an object of a discretion that can be exercised by the trustee of a non-fixed trust; • a person who has an interest in the entity that carries a right to returns from the entity; • a person who has voting rights beyond specified security-related rights; • a person who has a right to participate in the management or control of the entity; or • a person who holds an interest (not excluded by the debt test) issued by the entity that may or will convert into a membership interest in the entity.
What the Division will do	Division 153 adjusts the core rules by including specific rules about the treatment of distributions in the hands of a recipient.
How are distributions treated?	A distribution from profits adds to the taxable income of a member while one from contributed capital generally does not.

Detailed explanation of new law

14.7 Distributions from an entity are taken into account in working out the recipient's net income. A *distribution* is basically any benefit – any value – that has been provided by the entity to a member because they are a member, or to a person because they have previously been a member of the entity or are likely to become one. A distribution can also be a transfer of value from an entity to an associate of any of those persons ***[subdivision 960-C]***.

14.8 The definitions of ***member*** and ***membership interest*** are included in Subdivision 960-B. The definitions apply to *all* tax entities and not just to those which the consistent entity rules apply. However, the relevance of these terms in applying provisions outside the consistent entity regime (e.g. the CGT provisions) and to entities excluded from the regime (e.g. excluded trusts) is not explained as part of this draft legislation.

Who is a member?

14.9 A ***member*** of an entity is a person who has a ***membership interest*** in the entity ***[subsection 960-115(1)]***.

Tracing membership through a nominee and bare trust

14.10 Where a nominee or bare trust is a member of an entity, the beneficiaries of that trust will also be members of the entity ***[subsection 960-115(2)]***. This rule only applies to a beneficiary who has, at all times since the trust commenced, been absolutely entitled to the trust property that is the trust's interest in the entity. This ensures that a distribution by the entity that by-passes the trust and is made directly to the beneficiary will be subject to the consistent entity rules.

Joint membership

14.11 If 2 or more people jointly hold interests or rights that give rise to membership of an entity, each of them is a member ***[subsection 960-115(3)]***. This covers the situation where 2 or more people:

- together hold the membership interest in the entity; or
- each hold a separate component of the membership interest – for example, one person holds a bundle of rights that confer membership and they assign the right to a distribution to another person and retain the right of control – each person will be a member.

What is a membership interest?

14.12 The definition of ***membership interest*** is set out in a table in the draft legislation. The table comprises both a list of examples of what is a membership interest for a particular type of tax entity and a general rule. This approach recognises the need to clarify the members of different entity types.

14.13 A ***membership interest*** includes:

- holding a prescribed interest – that is:

  - holding a share in a company limited by shares;
  - being a guarantor of a company limited by guarantee;
  - holding an interest in a registered managed investment scheme;
  - having an interest in a limited partnership as a partner;
  - holding a beneficial interest in the income or capital of a trust estate;
  - having an interest as a discretionary beneficiary of a non-fixed trust, that is an interest in the proper administration of a trust because the person is an object of a discretion that can be exercised by the trustee of a non-fixed trust;
- holding an interest carrying a contingent right to a return from an entity, that is, a right to a return contingent on either the performance or the discretion of the entity;
- holding voting rights in the entity beyond specified security rights;
- having rights to participate in management or control of the entity; or
- holding an interest (not excluded by the debt test) issued by the entity that may or will convert into a membership interest in the entity.

[Table, subsection 960-120(1)]

A membership interest does not include an interest in returns from the entity which is remuneration under a contract of employment. Nor does it include an interest which is characterised as debt according to the ‘debt test’ in Recommendation 12.11.

Examples of membership interests

14.14 A person has a membership interest if they come within one of the examples that link particular membership interests to certain entity types. These rules put beyond doubt certain interests being membership interests.

Corporations Law companies

14.15 A person has a membership interest in a company limited by shares if they hold a share in the company ***[subsection 960-120(1), item 1]***. A person has a membership interest in a company limited by guarantee if they are a guarantor ***[subsection 960-120(1), item 2]***. The terms ***company limited by shares*** and ***company limited by guarantee*** have the meaning given to them in the *Corporations Law* ***[subsection 960-120(2)]***; this does not require the companies to be established under that law, and companies may be established under State or foreign laws.

14.16 A person will not have a membership interest in a company if they hold redeemable preference shares or debentures in a company that will be classed as debt under the recommended debt test. Also, the voting rights ordinarily attached to a redeemable preference share will be insufficient to bring the holder of the share within the control test.

Trusts

14.17 A person has a membership interest in a trust if they have a beneficial interest in the income or capital of the trust or an interest in its proper administration because they are the object of a discretion that can be exercised by the trustee ***[subsection 960-120(1), item 4]***. This avoids debate as to whether a beneficiary's interest in the income or capital of a trust amounts to a right to receive it and whether the object of a discretionary trust has an interest in the income or capital of the trust.

Managed Investment Schemes

14.18 A person has a membership interest in a managed investment scheme that is registered with the Australian Securities and Investments Commission (the ASIC) if they have an interest in the scheme ***[subsection 960-120(1), item 3]***. Such schemes are generally trusts and involve persons contributing money or assets to acquire interests in the scheme. The contributions are pooled or used in a common enterprise to produce financial or other benefits for scheme members. Life insurance and superannuation funds cannot be managed investment schemes ***[definition of 'managed investment scheme' in section 9 of the Corporations Law]***.

14.19 Schemes with more than 20 members or that are promoted by a person in the business of promoting such schemes must register with the ASIC. A managed investment scheme that satisfies the definition of a CIV will be taxed in accordance with the special rules for CIVs.

Limited partnerships

14.20 A person has a membership interest in a limited partnership if they are a partner in the partnership, whether they are a limited partner or a general partner ***[subsection 960-120(1), item 5].*** This avoids any contention that a limited partner's exclusion from day to day involvement if they retain limited liability, coupled with some sorts of partnership agreement, could exclude the partner from being a member under the general tests should they exercise certain partnership rights.

More on membership interests

14.21 Beyond the above specific membership categories, a ***membership interest*** is an interest issued by the entity that carries a continuing right to a variable or fixed return from the entity where the right itself depends on the economic performance of the entity or flows from the discretion of the entity ***[subsection 960-120(1), item 6]***. The interest may take any form and need not be a proprietary right or a chose in action.

14.22 The coming into existence of a right to receive a particular membership-related distribution does not itself constitute a separate membership interest in the entity ***[section 6-145, item 1]***. The consistent entity rules tax actual distributions, though there are some overriding provisions discussed in Chapter 16 (about unpaid trust entitlements).

14.23 Voting rights beyond those specified – consistent with security interest protection – will give a membership interest ***[subsection 960-120(1), item 7]***, and so will rights to participate in management or control ***[subsection 960-120(1), item 8]***.

14.24 A right to returns is sufficient even if it is not accompanied by control over the entity. Alternatively, control is sufficient even if there is no right to participate in profits. The control test will be used, for example, to identify the members of unincorporated or non-profit associations who are members although they may not have a right to participate in the association's income or capital.

14.25 Control may be attached to significant voting rights. In looking at what voting rights signal control of the entity, voting rights which are accepted in the *Corporations Law* as consistent with protecting the interests of a non-member creditor are not, by themselves, sufficient; for example, a right to vote on a return of capital to members or on a proposal to wind up the entity would not constitute control of the entity. That is, the ability to influence the distribution of profits or capital of the entity does not, by itself, necessarily amount to control.

14.26 A person who is a member only by virtue of their right to participate in the control or management of the entity ordinarily does not have a tax value for their membership interest. Because they do not have a tax value, they do not have anything against which to offset a contributed capital distribution. Therefore, all distributions they receive from the entity will be taxable, unless special rules (essentially for interests provided by someone else, such as trust interests provided by a settlor) apply.

14.27 Because interests issued by an entity that may or will convert into a membership interest also provide a return affected by the economic performance of the issuer, they are also membership interests ***[subsection 960-120(1), item 9]*** (unless excluded by virtue of the proposed debt test). The requirement that convertible interests be issued by the entity into whose membership interests they convert means that derivatives such as options that are created by third parties over membership interests in an entity will not be covered.

Employment contracts

14.28 Remuneration under some employment contracts is linked to the economic performance of the employer. For simplicity, and to prevent performance-linked salary bonuses being paid as franked distributions rather than salary, the right to such remuneration under an employment contract with the entity will not constitute a membership interest ***[subsection 960-120(4)]***. This does not prevent an employee being a member, or having a membership interest, on some other basis; for example, because they are also a shareholder or they also have sufficient rights of management or control.

A debt-like interest is not a membership interest

14.29 An interest that has the characteristics of a debt owed by the entity to the member, according to the recommended debt test, will *not* be a membership interest. Common examples of debt-like interests are debentures, redeemable preference shares and certain convertible notes. The tax treatment of distributions differs markedly from payments an entity makes in satisfaction of a debt. The former are frankable and the latter deductible. These differences in treatment make the distinction between debt and equity important. The intended debt test rules are not contained in this draft legislation.

Non-commercial loan from a member to a closely-held entity

14.30 The debt test will not apply to a *non-commercial loan* by a member (or their associate) to a closely-held entity. These loans are, in substance, capable of taking the place of membership interests. In widely-held entities, the interests of other members will generally limit the use of such loans in place of membership interests. In closely-held entities such safeguards are likely to be absent, so such debt needs to be treated as a contribution of capital to the entity ***[subsection 154-40(6)]***. Therefore, the loan is not a separate asset or liability for the purpose of working out net income under the core rules ***[section 6-145, item 3]***.

14.31 A commercial loan must be in writing, carry an interest rate equal to or greater than the standard home loan reference rate, and be for a term equal to or less than the prescribed term (25 years if secured over real property, 7 years if not) ***[subsection 995-1(1)]***. Many loans which are uncommercial in a wider sense will nevertheless be commercial for these purposes.

14.32 Repayments of principal or interest by the entity on such a loan made after the date of announcement will be a distribution subject to the profits first rule. This will prevent profit distributions being substituted by loan repayments that are not subject to the profits first rule ***[subsection 960-145(4)]***.

Class of membership interest

14.33 Membership interests that carry strictly identical or proportional rights to distributions are part of a single class. Only the rights to distributions need be equal. Other rights, such as voting rights, may be different ***[definition of 'class' in subsection 995-1(1)]***.

14.34 Determining classes of membership interests is relevant to calculating the slice of the entity being distributed as part of extinguishing a membership interest, see Chapter 17 (about determining the source of a distribution). It is also relevant to working out the tax values of membership interests in existence after a rearrangement of interests, see Chapter 16.

How are distributions treated?

14.35 A distribution is fully taken into account in working out the recipient's net income. The recipient does this using the core rules as supplemented by the consistent entity rules in Division 153. The tax treatment of the distribution then depends on the extent to which it is sourced from the distributing entity's profits, contributed capital or prior taxed amounts. ***[Section 153-5]***

When is a distribution taxed?

14.36 Generally, a distribution is taxed when it is received. Therefore, a right to receive a distribution, as exists for example once a dividend has been declared but before it has been paid, is not a distribution ***[subsection 960-150(7)]***.

14.37 The right to receive a distribution is also not an asset for the purpose of working out net income ***[section 6-145, item1]***. Including the right as an asset would result in the asset value being taxed. That result is not appropriate if no payment or benefit has actually been received.

14.38 There is one exception to the principle that distributions are only taxed when received. A right to receive a distribution from a discretionary trust is treated as a distribution if, because of the exercise or non-exercise of a discretion by a trustee, a trust asset vests in a person or an already vested interest is preserved, and the beneficiary knows or ought reasonably to know it ***[subsection 960-145(2)]***. The vested asset is taxed immediately to the beneficiary and becomes a prior taxed amount of the trust to prevent it being taxed again when eventually paid out, see Chapter 14.

Receipt

14.39 A distribution is always a receipt in the hands of the recipient so far as it would not otherwise add to taxable income, whether as a receipt, an increase in the tax value of assets, or a decrease in the tax value of liabilities. Adding together all receipts is the first step in working out net income under the core rules.

14.40 A cash distribution will be a receipt within the ordinary meaning of that term. An amount that is not actually received but is applied or dealt with on the member's behalf or as they direct will be a constructive receipt ***[subsection 5-65(1)]***.

14.41 The catch-all rule in section 153-5 treats a distribution as a receipt if the core rules fail to do so. The core rules are fairly comprehensive. Therefore, the catch-all rule will have limited application. But among other cases it will apply to deem a receipt in the case of an unpaid trust entitlement that is a membership-related distribution under subsection 960-145(2) – no actual amount is received and the asset that is the entitlement is ignored, see further discussion in Chapter 14.

Distribution of profits

14.42 A distribution from an entity's profits is taxable in the hands of the recipient. The distribution is a receipt that increases net income. No offsetting adjustment is made, so there is no need for unique provisions in relation to members to achieve the correct the tax treatment of members in this respect.

14.43 The recipient will be allowed a (generally refundable) credit for any tax already paid by the entity. The franking and imputation rules are not included in this draft legislation.

Distribution of contributed capital (membership interest continues)

14.44 A return of an entity's contributed capital is generally not taxable (except to the extent that it exceeds the tax value of the member's interest). It is treated symmetrically with contributions of capital to the entity ***[section 153-10]***.

Distribution to a member

14.45 The distribution is a receipt that increases net income, but it is offset by a reduction in the tax value of the membership interest to which it relates ***[subsections 153-15(1) and (3)]***. This reflects the treatment of the original contribution which was a payment offset by an increased tax value of an asset that is the membership interest.

14.46 In this way, the tax consequences of the distribution are effectively delayed until disposal of the membership interest, when the tax value reduction may result in a larger gain. Where the distribution relates to more than one membership interest, the tax value reduction is spread proportionately over all relevant interests ***[subsection 153-15(4)]***. Distributions that takes the form of rearranging or issuing new membership interests are subject to separate rules discussed in paragraphs 14.61 to 14.65.

14.47 The tax value of a membership interest cannot be reduced below zero, so any distribution of contributed capital after tax value is reduced to zero will be taxable. Section 153-15 and the core rules for working out taxable income together reproduce the effect of the CGT cost base reduction rule in section 104-35 of the ITAA 1997.

14.48 The tax value of some membership interests in a trust is always zero; for example, an interest held by a beneficiary of a testamentary trust or the object of a discretionary trust (they are given their interest rather than paying for it). There will be a decreasing adjustment if there is a distribution from the contributed capital of a trust and the tax value of the membership interest is zero and has always been zero. This will prevent a tax on members to the extent of contributed capital ***[section 153-20]***.

14.49 Such treatment is not appropriate where a member's interest has been acquired by them for a cost, giving it a tax value.

Distribution to a former or prospective member

14.50 The rules that reduce the tax value of a membership interest do not apply to a contributed capital distribution made to a person because they have previously been a member of the entity or they are likely to become a member ***[subsection 153-15(1)]***.

14.51 A former or prospective member will be taxed on a distribution of contributed capital because there is no membership interest in existence at the time of the distribution whose tax value can be reduced. The result in this situation is consistent with a contributed capital distribution made to a member whose membership interest tax value has been reduced to zero as a result of previous capital distributions.

Distribution to an associate of a member (or a former or likely member)

14.52 A distribution of contributed capital to an associate of a member (or a former or likely member) results in a receipt to the associate and the reduction of the tax value of the member's interest. ***[Paragraph 153-15(2)(c)]***

14.53 Because the receipt and tax value reduction occur in different hands, adjustments are made to obtain the correct result. For the associate, the receipt will be offset by a decreasing adjustment ***[paragraph 153-15(2)(a)]***. For the member, any reduction in the tax value of their membership interest will be offset by an increasing adjustment ***[paragraph 153-15(2)(b)]***. For a former or likely member, there is no tax value of a membership interest to reduce and so there will be no potential deferral of the tax liability.

14.54 If there is no reduction because the tax value has already reached zero, the increasing adjustment will increase the member's net income. If there is no reduction because tax value was always zero, the increasing adjustment is offset by a decreasing adjustment ***[section 153-20]***. These adjustments ensure the same result as if the member (or a former or likely member) had received the distribution instead of their associate.

Distribution that relates to pre-CGT interests

14.55 A distribution of contributed capital that relates to a pre-CGT membership interest is not taxable. To the extent such an interest has a tax value, it will be reduced by the amount of a contributed capital distribution (in some circumstances, such an interest can have a tax value: for instance, through a contribution of capital). To the extent the distribution exceeds the tax value of the interest, there will be a decreasing adjustment ***[section 153-25]***. If pre-CGT assets do not have a tax value at all (and those rules have not yet been written) then the rule for tax values that have always been zero would apply to give a decreasing adjustment ***[section 153-20]***.

Distribution of contributed capital (member interest ceases)

14.56 Where the distribution of contributed capital effectively extinguishes the member's interest in the entity because, for example, the member has agreed to sell their interest back to the entity, there is no membership interest whose tax value can be reduced. In that case, the net income formula will treat the distribution of contributed capital as consideration for disposal of the member's interest.

Distribution of prior taxed amounts

14.57 There is a further category of distribution (in addition to a distribution of profits or contributed capital) and that is a distribution by a trust of income that has already borne tax, for instance under section 97, 98, 99 or 99A of the ITAA 1936 (called ***prior taxed amounts***). Those provisions tax the beneficiary on their share of the net income of the trust, or the trustee if no beneficiary is presently entitled to the trust income. Effectively tax has already been paid at the member level. ***[Section 153-40]***

14.58 Prior taxed amounts will also include unpaid trust entitlements that, although retained in the entity, have been taxed to a member as a distribution under subsection 960-145(2). ***[Subsection 153-40(4)]***

14.59 A ***tax-free recipient*** is the beneficiary who was presently entitled to the amount that bore tax, was a beneficiary at the time the trustee was taxed or was taxed on the distribution under the new entity tax system.

14.60 Prior taxed amounts will increase the trust's available profits but it is not appropriate that they be taxed again if distributed to the tax-free recipient under the consistent entity rules ***[section 153-30]***. Therefore, a distribution of prior taxed amounts to a tax-free recipient will not be subject to the profits first rule ***[section 154-10]*** and will be offset in the member's hands by a decreasing adjustment equal to the amount of the distribution ***[section 153-35]***. There is no decreasing adjustment if the distribution is to someone who is not a tax-free recipient, that is, a member who paid the prior tax or on whose behalf it was paid. Such distributions are not to someone who has already been taxed or for whom the tax was paid and will therefore be taxable.

14.61 Prior taxed amounts are an ongoing issue and a transitional one. This is because every trust that is not always taxed under the new entity rules may have prior taxed income, and so may every discretionary trust. Prior taxed amounts are relevant to a trust that is taxed under the new entity rules from the commencement of those rules. They may also be relevant to a trust that, after commencement, is taxed under a rationalised Division 6 of the ITAA 1936 but subsequently enters the new regime (e.g. a deceased estate that is not wound up within 2 years of the date of death).

Distribution by rearrangement of membership interests

14.62 A distribution by an entity in the form of new membership interests in the entity requires special rules. In principle, every such issue could be seen as no distribution because the entity could be seen as retaining the same overall value. This is not the recommended treatment, because those able to benefit from increased value can do so equally by an issue of new interests or by a more conventional distribution.

14.63 The provision of additional membership interests among members of an entity (for example, by way of bonus units or a share split) can be a substitute for a distribution, as discussed at pages 417 to 421 of the discussion paper *A Platform for Consultation* by the Review. Treating such cases as distributions reflects the substance of the transaction and assists, in conjunction with other measures, in limiting capital streaming, so permitting the repeal of some specific anti-avoidance sections. While the value shifting among members involved in cases other than proportionate issues theoretically could be dealt with by value shifting rules, in practice such rules would be unworkable. Distribution treatment is the simplest approach to the issue and is used in a number of countries.

14.64 The amount of the distribution under the general rule will be the fair value of the additional interest provided less any consideration paid by the member for that interest. However, where members of a widely-held entity have a choice between receiving a distribution or additional membership interests (e.g. via bonus shares), the value of the alternative distribution is used. ***[Subsection 960-165(2)]***

14.65 The provision of additional memberships will not be a distribution only if no substantive change occurs in the proportionate interests of members in the entity. For example, additional interests may be provided to all members in uniform proportion to their existing holdings, such as through a general bonus share issue. In these cases, there is not likely to be a shift in value between members arising from the provision of additional membership interests.

14.66 Whether a distribution or not, adjustments may be required to the tax values of the existing or additional interests or both ***[section 153-45]***. The taxation treatment of the distribution includes an appropriate change in the tax value of the existing membership interests and any new ones ***[sections 153-50 and 153-55]***. Tax value rules are also required in some cases where the rearrangement or change in interests is not a distribution, essentially because it does not increase the overall value of any member's interests ***[sections 153-60 and 153-65]***. Tax value rules are discussed in Chapter 16.

Liability to contribute further capital ignored

14.67 A liability of a member to make a further contribution of capital to an entity, should the entity call for it, is not taken into account in working out the member's net income ***[section 6-145, item 2]***. To do so would give the member an inappropriate deduction for the liability.

Chapter 15 Distributions

Outline of Chapter

15.1 This Chapter explains what is a distribution, and its amount. Subdivision 960-C shows you how to work out whether a tax entity has made a distribution and, if so, the amount of the distribution.

Context of Reform

15.2 Under the current law, a shift in value from the entity level to the member level is not approached consistently. Taxing companies, trusts and limited partnerships under a consistent entity taxation system requires a single definition of distribution that applies to all of them.

15.3 All ways of transferring value to members should have the same consequences, to minimise the ability to structure shifts in value so as to avoid tax. To maintain the integrity of the system, the definition of distribution should also include distributions effected through indirect transactions involving associates of the entity or of the member.

Summary of new law

What the Subdivision does	Subdivision 960-C explains how to work out if an entity has made a distribution and, if so, the amount.
What is a distribution?	The giving of a benefit, for no or inadequate consideration, by an entity to a member because they are a member. There are also some special rules as to what is or is not a distribution.
What is the amount of the distribution?	The value of the benefit less any consideration paid by the member for it.

Detailed explanation of new law

15.4 Identifying and bringing to account a shift in value from the entity to the member is the cornerstone of the consistent entity rules. In the simplest case, a shift in value occurs when a tax entity directly provides a benefit to its member for less than adequate consideration.

Distributions to members

15.5 A distribution is the giving of a benefit, for no or inadequate consideration, by a tax entity to a taxpayer *because* they are a member of the entity ***[subsection 960-130(1)]***. The expression is wide so there is no structural impediment to capturing shifts in or provisions of value. While subsection 960-130(1) makes no reference to consideration, it needs to be read with a later provision that states that a benefit for which market value consideration is given is not a distribution ***[subsection 960-150(2)]***.

15.6 A benefit will be regarded as having been given to a member because of their membership unless a reasonable person would conclude otherwise ***[subsection 960-130(2)]***. This presumption exists because it would be unusual for an entity to be giving a benefit for inadequate consideration to a member for reasons other than their membership. However, there will be no distribution if it is reasonable to conclude that the benefit was given to the taxpayer in some other capacity, such as, as an employee. This is an objective test, not a test of the actual subjective state of mind of the entity or its representatives or controllers who decided to give the benefit.

What form can a benefit take?

15.7 A benefit can take any form ***[section 960-155]***. The term 'benefit' is deliberately wide so that a distribution will occur whenever there is a shift in or provision of value. However, as noted, there is no distribution to the extent that the member provides market value consideration for the benefit received ***[subsection 960-150(2)]***.

15.8 The concept of benefit is broader than the current law. It covers the provision of goods or services by the entity at a discount or their acquisition by the entity at an overvalue and granting the use of entity assets at less than their fair value. It also covers the provision of additional member interests (e.g. bonus shares). The provision of additional member interests is not a transfer of an asset from the entity, because the interests do not exist before the issue and are not assets of the entity – but they have value and are provided by the entity and to the member. They are specifically covered by paragraph 960-155(e), (f) or (i). While some distributions may also come within the general value shifting rules, this should now only happen to the extent that a distribution does not arise from provision of the benefit.

15.9 Table 15.1 sets out specific benefits that the draft legislation lists. The list is not exhaustive, nor is the generality of the rule intended to be read down by reference to the particular examples.

Table 15.1 Benefits

Type of benefit	*New law reference*
Paying money to a person; this includes paying an amount in satisfaction of a right to an asset, such as a 'shareholder's right to a declared dividend.	***paragraph 960-155(1)(a)***
Reducing the liability of a person	***paragraph 960-155(1)(b)***
Crediting an amount in a person's favour	***paragraph 960-155(1)(c)***
Transferring an asset to a person or making it available for their use	***paragraph 960-155(1)(d), paragraph 960-155(1)(e)***
Providing services to a person	***paragraph 960-155(1)(g)***
Conferring a right or privilege on a person or making a facility available to them	***paragraph 960-155(1)(f)***
Applying money, an asset or services for the person's benefit or at their direction (including by reinvestment, accumulation or capitalisation)	***paragraph 960-155(1)(h)***
Issuing a membership interest to the person	***paragraphs 960-155(1)(e), (f) and (i)***

Example 15.1 Types of benefit

- Andrew is a member of Grapeco Distributors, a retail wine merchant. He buys a bottle of wine from one of the entity's shops. The wine is offered at a discounted price, but the discount is offered to all purchasers to increase customer loyalty, not just to entity members. There is no distribution.

- Margaret, a member of Softy (an entity that does not produce or deal in software), is offered some software by the entity at no charge. She directs that it be supplied and installed for the benefit of her associate, James. The application by the entity of the assets and the provision of services to James is a benefit to Margaret, and therefore a distribution to Margaret.

- Don and Liz are members of Grow, a manufacturing entity. Goods are acquired by the entity from Don at a value greater than market value and services are provided to Liz at a discount which non-members do not receive. Don and Liz have both received benefits. While they provided consideration, it is for less than market value. Both have therefore received a distribution. In Liz's case, the exception for loyalty schemes may exclude the benefit from being a distribution, depending on the circumstances.

Loans to and from members

15.10 A loan by a widely-held entity, or a 'commercial loan' made by a closely-held entity, to a member is not a distribution ***[subsection 960-145(3)]***. However, under provisions to be drafted, for closely-held entities, failure to repay the loan will trigger a distribution to the value of the entire outstanding balance of the loan.

15.11 For loans made by widely-held entities to a member, the general distribution rules will apply to ensure a distribution to the extent the interest charged by the entity is less than a commercial rate. Any part of a loan balance forgiven because the borrower is an entity member will also be a distribution. ***[Sections 960-130 to 960-145]***

15.12 Where a tax entity that is closely-held makes a non-commercial loan to a member (or an associate, or a past member, or a member-to-be) because of that membership, the amount lent is a distribution ***[subsection 960-145(3)]***. Conversely, where a member (or an associate, or a past member, or a likely member) makes a non-commercial loan to a closely-held entity because of that membership, payments to that taxpayer in respect of that loan are distributions ***[subsection 960-145(4)]***.

What is a non-commercial loan?

15.13 'Non-commercial' loan as a defined term applies both to loans from a closely-held *tax entity* to a person and from a person to a closely-held *tax entity* ***[see definition of 'non-commercial loan' in subsection 995-1(1)]***. A loan will be treated as 'non-commercial' unless 3 conditions are met:

- the loan is made under a written agreement; and
- the interest rate payable on the loan, for years of income after the year in which the loan is made, must equal or exceed the 'Indicator Lending Rates – Bank variable housing loan interest rate' last published by the Reserve Bank of Australia before the start of the year in which the loan is made; and
- the maximum term of the loan must not exceed 25 years for a loan secured over real property, and must not exceed 7 years for all other types of loans.

Distributions by liquidators and the like to be treated as by the entity

15.14 A benefit provided by an external administrator (such as a liquidator, a receiver, a receiver and manager, an administrator under a deed of arrangement with creditors or any person charged with winding up or terminating an entity) will be taken to be provided by the entity ***[section 960-160]***. This removes the uncertainty that would otherwise arise as to whether in these cases the relevant entity itself provides the benefit required by section 960-130.

Benefits that are not distributions

15.15 There is a number of circumstances where a benefit is not a distribution. ***[section 960-150]***

Table 15.2 Benefits that are not distributions

Not a distribution	***Because***
The creation of a right to receive a distribution. ***[Subsection 960-150(7)]***	The system generally taxes distributions only when they are actually or constructively received. Exceptions (about unpaid trust entitlements) are discussed in the Chapter 16.
A benefit for which market value consideration has been provided. ***[Subsection 960-150(2)]*** Consideration in the form of a cancellation of a membership interest in the entity is ignored.	There has been no shift in value to the recipient of the benefit. If not ignored, a payment to a member as part of, say, an off-market buy back would not be a distribution.
A benefit given as consideration for an on-market buy back by the entity of its own membership interest. ***[Subsection 960-150(5)]***	The member will not know or be able to control whether the interest being sold was bought by the entity or someone else and so, regardless of the identity of the purchaser, the member treats the amount received as consideration for the sale of their interest.
A benefit that takes the form of a proportionate issue of new membership interests. ***[Subsection 960-150(4)]***	The value of the member's interests have not increased, or have done so only to the extent the member provided consideration for them.
A benefit provided to a member if the benefit is also a distribution to the member's associate. ***[Subsection 960-150(6)]***	To also treat the benefit to the member as a distribution would count it twice. Therefore the distribution to the member is ignored. This rule acts as a 'tie breaker'.

What is the amount of a distribution?

15.16 It is either:

- the amount of the benefit less any consideration provided for it (if the benefit is money) ***[paragraph 960-165(1)(a)]***; or
- the fair market value of the benefit less any consideration provided for it (if it is in any other form) ***[paragraph 960-165(1)(b)]***.

15.17 As an exception, to reduce compliance costs and provide certainty, where a distribution by a widely-held entity arises from providing additional membership interests to members (a rearrangement) and a member had a choice between receiving the additional interests or another amount, the value of the distribution is that other amount ***[subsection 960-165(2)]***.

15.18 For working out the amount of a distribution when it is in a form other than the payment of money, the ***fair market value*** of a benefit that is not money is the market value the benefit for a person intending to make the same use of it as the recipient ***[subsection 960-165(1)]***.

15.19 Consideration in the form of a surrender, cancellation or redemption of a taxpayer's membership interest is ignored when determining the amount of consideration given by the person ***[subsection 960-165(3)]***. As noted before, such consideration is also ignored in determining whether the member has paid market value for the benefit ***[subsection 960-150(3)]***.

Example 15.2 Consideration provided in an off-market buy back

> In an off-market buy back Sandy, an entity member, provides consideration in the form of cancellation of his membership interest. The entity provides him with a bank cheque for the agreed value of the extinguished interest.
>
> Consideration in the form of cancellation of Sandy's membership interest is ignored when determining if there is a distribution, and in determining the amount of the distribution.

Indirect distributions

15.20 Indirect shifts in value may also be distributions – either because of the wide nature of the general rule or because of specific rules. They are treated as distributions because they are the economic equivalent of a shift in value from entity to member.

15.21 Shifts in value can occur indirectly in one of 5 ways:

- the benefit is provided to someone who is not a member, but who has a membership connection;
- the entity arranges for an associate or third party to provide the benefit on their behalf;
- the entity provides additional membership interests instead of paying a distribution (the shift in value to the member in this case is from other members rather than from the entity);
- a member of a trust agrees with the trustee that an asset to which the member is presently entitled will be held on a separate trust or lent by the member back to the trustee; or
- a member of a discretionary trust obtains a vested and indefeasible interest in a trust asset that remains unpaid.

15.22 The first two shifts in value are discussed in this Chapter and the last three in the Chapter 16.

Benefits to non-members

15.23 There will be a distribution if a benefit provided by an entity to a taxpayer, for no or inadequate consideration, has been provided because the taxpayer is:

- a former member;
- a prospective member; or
- an associate of a member, or of a former or prospective member.

15.24 Because these persons are one step removed from actual membership, there will only be a distribution if a reasonable person would conclude that the benefit is given because of the person's membership link to the entity ***[section 960-135]***. This is an objective test, not a subjective test of the provider's actual state of mind (i.e. the state of mind of the controllers or representatives of the entity).

15.25 Opportunities to shift value from an entity to a former or prospective member or associates without the transaction being subject to tax are reduced. Also, a person's membership status at the time of the distribution becomes less important to the taxation of the benefit.

Example 15.3: Benefits to a future member of an entity

Ann is about to join an entity. It gives her a benefit because she will become a member soon. There is a distribution to Ann.

Entity arranges for an associate or third party to pay the benefit

15.26 In such cases, there would not normally be a distribution because the benefit has not been paid by the entity.

15.27 There is one general exception. That is where the entity pays the benefit to the associate or third party to pass it on to the entity member. In that case, it can be said that in paying the benefit to the associate or third party, the entity has applied the distribution amount for the member's benefit ***[subsection 960-130(1) and paragraph 960-155(h)]***. Accordingly, there would be a distribution under the general rule.

Benefits provided by an associated tax entity

15.28 However, there is a specific rule which says that any benefit provided by an associate of the entity to a member of the entity is a distribution made by *the associate*, if the associate is also a tax entity ***[subsection 960-140(1)]***. This specific rule does two things.

15.29 First, it identifies a distribution where one might not otherwise exist. That is, the associate will be taken to have made the distribution even if they did not receive compensation from the entity for doing so.

15.30 Where the parties are associated, there may be no payment by the entity to the associate for or on behalf of the member. An example of this would be a wholly-owned private company group in which a parent company simply directs a subsidiary to provide benefits to individual members of the parent company without compensating the subsidiary for the cost of providing those benefits.

15.31 Therefore, the rule applies regardless of whether the entity has paid the associate to provide the benefit. The underlying assumption is that, whenever an associate of the entity provides a benefit to members of the entity, they do so because of their relationship with the entity.

15.32 Second, if the conditions of the rule are met, the distribution is said to have been made by the *associate* and not the entity. This has been done for practical and compliance reasons. Ascribing the distribution to the entity (rather than the associate) would have required reversal of the associate's net income position and amendment of the entity's return.

15.33 However, without more, it would be open to the entity to arrange for the distribution to be made by an associate that did not have available profits, thus avoiding the profits first rule. To prevent this, the associate is deemed to have made the distribution out of available profits regardless of whether profits actually exist ***[section 154-20]***.

Benefits provided by an associate (not a tax entity)

15.34 The specific rule is not appropriate if the associate is an individual. For example, an individual in partnership with a closely-held entity who gives an expensive birthday present to a member of the partner entity because they are friends would otherwise be regarded as having made a distribution under the specific rule.

15.35 Also, the consistent entity rules only apply to tax entities and to their members. It would not be appropriate for them to treat as a distribution an action by someone who fits neither category.

15.36 Accordingly, where the benefit is provided by an associate who is an individual, the distribution is taken to have been made by the entity, but only so far as the entity provides the associate with consideration to provide the benefit ***[subsection 960-140(2)]***. This proviso ensures there are no tax consequences where an individual acts on their own initiative in providing a benefit.

Benefits provided by a third party

15.37 Unrelated third parties will generally only provide benefits to non-members if they perceive an economic benefit. Where the entity pays the third party to make a distribution to its members, the payment would generally be viewed as a distribution by the entity under the general rule. That is, the payment will be taken to have been made for the member's benefit ***[subsection 960-130(1) and paragraph 960-155(1)(h)]***.

15.38 However, a specific rule has also been included to cover the situation. It takes the entity to have made a distribution if it gives consideration to a third party to provide the benefit ***[subsection 960-140(2)]***.

15.39 The specific rule puts the matter beyond doubt. Also, it may conceivably go beyond the general rule in that it applies regardless of the nature of the consideration provided by the entity. The entity may simply pay the third party for providing the benefit. Alternatively, the third party could obtain a marketing advantage by providing discounts to members of another entity. The specific rule covers both examples.

Interaction with other provisions

Fringe Benefits Tax legislation

15.40 In some cases a distribution may satisfy the definition of a non-cash benefit in the fringe benefits tax legislation. However, such distributions will be dealt with under the consistent entity rules in Divisions 150 to 156 and not under the *Fringe Benefits Assessment Act 1986* ***[note to subsection 153-5]***. The consistent entity rules will take precedence over the fringe benefits tax legislation.

Division 6AA (about the income of certain children)

15.41 Division 6AA of the ITAA 1936 was introduced to discourage income splitting by the allocation of income to children. Its effect is to tax the unearned income of minors however derived at the top marginal tax rate.

15.42 Division 6AA (or a redrafted equivalent) will continue to apply to all distributions by an entity after commencement of the consistent entity rules. It will apply regardless of whether the child's income comes from a company or a trust taxed under the entity tax system or an excluded trust. The effects of current Division 6AA will thus be maintained.

15.43 The higher rates of tax under Division 6AA do not apply to the income of most excluded trusts. That is, not because they are excluded trusts, but because Division 6AA explicitly exempts income from most of those trusts from the application of the Division's higher tax rates.

15.44 The fact that certain income of a child from a trust would be excluded from the higher rates of tax under Division 6AA does not mean that the trust shall be excluded from entity treatment. After all, the Division 6AA rates apply regardless of whether the child's income is earnt directly, or through a company, or through a trust. Excluded income may be earnt from a discretionary trust, or from other cases to which the principles underpinning the list of excluded trusts do not apply.

Chapter 16
Unpaid trust entitlements and rearrangement of membership interests

Outline of Chapter

16.1 This Chapter draws together the rules for:

- rearrangements of membership interests (where the entity does something that changes the number of membership interests held by a particular member) ***[Subdivision 153-D]***; and

- unpaid trust entitlements (where a member becomes entitled to a trust asset that continues to be held by the trustee) ***[section 960-145]***.

16.2 Their treatment turns on whether the entitlement or rearrangement is a distribution. In both cases there is no direct shift in value from a tax entity to its members, but there may be a shift in value between members akin to a distribution which will produce similar tax consequences to a distribution.

Context of Reform

16.3 Replacing the company-specific dividend concept with the more comprehensive concept of distribution has provided a solid platform for dealing with rearrangements and entitlements. However, some adjustments are needed to ensure that certain rearrangements and certain unpaid entitlements are properly dealt with.

Rearrangement of membership interests

16.4 Entities can provide additional membership interests to members as a substitute for a normal distribution. A member receiving additional interests may benefit from sharing in a greater proportion of the value of the entity, so that there is a shift in value to the member from other members. This can, in substance, be a distribution by the entity. An example is a company providing a choice to members of receiving a cash payment or a bonus share of equal value.

16.5 A consistent treatment of distributions by way of additional interests or other means is therefore required, and is achieved by the general distribution rules. However, where a tax entity provides additional interests proportionally to existing interests – for example, a general bonus share issue – there is no shift in value between members and so nothing akin to a distribution. Special rules are required to deal with these cases, and the analogous case of the proportionate cancellation of interests.

16.6 Where relevant, the rearrangement rules will apply, excluding the general value shifting rules that are being developed.

Unpaid trust entitlements

16.7 Taxing trusts like companies has meant that a beneficiary's present entitlement to a share of the income or capital of the trust is no longer the trigger for determining when they will be taxed. Trusts will now be taxed on their income (like companies and other tax entities) and beneficiaries will be taxed when an actual distribution is made (like members of other entities).

16.8 There are 2 clarifications of when there is taken to be a distribution. First, where, in relation to a fixed interest, a beneficiary becomes presently entitled to a share of the trust income, but directs the trustee to reinvest it on their behalf in a new trust or as a loan back ***[subsection 960-145(1)]***. Second, where the exercise of a discretion (or failure to exercise a discretion) results in the beneficiary obtaining a new asset – that is, a right to a payment or to an asset ***[subsection 960-145(2)]***.

16.9 In neither case has there been an actual payment, but the beneficiary has received a benefit that should be taxed. In the first case the entitlement has been applied for the beneficiary's benefit and at their direction (equivalent to a distribution and reinvestment). In the second case either an asset has been created that was not previously held by the member (the right to receive the payment or asset), or a contingent asset has become absolute.

Summary of new law

Rearrangement of membership interests

What the Subdivision does	Subdivision 153-D and related provisions set out special rules for rearrangements regarding distributions and tax values.
What is a rearrangement?	Where new or additional membership interests are provided to existing members or existing interests are cancelled.
Which rearrangements are distributions?	Those that involve the non-proportionate provision of additional membership interests to members in their capacity as members for no, or inadequate, consideration.

What is the amount of the distribution?	Generally, the difference between the fair market value of the interest and any consideration paid by the member.
When do special tax value rules apply?	When a rearrangement is a distribution or there is a proportionate rearrangement. They do not apply where market value consideration is paid or given.
Which rearrangements are not distributions?	There is no distribution if additional interests are provided to members in a way that maintains each member's proportionate interest in the entity, or adequate consideration is provided.

Unpaid trust entitlements

What the section will do	Section 960-145 explains when a distribution will arise where a member becomes entitled to a trust asset that continues to be held by the trustee.
Member holds a fixed interest in the trust	There will be a distribution of an asset to which a beneficiary becomes presently entitled if there is an express or implied agreement between the entity and the beneficiary that the asset be held by the trustee on a new trust or lent back to the trustee.
Member's interest is discretionary	There will be a distribution if a trust asset vests in a taxpayer (or a vested interest in an asset is preserved) because of the exercise or non-exercise of a discretion by the trustee.
When will there be a new trust?	A new trust will only be recognised if there is clear evidence that the parties intend to create a new trust.

Detailed explanation of new law

16.10 *Rearrangements of membership interests* are discussed in 3 parts:

- what is a rearrangement;
- rearrangements that are distributions; and
- rearrangements that are not distributions.

16.11 *Unpaid trust entitlements* are discussed in 3 parts:

- present entitlement is generally no longer relevant;
- first exception – the trustee and beneficiary agree that an asset be held by the trustee on a new trust or lent back to the trustee; and

- second exception – trust property vests in the object of a discretionary trust, who is or should be aware of it, but remains unpaid.

What is a rearrangement of membership interests?

16.12 A ***rearrangement of membership interests*** arises from a tax entity providing additional membership interests to existing members or splitting, consolidating, cancelling or redeeming existing interests. That is, a rearrangement is anything that changes the number of membership interests in a tax entity held by existing members of that entity. ***[Section 960-175]***

16.13 Only unitised interests can be rearranged, for example shares in a company or units in a unit trust ***[paragraph 960-175(a)]***. If interests are not unitised, they can be extended or diminished, but this will not produce separate interests requiring reallocation of tax values. For instance, if a beneficial interest in a fixed trust is increased (say because another interest ceases) the beneficiary whose interest has increased still has only an interest under the trust, not 'another' interest.

16.14 There is also no rearrangement if additional interests are provided to a taxpayer not currently a member (though there may still be a distribution in such a case, for instance where the taxpayer was previously a member or was likely to become one).

Rearrangements that are distributions

16.15 Only rearrangements that involve providing additional membership interests can be distributions. Consolidating or cancelling interests are rearrangements but *not* benefits, and so cannot be a distribution. Consideration provided to a member in respect of a cancellation – for example, consideration paid by a tax entity in buying back an interest in the entity – clearly is a benefit, but the treatment of such related benefits is not affected by the rearrangement rules. Such consideration is dealt with as a distribution to which the 'slice' approach applies.

Is there a distribution?

16.16 The definition of distribution does not specifically include rearrangements. They are treated the same as any other transaction between a tax entity and its members. As providing additional membership interests or splitting existing interests is a benefit (generally under paragraph 960-155(e), (f) or (i)), there will be a distribution so long as the benefit is provided to a taxpayer because they are a member of the entity (or former or likely member, or associate of such a member), subject to the exceptions discussed below. ***[Subdivision 960-C]***

First exception – member pays market value for the benefit

16.17 There is no distribution if a tax entity provides membership interests to members for which the members pay consideration equal to their market value. In that case, no value will have been shifted to the member. ***[Subsection 960-150(2)]***

Second exception – the rearrangement is proportionate

16.18 There is also no distribution if there is a proportionate rearrangement, as in these cases there has been no shift in value to any members and hence nothing akin to a distribution to any members ***[subsection 960-150(4)]***. This exclusion only applies to rearrangements. Where there is a proportionate rearrangement, adjustments (discussed in paragraphs 16.37 to 16.44) need to be made to the tax value of relevant membership interests even though there is no distribution in such cases ***[sections 153-60 and 153-65]***.

16.19 The concept of a proportionate rearrangement is dealt with in the definition of ***proportionate rearrangements of membership interests***. To deal adequately with entities with multiple classes of membership interests, a form of value shift test is employed – where as a result of a rearrangement no change would reasonably be expected (other than in respect of consideration paid or received) in the market value of each member's parcel of membership interests, there is no distribution. To meet the test, it is not necessary to determine actual before and after market values. This avoids the risk that other events, or changes in market sentiment, might produce different before and after market valuations. ***[Section 960-180]***

16.20 In applying the proportionate rearrangement test, distributions made pursuant to the same decision by the entity and made within a period of 5 business days, are taken to all be made at the same time ***[section 154-105]***.

Example 16.1 Proportionate issue of units

Corner Grocery unit trust has 2 classes of units – 60 Class A units divided evenly between Mr and Mrs Smith and 40 Class B units divided evenly between Mr and Mrs Jones.

The Class A units are entitled to 60% of the income and assets of the trust and the Class B units to 40%.

The Smiths each receive 15 additional Class A units – one for every 2 units they already own. No consideration is provided by the Smiths. The rearrangement is proportionate (both as between the 2 classes and within Class A) as the market value of each members' parcel of interests can reasonably be expected not to change.

Example 16.2 Bonus share plan that is not proportionate

> Big Aussie company runs a bonus share plan. Members who sign up to the plan agree to receive bonus shares instead of a dividend (cash distribution). Not all members have signed up. Because some members receive cash and others shares, a share issue under the plan is not proportionate. The result is that members will be taken to have received a distribution whether it is in the form of cash or bonus shares.

Amount and source of the distribution

16.21 Where the provision of additional membership interests is a distribution, the amount (with one exception) and source of the distribution is worked out using the general entity rules. The amount of the distribution will therefore be the fair market value of the additional interests less any consideration provided to the entity by the recipient of the benefit ***[subsection 960-165(1)].***

16.22 The exception, done to reduce compliance costs and provide certainty, is that where a distribution by a widely-held entity arises from a rearrangement and a member had a choice between receiving additional interests or another amount, the value of the distribution is that other amount ***[subsection 960-165(2)].***

Example 16.3 Bonus units issued at a discount

> Cash Multiply, a widely-held unit trust, offers members the opportunity of receiving a cash distribution of $5 per unit or an equivalent amount of additional units valued at their stock exchange listed price, discounted by 5%.
>
> One of the trust's members, Dolores, agrees to take an additional 5,000 units. Dolores is taken to have received a distribution of $25,000, being the amount of the cash distribution that she could have chosen to receive.

16.23 Whether the distribution is from available profits, prior taxed amounts or contributed capital is determined using the general profits first rule or its exceptions. ***[Division 154]***

Tax value of additional interests that are distributions and effect on net income

16.24 The tax values given to additional interests arising from rearrangements that are distributions, and adjustments to the tax value of existing interests, depend on whether the distribution is entirely from profits (or prior taxed amounts or both) or whether there is, in part or whole, a distribution of contributed capital. In most cases a rearrangement that is a distribution will be entirely from profits.

16.25 These provisions do not cover the case where there is a rearrangement under which a member's interests are cancelled and a new parcel of interests is provided. Further consideration is being given to what rules are necessary in these cases.

16.26 In applying the provisions, the rule regarding distributions in section 960-170 does not apply. That rule treats, for example, a reference to a distribution being made from available profit, as a reference to a distribution to the extent that it is from available profit (even if the distribution is also in part from contributed capital). While generally allowing for clearer drafting, it does not apply here as it is necessary to distinguish the different parts from which a distribution by way of a rearrangement is made. ***[Subsections 153-50(2) and 153-55(7)]***

Where the distribution is entirely from profits and prior taxed amounts

16.27 Where the additional interest is a distribution entirely from available profits or prior taxed amounts, the tax value assigned to the additional interest is the same as if the entity made a cash distribution to the member who then used that cash (and any additional consideration the member supplied) to purchase the interest. ***[Section 153-50]***

Where the distribution is in whole or part from contributed capital

16.28 Where the additional interest distribution is entirely from contributed capital, or in part from contributed capital with the balance from available profits or prior taxed amounts, different tax value rules apply. As well as providing for the tax values of any additional interests, the tax values of a member's existing interests are also adjusted. ***[Section 153-55]***

16.29 Under general rules, a distribution of contributed capital reduces the tax value of the interest in respect of which it was provided by the amount of the distribution ***[Subdivision 153-B]***. An additional interest purchased using the distributed amount would have a tax value equal to that amount. The net effect on total tax values is zero. Hence, section 153-55 ignores contributed capital distributions in determining tax values (as the net effect of them is zero), and the general rule that a contributed capital distribution reduces tax values is turned off for distributions by way of rearrangements ***[paragraph 153-15(1)(b)]***.

16.30 To reflect the shift in value between a member's existing interests and the additional interests, a part of the total tax values of a member's existing interests is allocated to the additional or new interests ***[subsection 153-55(1)]***. Not all of a member's existing interests need be adjusted – only those to which the distribution relates ***[subsection 153-55(2)]***.

16.31 The allocation is based on the extent of the value shift from the existing interests to the additional interests (measured in proportion to the respective market values) ***[subsection 153-55(5)]***.

- The amount allocated to the existing interests of a member is apportioned among them on the basis of their previous tax values. This preserves the relative differences in tax values for these interests. ***[Subsection 153-55(3)]***

- The amount allocated to the additional interests of a member is apportioned among them on the basis of market value. Where the additional interests are all of the same class, this is effectively a simple pro rata rule. ***[Subsection 153-55(4)]***

16.32 Any consideration paid by the member for the new or additional interests, or the extent to which the additional interest is also in part a profit distribution, is part of the tax value of the additional interests. ***[subsections 153-55(4) and (6)]***

Table 16.1 Tax value of membership interests where there is a distribution by way of a rearrangement

Source of the distribution	Tax value of membership interests
The distribution is entirely from available profits or prior taxed amounts (or both). ***[Section 153-50]***	The tax value of an additional interest is: • the amount of the distribution that relates to that interest; plus • any consideration paid by the member for that interest.
Any part of the distribution is from contributed capital (part of the distribution may be from available profits or prior taxed amounts). ***[Section 153-55]***	The tax value of an additional (new) interest is: • the amount of the distribution that is from available profits or prior taxed amounts attributed to that interest; plus • any amount paid by the member attributed to that interest; plus • part of the tax value of the member's existing interests. The tax value of a member's existing interests are reduced in proportion to the amount allocated to the additional interests.

16.33 The consequence of the tax value rules for the member is that where a distribution is made to a member by way of a rearrangement, the member's net income will increase by the amount of the distribution that is from available profits. Any part of the distribution that is from a prior taxed amount receives the same treatment under the tax value rules as a profit distribution, but there will be no change in the member's net income because of the decreasing adjustment that applies generally ***[section 153-35]***.

Pre-CGT interests

16.34 The above rules do not apply to rearrangements in respect of membership interests acquired prior to 20 September 1985. Rules for pre-CGT interests are still to be developed. Consistent with the current law, additional interests provided in respect of pre-CGT interests will in certain circumstances also have pre-CGT status.

Contributed capital

16.35 A distribution by way of a rearrangement will, to the extent the distribution is from contributed capital, reduce the contributed capital of the entity under the general entity rules ***[section 153-15]***. On the other hand, consideration provided by a member for the additional membership interests will increase the entity's contributed capital under the general entity rules by the same amount ***[subsection 154-40(1)]***. Contributed capital will also be taken to increase by the amount of the distribution made by way of the rearrangement ***[subsection 154-40(3)]***.

16.36 The net effect on a tax entity's contributed capital of a rearrangement that is a distribution will be an increase equal to consideration paid by members for the additional interests plus any part of the distribution that is from available profits or prior taxed amounts. Distributions from contributed capital have no net effect (being taken to both reduce and then increase contributed capital).

Example 16.4 Example showing how the above rules apply to entity and member

Alpha Co. is a company with 2 shareholders, Brian and Carmen, who each hold 50 shares with a tax value of $2 each.

In an income year following commencement Alpha Co. issues Brian with 15 new shares that have a market value of $5 each or $75 in total. Brian gives no consideration for the shares.

The issue of the new shares is a distribution to Brian because the new shares are a benefit provided to Brian for less than market value in Brian's capacity as a member.

The amount of the distribution is $75. As a result of applying the profits first rule, $50 of the distribution is from available profits and $25 from contributed capital.

Brian's taxable income is worked out as follows

The tax value rules apply to work out the closing tax value of the additional and existing shares. The tax value of Brian's existing shares is spread over the existing and additional shares, for no net change, while the profit component of the distribution adds to the tax value of the additional shares, for a net increase of $50.

The result is that Brian's net income is increased by the amount of the profit distribution, as reflected in the increase in the overall tax value of Brian's assets, i.e. $50.

Alpha Co.'s contributed capital is worked out as follows

Alpha Co.'s contributed capital account has a net increase of $50. The contributed capital distribution reduces contributed capital by $25, while the amount of the distribution made by way of the rearrangement increases contributed capital by $75.

Rearrangements that are not distributions

16.37 There are 2 types of rearrangement that are *not* distributions but for which special tax value rules are provided:

- the proportionate provision of additional membership interests (specifically excluded from the definition of distribution) for less than market value ***[section 153-60]***; and
- the proportionate cancellation or redemption of membership interests (which is not a benefit and so cannot be a distribution) for less than market value ***[section 153-65]***.

16.38 There is no need for tax value adjustments where market value has been given or paid. As on-market buy backs will always be for market value, the tax value adjustments described below will not apply to them.

Proportionate provision of additional interests for less than fair value

16.39 The provision of additional membership interests that is a proportionate rearrangement is, as discussed above, the second exception to the general rule that the provision of additional membership interests is a distribution. ***[Subsection 960-150(4)]***

16.40 Where the proportionate rearrangement test is met, and it involves the provision of additional membership interests for less than market value, then section 153-60 applies. As a consequence, the tax values of the existing and additional interests are determined as if there had been a distribution of contributed capital. That is, in accordance with section 153-55. This shifts tax value from the existing interests of a member to the member's additional interests in line with the shift in market value between the 2 sets of interests.

16.41 For a proportionate rearrangement, the net effect on net income is zero. That is, there is no increase in the tax value of a member's assets, except to the extent of any consideration paid by the member to acquire the additional interests. As the consideration provided will be a payment by the member, any increase in total tax values is exactly offset for net income purposes.

Proportionate cancellation of interests for less than fair value

16.42 The consolidation, cancellation or redemption of interests satisfies the definition of rearrangement but can never itself be a distribution as there is no benefit provided by the entity to a taxpayer ***[section 960-130]***. Nor is there a benefit to members whose interests are not cancelled if the cancellation is non-proportionate, even if value shifts from the cancelled interests to those remaining.

Example 16.5 Proportionate cancellation

Bris company has issued 180 shares as follows:

- Bill – 30 shares;
- Lola – 60 shares;
- Norman – 90 shares.

Bris Co. decides to consolidate its issued shares by cancelling one share for every 3 held. No consideration is paid by Bris Co. The cancellations are proportionate so no change in the market value of the parcels of shares held by Bill, Lola or Norman would reasonably be expected. The following tax value rules therefore apply.

16.43 Where a cancellation of interests is a proportionate rearrangement for less than market value, and no additional interests are issued in connection with the cancellation, then the tax values of a member's remaining interests may be adjusted upwards ***[subsection 153-65(1)]***. The purpose of the adjustment is to prevent a realisation loss arising for a member simply due to the failure of the entity to pay full consideration. Given that purpose, no adjustment is necessary if the effect would be to reduce the tax value of the remaining interests (which would otherwise reduce a taxpayer's net income) ***[subsection 153-65(2)].***

16.44 Rules relating to cancellations that are not proportionate rearrangements, and that are not for market value, have not yet been finalised. As noted at paragraph 16.25, further consideration is also being given to entity reorganisations where a cancellation of interests is combined with the provision of new interests.

Rearrangements summary table

16.45 The following table summarises the treatment of rearrangements.

Table 16.2 Treatment of a rearrangement of membership interests

Type of rearrangement	*Treated as*
Non-proportionate provision of additional interests to a member for less than market value.	• a distribution; and • special tax value rules apply to

	additional interests and possibly to existing interests.
Proportionate provision of additional interests to members for less than market value.	• not a distribution; and • special tax value rules apply to additional and existing interests.
Non-proportionate cancellation of interests for less than market value.	• not a distribution; and • to be dealt with at a later stage.
Proportionate cancellation of interests for less than market value.	• not a distribution; and • special tax value rules apply to existing interests.
Provision of additional interests or cancellation of interests for market value.	• not a distribution; and • no special tax value rules apply.

Present entitlement not relevant

16.46 Moving to tax trusts like companies means that a beneficiary's present entitlement to a share of the income or capital of the trust is generally no longer relevant to determining either the tax liability of the beneficiary or the trust. Specific rules provide for limited cases in which an unpaid trust entitlement is recognised as a distribution. Present entitlement may still be relevant to trusts that are excluded from the consistent entity rules.

16.47 It is common for beneficiaries to become presently entitled to an amount of trust income which they do not actually receive. The unpaid entitlement may be treated in the trust's books as a loan from the beneficiary to the trust. Generally, in law, this does not give rise to a debtor/creditor relationship but rather to a trust under which the trustee holds the unpaid amount solely for the benefit of the beneficiary. However, in practice, unpaid beneficiaries may have little knowledge of their present entitlement, and the unpaid amount is often treated as another aspect of the ongoing trust.

Interaction with the general distribution rule

16.48 Specific rules extend the general rule which relies simply on a tax entity providing a benefit to a member because they are a member. More specific rules cover unpaid trust entitlements because present entitlement by itself is not a distribution. This is because the coming into existence of a right to receive a distribution is itself not a distribution ***[subsection 960-150(7)]***. There will only be a distribution if the additional conditions in these rules are met.

Trust distribution – agreement between trustee and member

16.49 There will be a distribution if the trustee of a fixed trust and a member agree (expressly or impliedly) that an asset to which the member is presently entitled be held by the trustee on a separate trust or lent by the member back to the trustee ***[subsection 960-145(1)]***. The member is taken to have received a distribution that is reinvested in accordance with their agreement with the trustee.

Consequences of treating amount as a distribution

16.50 Where the agreement is for the trustee to hold the amount on a separate trust, the asset is transferred from the original to the new trust. The reduction in value of the assets of the original trust is offset by the general increasing adjustment for distributions.

16.51 The amount of the distribution and whether it is sourced from profits or contributed capital are worked out using the general entity rules ***[section 960-165].***

The new situation

16.52 The entitlement ceases and is replaced by a new investment. The member's rights are now governed by the terms of that new investment.

16.53 If the asset is held on a new trust, the beneficiary will have a membership interest in the new trust and, as a result, will be a member of the new trust. ***[Sections 960-115 and 960-120]***

16.54 If the asset is lent back, its treatment depends on whether the loan is on commercial terms. A commercial loan receives no special treatment – it will be an asset of the member and a liability of the entity. A non-commercial loan made by a beneficiary to a closely-held entity is an asset to the member and a liability to the entity. In both cases the tax value is nil. The loan amount is a contribution of capital to the existing entity (there is no new entity in the loan case) ***[section 6-145, item 3]***.

Contributed capital

16.55 An amount held on a new trust forms part of the contributed capital of the new trust ***[subsection 154-40(1)]***. A loan amount is only added to contributed capital if the loan by the member is to a closely-held entity and non-commercial ***[subsection 154-40(6)]***.

Subsequent distributions by the entity

16.56 These are subject to the general entity rules and will be treated in accordance with the terms of the new investment.

Trust distribution – vesting of an interest in a discretionary trust

16.57 There will be a distribution if, because of the exercise or non-exercise of a discretion by a trustee, an interest in a trust asset vests (or an already vested interest is preserved) and the object of the discretion – the member – knows, or ought reasonably to have known, of the vesting or the preservation. ***[Subsection 960-145(2)]***

16.58 There is a distribution because the object of the discretion has either:

- received a new asset (that is, a right to receive a payment or asset) which is not reflected in the rights held immediately prior to the exercise; or
- an existing contingent right to receive a payment or asset has become absolute.

16.59 The entity has a liability to make the payment or transfer an asset (though the liability is not part of the calculation of taxable income). Value has shifted from entity to the member.

Examples of vesting and preservation of vesting

16.60 The legislation ensures a distribution in 3 situations. First, as a result of a trustee exercising a discretion, an interest in a trust asset vests in a taxpayer so they are absolutely entitled to the asset. There is a distribution from the trust to the taxpayer. ***[Subparagraph 960-145(2)(b)(i)]***

16.61 Second, as a result of a trustee *not* exercising a discretion, an interest in a trust asset vests in a taxpayer. This covers the situation where default beneficiaries obtain an interest in the income or capital of the trust if the trustee does not exercise a discretion in favour of one of the other beneficiaries. Once the period for exercising the discretion has elapsed, what was previously only a contingent interest in the trust property (contingent on the non-exercise of the discretion) becomes a right to payment. At that point there is a distribution from the trust to the default beneficiaries. ***[Subparagraph 960-145(2)(b)(i)]***

16.62 Third, as a result of a trustee *not* exercising a discretion, a taxpayer's vested interest in a trust asset is preserved. This covers the situation where default beneficiaries have a right to income or capital unless a discretion is exercised. The right is a vested interest, but it is capable of being divested if the discretion is exercised. Once the period for exercising the discretion has elapsed, the right becomes both vested and indefeasible. At that point there is a distribution. ***[Subparagraph 960-145(2)(b)(ii)]***

Knowledge

16.63 There will only be a distribution if the beneficiary knows, or ought reasonably to have known, of their entitlement ***[paragraph 960-145(2)(c)]***. This requirement avoids the problems in the current law of imposing tax liabilities on beneficiaries who both are unaware of their entitlement and may be unable to pay the tax.

Asset and liability

16.64 The beneficiary's right to receive a payment or asset is itself an asset. The trust's obligation to make the payment or transfer the asset is a liability. Both have a nil tax value. ***[Section 6-145, item 1]***.

Increasing adjustment does not apply

16.65 The increasing adjustment for distributions does not apply. The asset that has vested (or in relation to which a vested interest has been preserved) remains in the trust so there has been no payment by the entity and no reduction in the tax value of its assets.

Distribution

16.66 The amount of the distribution and whether it is sourced from profits or contributed capital are worked out using the general entity rules ***[section 960-165].***

Prior taxed amount

16.67 The vested asset becomes a prior taxed amount of the trust ***[subsection 153-40(4)]***.

No new trust

16.68 Any new trust that arises by operation of law over the vested asset that remains unpaid is disregarded for the purposes of the new law. The vested asset remains part of the original trust ***[subsection 960-105(2)].***

Chapter 17
Source of distributions

Outline of Chapter

17.1 Division 154 explains how to determine the source of a distribution from a tax entity – that is, how much of the distribution is from profits, how much is from contributed capital and how much is from prior taxed amounts. Its source determines how it is taxed in the hands of the recipient.

Context of Reform

17.2 The consistent entity rules allow deferral of member level taxation on profits retained in a tax entity. The profits first rule stops this deferral continuing after distribution by treating distributions as out of profit (and so as a gain to the member) where the entity has profits available and while the member's relative interest in the entity is retained.

17.3 Deferral is not a concern for a distribution made in connection with the cancellation of a member's interest. A member who gives up their interest is not postponing member level taxation of gains, as no further gains from the interest are expected. Apportioning, under the 'slice' approach, a distribution into components of entity contributed capital and profit allows the real economic gain to the member to be taxed appropriately.

Summary of new law

What the Division will do	Division 154 explains how to determine the source of a distribution from a tax entity.
What are the possible sources of a distribution?	Distributions can be either from profits, contributed capital or (relevant only to trusts) prior taxed amounts.
What is the general source rule?	A distribution is from profit to the extent the entity has available profits (including unrealised gains) and the balance is contributed capital.
What exceptions are there to the 'profits first' rule?	Primarily distributions connected with the cancellation of a membership interest, and also in certain cases for trusts (including prior taxed amounts).

Detailed explanation of new law

17.4 The tax treatment of a distribution at member level depends on whether it is sourced from a tax entity's profits, contributed capital or prior taxed amounts (see Chapter 14). Its source will also determine whether imputation rules apply. The primary rule for determining source is the profits first rule.

Profits first rule

What is the 'profits first' rule?

17.5 A distribution will be taken to be from profits to the extent that a tax entity has available profits immediately before the distribution is made ***[paragraph 154-1(a)]***. In general, while members hold their membership interest they share the ongoing gains from the entity. So distributions are taken to come from gains while the entity has gains.

17.6 Where the distribution exceeds the amount of available profits, the excess is taken to be from the entity's contributed capital ***[paragraph 154-1(b)]***. Because prior taxed amounts are an exception to the 'profits first' rule, they will be available for distribution or retention and are not included in available profits. However, if a distribution exceeds both available profits and contributed capital, it must be from prior taxed amounts ***[paragraph 154-10(2)(b)]***.

What are available profits?

17.7 Basically, available profits are the *net market value of the entity's assets*. Two other adjustments are made that have limited application. The formula works as follows:

- calculate the net market value of the entity's assets;
- add the non-asset component of distribution; and
- subtract any prior taxed amounts.

[Subsection 154-35(1)]

What is the 'net market value of the entity's assets'?

17.8 The market value of the entity's assets less the amount of its liabilities ***[subsection 154-35(1)]***. Available profits therefore capture all accumulated profits, whether realised or unrealised, and whether taxable at the entity level or not.

17.9 As contributed capital is taken to be a liability of the entity, the net market value of an entity's assets is reduced by the amount of the entity's contributed capital. Contributed capital is explained in more detail in Chapter 18. It is basically whatever has been contributed to the entity for or to add value to a membership interest in the entity. It includes capital subscribed to establish a company and further raisings, and amounts settled to establish a trust and subsequent settlements. Certain other amounts (mainly as part of transitional arrangements for trusts existing at commencement of the consistent entity rules) are also credited to an entity's contributed capital account.

17.10 Where a tax entity's contributed capital would otherwise be less than nil (which may occur, for instance, for some trusts as a result of the transitional measures) it is taken to be nil in applying profits first (and slice) rules. ***[Section 154-75]***

17.11 Any asset or liability of the entity that is treated as having a nil tax value for calculating the net income of the entity under section 6-145 is disregarded in calculating the net market of assets ***[subsection 154-35(3)]***. Including them in the formula would produce a distorted view of available profits (for instance, a decision to pay a dividend might otherwise be a liability and hence 'reduce' available profits).

What is the 'non-asset component of the distribution'?

17.12 The part of a distribution that is a benefit other than a payment of money, or the transfer of a non-cash asset, or the reduction of a liability owed to the entity by the recipient ***[subsection 154-35(1)]***. This adjustment is not relevant to cash distributions, and hence will have limited application.

17.13 Where a distribution arises from the provision of services, or making an asset available for use, for less than market value then the distribution will have a non-asset component. The non-asset component is added to available profits to reflect the fact that the distribution is not being made from the assets the entity has immediately prior to the distribution. The value being provided by the distribution would otherwise not have been included in the available profits of the entity, even though it is there and is being made available by the distribution.

Example 17.1 Adjusting available profits for non-asset distributions

> Commercial property worth $10,000 is settled on a trust that is a tax entity. The net market value of the trust's assets and liabilities (including contributed capital) is zero ($10,000 less $10,000).
>
> The property is used rent-free by a beneficiary of the trust. The use of trust property is a distribution of an amount equal to fair market value rental. Without the non-asset distribution adjustment, there would be no available profit, and the distribution would be taken to be from contributed capital even though contributed capital remains intact.
>
> This is the same result as if the trust has charged fair market value rent and then made an equal distribution to the member. The rental receipts

of the entity would have ensured that available profits equalled the distribution amount.

What are the entity's 'prior taxed amounts'?

17.14 Prior taxed amounts (explained in more detail in Chapter 14) are amounts retained in a trust that have borne tax before the entity became subject to the entity tax regime or unpaid entitlements that have been taxed under subsection 960-145(2) of the consistent entity rules ***[subsection 154-35(1) and section 153-40]***. Without a deduction of prior taxed amounts, a trust's available profits would be overstated, and prior taxed amounts would not be excepted from the profits first rule.

Reliance on accounting records

17.15 Tax entities may rely on their accounting records and statements to determine that a distribution is wholly from available profits. This would mean that valuation of the entities' assets and liabilities is not required before making a distribution. The provision is intended to reduce the compliance cost of entities. For most ongoing entities, it will usually be the case that the use of accounting records would see a distribution as coming entirely from profits. ***[Subsection 154-35(2)]***

17.16 The use of this alternative is subject to 2 conditions. First, the accounting records must indicate that the distribution can be made *wholly* from the entity's profits ***[paragraph 154-35(2)(a)]***. If the accounting records do not indicate the entire distribution can be from profits, the formula approach must be used. This will nearly always be the case where 'slice' applies to a distribution, because it will be rare for accounting records to show that there is no contributed capital referable to the interest being cancelled for consideration.

17.17 Second, the records must be prepared and kept in accordance with generally accepted accounting principles ***[paragraph 154-35(2)(b)]***. In considering the accounts, adjustments can be made as necessary for differences between contributed capital for tax purposes (the tax value) and capital for accounting purposes.

17.18 Where a tax entity's accounting records show that a distribution is made *wholly* from the entity's profits, it is open to the entity to use the formula approach to prove otherwise. However, even if strict use of the formula would show that part of the distribution is not from profits, an entity can still rely on its records (subject to general anti-avoidance provisions). In other words, only the entity can look past the accounting records if the records indicate a distribution to be wholly from profits. ***[Subsection 154-35(2)]***

Dealing with multiple distributions

17.19 Where the total distributions made to more than one member at the same time exceeds the entity's available profits at that time, each member's distribution will contain a proportionate amount of available profits ***[section 154-5]***. At the 'same time' may, as discussed at paragraphs 17.21 to 17.25, include all payments within a 5 day period.

Example 17.2 Multiple distributions

> Distributions (subject to the profits first rule) of $10 each are made to 2 members of a company at the same time.
>
> Available profits of the entity immediately before the distributions are $16. Each member would be taken to receive $8 of profits and $2 of contributed capital.

17.20 This provision provides for equal treatment between members, and has a limited role in preventing profits being streamed to some members and contributed capital to others.

Distributions made at the same time

17.21 To avoid the compliance costs that could arise from having to determine available profits many times when a large number of distributions are made within a short period of time, a grouping rule applies. Distributions made within the same 5 business day period and under the same decision of the entity are taken, for certain purposes, to be made at the time the first of those distributions is made. ***[Subsection 154-105(1)]***

17.22 Distributions, made pursuant to a single decision of the entity, that are spread over a period of greater than 5 business days will need to be grouped into periods of 5 business days, with distributions in each period taken to be made at the time of the first distribution in that period. No day can form part of more than one such period; that is, such periods cannot overlap. ***[Section 154-105(3)]***

17.23 Available profits must be re-calculated for each period, immediately prior to the first distribution of that period ***[paragraph 154-105(1)(c)]***. Distributions made in each period will be 'multiple distributions', ensuring that for each period, each distribution will contain a proportionate component of available profits ***[paragraph 154-105(1)(d)]***.

17.24 The question of whether a rearrangement of membership interests is proportionate must be answered as if all distributions in a period were made when the first of them was made. So the expected effect of a rearrangement on the market value of each member's parcel of membership interests must be ascertained under section 960-180 on that basis. ***[Paragraph 154-105(1)(e)]***

17.25 Where several 'same period' distributions each contain contributed capital, the entity's contributed capital account is reduced at the time of the first to reflect the total reduction ***[subsection 154-105(2)]***. This is consistent with the calculation of available profits, which draws on the balance of the entity's contributed capital account at the time of the first distribution.

Example 17.3 Distributions made over a period of time

Several distributions are made between 1 June and 5 June under the same entity decision. The distributions are treated as a single distribution and available profits are calculated immediately prior to the distribution on 1 June. If available profits are insufficient, each of the distributions will have the same proportionate amount of profits.

On 9 June, a further distribution is made pursuant to the same entity decision as before. The entity cannot treat the 9 June distribution as falling in the same 5 day period as the 5 June distribution. A new calculation of available profits must be done for the distribution.

The slice rule

What is the 'slice' rule?

17.26 For distributions related to the cancellation or termination (whether formal or informal) of an interest in a tax entity, their source is taken to be the contributed capital, taxed profits and untaxed profits attributable to the cancelled interest. The slice rule is expressed as an exception to the 'profits first' rule to ensure there is no gap in practice between the 2 rules. ***[Section 154-15]***

17.27 The slice rule provides a means for tax entities to return contributed capital along with profits in a manner which is fair as between members, while placing a limit on dividend substitution and capital streaming opportunities.

When does the 'slice' rule apply?

17.28 The 'slice' rule will apply when the distribution is made as part of a process that results directly in a membership interest ceasing to exist. A membership interest may cease to exist by being cancelled or redeemed, by an obligation being satisfied, by the entity ceasing to exist, or otherwise ***[subparagraph 154-15(1)(a)(i)]*** . The membership interest which ceases to exist is then the interest in relation to the distribution ***[paragraph 154-15(2)(a)]***.

17.29 Examples of where membership interests may cease to exist are an off-market share buy back; a share cancellation as part of a capital reduction; cancellation of a unit in a unit trust; an in kind distribution of an asset to a partner leaving a limited partnership where the partner has a right to the asset; or the vesting of the assets of a discretionary trust.

17.30 The 'slice' rule also applies to a distribution if it is made as part of a process that results directly in a taxpayer's proportionate interest in the income or capital of a trust or limited partnership being reduced

[subparagraph 154-15(1)(a)(ii)]. For example, where a beneficiary has a fixed interest in 10% of the income and capital of a non-unit trust, and that interest is reduced to 5% in return for a distribution. In such cases the relevant share of the membership interest is treated as a separate, cancelled interest ***[paragraph 154-15(2)(b)]***.

17.31 The 'slice' rule does not apply to a distribution made by way of a rearrangement of membership interests ***[paragraph 154-15(1)(b)]***. This would be the case where a member's existing interests are cancelled and new interests (a distribution) are provided in return. Rules for such entity reorganisations are to be considered.

17.32 Distributions by a liquidator may be made as part of an entity termination process. As such, they are considered only under subsection 154-15(4), rather than subsection 154-15(1). ***[Subsection 154-15(3)]***

Distribution as part of an entity termination process

17.33 The 'slice' rule will apply to a final distribution to a member in respect of a particular membership interest made as part of the process of winding up, dissolution or termination of a tax entity ***[paragraph 154-15(4)(a)]***.

17.34 A distribution by a liquidator does not directly cause the cancellation of membership interests. That occurs when the company is subsequently dissolved. However, for practical purposes a final distribution for a membership interest does extinguish the member's entitlement to any further distribution in respect of that interest.

17.35 A non-final (interim) liquidator's distribution does not extinguish a member's entitlement to further distributions in respect of the interest, and is not as such part of extinguishing either the interest or its value. As such, 'profits first' is still applicable and appropriate to such interim distributions.

Example 17.4 Liquidation distributions, 'profits first' and 'slice'

A company in liquidation has ordinary and preference shareholders (that are not debt interests). The company's articles provide different entitlements to distribution of surplus assets between the 2 classes in the event of liquidation.

The liquidator, having paid all creditors in full, but not having realised all company assets, pays a distribution of $1 per share to holders of both classes. The liquidator advises holders of the preference shares only that there will be no further distribution in respect of the preference shares.

- The distribution in respect of the ordinary shares will be subject to 'profits first'.

- The distribution in respect of the preference shares will be subject to slice.

The liquidator, having now realised all company assets, distributes $1.50 per ordinary share, being the extent of the administrator's capacity to pay dividends. The liquidator advises it is the final dividend of the administration. 'Slice' will apply to this distribution.

17.36 The slice rule will also apply to a distribution made as part of a process that results directly in the value of a tax entity's assets being reduced to nil or a negligible amount ***[paragraph 154-15(4)(b)]***. In such a case, the entity and the membership interest may continue indefinitely, but as a shell empty of value. Again, in this case, membership interests have effectively terminated and are treated as such by applying the slice rule. An interim liquidation distribution would not directly result in an entity's assets being reduced to nil.

17.37 Special rules apply to non-fixed membership interests in trusts to limit the circumstances in which the slice rule applies. The mere exercise of a discretion by the trustee in a member's favour is not sufficient to cause a non-fixed membership interest in a trust to cease to exist ***[paragraph 154-15(5)(c)]***. This is because such an exercise does not of itself limit the trustee's capacity to exercise a discretion in that member's favour again.

- A distribution that was final in relation to a class of non-fixed interests, or reduced the assets of a non-fixed trust to a negligible amount, would still be subject to the slice rule.
- Non-fixed entitlements to a particular trust asset or trust assets generally would also be taken to cease to exist if the trust ends or the class of interests to which it belongs ends, so distributions in bringing this about would be subject to the slice rule.

[Paragraph 154-15(5)(d)]

Series of distributions under a single decision

17.38 To reduce the number of times where the components of the 'slice' of a tax entity need to be calculated, where a series of distributions is made in relation to membership interests of a particular class and each one in the series is subject to the slice rule, the components of each subsequent distribution will be the same as those of the first distribution ***[subsection 154-90(3)***, until one of the following events occurs:

- the franking account balance changes for a reason unrelated to earlier distributions in the series (for example, the receipt of a franked dividend) ***[paragraph 154-90(3)(d)]***; or

- the relevant contributed capital sub-account balance changes for a reason unrelated to earlier distributions in the series (for example, the payment of an amount due on a share) ***[paragraph 154-90(3)(e)]***; or
- there is a change in the amount of the distributions to be made in the series (keeping distributions to a uniform amount in respect of each interest cancelled maintains the consistency required to be part of the series) ***[paragraph 154-90(3)(f)]***.

17.39 In calculating the taxed profit component of a slice of a tax entity, in those cases where the market value of the entity or its assets enter into the calculations, this provision will remove the formal need to recalculate the taxed and untaxed profit components as market values change.

17.40 On-market buy backs will usually not benefit from this provision as the amount paid as consideration for buying back each interest will vary and so not be uniform.

Calculating the 'slice' components

17.41 The 'slice' rule apportions a distribution into components of contributed capital and profit relevant to the membership interest that ceases to exist or otherwise terminates ***[subsection 154-90(1)]***. Where a relevant distribution contains a prior taxed amount, the slice rule applies to the amount of the distribution less the prior taxed amount. (In effect, the payment of a prior taxed amount can be seen as a separate distribution to the one to which the 'slice' rule applies.)

17.42 The slice components are determined in a series of steps. The membership interest's share of contributed capital is worked out first. If equal to or greater than the distribution, the whole distribution is contributed capital. If less than the distribution, the remainder of the distribution is from profit. The taxed profit component is then worked out, and the excess remaining above the slice of taxed profit, if any, is untaxed profit. ***[subsection 154-90(2)]***

What is the interest's share of contributed capital?

17.43 The calculation depends on how many classes of membership interest the entity has and on the particular interest's share relative to other interests in the same class. ***[Section 154-95]***

17.44 The *first step* is to establish the amount of contributed capital attributable to the class to which the interest belongs. ***[Subsection 154-95(1)]***

- Where the entity has just one class of membership interests, the contributed capital attributable to the class is the balance of the entity's contributed capital account. ***[Subsections 154-80(1) and 154-95(1)]***

- Where the entity has more than one class of interests, the contributed capital attributable to a particular class will be the balance of the contributed capital sub-account for that class ***[subsection 154-95(1)]***. Contributed capital sub-accounts are discussed in more detail in Chapter 18.

- Where the balance of the account would otherwise be less than nil, it is taken to be nil. ***[Paragraph 154-75(b)]***

17.45 The *second step* is to establish the interest's share of the contributed capital account or sub-account relative to other interests within its class ***[subsection 154-95(2)]***. The calculation of the share depends on whether the interests in the class are:

- unitised (for example, a share in a company or a unit in a unit trust)
  - in this case, each single interest shares equally, based on the number of such interests in the class; or
- fixed but not unitised (for example, an interest in a non-unit fixed trust or limited partnership)
  - in this case, each separate interest shares in proportion to its share of all the interests in the class; or
- an interest in a discretionary trust
  - in this case, each separate interest shares in proportion to its share of the distribution to the whole class of interests being cancelled.

[Subsection 154-95(3)]

17.46 The proportional share is called the *contributed capital factor for membership interest*. In the case of a unitised, or fixed interest, the proportion is simply established (as set out above). However, with non-fixed interests, the only objective method of establishing the factor is by comparing the distribution to a particular interest with distributions to other interests in the class (noting that the 'slice' rule can only apply to non-fixed interests when an entire class terminates). ***[Subsection 154-95(2)]***

17.47 Applying the contributed capital factor (proportional share) to the balance of the relevant contributed capital sub-account determines the interest's absolute share of contributed capital.

Example 17.5 Calculation of contributed capital component

Item	***Circumstances of the membership interest***	***Balance of contributed capital sub-account***	***Contributed capital factor of membership interest***	***Interest's share of contributed capital***
1	A member has one share of 100 ordinary shares in the class.	$200	1/100	$2
2	A member has rights to 20% of the income and capital of a trust.	$200	1/5	$40
3	Termination of a discretionary trust – distribution for interest $125; total distribution $1,000.	$400	1/8	$50

Working out the taxed profit component of a distribution

17.48 The *taxed profit component* of a distribution is treated as a fully franked profit distribution, representing the interest's share of the entity's retained taxed profits. The calculation of the taxed profit component differs from that of contributed capital as taxed profits are not differentially allocated between classes. In effect, franking credits are treated as being equally available for all of an entity's profits regardless of class.

17.49 The entity's franking account balance is a convenient and objective measure of its retained taxed profits. The draft legislation assumes that the franking account will be maintained on a tax-paid basis. Consequently, the balance of the franking account is grossed up to determine total retained taxed profits ***[subsection 154-100(3)]***. The gross-up formula for on-market buy backs differs as the buy-back amount is not franked, and so taxed profits are estimated gross of entity tax ***[subsection 154-100(4)]***.

17.50 The interest's share of the grossed-up franking account balance, as with its share of contributed capital, is determined by the interest's character and its share of all interests in its class. This share, as a proportion, is called the *taxed profit factor for the membership interest*. ***[Subsection 154-100(1)]***

17.51 As with contributed capital, where interests are unitised or fixed, an interest's position relative to other interests in its class is generally clear. However, because an entity's taxed profit is not attributed to particular classes of interests, applying a simple proportionate approach for these types of interests can only be done where the entity has just one class of membership interests. ***[Subsection 154-100(2), items 1 and 2]***

17.52 Where a tax entity has more than one class of membership interests, other formulas are used to establish the interest's share of overall taxed profit ***[subsection 154-100(2), items 3, 4 and 5]***. The formula in item 3 uses the market value of interests in a listed widely-held entity as a proxy for the value of the entity's assets. While the formulas for items 4 and 5 are the same, they are differentiated as item 4 will, and item 5 will not, apply in preference to items 1 to 3 where they overlap.

Example 17.6 Calculation of taxed profit factors

> An entity has 100 shares of a single class. The factor is 1/100. ***[Subsection 154-100(2), item 1]***
>
> Mark has a 10 per cent fixed interest in the income and capital of a trust. Judy has a fixed interest in the remaining 90 per cent of income and capital. As their interests are strictly proportional, they are a single class. The factor for John's entire interest is 1/10. If only half of John's interest ceased to exist, the factor would be 1/20. ***[Item 2]***
>
> The market value of a membership interest in a widely-held and listed company is $10, its share of contributed capital $6, the market value of all membership interests in the entity is $1 million and the balance of the entity's contributed capital account $680,000. The factor is [$10 – $6] divided by [$1,000,000 – $680,000] or 1/80,000 ***[item 3]***. Thus, item 3 distributes taxed profits in proportion to the interest's share of market value net of contributed capital.
>
> Using the figures from item 3 of the 'calculation of contributed capital component' table in Example 17.5 – the factor would be [$125 – $50] divided by [$1,000 – $400] or 1/8 ***[item 4]***. Thus, item 4 distributes taxed profits according to the interest's share of available profits.
>
> A class of non-fixed interests in a trust terminates. The factor is the distribution less the interest's share of contributed capital, divided by the available profits. Available profits, for this purpose, can only be calculated via the formula approach in the profits first rule if the contributed capital component is greater than zero (as accounting records would be unable to show that the entire distribution is wholly from profits). ***[Item 5]***

Working out the untaxed profit component of a distribution

17.53 The untaxed profit component of a distribution is the balance of the distribution: the amount, if any, that is neither contributed capital nor taxed profit. ***[Subsection 154-90(2)]***

Other exceptions to the 'profits first' rule

17.54 There are 3 exceptions to 'profits first', other than the 'slice' rule. The other exceptions relate to the circumstances of the distribution (e.g payment to a non-member) or its source (e.g. from prior taxed amounts or certain realised proceeds). CIVs, discussed in Chapter 19, are also not subject to the profits first rule.

Exception for prior taxed amounts

17.55 The profits first rule does not apply to a distribution from prior taxed amounts, reflecting the fact that they have already been fully taxed. A distribution from this source can be made regardless of whether the entity has available profits from which the distribution could otherwise be made. ***[Subsection 154-10(1)]***

17.56 To provide for certainty in interpreting the legislation, it is made clear that under the 'profits first' rule a tax entity can make a distribution of contributed capital even if it still has prior taxed amounts, and that where available profits and contributed capital are exhausted, a distribution must necessarily be from prior taxed amounts ***[paragraph 154-10(2)(b)]***.

17.57 Prior taxed amounts paid in respect of the termination of a membership interest are also not subject to the 'slice rule'. Prior taxed amounts are discussed in greater detail in Chapter 14.

Exception for certain indirect distributions

17.58 Where a benefit is paid by an associate of a tax entity, then the associate is taken to have made the distribution, provided the associate is also a tax entity ***[subsection 960-140(1)]***.

17.59 A distribution made in these circumstances is taken to be wholly from the profits of the associate, regardless of whether that entity has available profits ***[section 154-20]***. Contributed capital of a tax entity can only be returned in respect of membership interests in the entity.

Exception for certain realised proceeds of trusts

17.60 These rules are not contained in the draft legislation. They are intended to maintain the effect of current CGT treatment of gains on realisation of assets held in a trust at the announcement of the CGT changes. These amounts include capital gains realised on pre-CGT assets and the indexation component or goodwill exemption component of capital gains, or substitute capital gains exemptions.

17.61 These amounts (as discussed in Chapter 18) will be credited to the trust's contributed capital account. Without an exception from the profits first rule, they could not then be distributed until all available profits were distributed. Consistent with the commitment in *A New Tax System*, the profits first rule will not apply if these amounts are distributed in the same income year as the gains are realised. ***[Section 154-25]***

Chapter 18
Contributed capital

Outline of Chapter

18.1 Subdivision 154-C includes explanation of the amounts included in a tax entity's contributed capital and the accounts tax entities need to keep to record this.

Context of Reform

18.2 A regime for taxing entities needs to recognise amounts contributed to a tax entity for membership (contributed capital) and the return by the entity of those amounts among its members. Receipt of contributed capital by an entity is not taxable, and distributions to members of contributed capital are treated differently from profit distributions.

18.3 Identifying a tax entity's contributed capital at any point in time is central to determining whether a tax entity has available profits when making a distribution to its members (under the 'profits first' rule), or, when a distribution relates to the cancellation of a member's interest, determining the contributed capital attributable to the cancelled interest (under the 'slice' rule).

Summary of new law

What the Subdivision does	Subdivision 154-C explains the amounts included in a tax entity's contributed capital and the accounts tax entities need to keep.
What is contributed capital?	Contributions made to a tax entity for or in relation to membership interests in the entity. It includes amounts settled on a trust.
What amounts are treated as contributed capital?	Specific rules relating to trusts and companies treat certain amounts as contributed capital to maintain substantively the tax treatment of certain realised gains and as part of transitional arrangements.
What accounts must tax entities keep?	A contributed capital account, and sub-accounts where there are multiple classes of interests in a tax entity.

Detailed explanation of new law

18.4 Tax entities must keep a contributed capital account, and possibly sub-accounts, for the purpose of applying the consistent entity rules. To do so, increases and reductions in contributed capital need to be identified and taken into account.

What is contributed capital?

18.5 There are 7 ways in which a taxpayer can contribute capital to a tax entity:

- contributions for the issue of membership interests;
- contributions to satisfy a liability in respect of a membership interest;
- contributions that allow interests to be created;
- contributions to enhance the value of interests or entity assets;
- contributions by rearrangements that are distributions;
- amounts paid for options that are not membership interests, to acquire membership interests when the option is exercised; and
- non-commercial loans made by a member to a closely-held entity.

[Section 154-40]

18.6 For each amount contributed to a tax entity, there is a credit to the entity's contributed capital account (discussed in paragraphs 18.23 to 18.32). ***[Section 154-50]***

Issue of membership interests

18.7 The contributed capital of a tax entity includes contributions made to the entity as consideration for the issue of interests in the entity. For example, consideration for the issue of new shares or units is contributed capital. Giving consideration need not be the sole purpose in this case as there is a clear relationship between membership interests and a contribution. ***[Paragraph 154-40(1)(a)]***

18.8 A contribution may be in the form of a payment or transfer of an asset. It need not be made at exactly the same time as the interest is issued ***[subsection 154-40(2)]***. Also, it need not be made by the holder of the membership interest; it could be made by someone else on their behalf.

Satisfying a liability in respect of a membership interests

18.9 The contributed capital of a tax entity includes contributions made to the entity to satisfy an obligation to the tax entity that attaches to an interest in the entity. For example, a further payment on a share that was partly paid or a payment under a guarantee to a company limited by guarantee. Again, satisfying the obligation is not required to be the sole purpose. ***[Paragraph 154-40(1)(a)]***

Allowing membership interests to be created

18.10 The contributed capital of a tax entity includes contributions made to the entity with the sole purpose of allowing membership interests in the entity to be created ***[subparagraph 154-40(1)(b)(i)]***. A sole purpose test applies to this case, and to the enhancement of the value of membership interests, in order to distinguish between dealing in respect of membership interests and dealings between taxpayers and the tax entity not related to membership interests.

18.11 An example of where this provision would be satisfied is cash or assets transferred to a trustee by the settlor to be held on trust for the purposes of the trust. The vesting of property in a trustee signals the creation of a trust and, at that point, the creation of membership interests of the beneficiaries. Another example is subscription for shares in a company to be formed, or for additional shares in an existing company.

Periodic membership fees

18.12 A periodic membership fee is not contributed capital. It is neither paid solely to allow an interest to be created, nor solely to enhance the value of member interests or of the entity. Rather, it is paid for a periodic advantage. ***[Subsection 154-40(4)]***

18.13 Further rules regarding periodic membership fees, not yet drafted, are under consideration. One option could be to view the periodic fee as a prepayment for discounted goods and services to be made available to the member during the membership period, as the member is in effect paying for the availability of those goods and services in advance.

Enhancing the value of membership interests or entity assets

18.14 Property settled on commencement of a trust can be added to by subsequent settlements which will also be contributed capital. Such settlements are examples of payments or transfers made for the sole purpose of enhancing the value of existing interests (e.g. for fixed trusts) or the value of the assets in respect of which a discretion may be exercised in favour of members (e.g. for non-fixed trusts). ***[Subparagraphs 154-40(1)(b)(ii) and (iii)]***

Distributions by way of rearrangements that are distributions

18.15 Where there is a distribution by way of a rearrangement of membership interests (i.e. additional interests are provided to members non-proportionately and for less then market value) there is taken to be a contribution of capital equal to the amount of the distribution. ***[Subsection 154-40(3)]***

18.16 The treatment of distributions made by way of rearrangements in effect assumes that the tax entity makes a cash distribution to a member who then uses that cash to pay for the additional interest. Treating such distributions also as contributed capital replicates the treatment the payment of cash for the additional interests would have received.

Options to acquire membership interests

18.17 Where a tax entity issues an option to acquire a membership interest in that entity then it will generally be a membership interest itself, and amounts paid for that option will be contributed capital under the rules discussed above. ***[Subsection 960-120(1), item 9; subsection 154-40(1)]***

18.18 However, where such an option is not a membership interest because it fails a debt test then an amount paid to a tax entity for the option will be contributed capital when the option is exercised ***[subsection 154-40(5)]***. This amount could otherwise be argued not to be paid for any required sole purpose, or as consideration for the issue of a membership interest, and so not to be contributed capital. Payment of a further amount to acquire the interest on exercise of the option is contributed capital by subsection 154-40(1).

Non-commercial loans

18.19 The amount of a non-commercial loan made by a member to a closely-held entity is contributed capital ***[subsection 154-40(6)]***. Repayments of interest or capital in respect of such loans are treated as distributions from the entity to the member.

18.20 A non-commercial loan is one which is not made under a written agreement; which bears interest in any year at less than the 'Indicator Lending Rates – Bank variable housing loan rate'; or which has a term of more than 25 years (or 7 years if the loan is not secured over real property). ***[Definition of 'non-commercial loan' in subsection 995-1(1)]***

Reducing contributed capital

18.21 A tax entity's contributed capital is reduced by the amount of a distribution made from contributed capital. ***[Paragraph 154-55(a)]***

18.22 It is also reduced by the component of consideration for an on-market buy back that is attributable to contributed capital ***[paragraph***

154-55(b)]. The consideration paid by the entity for the buy back is not treated as a distribution to allow the treatment of the recipient member to be akin to a sale by the member to a third party. However, in some respects it is necessary at the entity level to deal with consideration as if it is a distribution. ***[Section 152-15]***

Contributed capital accounts

18.23 Every tax entity must maintain both a contributed capital account and sub-accounts for each class of membership interest where there are separate classes. ***[Section 154-45]***

Maintaining contributed capital sub-accounts

18.24 Entities with multiple classes of membership interests will need to keep records of the contributed capital attributable to each class of interest (called *sub-accounts*). Where there is only a single class of interests, the entity's contributed capital account is also the sub-account for that class ***[subsection 154-80(1)]***.

18.25 Membership interests form a ***class*** if they all carry strictly identical or proportional rights to distributions by the entity, even if they carry different rights in relation to some other matter such as voting rights. In a simple wholly discretionary trust, the objects of the trust form a single class because each object has the same rights in relation to distributions as every other – that is, no right beyond the right to have the discretions administered. This is discussed in more detail in Chapter 14 ***[definition of 'class' in subsection 995-1(1)]***.

What are sub-accounts used for?

18.26 Sub-accounts are used in applying the 'slice' approach. The source of a distribution related to the cancellation or termination of a membership interest is worked out using the slice rule. That involves working out the share of contributed capital and profits attributable to the cancelled interest. This is straightforward where the entity has only one class of interests. But where there are multiple classes, calculating the contributed capital attributable to each class is necessary to calculate the slice components of a distribution in a way that is fair to all members.

Credits to sub-accounts

18.27 The sub-accounts, when added together, must equal (and may not exceed) the total of the entity's contributed capital. Each sub-account is credited with the capital contributions attributable only to the particular class of membership interests to which it relates, and with its share of contributions that are attributable more widely. ***[Subsections 154-40(7) and 154-80(2) and (4)]***

18.28 The sub-account credit provisions are linked to the different ways that contributed capital arises. Therefore, there is a credit to a sub-account for a membership class if:

- an amount is contributed in relation to a membership interest in that class under the general contributed capital rules ***[subsection 154-40(7) and paragraph 154-80(2)(a)]***; and
- the entity's contributed capital is otherwise increased by an amount treated as contributed capital (a link to the asset specific rules for trusts and companies discussed at paragraphs 18.36 to 18.48) ***[paragraph 154-80(2)(b)]***.

18.29 Contributed capital amounts that cannot be allocated to a particular class are distributed proportionately among all classes on the basis of each sub-account's existing balance. ***[Paragraph 154-80(2)(c) and subsection 154-80(4)]***

18.30 Further rules for sub-accounts will be developed once the full set of provisions regarding the contributed capital account balance of existing entities when the consistent entity treatment rules begin to apply to them (for example, for trusts) are developed.

Debits to sub-accounts

18.31 There is a debit to a sub-account for a particular class if contributed capital is distributed in relation to a membership interest in the class, or is paid in respect of an on-market buy back. ***[Subsection 154-80(3)]***

18.32 If contributed capital is distributed to members of a class in excess of the capital attributable to that class, the balance of the class is nil and the excess negative amount is spread across the other classes ***[paragraph 154-80(3)(c) and subsection 154-80(5)]***. This ensures that the balance of a particular sub-account can never be a negative amount. An excess distribution in relation to a particular class could only occur under the profits first rule, and never the slice rule.

Balance not affected by demutualisation

18.33 The balance of a tax entity's contributed capital account is not affected by its demutualisation ***[section 154-70]***. Demutualisation involves all the membership rights in a mutual entity being extinguished and the members being issued with transferable member interests (such as shares). This provision refers to entities that demutualise after the commencement of the consistent entity rules. Consideration is being given to whether further rules are needed to deal effectively with demutualisations.

Previously excluded trusts that become subject to consistent entity rules

18.34 Some trusts are to be excluded from consistent entity treatment, for example, deceased estates for at least the first 2 years of their administration. If their circumstances change – or in the case of a deceased estate, if it is not wound up within 2 years – so they no longer satisfy the exclusion, they may be taxed under the consistent entity rules. In these circumstances, they will need to work out their contributed capital.

18.35 They will do this by going back and notionally reconstructing their contributed capital using the relevant rules. They go back to the later of the commencement date of the consistent entity rules or the date they came into existence. When they become subject to the consistent entity rules their contributed capital will therefore be the same as if they had always been so subject. This approach allows them to access the trust transitional rules (discussed in paragraphs 18.41 to 18.45) in appropriate cases ***[section 154-65]***.

Credits to contributed capital account for certain assets

18.36 The contributed capital of entities will include some realised gains that have not been taxed in the entity. Treating these amounts as contributed capital will in substance maintain their current tax treatment on distribution.

18.37 These rules are the major part of the rules for trusts existing before commencement making the transition to consistent entity treatment, though they have an ongoing operation. For such trusts, it is also necessary to look at the assets (and liabilities) they hold at commencement so as to recognise previous contributions (less returns).

18.38 The draft legislation anticipates the inclusion of these provisions but is incomplete ***[section 154-50]***. The rules cannot be provided in detail until the capital gains provisions have been fully incorporated into the revised rules for calculating taxable income. They will also need to reflect the Review's capital gains recommendations.

18.39 Special rules may also be required for testamentary trusts and for corporate unit trusts and public trading trusts that are already taxed like companies. These rules have yet to be developed.

Trusts – non-transitional amounts

18.40 For trusts, realised exempt gains under the small business CGT goodwill exemption or, if adopted, all exempt amounts under the recommended new small business exemption, will be included in contributed capital on realisation. This will be so regardless of whether the relevant assets were acquired before or after the consistent entity rules commence.

Trusts – transitional amounts

18.41 On commencement of the consistent entity rules, cash and the tax value of assets (less liabilities) held by a trust at that date will be credited to the trust's contributed capital account. Tax values may need to be adjusted depending on how the relevant tax value rules are developed for the various asset classes. That start-up amount will be reduced by any prior taxed amounts of the trust (as discussed at paragraph 18.43).

18.42 For assets held by a trust before announcement, certain further gains may be credited to the trust's contributed capital account on the disposal of those assets. These amounts will include realised gains on pre-CGT assets or gains that are exempt by CGT indexation.

Prior taxed amounts

18.43 The prior taxed amounts of a trust at commencement of the consistent entity rules will consist of previously taxed retained income of the trust ***[section 153-40]***. They are deducted from contributed capital at commencement date to prevent double counting as retained income is also reflected in the asset base of the trust (which will be used to establish starting contributed capital). Prior taxed amounts benefit from a more favourable tax treatment than contributed capital amounts ***[sections 153-35 and 154-10]***.

Negative credit to the contributed capital account

18.44 Reducing start-up contributed capital of trusts by liabilities and prior taxed amounts may result in a negative amount being credited to a trust's contributed capital account. While the balance of contributed capital is negative, contributed capital will be taken to be nil for the purpose of working out the tax value of the contributed capital liability, for calculating the trust's available profits or in applying the 'slice' approach. It will continue to be a negative amount for the purpose of adjusting the contributed capital account (and any relevant sub-accounts) as a result of further credits or debits. ***[Subsection 154-75]***

Example 18.1 Negative contributed capital at commencement

The assets of the Share Holding Family Trust are shares in a publicly listed company. The shares have a tax value of $10,000.

The trust acquired the shares in part with borrowed funds and, as a result of capitalising the interest on the debt, the liabilities of the trust on commencement are $12,000.

On commencement, the trust's contributed capital account has a negative balance of $2,000. For the purposes of ascertaining the tax value of contributed capital, applying the profits first rule or applying the slice rule, the balance would be taken to be nil.

> After commencement, the shares are sold for $30,000. The whole of the $20,000 gain is attributable to indexing the tax value of the shares and so is not taxable in the trust. Therefore, the $20,000 gain is added to the trust's contributed capital. The new contributed capital of the trust is $18,000.

The trust transitionals and exceptions to the profit first rule – distribution of realised proceeds

18.45 Amounts credited to the contributed capital account of a trust upon disposal of an asset that was held by the trust at a certain date will also be able to be distributed as an exception to 'profits first'. The exception will only apply if the relevant amounts are distributed in the same income year they are realised. ***[Subsection 154-25]***

Companies in liquidation and gains on pre-CGT assets

18.46 The contributed capital of a company in liquidation will include a capital gain that is disregarded in working out the company's taxable income because it relates to a pre-CGT asset ***[section 154-50]***. When distributed, subject to the general profits first and slice rules, it will receive the general contributed capital treatment.

18.47 This rule preserves, albeit in a narrower form, the effect of section 47 in the ITAA 1936. Under section 47, *all* gains not taxed under CGT (or the general provisions) are passed out to shareholders as capital on the winding up of the company. The new rule only applies to gains that are not taxed because the asset is pre-CGT. Therefore, it does not apply to post-CGT assets that are not subject to CGT for other reasons e.g. motor vehicles.

18.48 This rule applies to all companies including co-operative companies and unincorporated bodies.

Application and transitional provisions

18.49 The consistent entity rules will apply to entities from 1 July 2000.

18.50 A tax entity in existence at commencement of the consistent entity rules will need to work out the amount standing to the credit of its contributed capital as at that date. Thereafter, additions to, and reductions from, its contributed capital will be governed by the contributed capital rules.

18.51 The amount credited to the contributed capital account of a trust at commencement has been discussed at paragraphs 18.32 to 18.45 (as the transitional rules for trust contributed capital, while applying at commencement date, also have an ongoing character in relation to certain gains on post-commencement disposals). The contributed capital of companies and limited partnerships on commencement is discussed below.

Contributed capital of a (no par value) company

18.52 The contributed capital of a no par value company in existence at commencement is basically its paid up share capital. That is, the amount standing to the credit of its share capital account as at that date, less amounts that remain unpaid on shares. Amounts that are not part of share capital (called tainted amounts) are also excluded ***[subsection 154-60(1), item 1]***.

18.53 The exclusion of tainted amounts is achieved by 2 rules – one for amounts that tainted an account after the abolition of par value on 1 July 1998 (the *tainting amount*) and one for amounts that tainted an account prior to that date (*net tainted amounts*). The format of this transitional has been greatly influenced by the changes that occurred on 1 July 1998. For that reason those changes are briefly explained below.

Background

18.54 From 1 July 1998, the concept of par value for shares and the associated concept of share premiums was abolished for *Corporations Law* companies – see the *Company Law Review Act 1998*. As a result, the distinction between paid up capital and share premiums was removed, effectively creating one share capital account comprising both paid up capital and share premiums.

18.55 Consequential amendments were made to the ITAA 1936 to ensure that provisions dependent on the concept of par value were made compatible with the changes to the *Corporations Law* – see the *Taxation Laws Amendment (Company Law Review) Act 1998*. The amendments included the introduction of share capital account tainting rules to prevent companies disguising a profit distribution as share capital.

18.56 Those tainting rules were similar to the tainting rules that governed share premium accounts. However, a tainted share premium account (under the old rules) folded into the share capital account does not taint it (under the new rules). Instead, the tainted share premium account is separately identified within the share capital account and distributions of genuine share capital can therefore be made in preference to tainted share premiums ***[subsection 160ARDM(2) of the ITAA 1936 as proposed to be amended by the Taxation Laws Amendment Bill (No. 7) 1999 introduced into the Senate on 30 June 1999]***.

Paid up share capital

18.57 The ***paid-up share capital*** of a company has the same meaning as in subsection 6(1) of the ITAA 1936 ***[subsection 154-60(3)]***. For a company, it is equal to the amount standing to the credit of its share capital account less:

- amounts that remain unpaid on shares; and
- the tainting amount.

18.58 The definition of ‘paid up share capital’ contained in subsection 6(1) of the ITAA 1936 has been adopted. But it is worked out ignoring any prior reduction of share capital made by the company under section 258F of the *Corporations Law* because paid-up share capital was lost or not represented by available assets ***[subsection 154-60(1), item1]***.

18.59 A *share capital account* is generally an account that only contains share capital ***[section 6D of the ITAA 1936]***. But for the purposes of the definition of paid up share capital, it can include a share capital account that has been tainted by the deposit of other amounts.

18.60 The *tainting amount* is any amount added to the share capital account, *after* the tainting rules commenced on 1 July 1998, that is not genuine share capital ***[section 160APA of the ITAA 1936]***. The punitive nature of the tainting rules makes it unlikely that a company has tainted its share capital account.

Example 18.2 Par value company with a tainting amount on commencement

Modest Models Pty Ltd was incorporated in 1990 under the *Corporations Law*. It issued 2 shares, each with a par value of $100 and a $50 premium. Those amounts were fully paid. In 1995 it issued 2 further shares. Again, each had a par value of $100, but they were only partly paid as to $25 each.

On 1 July 1998, the amount standing to the credit of Modest Models new share capital account was $500 (though its paid-up share capital was only $350).

On 10 July 1998, the company capitalised profits by transferring $8,000 worth of profits into its share capital account which resulted in the share capital account becoming tainted.

On commencement of the new entity rules, the start-up contributed capital of Modest Models is $350 worked out as follows:

- $8,500 (amount standing to credit of share capital account); less
- $150 (amount unpaid on shares); less
- $8,000 (tainting amount).

Tainted share premiums

18.61 A tainted share premium account merged with share capital (less any distribution from the account since that date) is also excluded from contributed capital on commencement. The amount excluded is called the *net tainted amount* ***[subsection 154-60(1), item 1 and subsection 154-60(3)]***. This aspect of the transitional reflects proposed subsection 160ARDM(2) of the ITAA 1936.

Contributed capital of a (par value) company

18.62 Companies not incorporated under the *Corporations Law* will continue to have par value shares and share premium accounts; for instance, companies incorporated under State legislation. Their contributed capital at commencement is therefore dealt with by a separate transitional rule.

18.63 The contributed capital of a par value company is the sum of amounts paid up on its shares plus any share premiums held by it, retained in the company at that date ***[subsection 154-60(1), item 2]***. This provision will allow a par value company whose share premium account has been tainted by inclusion of other amounts to separate out genuine share premiums and include them in contributed capital on commencement.

Example 18.3 Par value company with a tainted share premium account on commencement

Fishing Co-op Inc was incorporated under legislation passed by the Tasmanian State Government. The amount paid up on shares issued by it is $10,000. It also received share premiums of $5,000.

In 1999, its share premium account was tainted when profits were transferred into the share premium account.

On commencement of the new entity rules, the start-up contributed capital of Fishing Co-op Inc is $15,000. The tainted amount is *not* included in its start-up contributed capital.

Par value / no par value distinction not relevant post-commencement

18.64 After commencement, par value and no par value companies will both be able to rely on the same general concepts of contributed capital. The definition has been cast in terms of contributions made for membership interests. For the purpose of determining contributed capital for tax purposes, the characterisation of a company's share capital in terms of par value or otherwise is irrelevant.

Tainting rules not necessary

18.65 This streamlined approach to contributed capital also makes share capital tainting rules unnecessary for tax purposes. The new law only adds genuine share capital to contributed capital. The current law identifies share capital in the first instance by reference to a share capital account. There is then a need to exclude credits to that account that are not genuine share capital (that is, tainted amounts).

Contributed capital of a company limited by guarantee

18.66 The contributed capital, at commencement, of a company limited by guarantee is the sum of amounts, retained in the company at that date, that was paid to it in satisfaction of the liability guarantees ***[subsection 154-60(1), item 3]***. A company limited by guarantee does not have share capital. A member's obligation to contribute capital to it is limited to the amount they agree (or guarantee) to contribute if the company is wound up. Therefore, this transitional will generally only apply to establish actual contributed capital for a company limited by guarantee that is in the course of being wound up at commencement.

Companies limited both by shares and guarantee

18.67 A company can be limited by both shares and guarantee. Its contributed capital on commencement is the sum of its share capital and any amounts paid under guarantees ***[subsection 154-60(2)]***.

Other companies and limited partnerships

18.68 The contributed capital of other companies (e.g. unincorporated bodies) at commencement is worked out as though the consistent entity rules had applied to them at all times since they came into existence ***[subsection 154-60(1), item 4]***. This will basically be the balance of amounts paid to the entity to obtain a membership interest in the company. A similar rule will probably apply to limited partnerships. This approach mirrors the rules for previously excluded entities that become subject to the consistent entity rules – that is, they reconstruct their contributed capital account as though they had always been in the system. (This is consistent with the way limited partnerships are taxed as companies under current law.)

Chapter 19
Collective investment vehicles

Outline of Chapter

19.1 Division 157 of the draft legislation provides additional rules for certain entities, referred to as CIVs, and their members.

19.2 A CIV will not have to pay tax on its taxable income for an income year if all, or virtually all, of its taxable income for that year is distributed within that year or shortly afterwards.

19.3 When a CIV makes a distribution of taxable income for an income year to a member within the income year or shortly afterwards, the income retains its source and character as if that income had been received directly by the member. Taxable income which flows from a CIV through to its members in this way is taxed at the investor level only. This is referred to as taxation of that taxable income on a *flow-through* basis.

Context of Reform

19.4 In his press release of 22 February 1999, the Treasurer announced that cash management trusts and, in principle, other CIVs would be taxed on a flow-through basis under the new business entity tax regime outlined in *A New Tax System*. If tax were applied on these vehicles at the entity level, low marginal rate investors would face a delay before refunds of imputation credits were received and they would also incur additional compliance requirements.

19.5 Section 16 of the Recommendations outlines the recommended policy basis for the tax treatment of CIVs and their members. The key recommendations are that distributions of taxable income be taxed on a flow-through basis and that distributions of tax-preferred income not be taxed at the time of the distribution. The closing tax value of the investor's interest in the CIV is reduced when distributions of contributed capital and certain tax-preferred income is received.

19.6 This treatment seeks to ensure that investors who invest through a CIV in order to obtain the benefits of a diversified investment portfolio are not disadvantaged compared with investors who acquire the same portfolio by investing directly.

19.7 Because a CIV's taxable income retains its character as, for example, capital gains, dividends, or interest when distributed, non-resident portfolio investors will not be affected by entity taxation when investing through CIVs.

19.8 To ensure that CIVs cannot compete unfairly with other entities, as well as addressing compliance, complexity, and streaming issues, the CIV rules are restricted to those entities meeting certain eligibility criteria.

Summary of new law

19.9 The following table sets out a summary of the new law.

Table 19.1

What the Division will do	
Division 157	Provides additional rules for the taxation of CIVs and their members
Subdivision 157A	Provides the circumstances where a CIV will, and will not, be taxed
Subdivision 157B	Provides how distributions made by a CIV are taxed in the hands of recipient members
Subdivision 157C	Provides how entities become a CIV
Subdivision 157D	Provides the obligations of being a CIV
Subdivision 157E	Provides what happens where an entity becomes or ceases to be a CIV
Will CIVs be liable to pay tax on their taxable income?	A CIV is not liable to pay income tax on its taxable income for an income year if: • it fully distributes that taxable income within that income year or within 2 months after the end of that year; or • it distributes 98% or more of that taxable income within that income year or within 2 months after the end of that year, and it failed to fully distribute all of that taxable income because of an error or miscalculation on its part.
When must distributions of taxable income be made so that a CIV need not pay any tax?	A CIV's taxable income for an income year must be distributed to members within that year or within 2 months after the end of the year.

How are distributions of taxable income treated in the hands of recipient members?	Distributions of taxable income for an income year to a member retain the same source and character of that income in the hands of the member as if the member received the income directly provided the income is distributed within that year or within 2 months after that year. As a result, realised capital gains distributed by the CIV to members retain their character as capital gains in the hands of the member receiving the distribution. Members will apply the relevant percentage reduction in the amount of gain to be included for capital gains taxation. Distributions of taxable income for an income year which are not distributed within 2 months after the end of that year are treated as unfranked dividends.
How are other distributions treated in the hands of recipient members?	Certain distributions of tax-preferred income (e.g. arising from depreciation allowances) and contributed capital result in a decrease in the closing tax value of the membership interest of the member equal to the amount of the distribution. Distributions attributable to pooled development funds or infrastructure borrowings result in a decreasing tax adjustment for the member but not a decrease in the closing tax value of the member's interest.

What tax treatment applies to redemptions or cancellations of membership interests?	Distributions made in relation to the cancellation or redemption of a member's interest in a CIV are taken to be a distribution of the CIV's contributed capital. The closing tax value of the member's interest will be reduced to zero upon the redemption or cancellation. Provisions are being developed which will identify the taxable income as a capital gain or loss. However, if the distribution is made at a time when the CIV is winding down (i.e. the CIV has undertaken a process that will lead to its cessation), the member is taken to have received a proportionate slice of the CIV's taxable income, tax-preferred income, taxable income for an income year that has not been distributed within 2 months after the end of that year, and contributed capital.

What entities are eligible to be treated as a CIV?	To be taxed as a CIV, an entity must satisfy certain eligibility criteria including the following: • the entity must be a fixed unit trust; • the entity must satisfy certain ownership requirements including that either: – the entity is widely-held; – every member of the entity is a 'pooled investment entity', a government body not liable to tax, or a non-resident entity; or – the entity is a registered managed investment scheme and 75% or more of the membership interests in the entity are held by pooled investment entities; • the entity must have an Australian presence; • the entity must be constituted by units that confer a fixed equal beneficial interest in all the assets of the trust; • the entity must invest in assets that are of a 'passive' investment nature although it could also trade in these assets; and • the entity must elect to be taxed as a CIV.
What are the obligations of being a CIV?	Obligations of being a CIV include the requirement: • to keep appropriate records of its taxation affairs; and • with each distribution, and shortly after the end of the income year, provide members with a kkstatement that sets out the information necessary for the member to account for any distributions that the member has received in his or her tax return, including advice as to how to adjust tax values as appropriate.

Comparison of key features of new law and current law

19.10 The following table sets out a comparison of the key features of the tax treatment applying under the new law compared with the current.

Table 19.2

New Law	***Current Law***
The taxable income of the CIV is calculated as though the CIV is a resident entity (with adjustments to exclude certain exemptions and concessions which are intended for 'active' businesses such as research and development concessions).	The net income of the unit trust is calculated as though the unit trust is a resident individual taxpayer.
Investors are taxed on distributions of taxable income in the income year in which the distribution from the CIV is received, or deemed to have been received.	Investors are taxed on a present entitlement basis in relation to the net income of the trust where the trust is not taxed on a corporate basis.
The taxable income of a CIV retains its source and character in the hands of the member only if distributed within a specified period.	The net income of the unit trust retains its source and character in the hands of the investor.
Distributions of certain tax-preferred income and contributed capital up to the tax value of the unit are not taxed upon distribution. The closing tax value of the member's interest is reduced by the amount that is distributed. Any excess of the distribution over the tax value is taxed on receipt.	Broadly speaking, distributions of contributed capital and tax-preferred income up to the tax value of the unit are not taxed upon creation of a present entitlement or upon distribution. However, the cost base of the unit is reduced by the amount of contributed capital or tax-preferred income that is distributed. Any excess of the distribution over the cost base is taxed on receipt.
The trustee is liable to pay tax at the entity rate on any taxable income that is not distributed within the income year or shortly afterwards.	The trustee would not be liable to tax in those cases where the beneficiary is presently entitled to all of the income. Where the trust is taxed on a corporate basis the trustee bears the primary liability to tax.

Detailed explanation of new law

What are the requirements of being a CIV?

19.11 Subdivision 157-C explains which tax entities may become CIVs for tax purposes and how they become a CIV.

19.12 In summary, an entity must meet all of the following requirements at a particular time to be eligible to be treated as a CIV for taxation purposes:

- the entity must be a fixed trust that is a unit trust ***[paragraph 157-95(1)(a)]***;
- the entity must have an Australian presence ***[paragraphs 157-95(1)(b) and (c)]***;
- the entity must satisfy certain membership eligibility requirements ***[paragraph 157-95(1)(d)]***;
- the membership interests in the entity must be all equivalent ***[paragraph 157-95(1)(e)]***; and
- the entity's activities must be limited to eligible 'investment activities' ***[paragraph 157-95(1)(f)]***.

19.13 These eligibility requirements serve several purposes including that CIVs do not use the additional tax rules applying to them to compete unfairly with other entities. The range of investments that can be undertaken by CIVs is restricted to those of a 'passive' kind. Broadly speaking, this includes investment in land for rental and investment (including fixtures such as buildings but not, for example, the provision of services in buildings) or trading in a range of financial arrangements including shares, trust units, and bonds. Further, the requirement for CIVs to have an Australian presence will ensure that appropriate compliance with the CIV rules can be monitored by the ATO, something that would not be possible if non-resident entities could be CIVs.

19.14 The eligibility requirements do not impose a requirement for members of the CIV to have the same income year as the CIV. However, action may be taken if there is evidence that this flexibility is being exploited to defer the payment of tax by distributing taxable income through a series of other CIVs with slightly overlapping income years.

What is a fixed trust?

19.15 A fixed trust is a trust where all of the income and capital of the trust is the subject of fixed entitlements held by the members. In this context, a member can be a natural person, a company, a trustee or the partners in a partnership. Therefore, an entity where some part of the income or capital may be distributed at the discretion of the trustee or another member will not be a fixed trust. ***[Subsection 995-1(1)]***

What is an Australian presence?

19.16 An entity must have an Australian presence if it is to be treated as a CIV. A CIV will have an Australian presence when the following 2 conditions are met:

- the central management and control of the entity is in Australia ***[paragraph 157-95(1)(b)]***; and
- at least one trustee of the entity is resident in Australia. ***[paragraph 157-95(1)(c)]***.

When does a trust have membership interests that are all equivalent?

19.17 The entity must be constituted by equivalent membership interests if it is to be treated as a CIV for taxation purposes. Equivalent membership interests will arise where:

- each membership interest in the entity carries the same fixed beneficial interest in all of the entity's assets ***[paragraph 157-95(3)(a)]***; and
- each membership interest carries a right to share equally in any distributions of tax-preferred income or contributed capital and any distributions from taxable income from a particular source or of a particular character ***[paragraph 157-95(3)(b)]***.

19.18 The equivalent interest requirement in respect of taxable income is illustrated in the example below.

Example 19.1

> A CIV with 500 members (half of which are non-residents) each holding one unit in the entity makes a distribution from its taxable income of $5,000. The distribution from the CIV comprises $2,500 in foreign source income and $2,500 in dividend income.
>
> The requirement that membership interests share equally in any distributions from taxable income from a particular source or character would prohibit the CIV from distributing foreign source income to non-resident members only, and distributing dividend income to resident members only. Instead, the income would have to be distributed equally to each unit held so that the holder of each unit received $5 of foreign source income and $5 of dividend income.

What are eligible 'investment activities'?

19.19 The entity's activities must also be limited to a defined range of 'investment activities' if it is to be treated as a CIV for taxation purposes.

Restricting CIVs to generally 'passive' investment in the form of investing in land, or investing and trading in financial arrangements such as shares, trust units and bonds is intended to maintain competitive neutrality with entities subject to tax under the consistent entity rules. An entity's activities are limited to investment activities that consist wholly of either or wholly of both:

- investing in land (which includes fixtures), or an interest in land, for the primary purpose of receiving rent ***[paragraph 157-95(4)(a)]***; or
- investing or trading in any, or all, of the following:
  - secured or unsecured loans (including deposits with a bank, debentures, stock or other securities) ***[subparagraph 157-95(4)(b)(i)]***;
  - bonds, debentures, stocks or other securities ***[subparagraph 157-95(4)(b)(ii)]***;
  - shares in a company ***[subparagraph 157-95(4)(b)(iii)];***
  - units in a unit trust ***[subparagraph 157-95(4)(b)(iv)]***;
  - futures contracts ***[subparagraph 157-95(4)(b)(v)]***;
  - forward contracts ***[subparagraph 157-95(4)(b)(vi)]***;
  - interest rate swap contracts ***[subparagraph 157-95(4)(b)(vii)]***;
  - currency swap contracts ***[subparagraph 157-95(4)(b)(viii)]***;
  - forward exchange rate contracts ***[subparagraph 157-95(4)(b)(ix)]***;
  - forward interest rate contracts ***[subparagraph 157-95(4)(b)(x)]***;
  - life insurance policies ***[subparagraph 157-95(4)(b)(xi)]***;
  - a right or option in respect of such a loan, security, share, unit, contract, or policy ***[subparagraph 157-95(4)(b)(xii)]***; or
  - any similar financial instruments ***[subparagraph 157-95(4)(b)(xiii)]***.

19.20 A CIV will not meet the investment activity requirement if it is able to undertake non-investment activities using another tax entity that it directly or indirectly controls or is able to control. This rule ensures that the restriction that CIVs only undertake defined investment activities cannot be circumvented. ***[Subsection 157-95(5)]***

19.21 Special rules will also apply to prevent CIVs from circumventing the eligible investment activities test by using stapled-stock type arrangements. The effect of these rules is that an entity will not satisfy the eligible investment activities test if:

- the membership interests in the entity (i.e. the first entity) are stapled to membership interests in another entity (i.e. the active entity) ***[paragraph 157-95(6)(a)]***;
- the activities of the active entity are not limited to investment activities ***[paragraph 157-95(6)(b)]***; and
- the first entity and the active entity are parties to an agreement under which the active entity pays rent, interest, dividends or other returns to the first entity ***[paragraph 157-95(6)(c)]***.

19.22 For the purposes of this rule, membership interests are stapled if, by becoming a member of one of the entities, the member becomes, or may become, a member of the other entity ***[subsection 157-95(7)]***.

Example 19.2

A unit trust enters into an arrangement by leasing a hotel that it owns to a management company.

The company uses the hotel as part of its business operations to derive profits, operations that would not satisfy the passive activity test under the CIV rules.

As part of the arrangement, the company agrees to pay rent to the unit trust in return for use of the hotel. The rent received by the unit trust satisfies the passive activity test.

An investor buys an interest in the unit trust. By becoming a member in the unit trust, the member also becomes a member of the company because the interests in both entities are stapled.

The unit trust is seeking to be taxed as a CIV.

The stapled stock rule prevents the unit trust from satisfying the passive activity test. The unit trust is therefore ineligible to be taxed as a CIV.

When will an entity meet the membership eligibility requirements?

19.23 To be eligible to be treated as a CIV, entities must satisfy certain membership eligibility requirements. These requirements are that either:

- the entity is widely-held [subparagraph 157-95(1)(d)(i)];

- every member of the entity is one or more of the following ***[subparagraph 157-95(1)(d)(ii)]***:
  - a ‘pooled investment entity’ (see paragraph 19.26);
  - a non-resident entity (other than an individual); or
  - a government body that is not liable to pay income tax; or
- the entity is a registered managed investment scheme within the meaning of the *Managed Investment Act 1998* (see paragraph 19.32) and 75% or more of the membership interests in the entity are held by pooled investment entities ***[subparagraph 157-95(1)(d)(iii)]***.

What is the widely-held test?

19.24 An entity will be taken to be widely-held if the entity has at least 300 members and ***[subsection 960-110(1)]***:

- 20 or fewer individuals between them do not hold, directly or indirectly, and for their own benefit, 75% or more of the fixed entitlements to income or capital of the entity (i.e. the concentrated ownership test) ***[subsection 960-110(2)]***; and
- the entity’s constituent documents do not permit the rights of membership interests being varied or abrogated in such a way that would result in the entity no longer being widely-held within the meaning of ‘widely-held’ tests ***[subsection 960-110(3)]***.

19.25 For the purposes of this test all of the following are taken to be a single individual:

- an individual, whether or not the individual holds membership interests in the entity;
- the individual’s associates; and
- in relation to any membership interests in respect of which other individuals are nominees of the individual or of the individual’s associates – those other individuals.

[Subsection 960-115(4)]

What is a pooled investment entity?

19.26 Entities will satisfy the membership eligibility requirements if every member of the entity is a ‘pooled investment entity’ ***[subparagraph 157-95(1)(d)(ii)]***.

19.27 For this purpose, a pooled investment entity includes:

- another CIV [paragraph 157-95(2)(a)];
- a complying superannuation fund (other than an excluded fund) ***[paragraph 157-95(2)(b)]***;
- a complying approved deposit fund ***[paragraph 157-95(2)(c)]***;
- a pooled superannuation trust ***[paragraph 157-95(2)(d)]***;
- a statutory fund of a life insurance company ***[paragraph 157-95(2)(e)]***;
- a friendly society (in respect of its life insurance business) ***[paragraph 157-95(2)(f)]***.

19.28 An entity will also satisfy the membership eligibility requirements if every member of the entity is a government body that is not liable to pay income tax or a non-resident entity (other than an individual) ***[subparagraph 157-95(1)(d)(ii)]***.

19.29 A government body for this purpose means:

- a government, or an authority of a government, that is not liable to income tax;
- a State/Territory Body (STB) (within the meaning of Division 1AB of the ITAA 1936) the income of which is wholly exempt from tax; or
- a body or association to which subsection 30-20(1), 30-25(1), or section 50-25 of the ITAA 1997 applies.

[Section 995-1]

19.30 It follows that an entity could satisfy the membership eligibility requirements if the entity's membership interests were entirely held by, for example, a single non-resident entity.

19.31 Finally, an entity will also satisfy the membership eligibility requirements if the entity is a registered managed investment scheme and 75% or more of the membership interests are held by pooled investment entities ***[subparagraph 157-95(1)(d)(iii)]***.

19.32 A registered managed investment scheme takes its meaning from the *Managed Investments Act 1998*. Registered managed investment schemes generally have at least 20 members and must comply with a number of regulatory safeguards which will ensure that the CIV rules are only available to genuine managed investment activities. For example, in deciding whether or not to issue a licence, the Australian Securities and

Investments Commission is required to consider the applicant's good fame and character, expertise and ability to perform duties associated with being responsible for the management of the scheme (i.e. the responsible entity). The responsible entity is also required to hold a securities dealer's licence which will authorise it to operate a managed investment scheme.

How does an entity elect to be a taxed as a CIV?

19.33 To be taxed as a CIV an entity must make an irrevocable election (in addition to satisfying the eligibility requirements discussed above). ***[Subsection 157-100(1)]***

19.34 The election must be in writing and a copy given to the Commissioner within 21 days of the election being made ***[subsections 157-105(1) and (4)]***. An entity can only ever make one election to be taxed as a CIV ***[subsection 157-105(1)]***.

19.35 The election must provide the following details:

- the day on which the election is to take effect ***[paragraph 157-105(2)(a)]***. The date specified on the notice must be later than the day on which the election is made ***[subsection 157-105(3)]***;

- the entity's name, address, Tax File Number (if it has one), and Australian Business Number of the entity (if it has one) ***[paragraphs 157-105(2)(b) and (c)]***; and

- any further information as required by the Commissioner ***[paragraph 157-105(2)(d)]***.

19.36 The entity may apply to the Commissioner for a different day to that specified in the election for commencement of being treated as a CIV. The Commissioner may approve in writing a different day as the day on which the election takes effect. The entity can also request that the Commissioner change the day that may have already been approved. ***[Subsections 157-105(5) and (6)]***

19.37 The election takes effect on the date specified in the election unless the Commissioner has approved another day. If an entity applies to the Commissioner for a different day more than once, the election takes effect on the day specified in the notice most recently approved by the Commissioner. ***[Subsection 157-105(7)]***

19.38 Once an entity makes an election, it is treated as a CIV from the time the written election takes effect (and will not be a CIV from the time it ceases to be eligible to be a CIV). ***[Subsection 157-100(2)]***

Are there any occasions where a CIV can fail the widely-held requirement and continue to be treated as a CIV?

19.39 There are 3 occasions where a CIV can fail the widely-held requirement and continue to be treated as a CIV. These are where:

- the entity is within the first 6 months of becoming a CIV ***[subsection 157-110(3)]***;
- the entity has given notice to its members that it is to wind down ***[subsection 157-110(6)]***; or
- in certain circumstances, the entity fails the ***minimum membership requirement*** (see paragraph 19.47) of the widely-held test due to fluctuations in membership numbers because of ordinary trading in membership interests ***[subsection 157-110(4)]***.

Start-up period

19.40 Because it is often the case that entities in which membership interests are offered may take a while to grow, an entity that elects to become a CIV will be deemed to be a CIV during its start-up period even if it does not strictly meet the widely-held requirement ***[subsection 157-110(3)]***. The widely-held requirement is that criteria that requires a CIV to have at least 300 members and to meet the concentrated ownership test (see paragraph 19.24) ***[subsection 157-110(1)]***.

19.41 As a result, the widely-held requirement does not apply to an entity for the first 6 months after it becomes a CIV.

Wind down period

19.42 An entity may give to its members written notice that the entity is to wind down. The notice must be given in the same way as a notice under the entity's constituent document ***[subsection 157-110(6)]***.

19.43 The entity must also furnish the Commissioner with a copy of the notice within 21 days of it being given to the members ***[subsection 157-110(7)]***.

19.44 Where an entity provides a notice of its intention to wind down, the entity remains subject to the CIV rules (even though it may not satisfy the widely-held requirement during the course of the wind down period) for the period starting from:

- when the notice is given to members ***[paragraph 157-110(8)(a)]***; and

- ending when either the entity is wound up or within 12 months of the members being notified, whichever happens first ***[paragraph 157-110(8)(b)]***.

19.45 The Commissioner has the discretion to extend this period ***[subsection 157-110(9)]***.

Membership fluctuations

19.46 An entity will also not cease to be a CIV if it fails the ***minimum membership requirement*** of the widely-held test because of fluctuations in membership numbers due to ordinary trading in membership interests and either:

- the period of the entity's failure to meet the minimum membership requirements does not exceed 21 continuous days ***[subparagraph 157-110(4)(b)(i)]***; or

- within the 21 day period the entity provides a notice to its members of its intention to wind down the trust (see paragraph 19.42 above) ***[subparagraph 157-110(4)(b)(ii)]***.

19.47 The ***minimum membership requirement*** is that criterion requiring CIVs to have at least 300 members ***[subsection 157-110(2)]***. Therefore, an entity wanting to be treated as a CIV must always satisfy the concentrated ownership test unless it is within the start-up or wind down period.

19.48 It follows that where an entity fails to satisfy the minimum membership requirement at the end of 21 days the entity will cease to be treated as a CIV from the first day it failed, unless it has provided a notice under subsection 157-110(6) to wind down the trust within that 21 day period.

19.49 The Commissioner also has a discretion to extend the 21 day period discussed above ***[subsection 157-110(5)]***. In deciding whether to exercise this discretion the Commissioner would have regard to the following:

- the nature of the failure to satisfy the widely-held test ***[paragraph 157-110(5)(a)]***;

- the events that led to the shortfall ***[paragraph 157-110(5)(b)]***;

- the duration of the shortfall ***[paragraph 157-110(5)(c)]***;

- the extent to which there may have been previous shortfall occurrences ***[paragraph 157-110(5)(d)]***;

- any other matters the Commissioner considers relevant ***[paragraph 157-110(5)(e)]***.

Example 19.3

A CIV fails to satisfy the minimum membership requirement on, say, 1 August 2005.

The CIV makes a decision to wind down as it is unlikely to be able to satisfy the minimum membership requirements within the next 21 days.

The CIV provides a wind down notice to its members on 14 August 2005.

As the notice was provided within 21 days of the CIV failing to meet the minimum membership requirement, the CIV will continue to be treated as a CIV for the duration of the wind down. This treatment will, generally, not exceed 12 months.

However, if the CIV did not provide a wind down notice during the 21 day period and continued to fail the minimum membership requirements within that period, the entity would cease to be a CIV from 1 August 2005. Therefore, the CIV would be taxed as an ordinary entity thereafter.

What obligations does a CIV have?

19.50 A CIV is required to keep accurate records for each income year that show the following details:

- the source and character of taxable income for that income year ***[paragraph 157-120(a)]***;
- the amount of taxable income which is attributable to each of those sources or which has that character for the income year ***[paragraph 157-120(b)]***;
- what distributions it makes from:
  - its taxable income for that year ***[subparagraph 157-120(c)(i)]***;
  - an accumulated taxable amount (see paragraph 19.77) ***[subparagraph 157-120(c)(ii)]***;
  - other sources [subparagraph 157-120(c)(iii)]; and
- any other information necessary for giving members distribution statements or annual statements (explained below at paragraphs 19.52 and 19.53) ***[paragraph 157-120(d)]***.

19.51 An entity must also notify the Commissioner within 21 days after it ceases to be eligible to be a CIV ***[section 157-135]***.

Distribution and annual statements

19.52 In addition, if a CIV makes a distribution to a member, the CIV must give that member, at the time the distribution is made, a distribution statement ***[section 157-125]***. The distribution statement must set out the following information:

- the amount of the distribution ***[paragraph 157-125(a)]***;
- how much of the distribution is from:
  - taxable income ***[subparagraph 157-125(b)(i)]***;
  - an accumulated taxable amount ***[subparagraph 157-125(b)(ii)]***;
  - other sources ***[subparagraph 157-125(b)(iii)];***
- to the extent that the distribution is from taxable income;
  - the source and character of the income ***[subparagraph 157-125(c)(i)]***;
  - whether any withholding taxes have been deducted (if the income was in the form of dividends, interest or royalties) ***[subparagraph 157-125(c)(ii)]***;
  - whether any amounts have been withheld if the income was other than dividends, interest or royalties ***[subparagraph 157-125(c)(iii)]***;
  - the extent to which the income was franked ***[subparagraph 157-125(c)(iv)]***;
- the effect that the distribution may have on the tax value of the member's membership interest in the CIV and, if a distribution does change that value, how the change in value should be reflected in the taxpayer's tax return ***[paragraph 157-125(d)]***;
- the nature and amount of any decreasing adjustment that may be required because the distribution includes amounts described in section 157-75 (i.e. receipts arising from shares in a pooled development fund or payments relating to infrastructure borrowings) ***[paragraph 157-125(e)]***;
- any other information that is required by the Commissioner ***[paragraph 157-125(f)]***.

19.53 Similar information statements are also required to be given to members after the end of the income year, with the additional requirement that the distribution statement show the amount of foreign tax which has been paid on the income, if any ***[subparagraph 157-130(1)(d)(v)]***. These statements are required to be provided to members within 21 days after the end of the *distribution period* for the income year (see paragraph 19.59) ***[subsection 157-130(1)]*** . The Commissioner has the discretion to extend the 21 day period ***[subsection 157-130(2)]***.

What are the consequences if an entity enters or leaves the CIV rules part way through an income year?

19.54 Where an entity enters or leaves the CIV rules during the income year, the period before the entity became a CIV, the period during which the entity was a CIV, and any period after the entity ceased to be a CIV are treated as separate income years. ***[Section 157-145]***

19.55 Under the CIV rules, CIVs will be prevented from maintaining franking accounts and therefore will not be able to *frank* distributions made to members (although franking credits will be capable of flowing through to members where the CIV receives franked dividend income). As an exception to the foregoing rule a CIV may *frank* a distribution if:

- immediately before it became a CIV it had a franking account surplus ***[paragraph 157-150(a)]***;
- within 2 months after becoming a CIV it makes a distribution out of taxable income for an income year before it became a CIV ***[paragraph 157-150(b)]***; and
- it would have been able to frank the distribution to the same extent had the entity not become a CIV ***[paragraph 157-150(c)]***.

19.56 In effect, the provisions treat these distributions as if they are frankable dividends under the current imputation rules.

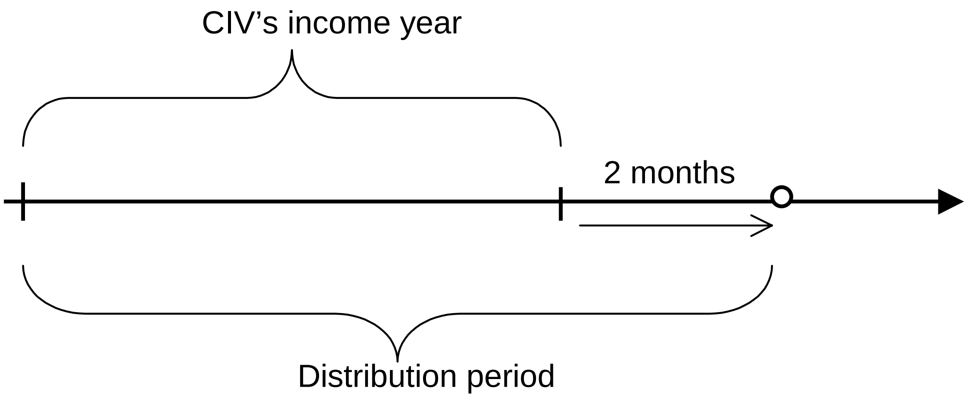
19.57 Rules are being developed to provide transitional roll-over relief in certain circumstances for the transfer of a company’s business, or all of a company’s assets, to a unit trust that comes under the CIV rules.

How are collective investment vehicles taxed?

19.58 Subdivision 157-A of the draft legislation provides additional rules for the taxation of CIVs. The effect of these rules is that a CIV will generally not have to pay income tax on its taxable income for an income year ***[section 157-10]***. The exception is where a CIV does not distribute all, or virtually all, of its taxable income for an income year before the end of the *distribution period* (see paragraph 19.59) ***[section 157-15]***. A CIV’s taxable income for the purposes of these rules is worked out on the basis that it is a resident entity to which the consistent entity treatment rules apply ***[section 157-30]***. Rules are being developed to exclude concessions intended to be only available to active businesses taxed under the consistent entity rules (e.g. the research and development allowance will not be available to CIVs).

19.59 The rules rely on a *distribution period* concept to ensure that taxable income received by a CIV in an income year can flow through to members in the same income year. Under this concept, the distribution period starts at the beginning of the relevant income year and ends two months after the end of that year ***[section 157-25]***. This concept is illustrated in Diagram 19.1.

Diagram 19.1



Example 19.4

> A CIV with an income year ending 30 June 2005 makes a distribution from its taxable income for that year on 2 August 2005.
>
> In determining the CIV's liability to pay tax on its taxable income for the 2004-2005 income year, the distribution is taken to have been made during the 2004-2005 income year.

19.60 In determining the extent to which a CIV has distributed its taxable income for an income year, the following distributions are taken into account:

- the total amount of distributions it makes from taxable income ***[paragraph 157-20(a)]***;
- the total amount of franking credits it passes on to members from that income ***[paragraph 157-20(b)]***; and
- the total amount of foreign tax credits it passes on to members from that income ***[paragraph 157-20(c)]***.

19.61 Where the sum of the amounts in the preceding paragraph is equal to the CIV's taxable income for an income year, the CIV is not liable to pay income tax on its taxable income ***[subsection 157-10(1)]***.

19.62 Franking credits and foreign tax credits passed on by a CIV to its members are included in the calculation of the amount of taxable income that it has distributed on the basis that these amounts would have been included in the CIV's taxable income when the income to which they relate was included.

19.63 A CIV will also not be liable to pay income tax on its taxable income for an income year if the amount it distributes from that taxable income before the end of the distribution period is equal to, or more than, 98% of its taxable income ***[paragraph 157-10(2)(a)]***. However, this particular rule only applies if the CIV's failure to fully distribute all of its taxable income before the end of the distribution period was the result of an error or miscalculation on its part ***[paragraph 157-10(2)(b)]***. Therefore, the rule will not provide any relief to a CIV where it has deliberately not distributed all of its taxable income.

19.64 In circumstances where a CIV fails to distribute the requisite level of taxable income, the CIV will be liable for income tax on its taxable income for an income year equal to the difference between:

- the amount of that taxable income; and
- the amount of taxable income that it distributes before the end of the distribution period.

[Section 157-15]

Example 19.5

> A CIV has taxable income of $100,000 for the 2000-2001 income year. Before the end of the distribution period it distributes $80,000 of that income to members. As a result, the CIV would be liable to pay tax at the prevailing entity tax rate on $20,000 of its taxable income.

How are distributions by collective investment vehicles taxed in the hands of members who receive them?

19.65 Where a distribution made by a CIV does *not* cancel the membership interest of the member, the resulting tax treatment depends on whether the distribution is from:

- taxable income ***[paragraph 157-50(1)(a)];***
- an accumulated taxable amount (explained in paragraph 19.77) ***[paragraph 157-50(1)(b)]***; or
- some other source ***[paragraph 157-50(1)(c)].***

19.66 If the CIV is unable to establish the funds from which the distribution came, the distribution will be taken to have been made from taxable income in the form of an unfranked dividend paid by a resident company out of profits received by it from sources in Australia ***[subsection 157-50(2)]***.

19.67 By express provision, the profits-first rule contained in section 154-1 of the consistent entity rules does not apply to CIVs ***[subsection 157-50(3)]***. Therefore, a CIV can make a distribution from contributed capital at a particular time even if it has taxable income available to distribute at that time.

Distributions from taxable income

19.68 Where a CIV makes a distribution to a member from its taxable income for an income year and the distribution is made after the end of the income year and before the end of the distribution period for that year, the member is taken to have received the distribution on the last day of that income year ***[section 157-45]***. This approach is consistent with the distribution period concept as it applies to CIVs.

Example 19.6

> If a CIV with an income year ending 30 June 2005 makes a distribution from its taxable income for that income year on, say, 1 August 2005, the member will be taken to have received the distribution on 30 June 2005 and will be required to include the distribution in his or her taxable income in the correlating income year. Consequently, the member will not include the distribution in his or her taxable income in the year in which the *actual* distribution is received.

Source and character

19.69 Where a CIV makes a distribution to a member from its taxable income for an income year and the distribution is from taxable income having a particular source and character, the distribution retains the same source and character in the hands of the member ***[subsection 157-55(1)]***. In other words, the distribution retains the same source and character in the hands of the member as if the member had received the income directly.

19.70 The term ‘source’ is a reference to the source of the income, whether in or out of Australia. The source of a particular distribution of taxable income may be relevant for determining whether a CIV has further withholding tax obligations. These obligations will be addressed in future rules dealing with withholding tax issues.

19.71 The term ‘character’ describes different types of taxable income including, but not limited to, interest income, dividend income, royalty income, business income, and income in the nature of a capital gain.

19.72 It follows that if a CIV receives, say, interest income from Australian sources, any distribution from that income will retain its source and character in the hands of the member receiving the distribution.

19.73 The requirement that a CIV be constituted by equal membership interests extends to an equal interest in the source and character of distributions made from taxable income ***[subparagraph 157-95(3)(b)(i)]***. Therefore, a CIV cannot distribute taxable income with a particular source and character to certain members and distribute taxable income with a different source and character to other members. This structural design feature prevents different kinds of distributions being streamed to certain members depending on their tax preferences.

19.74 If a CIV cannot establish the source and character of a distribution it makes from its taxable income, the distribution is taken to be an unfranked dividend paid by a resident company out of profits received by it from sources in Australia. ***[Subsection 157-50(2)]***

Distributions of taxable income from foreign source to non-resident

19.75 If a CIV distributes foreign source income from its taxable income to a non-resident, section 157-60 will have the effect that the foreign source income is exempt from Australian taxation in the hands of that member. This is achieved by providing the non-resident member with a decreasing tax adjustment equal to the amount of the foreign source income included in his or her taxable income ***[section 157-60]***. This provision is necessary because international tax agreements may treat the distribution as being attributable to an Australian permanent establishment and therefore subject to Australian taxation in the hands of non-resident members.

Distributions of accumulated taxable amounts

19.76 Where a CIV makes a distribution of an 'accumulated taxable amount', the member is taken to have received an unfranked dividend paid by a resident company out of profits received by it from sources in Australia ***[subsection 157-65(1)]***.

19.77 For this purpose, an accumulated taxable amount includes the following:

- either the whole or any part of a CIV's taxable income for an income year that it did not distribute within the distribution period for that year ***[subsection 157-65(2)]***;
- either the whole or any part of a CIV's taxable income for an income year that it did not distribute before the end of 2 months after it first became a CIV ***[subsection 157-65(3)]***; and
- after commencement of the provisions, any amount of a CIV's tax-preferred income that it did not distribute before the time it first became a CIV ***[subsection 157-65(4)]***.

19.78 Tax-preferred income is worked out using the formula:

Net market value of assets – Contributed capital – Taxable income

[Subsection 157-65(5)]

19.79 The terms 'contributed capital' and 'net market value of assets' take their meaning from the consistent entity rules and are determined immediately before the entity becomes a CIV. The term 'taxable income' is the entity's taxable income for the income year that ends immediately before it became a CIV ***[subsection 157-65(5)]***. Section 157-145 will have the effect that the period ending immediately before the entity became a CIV will be treated as a separate income year.

19.80 Special rules may be needed to deal with circumstances where an entity converts into a CIV after the date of enactment and the entity has unrealised capital gains at the time of conversion. There are several options that could be developed. One option may be to require entities to liquidate before converting to a CIV after an appropriate transition period. Another option may be to reduce the accumulated taxable amount when unrealised gains that existed at the time the entity became a CIV are realised and to tax the distribution as an unfranked dividend.

Distributions of other amounts

19.81 Where a CIV makes a distribution and the distribution is *not* from:

- its taxable income ***[subparagraph 157-70(b)(i)];***
- an accumulated taxable amount ***[subparagraph 157-70(b)(ii)]***;
- receipts arising from shares in a pooled development fund ***[subparagraph 157-70(b)(iii)]***; or
- payments relating to infrastructure borrowings ***[subparagraph 157-70(b)(iv)]***;

the consistent entity rules apply to the distribution as if it were a distribution from the CIV's contributed capital ***[section 157-70]***. These amounts would include such things as the CIV's contributed capital and tax-preferred income (other than tax-preferred income that is deemed to be an accumulated taxable amount under subsection 157-65(4)). This would include amounts freed from tax by accelerated depreciation allowances.

19.82 The effect of subsection 157-70 is that there will be a decrease in the closing tax value of the membership interest held by the member equal to the amount of the distribution. Broadly speaking, if the distribution is greater than the closing tax value of the member's interest, the excess will be taxed immediately. However, if the distribution is less than the closing tax value of the member's interest, tax will not be collected until such time that the interest is disposed of.

19.83 Where a distribution is from income arising from shares in a pooled development fund or payments relating to infrastructure borrowings, the distribution will not result in a decrease in the closing tax value of the membership interest held by the member. Furthermore, such distributions are effectively free of tax in the hands of the member receiving the distribution as a result of a decreasing tax adjustment for the member in the relevant income year equal to the amount of the distribution. ***[Section 157-75]***

Redemptions and cancellations

19.84 Where a CIV makes a distribution to a member that has the effect of cancelling or redeeming the membership interest, the distribution is treated as a distribution of contributed capital ***[subsection 157-80(2)]***. In this way the tax treatment is consistent with the outcome that would have occurred had the member disposed of the interest by selling it on market. However, this treatment only applies where the distribution is *not* made during the 'wind down period' set out in subsection 157-110(8) ***[paragraph 157-80(2)(c)]***.

19.85 The slice approach that operates under the consistent entity rules does not apply to distributions made by a CIV that extinguish the membership interests of members. ***[Subsection 157-80(1)]***

Example 19.7

> Peter buys units in a CIV for $2,000. Less than a year later, he redeems the units for $2,200 consideration. Peter would include the $2,200 consideration as a receipt in the calculation of his taxable income. Peter would also reduce the closing tax value of the units to $0. Therefore, Peter would have taxable income of $200 as a result of the redemption. (Provisions are being developed which would identify the $200 taxable income as a capital gain if the unit had been held for a year or more.)

Example 19.8

> Lucy buys units in a CIV for $1,000. The units are subsequently redeemed for $800. Lucy would include the $800 consideration as a receipt in the calculation of her taxable income. Lucy would also reduce the closing tax value of the units to $0. Therefore, Lucy would have a loss of $200 as a result of the redemption.

19.86 However, special rules apply where the CIV makes a distribution *during* the wind down period that has the effect of cancelling or redeeming a membership interest ***[subsection 157-80(3)]***. An explanation of the wind down period is provided in paragraph 19.44. The effect of these rules is that the member having his or her membership interest cancelled or redeemed will be taken to have received a slice of the CIV's taxable income, accumulated taxable amounts, and other amounts. The respective amounts are calculated in accordance with the formula provided in subsection 157-80(3). For example, the slice of taxable income for a distribution is determined using the formula:

$$\text{Amount of distribution} \times \frac{\text{Available taxable income immediately before distribution}}{\text{Net market value of assets immediately before distribution}}$$

[Paragraph 157-80(3)(d)]

19.87 Similarly, the slice taken to be an accumulated taxable amount is determined using the formula:

$$\text{Amount of distribution} \times \frac{\text{Sum of accumulated taxable amounts immediately before distribution}}{\text{Net market value of assets immediately before distribution}}$$

[Paragraph 157-80(3)(e)]

19.88 The balance of the distribution will be taken to be neither from taxable income nor an accumulated taxable amount and will therefore be taxed as if it is a distribution of the CIV's contributed capital. ***[Paragraph 157-80(3)(f)]***

Example 19.9

Joan holds 1,000 units in a CIV.

The CIV gives notice to its members, including Joan, that it is to wind down, effective immediately.

Shortly afterwards the CIV makes a $100 distribution to Joan to redeem all of her units.

Immediately before the distribution to Joan, the CIV calculates the following:

- net market value of its assets – $200,000;
- available taxable income – $50,000;
- accumulated taxable amounts – $20,000.

When Joan receives the $100 distribution it would be taken to be comprised of the following amounts:

Taxable income

Amount of distribution × Available taxable income immediately before distribution

$$\frac{}{\text{Net market value of assets immediately before distribution}}$$

$$= \$100 \times \frac{\$50{,}000}{\$200{,}000}$$

$$= \$25$$

Accumulated taxable amounts

$$\text{Amount of distribution} \times \frac{\text{Sum of accumulated taxable amounts immediately before distribution}}{\text{Net market value of assets immediately before distribution}}$$

$$= \$100 \times \frac{\$20{,}000}{\$200{,}000}$$

$$= \$10$$

Balance

$100 – $25 – $10 = $65

In summary, the $100 distribution in the hands of the Joan would be taken to be:

- $35 of taxable income:
  - $25 of which would have the source and character as it did in the CIV; and
  - $10 would be taken to be an unfranked dividend;
- $65 of the CIV's contributed capital and tax-preferred income.

Defined terms

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