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## FOREWORD

The papers included in this edition of the *Journal of the Australasian Tax Teachers Association (JATTA)* are based on presentations made at the 15<sup>th</sup> Annual Conference of the Australasian Tax Teachers Association (ATTA) held on Thursday 30 January to Saturday 1 February 2003 at the University of Wollongong, Wollongong, New South Wales.

The Vice-Chancellor of the University of Wollongong, Professor Gerard Sutton, opened the conference and welcomed the delegates. Plenary presentations were given on the opening day of the conference by the (now late) Hon. Justice Graham Hill, (Patron of ATTA) and Michael D'Ascenzo, Second Commissioner of Taxation (Australia). These were followed by a panel discussion of industry representatives on the conference theme 'The Tax and Accounting Interface'. On the second day of the conference a New Zealand perspective was provided by the plenary speakers Jim Gordon, of the Inland Revenue Department (New Zealand), and Professor John Prebble, Faculty of Law, University of Wellington.

The conference theme, 'The Tax and Accounting Interface', permitted cross-disciplinary discussion on a number of issues relevant to the key professions of financial accountancy and law. Sub-themes included: inconsistencies between tax law and accounting standards; the pressure of compliance with two systems; seeking harmony between the two systems; and international developments and comparisons. This edition of *JATTA* contains selected papers from the conference that address the theme of the tax and accounting interface. These papers illustrate issues associated with having to comply with both the tax system and the financial accounting system and the significance of the incongruencies between the two. We believe that these papers make a valuable contribution to the discourse and will stimulate continued debate.

The 15<sup>th</sup> Annual Conference was a success due to the efforts and support of many, including the sponsorship of the key Australian publishers in the taxation law field, and especially the tireless work of Shelley King (*nee* Johnson). Thank you to all those involved in the conference and the review process, the authors, and particularly the detailed work of our copy editor, Elaine Newby, without whom the publication of this edition of peer reviewed papers would not have been completed.

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22 December 2005

## **THE INTERFACE BETWEEN TAX LAW AND ACCOUNTING CONCEPTS AND PRACTICE AS SEEN BY THE COURTS**

JUSTICE D G HILL\*

### I INTRODUCTION

From time to time there is a call for the replacement of the present income tax base, and in particular the concepts of assessable income and allowable deductions, with a tax base founded upon the business accounts of the taxpayer.<sup>1</sup> Integration of tax and accounting rather than mere intersection might be thought to have a superficial attraction, at least for the corporate taxpayer.

First and foremost would be the saving in costs which are said to accrue in avoiding the need for two sets of business accounts to be kept, one for accounting purposes and one for tax purposes, and the need to reconcile the one to the other. A second, although less obvious advantage might be thought to rid taxation of the judge-made rules which have developed in tax law. No longer would antiquated legal concepts of income and the dichotomy of income and capital (emanating from concepts of trust law, the very domain of lawyers) obscure the income tax. In place of these arcane concepts would be substituted the more enlightened, practical and unambiguous concepts to be found in the practical experience of accountants and business people and perhaps economists.

However, the difficulties which face the proponents of the use of corporate accounts for tax purposes may prove insurmountable. Even if there were agreement on the accounting principles to be applied to an entity in every circumstance, the degree of flexibility in them would mean a potential loss of revenue. The greatest flexibility may perhaps be said to reside in the concept of materiality which to a lawyer suggests that almost any accounting treatment may be adopted as long as the outcome does not overall have a material impact. What is and what is not material leaves much room for discretion.

Perhaps some public companies are under sufficient pressure from shareholders to maximise profits, and thus dividends, to ensure that steps are not taken to defer profits, but the same cannot be said for non-public companies, which may prefer to reduce immediate profits and thus dividends in favour of increased capital growth, and one may doubt whether it could even be said for all public companies.

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\* Article based on a paper delivered by the late Justice Graham Hill to the 15<sup>th</sup> annual conference of the Australasian Tax Teachers Association, Wollongong, 31 January – 1 February 2003. The editor appreciates the contribution made by Ms Jennifer Farrell BA (UNSW) DipEd (Syd) LLM (UNSW) GradDipLegalPrac (College of Law), Research Assistant, Federal Court of Australia, in assisting to finalise this article.

<sup>1</sup> The idea of relating the tax basis to accounting concepts is not the same as the approach to be found in the present Australian legislation of referring to accounting rules in the course of legislative drafting, for example, the consolidation provisions do this in ss 705-70 and 705-90 of the *Income Tax Assessment Act 1997* (Cth) and so too do the thin capitalisation rules in ss 820-315, 820-410, 820-470, 820-675, 820-680 and 820-950 of the same Act.

Nor is there agreement on all accounting principles within Australia, let alone agreement internationally on accounting standards where there is an ongoing conflict for supremacy between principles adopted in the United States and those applicable in European Union countries. And although the growth of accounting standards in Australia over the past 10 to 15 years has ensured that the coverage of the standards is quite extensive, it is unlikely that such standards either now or in the future will, at least unambiguously, cover the whole range of situations which may face the totality of taxpayers.

Nor is the apparent attraction of dispensing with what, to economists at least, are wrong-headed legal principles quite as attractive as it sounds. The consequence, at least on the margins (and the problems of the dichotomy of the income/capital distinction, for example, are likewise only on the margins) will be to replace legal controversy with accounting controversy. To the already high costs of tax litigation will be added the costs of a new layer of disputation: the need for expert accounting evidence in all cases — or, at the very minimum, in those cases where there is room for disagreement — and ultimately judges will still be there.

The present article therefore assumes the continued existence of the current tax base and seeks to analyse from the case law to date the way in which accounting principles intersect with taxation in the basic areas which the court decisions deal with. In the cases reference is often made to accounting principles and principles adopted by business people. I do not think that there is any suggestion in the cases that these are different things. Accordingly, unless the context otherwise requires I will use the expression ‘accounting principles’ or cognate expressions to cover both accounting principles and the principles applicable to business.

## II THE BASIC CONCEPTS

As will be discussed below, questions of the relationship between general accounting and tax accounting have arisen both in the context of income derivation and in the context of losses or outgoings incurred. And it is these two areas which will be the focus of the present discussion. Indeed, these have also been the areas where the relationship to accounting has been most explored by the courts. However, these are not the only areas where accounting may impact the tax outcome. For example, the consolidation provisions make specific reference to accounting standards.<sup>2</sup>

The most obvious area outside the basic principles of income and general deductions where accounting principles must have great significance is that of capital allowances where ‘cost’ is a factor in the deduction — particularly depreciation. So, the diminishing value method described in s 40-70 of the *Income Tax Assessment Act 1997* (Cth) (‘the 1997 Act’) takes as an element in the formula adopted the ‘base value’ of the asset, which is generally its cost. The prime cost method likewise commences with the ‘asset’s cost’. Where the issue of cost is complicated, the court could have regard to (and indeed might be greatly assisted by) accounting evidence designed to establish what the cost of the asset is. ‘Cost’ is also an important element in the computation of a capital gain.

Where a particular deduction is predicated upon expenditure being incurred ‘in respect of’ some particular activity (for example, the construction of capital works)<sup>3</sup> or expenditure ‘on’ something<sup>4</sup> or ‘in relation to’ some activity,<sup>5</sup> then accounting evidence would be of assistance in any allocation that might be necessary where the expenditure has multiple

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<sup>2</sup> The references are set out in note 1.

<sup>3</sup> See *Income Tax Assessment Act 1997* (Cth) s 43-70(1).

<sup>4</sup> See, eg, *Income Tax Assessment Act 1997* (Cth) s 43-70(2).

<sup>5</sup> See, eg, *Income Tax Assessment Act 1997* (Cth) s 43-70(2).

purposes.

While a distinction can, as already noted, be drawn between accounting principles on the one hand and accounting or business usage on the other, there is no doubt that business usage will be of assistance, perhaps even determinative, in areas of the tax law where business terms are used. The obvious example is the concept of 'trading stock', now defined in s 70A of the 1997 Act in what is merely an inclusory definition. Generally there will be little doubt as to what is trading stock and thus little controversy. However, business usage and both accounting theory and practice were found to be of assistance in *Suttons Motors (Chullora) Wholesale Pty Ltd v Federal Commissioner of Taxation* ('*Suttons Motors*')<sup>6</sup> in determining whether goods on floor plan were trading stock for the purposes of the long since repealed trading stock valuation adjustment deduction.<sup>7</sup>

The evidence in *Suttons Motors* was admitted without objection. The full High Court, Gibbs CJ, Wilson, Deane and Dawson JJ (Brennan J dissenting), did not suggest that there was any difficulty in the evidence being received. This would be consistent with the general rule that evidence cannot be adduced as to the meaning of ordinary English words, but can be of words used in a technical sense. The majority judgement said:

The ordinary meaning of the term 'trading stock' upon which s 6(1) builds is that which is attributed to it by legal and commercial people for accounting and other purposes. ... It is not necessary for present purposes however to explore the outer limits of the area covered by that ordinary meaning of the term.<sup>8</sup>

The issue of what is the cost of trading stock, like the issue of the cost of depreciable items, can also raise accounting issues. An example is the decision of Jenkinson J, then of the Supreme Court of Victoria, in *Philip Morris Ltd v Federal Commissioner of Taxation*<sup>9</sup> where the question of absorption costing arose in the context of s 31(1) of the *Income Tax Assessment Act 1936* (Cth) ('the 1936 Act') which used the expressions 'cost price' and 'cost'. That case raised, but did not ultimately resolve, the question of whether ingredients and partially finished goods should be treated as trading stock. The case was ultimately settled and the interesting issues it raised not decided. It is understood that some of these issues are presently before the Federal Court for decision.<sup>10</sup>

In summary it can be said that accounting evidence will be relevant in any area of income tax where the legislation uses the language of accounting or business (whether that is 'cost' or 'cost price' or 'profit'), as well as in areas where it is necessary to allocate the amount of expenditure incurred for more than one purpose to only one of such purposes. The use of accounting concepts in the context of the general income or deduction provisions may be explained in the same way, although it can be argued that the accounting concepts actually in use differ not only from the statutory concepts applicable to deductions but also from those applicable to the derivation of income.

## A *Income Derived*

### 1 *Cash or Accrual Accounting*

It is not surprising that the relevance of accounting principles and evidence arose early in

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<sup>6</sup> (1982) 82 ATC 4415, 4424–6 where the evidence is summarised by Tadgell J of the Supreme Court of Victoria. The taxpayer was successful ultimately on appeal to the High Court: (1985) 157 CLR 277.

<sup>7</sup> *Income Tax Assessment Act 1936* (Cth) s 82D(1).

<sup>8</sup> (1985) 157 CLR 277, 281.

<sup>9</sup> (1979) 79 ATC 4352. Reference to the accounting evidence can be found at 4355–60.

<sup>10</sup> As at 1 February 2003.

the High Court tax jurisprudence in the context of cash or accrual accounting.<sup>11</sup> In some jurisdictions, such as the United States, the question is dealt with statutorily.<sup>12</sup> However the Australian legislation is silent and does no more than include in assessable income that income which is ‘derived’ by the taxpayer in the year of income.<sup>13</sup> *Commissioner of Taxes (SA) v The Executor Trustee & Agency Company of South Australia Ltd* (‘*Carden*’)<sup>14</sup> is today generally thought to stand for the proposition that an ordinary sole practitioner practice (in this instance a medical practice) must account for tax on a cash basis.<sup>15</sup> However the issue was not directly that. It was whether, in the last year of practice up to the date of death of the taxpayer, it was open to the Commissioner to assess the executor of the taxpayer upon an earnings basis and if so whether unpaid fees which had been rendered in the former period should have been brought to account. The High Court answered the first of these questions in the affirmative<sup>16</sup> and the latter in the negative<sup>17</sup> and in so doing affirmed that the deceased in the previous year properly accounted for tax on a cash basis. There was an incidental question of whether the Commissioner could reopen the assessment of the previous year to bring to account the book debts and an issue about apportionment of deductions.<sup>18</sup>

It seems that until that decision professional persons had been permitted to return income on a cash received basis, although there was no court authority to the effect that they had a right to be assessed on that basis. It is interesting to note that Latham CJ, dissenting, was of the view that the question of the method of accounting to be adopted by taxpayers was one to be answered solely by reference to the statute in question and not by reference to accounting practice. Accordingly, his Honour said:

It has frequently been argued that the ascertainment of income is a “business” matter, so that, for example, a court must take “profits” as determined by business men, with such deductions as are reasonable and proper from a business point of view, and must then apply income tax provisions to profits so ascertained. (Contentions as to allowances for depreciation of plant, &c., provide a good illustration.) Warrington LJ, referring to an argument of this character, in *Inland Revenue Commissioners v Von Glehn* ... said:- “The question whether this deduction is to be allowed is one that must be determined by the rules regulating the assessment of income tax and not by rules regulating what may be allowed in the preparation either for a company, an individual, or a firm, of the balance-sheet or the profit and loss account. A firm or a company carrying on business may within certain limits treat as a deduction from profits such sums as it pleases, but for the purposes of income tax the deductions which may be allowed from the gross profits are strictly regulated by the Income Tax Acts”. If the relevant Act deals with a matter in a particular manner, it is quite immaterial that taxpayers prefer to deal with it in another manner. It is for this reason that I have based my judgment entirely upon the statute and upon decisions which seem to me to be in point.”<sup>19</sup>

Dixon J, with whose judgement Rich and McTiernan JJ agreed, was of a different view. His Honour, in passages which are so well-known as not to require repetition, discussed the rival methods of ascertaining income and held that in the period to the end of the last complete year of income the cash receipts method provided the substantially correct reflex of the taxpayer’s income.<sup>20</sup> However, the rule that the receipts basis provided a ‘fair and

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<sup>11</sup> (1938) 63 CLR 108 (‘*Carden*’).

<sup>12</sup> 26 *Internal Revenue Code* 446.

<sup>13</sup> *Income Tax Assessment Act 1997* (Cth) s 6(5). Note year of income is generally 1 July – 30 June (unless another period adopted under s 18: *Income Tax Assessment Act 1936* (Cth) s 6(1)).

<sup>14</sup> (1938) 63 CLR 108.

<sup>15</sup> *Ibid* 160

<sup>16</sup> *Ibid* 109.

<sup>17</sup> *Ibid*.

<sup>18</sup> *Ibid*.

<sup>19</sup> *Ibid* 133–4.

<sup>20</sup> *Ibid* 158–59.



appropriate foundation' for estimating professional income was subject to the qualification that there be continuity in the practice of the profession.<sup>21</sup> The broken period up to the date of death stood upon a different footing, for it was not a complete period forming part of a continuous practice.<sup>22</sup> The period was subject to a special assessment required under the relevant South Australian legislation.<sup>23</sup> Without any real explanation it was said that it was thus open to the Commissioner in that period to adopt the earnings basis.<sup>24</sup>

Dixon J in his judgement notes that the tendency of judicial decisions to that time was to place increasing reliance upon the principles and practices of commercial accountancy.<sup>25</sup> His Honour said that unless the statute made specific provision the question of cash or accrual accounting depended upon appropriateness.<sup>26</sup> His Honour then said:

The reasons which underlie the practice of estimating for taxation purposes the income from trade or manufacture by means of a commercial profit and loss account consist in the impracticability of computing income in any other way and in the adoption for fiscal purposes of recognized commercial principles ... The result is that a tax upon the profits or income of such a business must be understood as a tax upon the profits or income computed according to the system, because, according to common understanding and commercial principles, that is the method of determining the profits ...

In the language employed by the statute in describing the subject of the tax, I am unable to find any special guidance or anything distinguishing the South Australian statute from other income tax legislation in reference to the choice between the accrual and the receipts basis of calculation.<sup>27</sup>

The passage I have cited would appear to bring about the result, absent any particular statutory provision, that accounting practice would be determinative of the issue of income derivation at least. However, it is interesting to note that it would appear that there never was any accounting evidence before the Supreme Court of South Australia from which the appeal was taken by way of a special case.

It was not until 1970 in *Henderson v Federal Commissioner of Taxation* ('*Henderson*')<sup>28</sup> that the High Court returned to considering the question of cash or accrual accounting. The question in that case was the appropriateness of adopting an accrual basis by the accounting firm of Bird and Partners in Western Australia. It arose in part because the change of accounting from a cash to an accruals basis had the consequence that book debts outstanding as at the commencement of the year in which the change took place were never brought to account for tax purposes.<sup>29</sup>

It is not clear from the report whether accounting evidence was given in *Henderson*, despite what had been said in *Carden*. The Commissioner's argument, at first instance, as reported, was that the 'proper construction of the Act cannot be determined by the method of accounting used'.<sup>30</sup> Gross income derived is not the same as profits, which is the accounting concept. Barwick CJ, with whose judgement McTiernan and Menzies JJ agreed, had little difficulty in concluding that the partnership in *Henderson* presented a different picture from the sole medical practitioner in *Carden*. Nor did his Honour accept the proposition that it was open either to the Commissioner or the taxpayer to elect which method of accounting could be

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<sup>21</sup> Ibid 158.

<sup>22</sup> Ibid.

<sup>23</sup> *Taxation Act 1927-1935* (SA) s 42.

<sup>24</sup> (1938) 63 CLR 108, 160.

<sup>25</sup> Ibid 153.

<sup>26</sup> Ibid 154.

<sup>27</sup> Ibid 155-7.

<sup>28</sup> [1969] HCA 14; (1970) 119 CLR 612 (18 April 1969).

<sup>29</sup> [1969] HCA 14 [20] - [21] (Windeyer J); (1970) 119 CLR 629.

<sup>30</sup> See (1970) 119 CLR 612, 616.

adopted. The only appropriate method to be adopted in the particular case was accrual accounting which his Honour saw as requiring bringing to account 'only fees which have matured into recoverable debts'.<sup>31</sup> There was no basis for some principle of estimation of work in progress.<sup>32</sup>

The concentration on 'recoverable debts' in *Henderson* led inevitably to the question which arose in *Commissioner of Taxation (Cth) v Australian Gas Light Co* ('*Australian Gas Light Co*'),<sup>33</sup> that is, the question of when fees can be considered to have matured into recoverable debts, in this instance whether or not a gas company reticulating gas to consumers was required to bring to account gas delivered to consumers where the gas meter had not yet been read. The full Court of the Federal Court, Bowen CJ, Fisher and Lockhart JJ, answered the question in the exceptional circumstances of the case in the negative because under the relevant legislative scheme unbilled gas had not matured into a recoverable debt until the meter was read.<sup>34</sup>

There have been a number of later cases which have considered the issue of cash versus accrual accounting in particular situations. These include: *Commissioner of Taxation v Firstenberg*,<sup>35</sup> *Commissioner of Taxation v Dunn*<sup>36</sup> and *Barratt v Commissioner of Taxation*<sup>37</sup> and *Dormer v Federal Commissioner of Taxation*.<sup>38</sup> In each of them, except perhaps *Dormer*, expert evidence was given.

What is significant for present purposes is that there seems to have been, by the time *Barratt* came to be decided, a shift in jurisprudential thinking on the place accounting evidence has in determining the issue of income derivation. The Dixon view, which on my reading of it had the consequence that accounting evidence was determinative of how the Act operated when the issue was income derivation, appears to have given way to the view that such evidence would be persuasive only. Gummow J in *Barratt* (with whose views Northrop and Drummond JJ agreed) adopted what had been said on the point by Davies J in *Dunn*:

Although ordinary accounting principles and practice are not determinative of the issue, they are relevant and may be influential, as Dixon J in Carden's case ... and Barwick CJ, Kitto and Taylor JJ in *Arthur Murray (NSW) Pty Ltd v Commissioner of Taxation (Cth)* (1965) 114 CLR 314 at 318 pointed out.<sup>39</sup>

The difference is not unimportant, although it appears not to have been noticed, at least until the judgement in *BHP*<sup>40</sup> to which reference will shortly be made. The question may be posed whether, assuming uncontroverted accounting evidence on the issue of income derivation, it would be open to a court to reject that evidence and decide an income derivation question in a way contrary to accounting practice. That has never happened and I doubt it ever will.<sup>41</sup> It can be said that the results in each of the cases involving the application of cash or accrual accounting would be accepted by accountants as representing the appropriate

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<sup>31</sup> Ibid 650.

<sup>32</sup> Ibid.

<sup>33</sup> (1983) 74 FLR 13.

<sup>34</sup> Ibid 21.

<sup>35</sup> (1976) 76 ATC 4141.

<sup>36</sup> (1989) 85 ALR 244.

<sup>37</sup> (1992) 36 FCR 222.

<sup>38</sup> [2002] FCAFC 385 (Wilcox, Spender and Cooper JJ, 29 November 2002).

<sup>39</sup> (1989) 85 ALR 244, 255.

<sup>40</sup> *BHP Billiton Petroleum (Bass Strait) Pty Ltd & Esso Resources Pty Ltd v Federal Commissioner of Taxation* [2002] FCAFC 433 (Hill, Heerey and Gyles JJ, 20 December 2002); 126 FCR 119.

<sup>41</sup> It can be argued that *Grollo Nominees Pty Ltd v Federal Commissioner of Taxation* (1997) 97 ATC 4585 presents a rejection of the absolute accounting principle rule. The case is discussed in the hearing 'Accounting for long term transactions'. However the decision on the point was dicta.

accounting treatment. But if, in fact, a court will always find consistently with accounting principle then it may be preferable to return to the Dixon formulation.

## 2 *Payment in Advance of Performance of Contractual Obligations*

The issue of the appropriate tax treatment of monies paid in advance of the performance of contractual obligations was decided by the High Court in *Arthur Murray* referred to above. Accounting evidence in that case was not given. Rather the case proceeded on an agreed statement of fact which was, to say the least, specific in its terms. So far as appears from the report of the decision, the statement was to the effect that the parties agreed that according to established accounting and commercial principles, and whether in the case of persons selling goods or performing services, amounts received in advance of the goods being delivered or services being performed are not regarded as income.

For present purposes the case is significant for two passages which, on one view at least, are contradictory in the way they regard the role of accounting evidence. In the first passage,<sup>42</sup> Barwick CJ, Kitto and Taylor JJ, though they referred to the importance of the general understanding among practical business people of what may constitute income and accountancy, then noted that the question nevertheless depended ‘basically’ upon the judicial understanding of the meaning which the words convey to those (presumably business people) who observe the relevant distinction (that is, as to when income is derived).<sup>43</sup> Bookkeeping was ‘but evidence of the concept’.<sup>44</sup>

In the second passage,<sup>45</sup> however, their Honours appear to have reverted (assuming there is any inconsistency) to the views of Dixon J in *Carden*. After noting that a different situation existed with deductions where, as we shall see, the Act is said to lay down rules inconsistent at least to some degree with accounting principles, their Honours emphasised that the 1936 Act laid down no test for the derivation of income.<sup>46</sup> Had it done so, then commercial and accounting practice clearly could not be a substitute for such a test. However, their Honours then observed:

The word “income”, being used without relevant definition, is left to be understood in the sense which it has in the vocabulary of business affairs. To apply the concept which the word in that sense expresses is not to substitute some other test for the one prescribed in the Act; it is to give effect to the Act as it stands. Nothing in the Act is contradicted or ignored when a receipt of money as a prepayment under a contract for future services is said not to constitute by itself a derivation of assessable income. On the contrary, if the statement accords with ordinary business concepts in the community – and we are bound by the case stated to accept that it does – it applies the provisions of the Act according to their true meaning.<sup>47</sup>

## 3 *Accrual Accounting Where the Debt Otherwise Recoverable is in Dispute*

The English legislation has no difficulty dealing with the situation where there is a bona fide third party dispute either as to the amount which a taxpayer is to derive in the year of income or as to the quantum of a deduction otherwise allowable in that year. The relevant legislation permits the accounts of the year to be reopened and adjusted to include additional amounts as income either where what is claimed to have been derived as income is ultimately

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<sup>42</sup> (1965) 114 CLR 314, 318. ‘The ultimate inquiry in either kind of case ... but evidence of the concept’.

<sup>43</sup> Ibid 318.

<sup>44</sup> Ibid.

<sup>45</sup> Ibid 319. ‘It was Dixon J’s understanding ... having finally acquired the character of income’.

<sup>46</sup> Ibid 320.

<sup>47</sup> Ibid.

increased or where the quantum of a deduction is later reduced. The problem in Australia is the tight time limits for amending assessments to be found in s 170 of the 1936 Act.<sup>48</sup>

A case which demonstrated the problem for the then Papua New Guinea legislation, which was couched in similar terms to the 1936 Act, is *Commonwealth-New Guinea Timbers Ltd v Chief Collector of Taxes (PNG)* ('*Commonwealth-New Guinea Timbers*').<sup>49</sup> In that case there had been an agreement between the taxpayer and the Australian government that if Australian customs duty was payable on the taxpayer's timber products on importation into Australia the Commonwealth would pay the taxpayer a subsidy not greater than the duty paid. In each year the taxpayer had returned as income the amount it claimed to be entitled to as a subsidy.<sup>50</sup> In so doing the taxpayer acted in accordance with established accounting principles.<sup>51</sup> The Commonwealth, however, denied liability to pay the taxpayer the amounts to which the taxpayer claimed to be entitled. Ultimately the Commonwealth paid in the 1961 tax year an amount in respect of claims for the 1958 and 1959 tax years. It was not obliged to do so.<sup>52</sup> In the 1961 year the taxpayer wrote off the balance of the amount it had not been reimbursed. The Commissioner included in the 1961 year the amount received from the Commonwealth but disallowed the deduction for the write-off. The taxpayer continued in later years to include as income amounts it claimed in those years to be entitled to be paid by the Commonwealth. It later requested the revenue authorities in Papua New Guinea to amend the assessments of these later years to exclude from assessable income the amounts to which the taxpayer claimed to be entitled in those years.

The result was a disaster for the taxpayer. It was held that because the taxpayer had no enforceable claim against the Commonwealth the amounts received from the Commonwealth were only income in the year of receipt.<sup>53</sup> No deduction was allowed for the written-off amounts as there had been no debt owed to the taxpayer which it could write off.<sup>54</sup> No amendment to the later year assessments was authorised to reduce the taxpayer's liability to tax in those years<sup>55</sup> because the power to reduce the taxpayer's liability could only be exercised to correct an error in calculation or mistake of fact and here the correction arose because of a mistake of law.<sup>56</sup> The comparable provisions of s 170(9) of the 1936 Act dealing with amendments, where an estimated amount has been included in assessable income where that income was derived from an operation or series of operations the profit or loss of which was not ascertainable, were also held inapplicable.<sup>57</sup>

The result offends both common sense and equity. Not surprisingly it is criticised by the late Professor Parsons in his text, somewhat by way of understatement, as being 'inconvenient'.<sup>58</sup>

*BHP*<sup>59</sup> was the first occasion when it became necessary for a court in Australia to consider when income is derived by an accruals based taxpayer in circumstances where there was a dispute between the taxpayer and a purchaser from the taxpayer as to the amount invoiced by the taxpayer for the sale of a commodity. Accounting evidence was led and not cross-

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<sup>48</sup> *Income Tax and Assessment Act 1936* (Cth) s 170.

<sup>49</sup> (1972) 72 ATC 4048.

<sup>50</sup> *Ibid* 4051.

<sup>51</sup> *Ibid*.

<sup>52</sup> *Ibid* 4051-2.

<sup>53</sup> (1972) 72 ATC 4048, 4049.

<sup>54</sup> *Ibid* 4049.

<sup>55</sup> Cf *Income Tax Assessment Act 1997* (Cth) s 170(4).

<sup>56</sup> (1972) 72 ATC 4048, 4049.

<sup>57</sup> *Ibid* 4049.

<sup>58</sup> R W Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (1985) paras 11.226-11.243.

<sup>59</sup> [2002] FCAFC 433; 126 FCR 119.

examined upon by the Commissioner. That evidence was to the effect that in the circumstances of the case it would be incorrect to bring to account as a profit in the financial statements of the taxpayer the disputed amounts until the dispute was resolved.<sup>60</sup> The resolution of the dispute took some years, during which time there had been a hotly contested arbitration extending over some 43 days and thereafter an application for judicial review of the arbitrator's award to the Supreme Court which was ultimately settled.

At first instance Kenny J held that the whole of the disputed amount was income in the year the commodity was supplied (or the year in which invoices were rendered, there being little practical difference between those two times).<sup>61</sup> Her Honour's decision might at first sight appear to involve an application of the principle that a jurisprudential analysis of income derivation must take precedence over accounting principle. However, a closer analysis shows that the primary judge was of the view that the accounting evidence was irrelevant because the expert accountant had proceeded upon a wrong analysis of the contractual arrangements.<sup>62</sup> On appeal, the full Court by majority (Hill and Heerey JJ) was of the view that her Honour had misunderstood the accounting evidence and accepted it as relevant.<sup>63</sup> The case was decided, ultimately, in accordance with that evidence. The Court left open the question of whether there was really a difference between the approach to accounting evidence taken in the *Australian Gas Light Co* and that taken by Dixon J in *Carden* and Barwick CJ in *Henderson*.

Gyles J delivered a separate concurring judgement. His Honour noted that Kenny J had taken the view that the price for the gas was one indivisible sum when it was not.<sup>64</sup> His Honour, having stated his agreement with the majority of the Court that in the case where there was a bona fide dispute, the vendors derived income only when that dispute was resolved,<sup>65</sup> then commented:

The question is whether that general principle is to be applied in the present case and, if so, how. It is not clear to me that the primary judge would disagree with that general principle, or with the opinion of Professor Walker to that effect. Rather, I take the primary judge to have declined to apply that general principle to a case where the dispute on the part of the purchaser is as to only one element of the calculation of a total price. In those circumstances, the primary judge preferred to apply another, and more basic, general principle – namely, that (depending upon the contract and other circumstances) the price for a commodity which is delivered is derived on revenue account no later than the time of delivery. It seems to me that her Honour took the view that it is not possible to apportion or dissect the price or consideration for the supply of the gas under the present contracts. I do not agree with the submission of the appellants that, on its face, this can be seen to be an error in principle and contrary to authority. It can just as easily be asserted (as it was by counsel for the respondent) that the primary judge was applying orthodox principle.<sup>66</sup>

The majority judgement made no comment on what the situation would have been if it had not been possible to apportion or dissect the price or consideration.

The comment of Gyles J will, perhaps, generate further litigation in a future case, assuming that it is accepted by the Commissioner. For my part, and as presently advised, I am not sure that I think there is any reason to believe that there is the distinction which his Honour drew or that the rule that derivation occurs on sale of trading stock is a more 'basic general principle' than the rule that derivation will occur only on resolution of a bona fide

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<sup>60</sup> 126 FCR 119, 127–8.

<sup>61</sup> Ibid 128.

<sup>62</sup> Ibid 129.

<sup>63</sup> Ibid 138.

<sup>64</sup> Ibid 150.

<sup>65</sup> Ibid 144.

<sup>66</sup> Ibid.

dispute. It is not easy to imagine a case where the question will arise. However, let it be assumed that the purchase price or consideration is such that the whole of it depends upon a formula, and there is a constituent of the formula about which there is a bona fide dispute. There are then two possibilities. The parties may agree that there is, on any view, a minimum figure payable or they may be in total disagreement about the price or consideration. I would imagine that if there were agreement about a minimum figure accounting, evidence would show that the proper treatment would be to bring the agreed figure in as income and defer, until the dispute is resolved, the balance. If that is so, then I see no reason why the courts would take any different view. If the whole of a single undissected purchase price is in dispute then the accounting evidence would presumably be that income was not derived until the dispute was resolved, whether by litigation or agreement. I do not see why the courts should not be guided by that evidence just as they are when there is a purchase price with multiple components. And the fact that the ordinary income tax rule is that income from the sale of trading stock is brought to account when the stock is sold does not seem to me to matter in such a case.

It is interesting to consider the consequences had the decision at first instance been affirmed. As it happens, on the facts in *BHP* the amounts that the taxpayers actually recovered were 'more or less' as invoiced. I say 'more or less' because the evidence suggested that there had been a series of invoices for different amounts so that the amount actually recovered represented the amount last invoiced and not necessarily the amount first invoiced.<sup>67</sup> If it be assumed that the amount actually recovered had been more — or less — than the amount invoiced then a number of questions arise. If it were more, the taxpayer would have understated its income and be liable to additional tax by way of penalty; if less, the taxpayer would presumably not be entitled to a deduction for a write off of the debt for the reasons given in *Commonwealth-New Guinea Timbers*<sup>68</sup> and there would be a difficult question of whether it would have been entitled to a deduction under s 51(1) of the 1936 Act. Further, the taxpayer would have had to pay the tax notwithstanding that the dispute deferred the time for payment for some years. Indeed, if it did not it would run the risk of being put into liquidation by the Commissioner. To repeat the views of Professor Parsons, the result would indeed have been 'inconvenient' to the taxpayer.

At the time of writing it is not known if the Commissioner proposes to seek leave to appeal the decision of the Federal Court from the High Court.

#### 4 *The American 'Claim of Right' Doctrine*

In *BHP*, reference is made in passing to US cases and particularly to the 'claim of right' doctrine adopted in that country.

At its simplest the US 'claim of right' cases make it clear that while a taxpayer in dispute with a customer will not — until that dispute is settled — have to bring to account amounts invoiced but not paid. However as soon as payment takes place — and notwithstanding that the dispute is continuing — the taxpayer must bring to account the amount which it has received under a 'claim of right'. The doctrine as stated by Brandeis J in the Circuit Court of Appeal for the 9<sup>th</sup> Circuit in *North American Oil Consolidated v Burnet*<sup>69</sup> is as follows:

If a taxpayer receives earnings under a claim of right and without restriction as to its disposition he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money and even though he may still be adjudged liable to restore its

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<sup>67</sup> (1972) 72 ATC 4048; 126 FCR 127.

<sup>68</sup> (1972) 72 ATC 4048; 126 FCR 127.

<sup>69</sup> (1932) 286 US 417.

equivalent.<sup>70</sup>

The US cases do not turn upon accounting evidence.<sup>71</sup> Hence it is not clear whether accountants in the US would account that way. However, presumably there might be a need for a provision to take into account the estimated amount which may have to be repaid by the trader if the trading account was to give a full and true view of the trader's affairs.

Professor Parsons in his text recommended adoption of the US model for the resolution of the type of problem which arose in *BHP*.<sup>72</sup> There is a problem, however, with the Professor's discussion of the claim of right doctrine which may be noted here. The learned author, when stating the US doctrine suggests that in the case of an accrual basis taxpayer income will be derived when the taxpayer asserts a claim of right to recover the amount, whether or not that amount has been paid,<sup>73</sup> and that, where no such right is asserted, income will be derived when an amount which is in dispute is paid.<sup>74</sup> Certainly US law is clear that payment of an amount in dispute will result in the taxpayer deriving income, even though the taxpayer may later have to repay the amount. What is not clear from the US authorities to which reference is made in the text is the correctness of the first of these propositions. Indeed, Professor Bittker in his work takes the more common sense view that disputed income will only accrue when the dispute is resolved, rather than when a claim is made, and restricts the claim of right doctrine to the case where actual payment is made.<sup>75</sup> The first part of Bittker's proposition accords with the law in Australia as now stated in *BHP*. The second part of the proposition, that dealing with payment of disputed amounts while the dispute continues, has not been the subject of any discussion in Australia.

Burchett J in *Zobory v Commissioner of Taxation*<sup>76</sup> refused to apply the claim of right doctrine (in its traditional formulation involving actual payment rather than claim) in Australia, noting that the unfairness of taxing a constructive trustee on monies received but not beneficially owned by the taxpayer — as was the case in *Healy v Commissioner of Internal Revenue*<sup>77</sup> — had been alleviated in the US by statute. One problem of adopting the claim of right doctrine in respect of payment of disputed amounts is clearly the question of whether Australian law would, as US law does,<sup>78</sup> allow the taxpayer a deduction if there is a need to repay. Another problem is of the kind discussed in *Zobory*. Australian taxation law has generally been thought to proceed upon the basis that it is only where a taxpayer has beneficially derived amounts that it can be said that the taxpayer has derived income. If amounts are received under a constructive trust<sup>79</sup> then it would seem to be the law in Australia that there has been no derivation.<sup>80</sup> If the obligation to repay did not arise by the application of trust law but in contract, should there be any different result? These problems are perhaps only on the fringe of the present article and accordingly will not be pursued further.

However, there remains an open question, in a case where a trader sells trading stock and in circumstances where there is a bona fide dispute, whether the trader derives income where some or all of the amount in dispute is paid by the purchaser under protest. If the view of

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<sup>70</sup> Ibid 424.

<sup>71</sup> See, eg, *ibid* 422.

<sup>72</sup> Parsons, above n 58, para 11.237.

<sup>73</sup> See, *ibid*, para 11.237, principle (1).

<sup>74</sup> 26 IRC §§ 41, 42(a).

<sup>75</sup> Boris I Bittker, *Federal Taxation of Income, Estates and Gifts* (2<sup>nd</sup> ed, 1992) 105–68.

<sup>76</sup> (1995) 64 FCR 86, 94.

<sup>77</sup> (1953) 345 US 278.

<sup>78</sup> 26 IRC §§ 41, 42(a).

<sup>79</sup> The factual situation in *Roxborough v Rothmans of Pall Mall Australia Ltd* (2001) 185 ALR 335, if adapted, might suggest a case where the problem could arise without the illegality involved in *Zobory*.

<sup>80</sup> See *Zobory* (1995) 64 FCR 86, 94.

Gyles J in *BHP* is correct, the answer to the question will at the least depend upon whether the purchase price is apportionable. If it is not apportionable, then his Honour would, it would seem, bring the whole of the consideration into account as income, notwithstanding that the amount properly payable may not be known for many years, and it will be irrelevant that the purchaser has made a payment. But assuming that the purchase price was not apportionable, there would remain for Gyles J, as well as for the other members of the Court in *BHP*, the question of whether payment would, in circumstances where there was a bona fide dispute, bring about derivation of income to the extent of the amount paid. There may even be a different result depending upon whether the payment is made to the vendor directly, or where there is payment into court.

### 5 *Accrual Accounting and Trading Stock*

There is no doubt that, both for ordinary accounting purposes and for the purposes of tax accounting, a trader in goods accounting on an accrual basis will bring to account income when the trading stock is sold. One common sense explanation for this is that once a sale takes place the trading stock sold must be taken out of the trading stock account for it will no longer be on hand and there will be a need for that stock to be replaced by the debt arising from the transaction of sale or, when the debt is paid, by the cash paid for the stock.

The question which arose in *J Rowe & Son Pty Ltd v Federal Commissioner of Taxation*<sup>81</sup> was whether, when trading stock was sold on terms, the whole of the sale price should be brought to account as income or whether income should be brought to account on a profit emerging basis (that is, as and when the purchase price came to be paid). Expert accounting evidence showed that general accounting practice was to bring to account the sale price of the goods at the time of making the contract, notwithstanding that at that time there was not an enforceable debt for the whole price.<sup>82</sup> The High Court followed the accounting principle. Indeed, Gibbs CJ adopted what might be called the Dixon approach in *Carden*, saying:

When the Act gives no directions on the point, the question when income is earned, and the method of accounting to be adopted for the purpose of ascertaining the income, depend upon business conceptions and the principles and practices of accountancy...<sup>83</sup>

Menzies J, with whose reasons Barwick CJ, McTiernan and Gibbs JJ had agreed, made the point perhaps elliptically, but certainly bluntly, when his Honour said:

It follows that I consider that the taxpayer's main contention is opposed to ordinary principles of accounting, to the scheme of the Act and to authority. It *must*, therefore, be rejected.<sup>84</sup>

It is convenient to deal at this point with other Australian cases which have involved trading stock.

The first is *Gasparin v Commissioner of Taxation*<sup>85</sup> where the full Federal Court (Jenkinson, Spender and von Doussa JJ) was required to decide in the case of land sales whether income was to be brought to account when contracts were exchanged or only when the sale was settled. In that case there was no uniform accounting view. The Court held that the profit was to be brought to account only at completion for it was only then that the land

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<sup>81</sup> (1970-1) 124 CLR 421.

<sup>82</sup> Ibid 451-2.

<sup>83</sup> Ibid 452.

<sup>84</sup> Ibid 450 (emphasis added).

<sup>85</sup> (1993) 50 FCR 73.



ceased to be trading stock of the trader.<sup>86</sup>

The second is *Farnsworth v Federal Commissioner of Taxation*.<sup>87</sup> That case raised the question of when income was derived where trading stock (fruit) was, as part of a marketing scheme, mingled with the produce of other farmers for sale and growers received progress payment for their fruit in circumstances where the balance payable was still outstanding at the end of the year of income, although it could be estimated. The Commissioner's argument that the estimated amount was income was rejected, notwithstanding that the trading stock had clearly, at the moment of delivery ceased to be trading stock on hand and to be reflected as such in the taxpayer's trading account.<sup>88</sup> There does not seem to have been any accounting evidence before the High Court at least, for the matter proceeded in that Court on a case stated which made no reference to accounting principles. Dixon J noted that this was a case where the taxpayer should be taxed on a cash receipts, rather than on an accrual basis.<sup>89</sup>

The accounting method suggested in *Farnsworth* was likewise adopted in *Federal Commissioner of Taxation v Squatting Investment Co Ltd*<sup>90</sup> in the context of a war-time wool scheme where growers received deferred amounts in respect of their wool which had been stockpiled. A similar result was reached for trust accounting purposes in the related decision in *Ritchie v Trustees Executors and Agency Co Ltd*.<sup>91</sup>

Finally in this context reference may be made to *Ballarat Brewing Co Ltd v Federal Commissioner of Taxation*<sup>92</sup> where discounts and rebates allowed by a taxpayer on the sale of its products were taken into account in calculating income, notwithstanding that as at the end of the year of income the preconditions for those discounts or rebates had not been satisfied. Fullagar J made it clear that the question of the correct figure to take into account in calculating 'sales' (an estimate) was one which depended upon (and presumably therefore was to be decided conclusively by) the conceptions of business and the principles of accounting.<sup>93</sup> To fail to take into account discounts which were almost invariably given was to adopt a figure which would be misleading.<sup>94</sup>

## 6 Accounting for Long Term Transactions

Accounting evidence (other than of the taxpayer's own books) does not seem to have been adduced in *Federal Commissioner of Taxation v Thorogood*,<sup>95</sup> a case often cited as supporting a profit emerging basis,<sup>96</sup> but actually not really deciding anything because of procedural difficulties. However Gibbs J in *XCO Pty Ltd v Federal Commissioner of Taxation*<sup>97</sup> did suggest that a profit emerging basis could be appropriate where a profit making scheme extended over a period of more than one tax year.<sup>98</sup> The question then is whether accounting principles will be relied upon to determine the method of calculation of profit where long term contracts have been entered into.

The question of accounting for profit from long-term construction contract was the

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<sup>86</sup> Ibid 83.

<sup>87</sup> (1949) 78 CLR 504.

<sup>88</sup> Ibid 518–19.

<sup>89</sup> Ibid 519.

<sup>90</sup> (1953–4) 88 CLR 413.

<sup>91</sup> (1951) 84 CLR 553.

<sup>92</sup> (1951) 82 CLR 364.

<sup>93</sup> Ibid 369.

<sup>94</sup> Ibid.

<sup>95</sup> (1927) 40 CLR 454.

<sup>96</sup> See, eg, *ibid* 458.

<sup>97</sup> (1971) 124 CLR 343.

<sup>98</sup> *Ibid* 351.

subject of discussion in New Zealand in *HW Coyle Ltd v Commissioner of Inland Revenue (New Zealand)*.<sup>99</sup> However, as the report notes, there was some difference of opinion then in the accountancy profession as to the appropriate method of accounting.<sup>100</sup> Two methods were used: the percentage of completion method or the completed contract method. The choice of method, so Holland J held, would vary depending upon the contract. Where there could be no accurate forecast as to whether there would be a profit or a loss it could be desirable to prepare accounts on a completed contract basis at least until such time as an accurate forecast was possible.<sup>101</sup> In other cases a percentage of completion method would produce an appropriate calculation of profit.<sup>102</sup> Not surprisingly it was held that the method to be adopted would turn upon the circumstances of each case and in particular the terms of the relevant contract.<sup>103</sup>

Perhaps the fact that the Commissioner issued a ruling on the tax treatment of long-term construction contracts brought about the result that there was little incentive to litigate the question. The ruling, IT 2450, rejected the completed contract method but permitted either the bringing to account of all progress and final payments received in the year (or billed or entitled to be billed) or an estimated profits basis from year to year

The subsequent case of V95<sup>104</sup> in the Administrative Appeals Tribunal was decided without accounting evidence and dealt with the tax treatment of a provision in the taxpayer's accounts for work which might have to be performed during a contract's liability period under a contract for manufactured hospital sterilisers.

*Grollo Nominees Pty Ltd v Federal Commissioner of Taxation*,<sup>105</sup> a decision of a full Court of the Federal Court comprising Sheppard, Foster and Whitlam JJ, was a case where accounting evidence was adduced in relation to long term construction contracts. The Court in that case adopted the view of accounting evidence that had been espoused by Gummow J in *Barratt*, to which reference has already been made. Their Honours commented in dicta that the emerging profits basis preferred by accountants did not seem one permitted by the Act.<sup>106</sup>

### 7 *The Computation of Accounting Profit as Opposed to Assessable Income Less Allowable Deductions*

Before turning to the impact of accounting principles on deductions there is what may be referred to as an intermediate question. It arose in *Commissioner of Taxation v Citibank Ltd*.<sup>107</sup>

Finance companies account for finance leases in such a way that each component of the lease 'rental' includes a finance element akin to interest and each such component includes a capital component. This method of accounting is known as the financial or actuarial method of accounting for financial transactions. The question was whether for the purposes of the 1936 Act a finance company could bring to account as income the finance element. The Commissioner required the taxpayer to bring to account as gross income the rental as received and take as a deduction against it depreciation as calculated under the Act. The advantage to the finance company (and thus disadvantage to the Commissioner) lay in the fact that there was a cap in the income tax law (s 57AF(2) of the 1936 Act) upon the amount upon which

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<sup>99</sup> (1980) 80 ATC 6012.

<sup>100</sup> Ibid 6019.

<sup>101</sup> Ibid.

<sup>102</sup> Ibid 6019–20.

<sup>103</sup> Ibid 6012.

<sup>104</sup> (1988) 88 ATC 631.

<sup>105</sup> (1997) 97 ATC 4585.

<sup>106</sup> Ibid 4587.

<sup>107</sup> (1993) 44 FCR 434.

depreciation was allowed in respect of luxury cars. There was, no doubt, the added advantage that acceptance of the financial (or actuarial) accounting method would avoid the need for the making of the alternative computation which, otherwise, the Australian income tax law would require

At first instance Beaumont J was attracted to the adoption of the commercial approach to the computation of the finance company's income.<sup>108</sup> On appeal, however, the full Court, (Jenkinson, Einfeld and Hill JJ) found that the financial method was inconsistent with the Act which requires there to be brought to account as assessable income amounts which are gross income, and there being offset against that assessable income amounts which were allowable deductions.<sup>109</sup> Once it was accepted (as indeed it had to be) that the rental instalments were gross income, there was no room for the adoption of an alternative approach designed to treat as assessable income a part of the gross income which commercial accounting principles recognised as the accounting profit.

### III A DIFFERENT APPROACH TO DEDUCTIBILITY?

The relevance of accounting evidence to the issues of deductibility under s 51(1) of the 1936 Act or s 8-1 of the 1997 Act is much less clear. For simplicity I will hereafter refer only to s 51(1) as there is no relevant difference between that subsection and s 8-1 of the 1997 Act.

As will be demonstrated, the case law often makes it clear that accounting principles are irrelevant because legal concepts prevail over them. On the other hand sometimes accounting principles have been regarded as relevant where the legislation may not have suggested that to be the case. It is convenient in discussing the issues to divide the discussion so that it deals with the different concepts that are to be found in the general deductibility sections. However, as will be seen there is necessarily overlap. The issues to be discussed are:

- the quantification of a loss,
- the timing of a loss,
- estimates – the insurance cases,
- the deductibility of provisions for long service leave and annual holiday pay, and
- the question of whether the loss or outgoing is one of capital.

#### A *The Quantification of Loss*

There is no reason to doubt that if a question should arise as to whether a taxpayer incurred a loss for the purpose of either s 51(1) or s 8-1, accounting evidence could be resorted to both to determine whether there was a loss and to determine the quantum of that loss. As Kitto J said in considering whether a profit arose for the purposes of the then s 26(a) of the 1936 Act: 'Whether a given amount is to be characterised as a profit ... is a question of the application of a business conception to the facts of the case.'<sup>110</sup> Likewise in the United Kingdom it is well established that: 'The question of what is or is not profit or gain must primarily be one of fact, and of fact to be ascertained by the tests applied in ordinary business',<sup>111</sup> although subject to the obvious proposition that the application of principles of commercial accounting must yield to any special income tax provision which requires a different result.<sup>112</sup>

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<sup>108</sup> Ibid 442.

<sup>109</sup> Ibid 434.

<sup>110</sup> *Federal Commissioner of Taxation v Becker* (1952) 87 CLR 456, 467. See also *XCO Pty Ltd v Federal Commissioner of Taxation* (1971) 124 CLR 343 (Gibbs J) to which reference was earlier made in the context of the profit emerging basis.

<sup>111</sup> *Sun Insurance Office v Clark* [1912] AC 443, 455 (Viscount Haldane).

<sup>112</sup> Ibid. See also *BSC Footwear Ltd v Ridgeway* [1972] AC 544 and *Willingdale (Inspector of Taxes) v International*

The same can be said of the conception of 'loss'. This having been said there have been no cases in Australia, of which I am aware, which have actually discussed the relevance of accounting principles directly to the question of establishing that there has been a loss or quantifying the amount of such a loss for the purposes of s 51(1).

Interestingly, however, the concept of loss was discussed by a full Court comprising Jenkinson, Olney and Sundberg JJ in *Burrill v Commissioner of Taxation*<sup>113</sup> in the context of s 70B of the 1936 Act dealing with losses arising from the disposal of a traditional security. The case came to the Federal Court on a case stated from the Administrative Appeals Tribunal and it does not seem that any accounting evidence had been adduced in the Tribunal or if it had, that it was referred to in the stated case. The decision, which depended upon the computation of a loss being made by reference to the face value of the security, rather than the market value of the security<sup>114</sup> may be criticised on commercial grounds for ignoring the time value of money. Be that as it may, the full Court suggested that the principle there discussed was as much relevant to s 51(1) as it was to s 70B.<sup>115</sup>

### B *The Timing of a Loss*

What causes the difficulty in using accounting evidence in the context of deductions is the concept of 'incurred', for there can be no deduction for a loss or outgoing unless it can be said that that loss or outgoing has been incurred. For present purposes it is not necessary to say other than that the word 'incurred' has no particular technical meaning. It bears its ordinary meaning of 'run into', or 'encountered' or 'fallen upon' but does not extend to include a loss or expenditure which is no more than 'impending, threatened or expected'.<sup>116</sup> That meaning and its relationship to accountancy principle is best dealt with in the discussion of the deductibility provisions.

A significant case in the context of s 51(1) is *New Zealand Flax Investments Limited v Federal Commissioner of Taxation*.<sup>117</sup> Indeed the legacy of the case is still with us. The facts are complicated. In short it can be said that the taxpayer had issued bonds entitling bondholders to an initial fixed return while the taxpayer developed its flax business (including preparing the ground and planting flax and developing plant for milling it). At the end of this development period bondholders were entitled to a percentage return on flax sales. Investors could pay either cash or the face value of the bonds by instalments. Commissions were paid to salesmen of the bonds. The taxpayer took into its commercial accounts the proceeds of the bonds sold (that is, their face value) as revenue, whether or not received. It sought to offset against that revenue all the expenditure it was obliged to outlay on cultivation, plant et cetera. The Commissioner disallowed the deductions for outlays, although he left standing the revenue side of the account for taxation purposes.<sup>118</sup>

It was argued for the taxpayer that the taxable income should be ascertained in accordance with accounting principles.<sup>119</sup> It was held that it was not correct to treat as income derived the whole face value of bonds subscribed for, whether or not that amount had been paid.<sup>120</sup> Indeed, it was said that the bond proceeds were really consideration for services to be

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*Commercial Bank Ltd* [1978] AC 834.

<sup>113</sup> (1996) 96 ATC 4629.

<sup>114</sup> *Ibid* 4630.

<sup>115</sup> *Ibid* 4634.

<sup>116</sup> *New Zealand Flax Investments Ltd v Federal Commissioner of Taxation* (1938) 61 CLR 179, 207.

<sup>117</sup> (1938) 61 CLR 179.

<sup>118</sup> *Ibid* 180.

<sup>119</sup> *Ibid* 189–91.

<sup>120</sup> *Ibid* 180.

performed over time and thus were not income when received, thus anticipating *Arthur Murray*.<sup>121</sup> On the deduction side the obligation to pay interest to investors was a definite liability, contingent only upon the bondholders paying up the bonds.<sup>122</sup> Dixon J then said:

There is no reason why the future liability should not be treated as incurred, if otherwise it were proper to throw it against the revenue items, as it would clearly have been if the full face value of the bonds were included in the assessable income. But I find it difficult to say upon the information before us whether any of this liability should be considered as properly attributable to the years in question. There is, I think, no objection to the commissioner's taking into consideration the actual events of the subsequent years in order to see whether, under a method of accounting by which only actual receipts from the bonds are included, the liability for interest would naturally be provided out of revenue from that source accruing in the year when the liability would be met, or whether safe or proper practice required for the purpose an appropriation and retention of part of the sums received in the accounting periods under assessment. In the same way I think that the commissions payable on the sale of bonds but deferred until the receipt of later instalments involve an outgoing 'incurred', but one which does not necessarily and as a matter of course fall into the assessment of the accounting period.<sup>123</sup>

His Honour indicated that the matter should be remitted to the Commissioner to be reassessed:

so as to enable him to include bond moneys received in the accounting periods and to allow whatever part, if any, of the deductions claimed for future interest and deferred commission appears *referable* to the accounting periods under assessment.<sup>124</sup>

The reference to referability did not re-emerge until *Federal Commissioner of Taxation v Australian Guarantee Corp Ltd*,<sup>125</sup> a case dealing with the deductibility by a finance company of interest on debentures where the interest was payable on maturity. It was held in that case that the taxpayer was entitled to the deduction progressively over the term of the debenture where the interest was then referable to that year.<sup>126</sup> Although the High Court granted special leave to appeal this decision, that leave was revoked when legislative amendments were introduced which rendered the significance of the decision immaterial.

The decision of the High Court in the later *Coles Myer Finance Ltd v Federal Commissioner of Taxation ('Coles Myer')*<sup>127</sup> showed the significance of referability, this time in the context of discounted bills or promissory notes. The taxpayer, a finance company, sold the bills or notes at a discount from face value around the end of the fiscal year. In the next financial year the taxpayer became obliged to pay to the purchasers of the bills the face value. It claimed to have incurred a loss at the time it discounted or sold the bills or notes, for at that time it became liable to pay the face value of the bill. The Commissioner argued that the taxpayer did not incur a loss until the year of income in which it became obliged to pay the holders of the bill the face value. The intermediate situation, which the High Court adopted, was that the loss on each transaction occurred progressively over the period of time from discounting of the bills or notes until the time for payment.<sup>128</sup>

Mason CJ, Brennan, Dawson, Toohey and Gaudron JJ said:

But it is not enough to establish the existence of a loss or outgoing actually incurred. It must be a

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<sup>121</sup> *Arthur Murray (NSW) Pty Ltd v Commissioner of Taxation (Cth)* (1965) 114 CLR 314.

<sup>122</sup> (1938) 61 CLR 179, 207.

<sup>123</sup> Ibid 207.

<sup>124</sup> Ibid 208 (emphasis added).

<sup>125</sup> (1984) 84 ATC 4642.

<sup>126</sup> Ibid 4642.

<sup>127</sup> (1992-3) 176 CLR 640.

<sup>128</sup> Ibid 666.

loss or outgoing of a revenue character and it must be properly referable to the year of income in question.<sup>129</sup>

Later their Honours said:

Under s 51(1) a loss or outgoing is a deduction only to the extent to which it is incurred in gaining or producing the assessable income. That provision has been described as ‘a statutory recognition and application of the accountancy principle which as the accountants who gave evidence referred to as the matching principle’ ...

Apportionment of the cost over the two years of income therefore accords with both accounting principle and practice and the statutory prescription.<sup>130</sup>

*Coles Myer* was, to some extent, the opposite side of the coin to *Willingdale v International Commercial Bank Ltd* to which reference has been earlier made by way of a footnote. However in the English case the bills or notes were long term and sometimes designated in foreign currency with the result that the House of Lords was of the view that the profit did not arise until the Bank was obliged to pay the face value of them or until the Bank sold them on the market.<sup>131</sup> In that case the accounting evidence was that the Bank could either account for the profit progressively or could account for the profit at the time the bills or notes matured, so long as, in the latter case, it made a relevant disclosure of how it had accounted.<sup>132</sup>

The High Court in *Coles Myer* gave the example of the long-term discount transaction in support of the correctness of the approach it had adopted,<sup>133</sup> but made no reference at all to *Willingdale*. The High Court pointed out that to allow the discount at the time of commencement, particularly in the case of discount arrangements that continue over a long term, would distort the accounts of the taxpayer, as indeed it would.<sup>134</sup> But if ‘matching’ were a relevant principle of tax law, as it is of accountancy, it may well have been the case that the deduction should only arise at the end of the transaction when according to the House of Lords the profit arose.

One explanation of *Coles Myer* that appeals to me is that the case is one concerning the deductibility of a loss, rather than the deductibility of an outgoing. If the question arose when the finance company incurred the obligation to pay the face value of the paper which was discounted, the answer would in my view clearly be the date of sale or discounting. However, that is not the point of time at which the taxpayer incurred the loss; rather it can be said that the loss is incurred progressively over the period of the transaction. However, it must be said that in the course of the judgement the High Court drew no distinction between loss and outgoing. Further, the subsequent discussion of the case by Dawson, Toohey, Gaudron, McHugh and Kirby JJ in *Federal Commissioner of Taxation v Energy Resources of Australia Ltd*<sup>135</sup> would seem to be contrary to the view I have just expressed. Their Honours said:

So, in *Coles Myer*, the Court held that the difference between the discounted proceeds of an issue of promissory notes and the amount payable on their maturity was a loss or outgoing that was incurred when the note was issued. However, the majority in that case held that the cost of the discount was deductible in the year in which it was incurred only ‘to the extent to which it is incurred in gaining or producing the assessable income’ of that year.<sup>136</sup>

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<sup>129</sup> Ibid 663.

<sup>130</sup> Ibid 665–6.

<sup>131</sup> *Willingdale (Inspector of Taxes) v International Commercial Bank Ltd* [1978] AC 834.

<sup>132</sup> Ibid 852.

<sup>133</sup> (1992–3) 176 CLR 640, 666.

<sup>134</sup> Ibid.

<sup>135</sup> (1996) 185 CLR 66.

<sup>136</sup> Ibid 75.

In discussing the problem in *Commissioner of Taxation v Mercantile Mutual Insurance (Workers' Compensation) Ltd*,<sup>137</sup> I pointed out that while the facts of the case were concerned not with an outgoing but with the deductibility of a loss, the High Court did not seem to draw any distinction between the two, rather they noted that it was easier to conceive of a loss being incurred over time than of an outgoing being incurred over time. Whatever may be said of *Coles Myer*, however, the position would clearly seem to be that there may be some losses or outgoings which may be incurred wholly within the year of income but their deductibility may be limited to the extent that the loss or outgoing is incurred in gaining or producing the assessable income of that year.

No case otherwise has applied the referability test. The subsequent cases concerning prepayments,<sup>138</sup> both of which were cases of outgoings, appear to have limited the application of *Coles Myer* to the special case of financing transactions.

### C *The Insurance Cases and Estimates*

One area where accounting practice has led to a sensible and commercial tax result is in the area of insurance, notwithstanding the view that is often expressed that s 51(1) is concerned with losses or outgoings which are 'incurred' and not with provisions for outgoings which might be incurred in the future.<sup>139</sup>

The first Australian authority to deal with the method of taxation accounting to be adopted by an insurance company was *Commissioner of Taxation (NSW) v Manufacturers' Mutual Insurance Ltd* ('*Manufacturers' Mutual*')<sup>140</sup> where it was held that pending claims were deductible where from a practical business point of view they would be paid and where a statement of affairs of the insurer would be inaccurate and misleading if they were not taken into account.<sup>141</sup>

*Manufacturers' Mutual* was followed in *RACV Insurance Pty Ltd v Federal Commissioner of Taxation* ('*RACV*')<sup>142</sup> where it was held that the taxpayer which wrote liability insurance was entitled to a deduction of an estimate of the value of claims reported but not yet paid, and claims where the contingency insured against had happened but the claim had not yet been reported (often referred to as 'claims incurred but not reported').<sup>143</sup> The estimates were made on a sophisticated basis. Nevertheless the Commissioner submitted that it was only when the liability to indemnify the insured was actually determined, by settlement or court order, that there was a loss or outgoing which was incurred for the purposes of s 51(1).<sup>144</sup>

The case may be seen either as deciding that the total premiums paid in the year were not income, but that it was only such premiums as were left after a deduction of an estimate of claims incurred but not reported and claims reported but not paid, or as deciding that a provision for these two kinds of claims was deductible. The former approach would be consistent with the estimate for discounts and rebates taken into account in *Ballarat Brewing* discussed above. However, the reasoning proceeds upon the latter basis, namely that the estimate was a loss incurred in the year deductible under s 51(1). Menhennitt J made the

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<sup>137</sup> (1999) 87 FCR 536, 549ff.

<sup>138</sup> See, eg, *Commissioner of Taxation v Woolcombers (WA) Pty Ltd* (1993) 47 FCR 561 and *Merchant v Commissioner of Taxation* (1999) 99 ATC 4221, although the latter case was ultimately decided on another basis.

<sup>139</sup> (1984) 84 ATC 4642, 4657.

<sup>140</sup> (1931) 31 SR (NSW) 575.

<sup>141</sup> *Ibid* 585.

<sup>142</sup> (1974) 74 ATC 4169.

<sup>143</sup> *Ibid* 4184.

<sup>144</sup> *Ibid* 4175.

following comments relevant to the accounting evidence:

The accountants who gave evidence said that in their opinion it would not give a true and fair view of an insurance company's accounts if there were not included in the profit and loss account as a debit estimates of claims estimated but not paid. It was said further that for an insurance company carrying on business for profit to declare profits and pay dividends without taking such claims into account would not be proper and that if dividends were paid out without taking such estimated claims into account it could well lead to the company having insufficient moneys with which to pay outstanding claims and might lead to insolvency. It would also appear from the evidence that the insolvency in recent years of a large overseas insurance company was mainly due to inadequacy of estimate of outstanding claims.<sup>145</sup>

The Court also held that adjustments of the provisions in later years should the amount provided for be inadequate (or should there be an overprovision) would give rise to a further deduction or assessable income as the case may be. Reference was made to *New Zealand Flax*, to which reference has already been made, and *Texas Co (Australasia) Ltd v Federal Commissioner of Taxation*.<sup>146</sup>

*RACV* was followed in *Commercial Union Assurance Company of Australia Ltd v Federal Commissioner of Taxation*.<sup>147</sup> Both cases were accepted as correct by a full Court of the Federal Court (Hill, Sackville and Hely JJ) in *Commissioner of Taxation v Mercantile Mutual Insurance (Workers' Compensation) Ltd*.<sup>148</sup> In that case the Court rejected an argument by the Commissioner that the deduction should be reduced having regard to the time which would be likely to elapse between the contingency insured and actual payment. The taxpayer was not required to discount to present value the amounts required to be paid in the future.<sup>149</sup> The Court held further that there was no general principle of tax law that no deduction could be obtained for a 'provision', so long as there was a loss or outgoing that was otherwise incurred.<sup>150</sup> In the insurance context there was a liability that was incurred when the contingency insured against happened and the deduction was an estimate of the amount which otherwise was unknown. Sackville J noted in his Honour's judgement that there was a real possibility of distortion where the time value of money was not taken into account,<sup>151</sup> but the point not having been taken his Honour was content to reach the same conclusion as the other members of the Court.<sup>152</sup>

It has also been held that the principle in *RACV* is equally applicable to a self-insurer, so that such a taxpayer could deduct the value of its existing statutory liability to make future compensation payments to injured workers, as long (of course) as the estimates were bona fide and not unreasonable.

It is convenient here to make reference to the decision of Newton J in *Commonwealth Aluminium Corporation Ltd v Federal Commissioner of Taxation*,<sup>153</sup> although it is not an insurance case. The Court held that the taxpayer was entitled to a deduction for a royalty payable in respect of mining carried out in the year in circumstances where the royalty had not been paid and indeed where it was not at the end of the year of income capable of calculation because it was based on average world value of aluminium which had not then

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<sup>145</sup> Ibid 4181.

<sup>146</sup> (1940) 63 CLR 382, 465-6.

<sup>147</sup> (1977) 77 ATC 4186.

<sup>148</sup> (1999) 87 FCR 536.

<sup>149</sup> Ibid 548.

<sup>150</sup> Ibid 549.

<sup>151</sup> Ibid 557-8.

<sup>152</sup> Ibid 557.

<sup>153</sup> (1977) 77 ATC 4151.



been calculated.<sup>154</sup> It was held that the obligation to pay had crystallised and that the taxpayer was entitled to a deduction of a reasonable estimate of the amount of the liability.<sup>155</sup>

The question of what would happen should it turn out that too much was paid by way of royalty by a taxpayer in a case where the royalty was allowed as a deduction came to be considered in *H R Sinclair & Son Pty Ltd v Federal Commissioner of Taxation*<sup>156</sup> where it was held that the refunded amount was income in the year of receipt.<sup>157</sup> It is not certain whether the accounting treatment had an impact, but Owen J did note that the amount had been correctly shown in the taxpayer's accounts as income of that year.<sup>158</sup> The Court did say, however, that the English decisions which deal with the problem by reopening the accounts for the year in which the initial deduction for the royalty was claimed might be more equitable but depended upon the special statutory provisions applicable there.<sup>159</sup>

#### D Annual Holidays and Long Service Leave

It is clear that no financial statements of a corporation would give a full and true view of its affairs unless a provision were made for annual holiday pay and long service leave accrued during the year. Yet it is equally clear that no deduction is available for income tax purposes for such a provision.

That no deduction was available for a provision in the accounts for annual leave was decided in *Federal Commissioner of Taxation v James Flood Pty Ltd* ('*James Flood*').<sup>160</sup> This was so because under the terms of the relevant industrial award no liability to pay the leave arose until an employee had commenced taking it, or had retired or died.<sup>161</sup> There was 'at best an inchoate liability in process of accrual but subject to a variety of contingencies'.<sup>162</sup> A similar approach was taken to long service leave in *Federal Commissioner of Taxation v Northern Timber and Hardware Co Pty Ltd*.<sup>163</sup>

The issue was litigated again, both in the context of annual holiday pay and long service leave in *Nilsen Development Laboratories Pty Ltd v Federal Commissioner of Taxation* ('*Nilsen*').<sup>164</sup> A deduction was again denied. Barwick CJ explained the reason for the decision as being that no liability, in the sense of a pecuniary obligation which has become due had 'come home' in the year of income so that it could be said that the liability had been incurred.<sup>165</sup> The terms of the industrial award made it clear that there was no obligation on an employer to make any payment until the particular leave was entered upon by the employee or the employee retired or died.<sup>166</sup> There was, in other words, an entitlement to leave, not an entitlement to payment for leave.

Gibbs J in *Nilsen* repeated the distinction drawn in *James Flood* between the Australian and the United Kingdom legislation. In the United Kingdom the question is what are the profits or gains of a taxpayer. So, it is necessary in determining those profits to have regard to commercial principles.<sup>167</sup> By contrast, in Australia the issue is whether a loss or outgoing has

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<sup>154</sup> Ibid 4164–5.

<sup>155</sup> Ibid 4166.

<sup>156</sup> (1966) 114 CLR 537.

<sup>157</sup> Ibid 537.

<sup>158</sup> Ibid 547.

<sup>159</sup> Ibid 543.

<sup>160</sup> (1953) 88 CLR 492.

<sup>161</sup> Ibid 504–5.

<sup>162</sup> Ibid 508.

<sup>163</sup> (1960) 103 CLR 650.

<sup>164</sup> (1981) 144 CLR 616.

<sup>165</sup> Ibid 623.

<sup>166</sup> Ibid 620.

<sup>167</sup> Ibid 628.

been incurred.<sup>168</sup> The answer to that question is constrained by the legal meaning given to the word 'incurred'. This has led to it being said that in Australia the question of the application of s 51(1) proceeds by way of a jurisprudential rather than a commercial analysis.<sup>169</sup> The Privy Council was not, it would seem, impressed by the Australian jurisprudential approach when it came to decide *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Ltd* ('*Mitsubishi*').<sup>170</sup> Indeed, their Lordships described it as being 'an unusual approach to a taxing statute'.<sup>171</sup>

*Mitsubishi* concerned the deductibility in New Zealand by a motor car assembler of a provision for the anticipated costs of meeting future warranty claims. It was held that a legal obligation to make a payment in the future had accrued during the year of income and accordingly the provision was deductible under the New Zealand equivalent to s 51(1).<sup>172</sup> This accords with the accounting treatment which would be required. It is obvious from the decision that their Lordships were in agreement with the insurance cases to which reference has been made and with the idea that in New Zealand the tax treatment should follow the accounting treatment.

The comments of McHugh J in *Coles Myer*<sup>173</sup> make it clear also that his Honour finds the principles laid down in *James Flood* and *Nilsen* to be difficult. However, it would seem unlikely that the High Court will revisit the question of the deductibility of provisions for long service leave and annual holiday pay in the near future, if at all.

### E Capital versus Income

It will be recalled that in *Carden* Dixon J noted that income was a concept of the world of business. So too is 'capital'.<sup>174</sup> If accounting evidence can be presented to show whether a particular amount, or part of an amount, is income, can accounting evidence assist in determining whether an amount or part of an amount is capital?

Cases which raise the question whether an outgoing is of capital or is on capital account generally revolve around the classic formulation of Dixon J in *Sun Newspapers Ltd v Federal Commissioner of Taxation*<sup>175</sup> rather than accounting evidence directed at showing that the amount in question is capital or income. I have encountered accounting evidence in this context only once, and that was in my capacity as counsel for the taxpayer in *Travelodge Papua New Guinea Ltd v Chief Collector of Taxes*.<sup>176</sup> Actually it was not that either party in that case called accounting evidence. Rather the taxpayer had accounted for the interest payable before the taxpayer opened for business and, in what I understand to be the usual way, by capitalising the interest. However, the fact that the taxpayer had accounted in this way was not thought by the judge who heard the matter to be significant.<sup>177</sup> Nor was it thought by the High Court in *Steele v Deputy Federal Commissioner of Taxation*<sup>178</sup> to be important.

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<sup>168</sup> Ibid.

<sup>169</sup> Ibid 629.

<sup>170</sup> (1995) 95 ATC 4711.

<sup>171</sup> Ibid 4714.

<sup>172</sup> Ibid 4716.

<sup>173</sup> (1992-3) 176 CLR 640, 679.

<sup>174</sup> In fact, in *Carden* Dixon J said, inter alia at 152-3: 'Familiar but striking examples of this necessary reliance upon commercial principles and general business understanding may be found in the case law dealing with expenditure laid out for the purpose of trade, with outgoings on account of capital...'

<sup>175</sup> (1938) 61 CLR 337, 359-65.

<sup>176</sup> (1985) 85 ATC 4432.

<sup>177</sup> Ibid.

<sup>178</sup> (1999) 99 ATC 4242, 4249 (Gleeson CJ, Gaudron and Gummow JJ).

#### IV CONCLUSION

The most important areas where accounting principles and income tax intersect are the basic areas of derivation of income and incurring of losses or outgoings. It is clear that accounting principle is, if not determinative, very persuasive in both these areas, except so far as the question arises whether an amount has been incurred, where the Australian courts have sometimes, although not always, adopted a jurisprudential rather than a commercial analysis.

The courts will almost always find accounting principles useful as new questions arise. And this is as it should be. Of course, there will be a difficulty where accounting principles permit alternative methods of accounting to be adopted or where they are silent on the question.

There is much to be said for legislative intervention to adopt the English system permitting the reopening of assessments where the quantum of a deduction or the quantum of income derived is incapable of being ascertained because of a dispute in which the taxpayer is involved. Otherwise the courts appear to be moving towards the accounting approach of permitting a deduction for estimated liabilities and not including as income amounts which are really in dispute. But this approach requires the allowance of a further deduction should the estimate be too low or the bringing to account as income amounts previously deducted should the estimate be too high. It would be desirable if the legislation dealt with such matters specifically either in the context of the power of the Commissioner to amend assessments or in widening the deduction for bad debts so as to permit a deduction for amounts included as assessable income where the amounts are not receivable.

## THE TAX AND ACCOUNTING INTERFACE

MICHAEL D'ASCENZO AND ANDREW ENGLAND\*

ABSTRACT: Unlike some European countries,<sup>1</sup> Australia operates as an 'Anglo-Saxon' type system that has a disconnect rather than dependence between accounting and tax requirements. Notwithstanding repeated calls for a convergence of the tax and accounting treatments of income and expenses,<sup>2</sup> a comprehensive alignment seems a dim prospect given basic differences in purpose and policy, and practical realities.

### I DIFFERENT PURPOSES OF TAX AND ACCOUNTING SYSTEMS

Tax and accounting systems exist for different reasons. The tax system, through tax laws, exists for the purpose of collecting revenue for the community and sometimes for encouraging or discouraging certain kinds of activities, and as a means of making transfer payments. The end result of an application of tax laws is usually that taxpayers are required to pay money to fund public spending. On the other hand, the accounting system, through accounting concepts and standards, exists for financial reporting reasons, for example, to help investors to make informed investment decisions.

This difference was summarised by the United States Supreme Court in *Thor Power Tool Co v Commissioner*:

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Inland Revenue Service is to protect the public fisc. Consistently [sic] with its goal and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goal and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even

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<sup>1</sup> See (1996) 5 *The European Accounting Review* 779: Supplement regarding the link between commercial accounting and tax accounting in 13 selected European countries.

<sup>2</sup> See, eg, Review of Business Taxation, *A Tax System Redesigned: more certain, equitable and durable* (1999) 204–5: Recommendation 4.24.

contrariety, of objectives, any presumptive equivalence between tax and financial accounting would be unacceptable.<sup>3</sup>

With these different purposes in mind, it can be argued that rules governing the calculation of profit or loss for income tax purposes (taxable income or tax loss) are necessarily different to those governing the calculation of profit or loss for financial reporting purposes. It might be said, for example, that taxation rules require greater precision because they may result in the compulsory extraction of money from the taxpayer.<sup>4</sup>

## II OVERSEAS EXPERIENCE

In his overview of accounting and taxation in Europe, Hoogendoorn summarises the position as follows:<sup>5</sup>

INDEPENDENCE	DEPENDENCE
Czech Republic	Belgium
Denmark	Finland
Ireland	France
Netherlands	Germany
Norway	Italy
Poland	Sweden
United Kingdom	

The countries with a strong link between accounting and taxation are listed under the heading ‘Dependence’, although legislation in 1996 removed the link for depreciation, inventory valuations, work in progress and warranty provisions in Sweden.

There has been a development towards more independence between accounting and taxation.<sup>6</sup> This development is linked to the transition to a market economy for some Eastern European countries, as well as to accounting harmonisation which interferes with the basic structure of dependence.

Some commentators argue that the link between taxation and accounting ‘pollutes’ the capability of financial reports to give a ‘true and fair’ view of the economic and financial situation of businesses.<sup>7</sup> The critics of the link say that ‘development of good accounting is hindered by tax concerns and the influence of the tax authorities who need consistent, well-specified and easy to verify rules instead of the more “true and fair” rules’.<sup>8</sup>

<sup>3</sup> 439 US 522 (1979) 542–3 (footnotes omitted).

<sup>4</sup> By contrast the accounting rules in the Netherlands have been described as providing ‘a great deal of flexibility’: Martin N Hoogendoorn, ‘Accounting and taxation in the Netherlands’ (1996) 5 *The European Accounting Review* 871, 872. Similarly Harold Dubroff, M Connie Cahill and Michael D Norris, ‘Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles’ (1983) 47 *Albany Law Review* 345, 381: argue that ‘GAAP are receptive to a degree of estimation and a lack of precision which is incompatible with the process of identifying a particular amount of ascertainably “correct” income tax’.

<sup>5</sup> Martin N Hoogendoorn, ‘Accounting and taxation in Europe – A comparative overview’ (1983) 47 *The European Accounting Review* 783, 786.

<sup>6</sup> *Ibid* 787.

<sup>7</sup> Fulvia Rocchi, ‘Accounting and taxation in Italy’ (1983) 47 *The European Accounting Review* 981, 987.

<sup>8</sup> Kristina Artsberg, ‘The link between commercial accounting and tax accounting in Sweden’ (1983) 47 *The European Accounting Review* 795, 805.

From a tax perspective, Johnson has argued against the Generally Accepted Accounting Principles ('GAAP') as a means of determining tax liability because, in many circumstances, corporations can under report their earnings without adverse non-tax consequences.<sup>9</sup> He argues that reported income as defined by GAAP is sufficiently 'elastic' that taxing income so defined would cause the reporting income to shrivel, which would both reduce tax revenue and also damage the pricing mechanisms of the capital markets. A problem raised by Artsberg is that in countries where there is a strong link between accounting and taxation, companies are often allowed to undervalue assets.<sup>10</sup> On the other hand, Artsberg also observes that for 'practical reasons it is easier to work with only one accounting system, and it saves money for the companies to have only one system'.<sup>11</sup>

The Review of Business Taxation ('the Ralph Review') found that most of the Group 1 countries it examined had a basic approach to determining taxable income whereby the starting point was accounting practice based on statutory accounts.<sup>12</sup> The Ralph Review found that there were two essential differences in the treatment between countries. Firstly most Group 1 and Group 2 countries had explicit recognition of accounting principles (for example, section 446(a) of the United States Internal Revenue Code).<sup>13</sup> Secondly all these countries had variations from accounting standards in their tax provisions.<sup>14</sup> The extent of the adjustments necessary to reconcile the tax and accounting position varied considerably between the countries.

So it seems that the international experience in the interface between tax and accounting is not uniform. While many European countries have a closer link between tax and accounting than does Australia, the link is subject to specific legislation and tax concepts tend to predominate.<sup>15</sup> There are commentators who argue that the dominance of tax detracts from the purpose of accounts of providing a 'true and fair' view;<sup>16</sup> and there are commentators who argue that accounting standards are not sufficiently precise to form the basis of taxation.<sup>17</sup>

In relation to the United Kingdom, Lamb concludes:

Although many voices claim that greater tax conformity would reduce complexity, and thereby cost, it seems likely that the UK tax and accounting rule-making will continue to operate with relative autonomy. While the practices of tax and accounting profit measurement are undeniably

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<sup>9</sup> Calvin H Johnson, 'Using GAAP Instead of Tax Accounting is a Bad Idea' (1999) 83(3) *Tax Notes* 425: TNT 74-119.

<sup>10</sup> Artsberg, above n 8, 811.

<sup>11</sup> Ibid 805.

<sup>12</sup> Review of Business Taxation, *An International Perspective an information paper commissioned from Arthur Anderson Examining how other countries approach business taxation* (1998) 5-6. The Group 1 countries were Canada, Chile, France, Germany, Ireland, Japan, Netherlands, New Zealand, Singapore, Sweden, Taiwan, United Kingdom and United States. They were chosen because, "they represent major world economies; or they are significant economic powers in the Asia Pacific region; or because of significant changes that have been made to their business tax systems in recent years." ... "The countries making up Group 2 were chosen for various reasons. In some cases, certain broad features of the tax systems in those countries are of interest. This is particularly the case with the international dimension of the tax system or with the way in which the taxation of company and individual taxation is at least partially integrated. Countries have also been chosen because of the concessional way in which they treat certain types of income and the analysis attempts to put this treatment in some context by examining the treatment of business income,"

<sup>13</sup> Ibid 93.

<sup>14</sup> Ibid.

<sup>15</sup> For example, in France there is 'fiscal supremacy on some points such as the calculation of depreciation and provisions': A Frydender and D Pham, 'Relationship between accounting and taxation in France' (1983) 47 *The European Accounting Review* 845, 848. In Belgium 'annual accounts ... are to a large extent tax-influenced': Ann Jorissen and Luc Maes, 'The principle of fiscal neutrality: the cornerstone of the relationship between financial reporting and taxation in Belgium' (1983) 47 *The European Accounting Review* 915, 929.

<sup>16</sup> See, eg, Fulvia Rocchi, 'Accounting and taxation in Italy' (1983) 47 *The European Accounting Review* 981, 987.

<sup>17</sup> See, eg, Harold Dubroff, M Connie Cahill and Michael D Norris, 'Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles' (1983) 47 *Albany Law Review* 345, 381.

interdependent, differences in profit calculations are inevitable as long as the rules remain out of phase and are expressed through independent institutions.<sup>18</sup>

A similar conclusion seems apt for the current position in Australia. Any substantial move towards convergence of tax and accounting treatments will require a meeting of minds between the accounting and tax professions and government.<sup>19</sup>

### III CURRENT USE OF ACCOUNTING PRACTICE IN AUSTRALIAN INCOME TAX LAW

In Australia there is no systematic connection between the income tax law and accounting concepts or standards. However, the two interrelate in various ways.

#### A *Timing of Recognition of Ordinary Income and General Deductions*

In interpreting income tax law, particularly in relation to the timing of recognition of income and outgoings under the ordinary income and general deduction rules, the courts have sometimes drawn upon accounting practice. In determining when ordinary income is 'derived', the courts have drawn upon business conceptions and the principles and practices of accountancy.<sup>20</sup> Hill and Heerey JJ recently summarised the position as follows:

Perhaps the only relevance *Ballarat Brewing* has for the present case is that it adds to the quite substantial case law in which the High Court has made it clear that where the question at issue is the derivation of gross income that, being a matter for which the ITA Act makes no specific provision, the Court will have regard to the conceptions of business and the principles and practices of commercial accountancy. The case also makes it clear that the Court would be reluctant to apply to income tax a method of accounting which would produce a misleading result in the absence of a specific statutory provision which required that.

Before turning to the accounting evidence in the present case it is important to note that while the earlier cases, such as *Carden, Arthur Murray* and *Henderson*, may be thought to have suggested that business and accounting principles are to be applied by the Court in determining questions of derivation, some later cases, for example the *Australian Gas Light Company* case in this Court have made the point that accounting principles are not determinative, although they may be persuasive.

Certainly where the question is whether a loss or outgoing is incurred for the purposes of s 51(1) it is clear that accounting principles are not determinative, cf *Federal Commissioner of Taxation v James Flood Pty Ltd* (1953) 88 CLR 492, *Nilsen Development Laboratories Pty Ltd v Federal Commissioner of Taxation* (1981) 144 CLR 616. Indeed, in the latter case Barwick CJ expressed the view that the "prudence and commercial propriety of such a course [accruing annual or long leave] has little bearing on the question whether there is present in the year of income a loss or outgoing within the meaning of s 51(1) where a jurisprudential analysis prevails over a commercial view, that accounting and business practice will not always be irrelevant and may indeed provide useful assistance to the Court: *Coles Myer Finance Ltd v Federal Commissioner of Taxation* (1992-3) 176 CLR 640 at 666 per Mason CJ, Brennan, Dawson, Toohey and Gaudron JJ.

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<sup>18</sup> Margaret Lamb, 'The relationship between accounting and taxation: The United Kingdom' (1983) 47 *The European Accounting Review* 933, 947.

<sup>19</sup> Note re Recommendation 4.24 of the Review of Business Taxation (1999) (above n 2) that the Australian Taxation Office work with the accounting and tax professions to identify differences between the accounting and taxation treatments of profits with a view to better aligning those treatments where the differences are inappropriate: With the shift of the responsibility for law design from 1 July 2002 from the ATO to Treasury (Commonwealth Treasurer, 'Reforms to Community Consultation Processes and Agency Accountabilities in Tax Design', Press Release No 022, 2 May 2002) Recommendation 4.24 is now a matter for Treasury.

<sup>20</sup> Examples often cited are *Commissioner of Taxation (SA) v Executor Trustee & Agency Co of South Australia* (1938) 63 CLR 108 (*Carden's Case*) 1 AITR 416, *Arthur Murray (NSW) Pty Ltd v Federal Commissioner of Taxation* (1965) 114 CLR 314 and *J Rowe & Son Pty Ltd v Federal Commissioner of Taxation* 71 ATC 4001).

It is not necessary in the present case to decide if there is really a difference between the emphasis put on accounting practices in the early cases and the views expressed in the later cases. It suffices here to say that on either view of the law the business and accounting practices assist the Court in the working out of the principles behind the statutory language of “income derived”.<sup>21</sup>

In determining when losses or outgoings are ‘incurred’, sometimes the courts have tended towards approaches such as those found in accounting. For example, in *Coles Myer Finance Ltd v Federal Commissioner of Taxation*<sup>22</sup> the High Court referred to commercial and accounting principles in deciding that a deduction for discounts on certain debt instruments should be spread over two years (the period of the instruments).<sup>23</sup>

Another example of the courts drawing upon accounting principles is their recognition that unreported insurance claims are presently existing liabilities of an insurer and that the provisions a general insurer makes in its accounts for them are an allowable deduction if they represent a reasonable actuarial estimate.<sup>24</sup> The result is that provisions for ‘incurred but not reported’ claims are deductible, but provisions for events that have not yet occurred are not deductible.<sup>25</sup>

Nevertheless, the courts have made it clear that the interpretation of tax law ultimately involves a jurisprudential analysis of relevant provisions. For example, expenses are not necessarily recognised for income tax purposes at the same time as they are for accounting purposes<sup>26</sup> and the cost of trading stock must be ascertained from the meaning apparent from the statute rather than from accounting (although the two may well coincide).<sup>27</sup>

Hanlan and Nethercott have argued that:

the merits of comparability between accounting practice and taxation law have been recognised by academics, courts of law and governments ... [but] [w]hile Australian courts have endorsed the importance of accounting concepts, principles and practices, such factors are not determinative in reaching a decision. That is, accounting practice, while relevant must be used solely as an aid assisting in the interpretation of the Tax Act (1936) and (1977), and cannot be substituted for legal or jurisprudential analysis itself.<sup>28</sup>

On this basis the approach of the courts in interpreting the law will affect the extent of divergence between accounting and tax concepts. The less formalistic the approach to judicial interpretation, the more likely it is that the outcome will reflect the commercial substance of a matter.<sup>29</sup>

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<sup>21</sup> *BHP Billiton (Bass Strait) Pty Ltd v Commissioner of Taxation* 2002 ATC 5169 (Hill & Heerey JJ, 20 December 2002) [66]–[69].

<sup>22</sup> 93 ATC 4214.

<sup>23</sup> *Ibid* 4222–3.

<sup>24</sup> *RACV Insurance Pty Ltd v Federal Commissioner of Taxation* 74 ATC 4169; *Commercial Union Assurance Company of Australia Limited v Federal Commissioner of Taxation* 77 ATC 4186; *ANZ Banking Group Ltd v Federal Commissioner of Taxation* 94 ATC 4026, 4035–6; *Federal Commissioner of Taxation v Mercantile Mutual Insurance (Workers Compensation) Ltd* 99 ATC 4404.

<sup>25</sup> See Taxation Ruling TR 97/15 ‘Income Tax: Conditional contracts: derivation of income; allowable deductions; trading stock on hand’ but cf *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Ltd* 95 ATC 4711.

<sup>26</sup> *Federal Commissioner of Taxation v James Flood Pty Ltd* (1953) 88 CLR 492; *Nilsen Laboratories Pty Ltd v Federal Commissioner of Taxation* (1981) 144 CLR 616, 81 ATC 4031.

<sup>27</sup> *Federal Commissioner of Taxation v St Hubert’s Island Pty Ltd* (1978) 138 CLR 210, 78 ATC 4104, 4113; *Philip Morris v Federal Commissioner of Taxation* 79 ATC 4352, 4356–7.

<sup>28</sup> Dean Hanlon and Les Nethercott, ‘Debt Defeasance: An Accounting/Taxation Interface’ (Paper presented at the Australasian Tax Teachers Association 14<sup>th</sup> Annual Conference, Manukau Business School, Auckland, New Zealand, 17–19 January 2002) 2.

<sup>29</sup> Sir Anthony Mason, ‘Future Directions in Australian Law’ (1987) 13 *Monash University Law Review* 149 has observed that ‘purposivism is more attractive because it emphasises substance over form’; but cf R C Allerdice, ‘The Swinging Pendulum: Judicial Trends in the Interpretation of Revenue Statutes’ (1996) 19(1) *UNSW Law Journal* 162, 163. Note also the comments of G T Pagone in ‘Taxation Update: Anti-avoidance Provisions’ (2002) 31 *Australian Tax Review* 241–52 (particularly 251) on recent judicial interpretations of Part IVA.



Another observation that can be made is that the doctrine of precedent applied in our system of law means that income tax law may not keep pace with developments in accounting concepts and standards. A court decision many years ago which drew upon accounting practice at that time may still represent the law now, even though the accounting practice upon which the decision was based may have changed.

### B *Specific Statutory Intervention*

Over the years, many specific statutory rules or regimes have been inserted into the income tax law that produce results similar to those found in accounting. One example is the alteration of the derivation point for income from deferred interest securities (Division 16E of Part III of the *Income Tax Assessment Act 1936* (Cth) ('*ITAA 1936*').

However, the statutory rules usually provide their own set of detailed rules for the valuation and timing of recognition of amounts. (See, for example, the Capital Gains Tax ('CGT') event and cost base rules in Divisions 104, 110 and 112 of the *Income Tax Assessment Act 1997* (Cth) ('*ITAA 1997*').)

Sometimes, specific statutory rules directly refer to accounting concepts or standards. For example, Division 240 of the *ITAA 1997* provides, in some circumstances, for the apportionment, according to generally accepted accounting principles, between income years of 'notional interest' payable by a hirer under a hire purchase agreement.<sup>30</sup> The 'notional interest' itself is, however, not worked out according to those accounting principles.

Another significant example of the reference in statutory rules to accounting concepts and standards is to be found in the new consolidation regime's provisions for working out the tax cost setting amount of the assets of an entity joining a consolidated group.<sup>31</sup> Step 2 of the calculation requires the addition of amounts for liabilities recognised by the joining entity in accordance with accounting concepts or standards of the Australian Accounting Standards Board.<sup>32</sup>

However, this use of an accounting concept and valuation of liabilities points up the potential hazards of using a hybrid of specific tax and accounting rules. The 'step 2' calculation requires a provision to reconcile the timing differences that can arise between when a liability (expense) is recognised for tax purposes and when it is recognised for accounting purposes.<sup>33</sup> To illustrate, assume the following facts:

Subco joins Headco in a consolidated group in Year 2. The cost base of Headco's shares in Subco is \$50. Subco has one asset (land) with a cost base to Subco of \$50 and a \$50 provision in its accounts, from Year 1, for employee's leave (recognised as a liability for accounting purposes). The market value of the land at the time of consolidation is \$100.

The allocable cost amount for Subco is \$100 (\$50 cost base of shares plus \$50 accounting liability). This means that, without more, the cost base of the land to Headco would become \$100. This means that if the land was immediately sold for its market value (\$100) there would be no capital gain assessable to Headco. The effect of this would be to recognise, for tax purposes, the provision for leave entitlements at a point before it should be recognised for those purposes and might, in fact, lead to a double deduction for them.<sup>34</sup>

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<sup>30</sup> *Income Tax Assessment Act 1997* (Cth) s 240-60(2).

<sup>31</sup> *Income Tax Assessment Act 1997* (Cth) div 705. See, in particular, s 705-60.

<sup>32</sup> *Income Tax Assessment Act 1997* (Cth) ss 705-70 – 705-80.

<sup>33</sup> *Income Tax Assessment Act 1997* (Cth) s 705-80.

<sup>34</sup> Such provisions are not incurred until there is a present liability to pay the employees (*Nilsen Laboratories Pty Ltd v Federal Commissioner of Taxation* (1981) 144 CLR 616; 81 ATC 4031).

To overcome this problem, a provision is required to extract the result that arises from using an inconsistent accounting concept in the cost setting process (section 705-80). Under that provision, Headco would have to calculate the allocable cost amount on the assumption that the provision for leave had been recognised for income tax purposes at the same time it is recognised for accounting purposes. On this assumption, Subco would have incurred a tax loss of \$50 in Year 1 (on the assumption that it had no income and no other expenses in that year).

However, this deemed tax loss is then subtracted from the allocable cost amount (section 705-100). Therefore, on this assumption, the allocable cost amount would be \$50 (\$50 cost base of shares plus \$50 accounting liability less \$50 deemed tax loss).

Under section 705-80, the amount added for the accounting liability is decreased by the difference between what it would have been with the assumption created by section 705-80 and what it is without that assumption (in this case \$50).

This all means that the cost base of the land to Headco is actually \$50, so that if it was sold immediately after consolidation a \$50 capital gain would be assessable. A deduction for the \$50 leave entitlements would then arise subsequently when the liability for them was incurred.

This example illustrates that many provisions in the income tax law are interrelated, and unless they all operate on the same basis (for example, accounting principles), the mix of accounting and jurisprudential approaches can lead to greater complexity than if it were designed on one basis alone. Care is required to ensure the coherence of the law in a way that minimises this complexity and the associated compliance costs.

#### IV DEVELOPMENT OF THE TAX BASE IS CONSISTENT WITH CURRENT ACCOUNTING CONCEPTS

The statutory intervention in the income tax law since the tax reform of 1985 has created an income tax base that has crept closer to the conceptual basis of accounting. That conceptual basis, found in Statement of Accounting Concept ('SAC') 4, emphasises assets and liabilities as the basis for determining profit or loss.<sup>35</sup>

Income tax law increasingly recognises asset based notions (for example, *ITAA 1936* Division 16E). Possible policy reforms in the area of the taxation of financial arrangements might continue this trend. However, the convergence so far as the recognition of assets is concerned is piecemeal rather than systematic or consistent.

In addition, while there have been some recent developments (for example, debt forgiveness rules),<sup>36</sup> the income tax law still struggles to recognise liabilities in a systematic way. This could be seen as the cause of problems like those that arose in *Federal Commissioner of Taxation v Orica Ltd.*<sup>37</sup>

Nevertheless, the removal of accelerated depreciation is the most obvious recent example of bringing accounting income and taxable income closer together.<sup>38</sup>

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<sup>35</sup> Australian Accounting Standards Board, *SAC 4 Definition and Recognition of the Elements of Financial Statements 3/95* (1995) ('SAC 4') prepared by the Public Sector Accounting Standards Board ('PSASB') of the Australian Accounting Research Foundation ('AARF'), and Australian Accounting Standards Board ('AASB'), issued by AARF for the Institute of Chartered Accountants in Australia ('ICAA') and the Australian Society of Certified Practising Accountants ('ASCPA') and by the AASB. Avail as a pdf file via the AASB website <[http://www.aasb.com.au/public\\_docs/concept\\_statements/SAC4\\_3-95.pdf](http://www.aasb.com.au/public_docs/concept_statements/SAC4_3-95.pdf)> 5 June 2005.

<sup>36</sup> *Income Tax Assessment Act 1936* (Cth) sch 2C.

<sup>37</sup> 98 ATC 4494 (1998), 39 ATR 66.

<sup>38</sup> *New Business Tax System (Capital Allowances Act) 1999* (Cth).

## V ACCOUNTING AND THE PRACTICAL CALCULATION OF TAXABLE INCOME

There is a practical interdependence between accounting and taxation. Many business taxpayers calculate their taxable income or tax loss in practice by reconciling from their accounting profit or loss. The key observation here is that accounting records and calculations are a vital part of the practical application and administration of the income tax system, even for those taxpayers who do not have to comply with accounting standards.

Accounting profit is the difference between revenue and expenses. Revenue is the 'inflows or other enhancements, or savings in outflows, of future economic benefits in the form of increases in [net] assets ... other than those relating to contributions by owners'.<sup>39</sup> Expenses are the 'consumptions or losses of future economic benefits in the form of reductions in [net] assets...other than those relating to distributions to owners'.<sup>40</sup> Thus, accounting profit (or income) is based on assets and liabilities, in particular the change in an entity's net position (to the extent that it does not result from contributions by, or distributions to, owners).

The profit and loss statement is a way of displaying the sources of that change in net assets (for example, retail sales or debt defeasance). In this way, the profit and loss statement explains how an entity's balance sheet at the start of the year comes to look like its balance sheet at the end (putting aside dealings with owners in their capacity as owners); it explains the movement of accounting values.

Under the income tax law, taxable income is the difference between assessable income and deductions (section 4-15 of the *ITAA 1997*). Assessable income is comprised of ordinary income and statutory income (section 6-5 and 6-10 of the *ITAA 1997*). Deductions are comprised of general deductions and specific deductions (sections 8-1 and 8-5 of the *ITAA 1997*).

This scheme explains taxable income but taxpayers often do not work out their taxable income by directly computing assessable income less deductions. In many cases they work off their accounts and make reconciliations for tax purposes. Also, they do not usually keep an ongoing set of tax accounts with accounts called ordinary income, statutory income, general deductions and specific deductions. Nevertheless, their taxable income, once computed, must be explicable on the bases of the scheme used in the income tax law.

Therefore, there is a distinction to be drawn between the concepts that work together to result in taxable income and its practical derivation.

## VI RECONCILING ACCOUNTING PROFIT TO TAXABLE INCOME

Basically, accounting profit does not equal taxable income because:

- it includes items that are not included in assessable income under the income tax law, or which are not deductible under the income tax law;
- of the items that should be included, it may use different amounts than would be included as assessable income or as an allowable deduction under the income tax law; and
- it omits certain items, whether as income or as an expense or outgoing.

So, a reconciliation is needed because accounting profit takes into account different *items* and may use different *amounts*. The process is a series of increasing and decreasing adjustments. Importantly, it is accounting profit that is in practice modified to get to taxable

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<sup>39</sup> SAC 4, above n 35, para 111.

<sup>40</sup> Ibid para 117.

income. This means that any adjustments relate to the items set out in the profit and loss account or statement.

*Increasing* adjustments under the income tax law may result from:

- an accounting expense that is *not* an allowable deduction, for example an expense that:
  - is not a ‘loss or outgoing’, such as an income tax expense;
  - is not ‘incurred’, such as provisions for leave;
  - is ‘capital’ in nature, such as expenses in building plant; or
  - is expressly denied deductibility, such as entertainment expenses;
- an accounting expense that is an allowable deduction, but the expense is more than the deduction;
- assessable income that is *not* accounting revenue, for example a notional or deemed amount, such as the amount by which franked dividends are grossed up; and
- assessable income that is accounting revenue, but the income is more than the revenue.

*Decreasing* adjustments under the income tax law may be made for:

- an allowable deduction that is *not* an accounting expense, for example carry forward tax losses;
- an allowable deduction that is an accounting expense, but the deduction is more than the expense;
- accounting revenue that is *not* assessable income, for example some upward asset revaluations; and
- accounting revenue that is assessable income, but the revenue is more than the assessable income.

## VII PROPOSALS FOR REFORM

There are frequently calls for reform to the tax law to reduce the gap between tax and accounting. It is almost a perennial issue. Calls for reform of this kind are increasingly a response to the complexity of the current income tax laws, both in terms of their policy and their structure and drafting. Another reason given is that compliance costs would fall because of a reduced need to maintain duplicate records and, most importantly, less need to follow duplicate processes in calculating profit or loss.

One of the major reforms often put forward is that taxable income or tax loss should equal, or at least be formally based upon, accounting profit or loss. This approach was touted again as recently as August late 2002.<sup>41</sup> However, there are many difficulties with the approach.<sup>42</sup>

- Accounting profit is calculated for a different purpose.
- Accounting profit can be used as a starting point, but it cannot provide the end result unless radical changes to tax policy can be contemplated (for example, current tax policy is that not all accounting provisions should be recognised for tax purposes).
- Most taxpayers do not at present need to comply with accounting standards.
- Accounting is moving away from determining profit on a realisation basis. For example, equity accounting may require companies to count towards their accounting profits income

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<sup>41</sup> See Brian Toohey, ‘Tax reform? Turn 8,500 pages and weep’ *Australian Financial Review*, 17–18 August 2002, 49.

<sup>42</sup> See (September 2001) ‘TVM - why make the change?’ (Paper prepared by the TVM Legislation Group and ATO for the Board of Taxation), see <[http://www.taxboard.gov.au/content/Tax\\_Value\\_Method/tvm\\_legpapers/index.asp](http://www.taxboard.gov.au/content/Tax_Value_Method/tvm_legpapers/index.asp)>

earned by entities over which they have a significant influence, causing capacity to pay difficulties if taxable income was based on accounting profits.<sup>43</sup>

- Applying the concept of materiality in a tax system is at the expense of fairness. As Gammie has argued, it ‘would be inappropriate if the materiality concept were to permit the taxpayer to be the sole judge of whether a particular treatment of a transaction in the accounts should be adopted in computing the final tax liability’.<sup>44</sup>
- Accounting is not as certain. (SAC) 4 requires assets and liabilities to be recognised if it is “probable” that the future economic benefits will eventuate or that the future sacrifice of economic benefits will be required. ‘Probable’ is interpreted to mean a greater than 50 per cent likelihood.<sup>45</sup> This certainty threshold could be one of the clearer differences between accounting and taxation.
- Accounting brings losses forward. The matching process of recognising expenses by associating costs incurred with revenues recognised, along with the principle of conservatism, explains the difference in treatment of bad debts between accounting and tax practice.
- Concessions that are currently available to taxpayers could be removed (or limited). As Tran observes: ‘Alignment of tax rules with (generally accepted accounting practice) means that the government has to use means other than the income tax system to achieve its policy objective.’<sup>46</sup>
- The international harmonisation of accounting standards may influence the tax base (or itself may be at risk).
- The accounting profession may be placed under added pressure. Auditors of company accounts may assume greater responsibility if accounting profit is used to measure taxable income. This may increase audit fees given the expanded work schedule and greater liability exposure.<sup>47</sup>

Notwithstanding the prospect of potentially lower compliance costs, consequences of any such an alignment might also include:

- higher taxable incomes (it has been said that reported accounting profits are usually higher than taxable incomes)<sup>48</sup> or lower taxable income if accounting income is sufficiently elastic that taxing it would cause it to diminish;<sup>49</sup>
- a threat to tax concessions for particular industries or that encourage investment in certain areas of the economy;
- possible tax avoidance issues, because of less precision in accounting standards (for example, in the area of financial transactions), and because accounting standards do not require transactions to be measured on an arm’s length basis; and
- the dependence of tax outcomes on accounting standards established independently of government.

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<sup>43</sup> Review of Business Taxation (1999), above n 2, 284.

<sup>44</sup> Malcom Gammie, ‘TVM and the relationship between taxation and commercial accounting methods’ (Paper presented at the ATAX/Board of Taxation TVM Conference, Sydney, 23–24 July 2001) 19.

<sup>45</sup> Jayne Godfrey, Allan Hodgson, Scott Holmes and Vernon Kam, *Accounting Theory* (2<sup>nd</sup> ed, 1994) 368.

<sup>46</sup> Alfred Tran, ‘Relationship of Tax and Financial Accounting Rules, An Empirical Study of the Alignment Issue’ (doctoral thesis submitted at the Australian National University, 1997) 34.

<sup>47</sup> Ibid para 3.3.8.

<sup>48</sup> Ibid xi and ch 4.

<sup>49</sup> Johnson, above n 9.

So, while there have been significant developments consistent with accounting concepts (for example, removal of accelerated depreciation), the bottom line is that the practical realities make a comprehensive alignment of tax and accounting difficult, and the potential benefits speculative.

## VIII THE RALPH REVIEW

The rationalisation of tax and accounting systems was addressed by the Review of Business Taxation (often referred to as the ‘Ralph Review’ after its chair, John Ralph). The Review recommended that appropriate regard be had to accounting principles in the development of the Australian Tax Code (recommendation 4.23) and that work be undertaken with tax and accounting professionals to identify differences between tax and accounting with a view to better aligning them (recommendation 4.24).<sup>50</sup>

It would have to be said that there has been little progress on these issues in the development of legislation post the Review. This might have something to do with the fact that the recommendations of the Review were designed as an integrated package but only some recommendations have actually been implemented. It may also be a reflection of the adoption of other priorities.

### *A Tax Value Method*

The Tax Value Method (‘TVM’) proposed by the Review of Business Taxation was a fundamental reform aimed at simplifying the income tax statute.<sup>51</sup> It was not aimed at aligning tax and accounting outcomes (tax policy prevented that). However, it was based explicitly on the same conceptual framework that now underlies accounting. That conceptual framework, found in SAC 4, emphasises assets and liabilities as the basis for determining profit or loss. Similarly, TVM was intended to be based on the changing tax values of assets and liabilities.<sup>52</sup>

The experience with the development of the TVM highlights the realities associated with adopting accounting outcomes as tax outcomes.

An aim of TVM was to align, at the conceptual level, accounting concepts and tax concepts. It was understood by those developing TVM (initially the Review of Business Taxation and then the Tax Board’s legislative group) that, while consistent with accounting at this conceptual level, TVM could never be the same as accounting. This reflected fundamental differences between the policy underlying accounting recognition and valuation criteria and the tax policy governing which gains or losses should be taken into account for tax purposes. This meant that, at the level of detail, TVM was different to accounting in many areas (just as the current income tax law is different, recognising policy differences) for example:

- The recognition criteria for TVM were often different to the recognition criteria for accounting. For example, provisions for employee’s leave while recognised in accounting were not recognised in TVM, reflecting tax policy.<sup>53</sup>

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<sup>50</sup> See above n 15. Recommendation 4.23 is also now a matter for Treasury, and the Office of Parliamentary Counsel.

<sup>51</sup> The advantage sought from TVM in adopting the conceptional basis of accounting was to provide a uniform structural platform for drafting tax law. As an example, the simplified capital gains tax rules in the TVM legislation released by the Board of Taxation in March 2002 reduced 40 CGT events to a maximum of 8, and reduced the size of the law by over 70%.

<sup>52</sup> Review of Business Taxation (1999), above n 2, 38, 155.

<sup>53</sup> *Ibid* 159.

- In income tax, gains and losses are largely recognised on a realisation basis, most assets had a tax value based on cost under TVM even though for accounting purposes their value may have reflected a market valuation.

Some commentators criticised TVM for this. But given tax policy constraints, an alignment of tax and accounting at the level of detail was never going to be possible.

The Commonwealth government's decision not to proceed with the TVM followed a recommendation from the Board of Taxation.<sup>54</sup> The Board reported significant industry concern about the cost and uncertainty associated with the TVM, including the possibility of substantial transitional costs for tax advisers and business generally.

Apart from the costs and uncertainty that may have been inherent in the TVM proposal, the adjustments required in relation to the timing and values of assets and liabilities for practical and policy reasons show how difficult it is to achieve a complete alignment of tax and accounting concepts.

### B *Minimum Company Tax*

As the Review of Business Taxation explained:

The motivation for an alternative minimum company tax (AMCT) springs from the fact that in some circumstances an entity's taxable income may be significantly less than its accounting income. An AMCT would be levied on accounting income or an adjusted taxable income. There are many major components of accounting income which it would simply be inappropriate to subject to taxation. For example, many companies have substantial dividend income which has already been subject to company tax. Further foreign source income is included in accounting income but, if it has been subject to a comparable tax rate in the source country, it is not subject to Australian tax.<sup>55</sup>

The use of a minimum company tax as an alternative was considered by the Review as likely to result in additional complexity and costs to the extent that taxpayers would be required to undertake two calculations to determine which approach had to be applied.<sup>56</sup> The use of a minimum company tax based on accounting profits has been criticised as providing 'an incentive for companies to manage their reported profits in order to avoid a potential tax liability' which would 'decrease the overall quality of financial reporting and reduce the efficiency of the capital markets'.<sup>57</sup> If, as is the case in those countries where the interface between tax and accounting is a dependent one, tax was based on accounting profits, the accounting standards would be subject to (and likely to be influenced by) legislative intervention.<sup>58</sup> In any event it is unlikely that Parliament would abdicate its responsibility for taxation matters to those responsible for setting accounting standards, in relation to the minimum company tax base.

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<sup>54</sup> See Commonwealth Treasurer, 'Government Decides Against the Tax Value Method', Media Release No 048, 28 August 2002; Board of Taxation, 'Evaluation of the Tax Value Method : a Report to the Treasurer and Minister for Revenue and Assistant Treasurer' (July 2002) available <[http://www.taxboard.gov.au/content/Tax\\_Value\\_Method/tvm\\_recommend/index.asp](http://www.taxboard.gov.au/content/Tax_Value_Method/tvm_recommend/index.asp)> 5 June 2005.

<sup>55</sup> Review of Business Taxation (1999), above n 2, 52.

<sup>56</sup> Ibid 51-3, 279-86.

<sup>57</sup> Ibid 285. See also Johnson, above n 9.

<sup>58</sup> For example, in Finland 'Tax laws have had a strong influence on accounting practice' (Marko Järvenpää, 'Taxation and financial accounting in Finland' (1996) 5 *European Accounting Review* 899, 911), and in Germany 'differences between the financial statements and the tax accounts may arise from specific tax rules that always supersede commercial rules' (Dieter Pfaff and Thomas Schröder, 'The relationship between financial and tax accounting in Germany - the authoritativeness and reverse authoritativeness principle' (1996) 5 *European Accounting Review* 963, 969).

## IX WHAT ROLE CAN THE ATO PLAY

The ATO's focus is on administration. This includes the interpretation of the tax law as an inherent requirement of being able to administer the law.

In interpreting the income tax law, the ATO must be guided by the words used by the legislature and, to the extent allowed by the words used, will have regard to the legislative policy and compliance cost implications. Where different interpretations are properly open, the ATO will adopt a purposive interpretation that reflects the legislative policy (and preferably one which also minimises compliance costs). In other words the approach is 'to make the law work in a constructive and positively directed fashion, tempered by a thoughtful awareness of its intrinsic limits'.<sup>59</sup>

Accordingly, the ATO has a preference for interpreting the law in accordance with accounting practice where that is consistent with the words used in their legislative context having regard to the legislation's policy intent.

An example is the approach taken in Taxation Ruling TR 2002/20, 'Income Tax' Thin Capitalisation – Definition of assets and liabilities for the purposes of Division 820. In Division 820 the terms 'assets' and 'liabilities' are used in a regime for determining an acceptable mix of debt and equity for funding a business. The legislation relies on the valuation rules in the accounting standards to provide values of, amongst other things, assets and non-debt liabilities, but is silent as to whether the terms take an accounting or jurisprudential meaning. The regime uses as its benchmark whether an 'arm's length' lender would lend to the borrower having regard, amongst other things, to the borrower's assets and liabilities. It is in essence a commercial test, and the ruling takes the view that the accounting meaning is the ordinary meaning of these terms in the context of Division 820.<sup>60</sup>

In addition to its interpretative function, the ATO provides substantial assistance to taxpayers (for example, educational material and advice) to help them comply with the tax law. There is merit in pursuing approaches that help taxpayers understand where the tax approach is different to the accounting approach so that their process of reconciling from accounting profit or loss to taxable income or loss is made easier. This might be able to be pursued both at the level of ATO administration and assistance, and at the legislative drafting level (by Treasury and the Office of Parliamentary Counsel).

As a means of reducing compliance costs there is merit in using accounting concepts where they are aligned with the legislative intent, so as to get leverage out of taxpayers' 'natural accounting records or systems'.

## X CONCLUSION

Tran concluded that the 'alignment of tax rules with accounting rules presupposes suitability of accounting rules to achieve the objectives and criteria of the income tax system. Unfortunately this is not the case'.<sup>61</sup>

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<sup>59</sup> J Scott Wilkie, 'Looking Forward into the Past: Financial Innovation and the Basic Limits of Income Tax' (1995) 43(5) *Canadian Tax Journal* 1147, 1166.

<sup>60</sup> There is an alternative view that the definition of 'assets' and 'liabilities' takes a traditional legal meaning. Some support for this view may be gained from the Explanatory Memorandum. However, this view is less apt for what is intended to be an 'arm's length' commercial test, and imposes higher compliance costs. It would require companies to determine assets and liabilities using jurisprudential concepts and then value the assets and liabilities so determined having regard to commercial standards.

<sup>61</sup> Tran, above n 46, 30.



Nevertheless the Review of Business Taxation recommended that divergent treatment of transactions in tax and accounting should be addressed if that difference is deemed to be inappropriate.<sup>62</sup>

Tax reform might be said to involve two aspects: (i) policy reform; and (ii) structural and drafting reform of the statute. The question of policy reform is of course a matter for government. The perspective of the latter is not necessarily to change policy but rather to reduce the unnecessary complexity that has arisen from the historical agglomeration of our income tax laws. Given the way in which taxable income and tax loss is computed in practice by many taxpayers (that is, by reconciling from accounting profit and loss), the real reform issue from this perspective is probably not whether accounting profit and loss should form the starting point for tax purposes. It already does this in practice to some extent. The real issue might be how to best structure and draft income tax law so as to use accounting concepts where it is sensible to do so, and to clearly identify where there are differences from accounting outcomes.

The way forward seems to be a careful and pragmatic review of the situations of divergence between accounting concepts and tax rules. As far as I know, as at 30 January 2003 such a review is not on the drawing board.

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<sup>62</sup> Recommendation 4.24 of *A Tax System Redesigned* (1999), above n 2.

# THE TAXATION AND ACCOUNTING INTERFACE IN NEW ZEALAND

JIM GORDON\*

## I INTRODUCTION

This article examines the legislative interface between accounting and taxation in New Zealand. It does not discuss, except in passing, the use of accounting concepts by the courts to decide tax cases.

The issues concerning whether New Zealand's *Income Tax Act 1994* ('*Tax Act 1994*') should more widely rely on accounting profit are considered, and a number of reasonably obvious problems with this suggestion are raised. The article then goes on to examine the Act's specific reliance on accounting principles and standards. There is also a brief discussion about potential further reliance on accounting standards for tax purposes.

## II NEW ZEALAND'S INCOME TAX SYSTEM – A BRIEF HIGH LEVEL OVERVIEW

The *Tax Act 1994* has English antecedents in the area of the calculation of income by trustees.<sup>1</sup> This predicates, among other things, a capital / revenue boundary. New Zealand does not generally tax capital gains nor allow deductions for capital losses or expenditure.<sup>2</sup> This is the case even though the *Tax Act 1994* states that 'the gross income of any person includes any amount derived from a business'<sup>3</sup> and 'the gross income of a person includes any amount that is included in gross income under ordinary concepts'.<sup>4</sup> This is on the basis that the term 'gross income' does not include capital amounts.<sup>5</sup>

Obviously, the *Tax Act 1994* has a number of overlays of greater or lesser significance over this trust basis. An example is the general separation and aggregation of income and

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<sup>1</sup> This has now been replaced by the Income Tax Act 2004, but in the matters covered by this paper there are no substantial changes

<sup>2</sup> Obviously there are a number of areas where this is not scrupulously followed, for example all gains from financial arrangements, except private ones, are on revenue account. However, the capital boundary is retained for capital losses from financial arrangements. Likewise, some land transactions are also on revenue account.

<sup>3</sup> *Income Tax Act 1994* (NZ) s CD 3.

<sup>4</sup> *Income Tax Act 1994* (NZ) s CD 5.

<sup>5</sup> This is not explicitly stated, but is (at least now) completely, accepted.

deductions, rather than the returning of income from a business activity on a net basis (although mathematically the answer is the same).

It has been suggested by some commentators that this structural separation of income and deductions means that some of the common law with which we have been familiar is no longer relevant.<sup>6</sup> The *Tax Act 1994* does not now (if it ever did) focus on 'net business income'. Thus cases that deal with 'net income' are now arguably irrelevant, although this has yet to be fully tested. The New Zealand tax system does rely on case law in the area of the capital / revenue boundary and in determining the timing of income derived and expenditure incurred, and will continue to do so.

Another overlay is the treatment of financial arrangements which completely ignores the derived and incurred rules, and instead focuses on income from financial arrangements as it would be defined by an economist (yield-to-maturity or market value based).<sup>7</sup>

Tax depreciation is calculated on statutory rates that are based on estimated economic life (as in financial reporting), but it may be straight line or diminishing value. These depreciation rates are then generally loaded by 20 per cent (that is, accelerated depreciation).

However, a number of provisions are not deductible:

- provisions for doubtful and bad debts (bad debts have to be specifically written off to be deductible); and
- provisions (whether incurred or not) for employee remuneration.<sup>8</sup>

Other provisions are deductible:

- insurance industry 'incurred but not reported' type provisions; and
- warrantee provisions.

#### *A References to Generally Accepted Accounting Principles*

The *Tax Act 1994* makes no general reference to income as per the financial reports or as calculated under New Zealand's Generally Accepted Accounting Principles ('GAAP'). There are, however, more specific references to GAAP that are referred to below. More relevantly, there are two references to specific accounting standards, being trading stock and research and development.

### III FINANCIAL REPORTING IN NEW ZEALAND

#### *A Statutory Financial Reporting*

The relevant statutory requirements for companies are those imposed by the *Companies Act 1993* (NZ) and the *Financial Reporting Act 1993* (NZ) ('*FRA*') (that require all companies to prepare financial reports). In numerical terms, a substantial number, if not a majority, of companies are 'exempt companies' that are allowed to produce simplified financial reports.

A company is an exempt company if:

- it is not a subsidiary;

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<sup>6</sup> Refer later discussion on income from long term construction projects.

<sup>7</sup> The financial arrangements area is the one major area where income and expenditure are not separated, rather they are dealt with in net terms.

<sup>8</sup> The actual rules do allow a deduction for remuneration incurred at balance date that is paid out within a specified period after balance date (refer ss EF 1 and EF 1A of the *Tax Act 1994*).

- it has no subsidiaries;
- it is not an overseas company carrying on business in New Zealand;
- its assets do not exceed NZD 450 000; and
- its turnover does not exceed NZD 1 000 000.

Exempt entities must report in the form specified in the Financial Reporting Order 1994 (NZ),<sup>9</sup> but there are no GAAP or ‘true and fair’ requirements. Some of these reports may still comply with GAAP if the preparer is a chartered accountant and there is no significant impediment to such compliance. All other companies, and a number of other entities, are reporting entities, or the equivalent, and have to prepare financial reports that comply with GAAP, with an overlay that they must contain sufficient information to be ‘true and fair’.<sup>10</sup>

It is interesting that the New Zealand Parliament in 1993 perceived that compliance with GAAP might not necessarily result in financial reports that are ‘true and fair’.<sup>11</sup> (However, refer below for more discussion on this.) GAAP is defined for the *FRA* in section 3 of that Act.

### B Professional Requirements

Where general purpose financial reports are prepared or audited by a member of the Institute of Chartered Accountants (‘ICANZ’),<sup>12</sup> there are obligations imposed on that member regarding the use of GAAP.

However, this raises the immediate question of what constitutes a general purpose financial report?’. Or, put another way, what does not constitute a general purpose financial report?’. Together with exempt companies, special purpose financial reports (for example, reports prepared for a bank or the Inland Revenue Department) are excluded and do not need to comply with GAAP.

General purpose financial reports can comply with differentially specified GAAP. In general, if an entity:

- is not publicly accountable;
- was there is no separation between the owners and the governing body; and
- is not large;

then differential (simplified) reporting exemptions apply.

An entity is ‘large’ for this purpose if it exceeds any two of the following:

- total revenue of NZD 5 million;
- total assets of NZD 2.5 million;
- 20 employees.

Paragraphs 5.1 and 5.2 of ICANZ’s explanatory foreword define GAAP, and then go on to discuss ‘fair presentation’ (its equivalent of ‘true and fair’). Compliance with GAAP is necessary to produce general purpose financial reports that are ‘true and fair’. The Foreword notes that:

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<sup>9</sup> Clause 3 and Schedule

<sup>10</sup> *Financial Reporting Act 1993* (NZ) s 11(1) and (2).

<sup>11</sup> The 1993 Act indicates this

<sup>12</sup> Institute of Chartered Accountants New Zealand (‘ICANZ’) is now the New Zealand Institute of Chartered Accountants (‘NZICA’).

in rare circumstances that compliance with [GAAP] does not result in the financial reports giving a true and fair view, additional information and explanations are to be provided in order to give a true and fair view.

It seems that the *FRA*'s 'true and fair' overlay to GAAP is therefore probably technically redundant.

The ICANZ definition of GAAP for its members is effectively the same as the *FRA*'s definition of GAAP. This is because, in effect, both point to the ICANZ pronouncements, which in turn incorporate the Accounting Standards Review Board's Financial Reporting Standards. The Accounting Standards Review Board is a creation of the *FRA*.

### *C No Requirement to Use GAAP*

In addition to financial reports for exempt companies and special purpose reports, people who are not ICANZ members have no obligation to follow GAAP, except for non-exempt company reports. Such non-members deal with a significant number of small business reports, albeit that they are frequently prepared for tax purposes and as such are probably special purpose reports.

### *D General Use of GAAP for Financial Reporting*

Numerically, therefore, it seems that a small portion of the financial reports of all businesses comply with GAAP.<sup>13</sup> Further, it seems likely that this lack of any requirement to comply with GAAP results in financial reports that may not be 'true and fair' as the auditor would understand this term.

The smaller the business is, the less likely its financial reports will comply with GAAP. Further, the more onerous GAAP becomes, or is perceived to become, the more, it appears, special purpose reports will be prepared.

## IV TAX AUTHORITIES RELIANCE ON FINANCIAL REPORTS

A common goal of a number of governments and their tax authorities is that of tax simplification. The question is fairly asked as to whether the authorities could rely on financial reports and use them as a basis for taxation, either by taxing the 'net income before taxation' disclosed by the financial reports, or by further adjusting that net income figure?.

There are a number of potential issues with this — the financial reports would, among other things, have to be consistently prepared from year to year, be verifiable and in the interests of equity between taxpayers, produced to a common standard. These issues could be addressed by the more widespread use of GAAP.

Another issue would be the lessening of the ability of government to offer taxation incentives if the reported 'net income before taxation' was to be taxed. Accelerated deduction-type incentives such as depreciation or film expenditure could be problematic.

Also, taxation could start to lead the development of GAAP, which would be inappropriate, especially given the number of stresses and strains that already exist with in the evolution of GAAP. It is interesting that differential GAAP already recognised, presumably subject to the 'true and fair' overlay, that the 20 per cent depreciation loading and the use of straight line or diminishing value rates is acceptable.

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<sup>13</sup> Estimate by the author, not authoritative in any way.

Further, in New Zealand, a current government focus is on simplification for small business, that is, the sort of business that is unlikely to currently report in compliance with GAAP. Given the compliance cost effect, imposing a GAAP requirement (with the objective of addressing some of the problems identified above) could be expected to result in a significant increase in compliance costs for this group, rather than the reduction that is being sought.

#### *A Financial Reports as a Starting Point for 'Net Income'*

Except where special purpose financial reports are prepared that lead directly to 'net [taxable] income',<sup>14</sup> the starting point for the taxation reconciliation is always the financial report's 'net income before taxation'. This figure is then adjusted by a variety of items to produce 'net income'.

To this extent it could be said that financial reports are therefore relied upon. However, given that the nature of the adjustments required will vary depending on the quality and contents of the financial reports, this reliance is somewhat superficial. Every item of income and expenditure that in net terms comprises taxable income should comply with the requirements of the *Tax Act 1994*. In practice, this leads to a number of reconciling items.

#### *B Reconciliation Between Accounting and Tax for New Zealand Companies*

The major reconciling items (permanent and timing) for large New Zealand companies that are audited are:

- depreciation (small value assets, software development costs, depreciation rates and gain / loss on sale adjustments) (both permanent and timing);
- trading stock (almost always timing);
- tax exempt dividends (permanent);
- gross-up for useable imputation credits (permanent);
- other dividend adjustments (for example, conduit) (permanent);
- employee remuneration provisions (almost always timing);
- other non-deductible provisions (for example, bad debts, ACC and trading stock) (almost always timing);
- goodwill amortisation (permanent);
- 'use-of-money' interest which is often mistakenly part of tax expense (permanent);
- gross-ups for foreign income (for example, foreign non-resident withholding tax on interest) which is often not done for accounting purposes (permanent);
- non-deductible expenditure (usually capital but expensed, for example legal costs/services) (permanent);
- capital gains / losses (permanent);
- entertainment expenditure (permanent);
- financial arrangement adjustments (often only for financial institutions) (timing);
- life and general insurers' adjustments (various);
- income and expenditure long line and exp for/in relation to long-term construction contracts (timing); and
- more specific adjustments for forestry, specified minerals and oil and gas (usually permanent).

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<sup>14</sup> *Income Tax Act 1994* (NZ) s BC 6.

One could argue that some of these adjusting items, for example the non-resident withholding tax gross-up and use-of-money interest, should not need adjustment if correctly dealt with in the first place. However, because the amounts are typically immaterial for financial reporting purposes, they must then be separately dealt with for taxation purposes.

Smaller entities' (non-audited) reconciling items typically include:

- gross-ups for credits on dividends received (if the gross-ups are not already in the reports), but, in this context, a number of smaller business will simply not receive dividends; and
- entertainment expenditure.

Typically financial arrangements are not included because for the more usual financial arrangements, the taxation requirements are the same as what good, or even reasonable, reporting would require. Depreciation is also not included because smaller entities use tax rates of depreciation – both the exempt companies' requirements and the differential reporting requirements allow this.

It seems that there is little scope for useful tax simplification by relying more on financial reports or general purpose financial reports that comply with GAAP, partially because it is the bigger entities that have to complete the most adjustments, and partially because the reconciling items can vary significantly from taxpayer to taxpayer.

## V TAX ACT REFERENCES TO GAAP AND ACCOUNTING STANDARDS

As indicated above, the *Tax Act 1994* contains a number of references to GAAP. These are generally to ensure that accounting concepts such as timing, assets, income and such like are properly defined. The references include:

- |                  |   |
|------------------|---|
| Section CD 3A    | which deals with the timing of certain monetary remuneration provisions' movements according to GAAP treatment;   |
| Subpart CG       | which deals with attributed foreign income of controlled foreign companies and foreign investment funds, and, for example, refers to shareholders funds and after tax accounting profit measured according to GAAP; |
| Section DK 5     | which provides that general insurers' provisions for claims must have regard to GAAP;   |
| Subpart EE       | which contains the trading stock valuation rules, refers to GAAP, and requires the use of Financial Reporting Standard ('FRS') 4 for larger taxpayers (accounting for inventories);                                 |
| Subparts FG – FH | which deals with thin capitalisation and excess interest allocation rules and refer to GAAP; and  |
| Section OB 1     | which contains the <i>Tax Act 1994</i> 's definitions and regularly refers to GAAP.   |

GAAP is itself defined in section OB1 of the *Tax Act 1994* as the *FRA* section 3 definition. Specific *Tax Act 1994* references are also made to two FRSs.

### A Trading Stock

The *Tax Act 1994* values trading stock, with modifications, with direct reference to the FRS 4 valuation of inventories.

At a high level, the modifications:

- exclude consumables because the *Tax Act 1994* has its own treatment;
- reduce perceived revenue risks;
- reduce small taxpayers' compliance costs; and
- exclude partially completed services.

The use of FRS 4 in this fashion means that the year-end add-back for trading stock can include items that are simply not deductible for tax purposes. Alternatively, the timing of the deductions might be different for taxation and accounting.

The best example of this is depreciation of manufacturing plant. The FRS calculation will be based on accounting depreciation and ignore tax depreciation. Ordinarily this will result in timing differences (resulting from the different accounting and taxation depreciation rates). However, where the plant has been revalued for accounting purposes, the difference is more permanent (albeit it that it must eventually reverse). While this is conceptually unusual, in practice it does not seem to have produced any problems.

The use for tax purposes of FRS 4, and the simplified version the *Tax Act 1994* allows, seems to have been widely accepted by taxpayers, although some of the larger ones might like even greater adherence to the standard.

### *B Research and Development*

The current provisions governing the deductibility of research and development link directly into FRS 13. Any expenditure that is expensed under paragraphs 5.1 or 5.2 of the FRS, or written off under paragraph 5.4, can be deducted for tax purposes.

Also, where research and development is less than NZD 10 000, it is not material and is expensed for accounting, it is tax deductible.

It has been suggested that this still leaves an issue with 'black hole expenditure': expenditure that is capitalised and amortised under the FRS, but where there is no tax deduction or depreciation. To date there is no empirical evidence that this problem is real. However, time will tell, and further tax policy work is being done on this.

This relatively new treatment of research and development seems to have been welcomed by most affected taxpayers. However, as suggested above, there are still some residual concerns.

### *C Potential Future Use of Accounting Standards*

Further reliance on GAAP to reinforce accounting concepts and on specific accounting standards is inevitable. The most prominent example of this could be long-term construction projects, which, for financial reporting purposes, are governed by FRS 14.

The 1991 Consultative Committee on the Taxation of Income from Capital compared the financial accounting treatment and the tax treatment of long-term construction projects and recommended that the tax treatment of these projects could be aligned with the financial accounting treatment.<sup>15</sup>

The current tax treatment of construction contracts with pre-determined customers is governed by case law. Income on construction contracts is assessable when it is derived in accordance with ordinary principles. Broadly, contractual provisions would determine the timing of revenue derivation under a construction contract. Where a contract provides for the

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<sup>15</sup> Consultative Committee on the Taxation of Income from Capital ('Valebh Committee'), *Final Report* (1991), ch 8 Tax Accounting Issues, Appendix 10 Recommendations.



circumstances in which progress payments are made, income under the construction contract is derived when the progress payments are due.

There is currently no specific requirement to match expenses with revenues. In particular, work in progress, once it is affixed to the building, appears not to be trading stock or revenue account property.

The use of accounting treatment as a timing rule for tax purposes would seem to be an appropriate way to tidy this up. However, the matter is not currently under consideration on the Government tax policy work programme.

## VI CONCLUSION

It seems doubtful that simplification of itself will lead to a general reliance by the *Tax Act 1994* on GAAP because of the compliance cost effect on smaller businesses. However, the use of GAAP to help define accounting concepts, such as income and shareholders' funds, and to time transactions is entrenched and is likely to expand.

Further use of accounting standards to address specific issues such as long-term construction contracts also seems to be likely, albeit not in the immediate future.

Although not discussed in detail in this article, there also will be continued reliance on case law that, in turn, will be supported by accounting concepts to address timing and capital / revenue matters (in particular).

## TAXING FINANCIAL INSTRUMENTS: UNCERTAINTY IN TAX AND ACCOUNTING?

RODNEY FISHER\*

**ABSTRACT:** The purpose of this article is to seek to identify trends which highlight the essential elements in the taxation of financial arrangements. To this end, the article reviews the existing taxation regime for financial instruments under Australian common law, and also examines the recommendations emanating from the reviews of the taxation of financial arrangements in Australia. The existing common law regime and the statutory proposals are compared and contrasted to highlight the distinctions between them. The article also has regard to accounting standards which may be of relevance. Additionally, some overseas regimes are reviewed for the guidance they may provide in relation to developing a model for taxing financial instruments.

From a consideration of these areas, the author seeks to discern developing trends in the taxation of financial instruments which may inform legislative development in Australia. While some trends can be identified from an examination of existing practice, the reviews undertaken and overseas experience, it would appear that accounting standards may not currently be able to provide guidance in the taxation treatment of financial instruments.

### I INTRODUCTION AND SCOPE

The late 1990s witnessed the results of the most recent major review of the Australian business taxation system with the release of '*A Tax System Redesigned*' ('the Ralph Report'),<sup>1</sup> containing a raft of recommendations for changes to the Australian regime. Among the recommendations in the Ralph Report were proposals for an accruals regime for the taxation of financial instruments. The Ralph Report was the third major report in the 1990s to make recommendations as to the legislative approach to be adopted in taxing financial arrangements, with none of the recommendations from any of the previous reports having yet been implemented, the taxation of financial instruments in Australia being still governed by domestic common law.

While legislation dealing with the demarcation between debt and equity has been introduced,<sup>2</sup> these provisions are broadly classification provisions, and do not deal with the

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Note that the statutory and other material in this article was current at the time of presentation of the paper. Subsequent to the presentation there have been legislative amendments and developments in the adoption of new accounting standards which impact on the analysis in the article.

<sup>1</sup> Review of Business Taxation, *A Tax System Redesigned*, July 1999

<sup>2</sup> Introduced by the *New Business Tax System (Debt & Equity) Bill 2001*(Cth).

consequences of the distinction. The long-awaited legislation dealing with taxation of financial instruments<sup>3</sup> provides conversion rules and taxation treatment for gains and losses on foreign currency, but does not address the issue of domestic financial instruments.

The approach taken in this article is to outline the existing Australian common law position and the recommendations made by the reviews as to legislative proposals, with a comparison of the alternative regimes. Also examined are accounting standards which may provide guidance as to taxing financial instruments, and overseas experiences which may provide lessons in legislating for such taxation.

From these analyses the author seeks to discern and highlight trends in the taxation of financial instruments, with such trends potentially providing useful insights for the development of any future Australian statutory regime for taxing financial arrangements.

### *A Nature of Financial Arrangements*

The issue of the taxation treatment of financial instruments arises as a consequence of the nature of financial instruments themselves. Financial instruments, for the purposes of this discussion, may be generally cast as being negotiable instruments traded at a discount to their face value. The feature of financial instruments which makes them of interest in taxation terms is that they may extend over taxation periods, with the consequence that they may be constructed to provide for a deferral of accrued gains which will not be realised until beyond the current income period, or alternatively the incurring of a liability in the current income period where the liability will not be met until a future period. It is the treatment of this deferred accrued gain or the advanced liability which is at issue for tax accounting for financial instruments.

## II CURRENT AUSTRALIAN APPROACH

Because there is no comprehensive legislative framework encompassing all financial arrangements, the Australian approach remains largely based on domestically determined common law. The difficult issue facing the judiciary has not so much concerned the accessibility or deductibility of interest or discount on instruments which span income years, but rather the quantum of the income or deduction in a particular income year. As highlighted by Beaumont J in *Federal Commissioner of Taxation (FCT) v Australian Guarantee Corp Ltd*: ‘the contest between the parties centres on the point of time, in terms of income year, in which the interest should be allowed as a deduction ... rather than deductibility as such ...’.<sup>4</sup>

### *A Common Law*

The approach currently adopted and applied by Australian courts is a straight line accruals approach to spread the amount evenly over the period to which it relates. In *Alliance Holdings Ltd v FCT*, Woodward J allowed a deduction for deferred interest payable on an accruals basis as ‘there was in each relevant tax year a present liability to pay the determined interest at a future date ...’.<sup>5</sup> This decision was followed by Lee J in *Australian Guarantee Corporation Ltd v FCT*<sup>6</sup> in the Supreme Court of NSW, a decision subsequently confirmed by

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<sup>3</sup> Introduced by the *New Business Tax System (Taxation of Financial Arrangements) Bill (No 1)* 2003 (Cth).

<sup>4</sup> (1984) 84 ATC 4642, 4658.

<sup>5</sup> (1981) 81 ATC 4637, 4643.

<sup>6</sup> (1984) 84 ATC 4024.

the Full Federal Court.<sup>7</sup> In accepting the accruals basis, Toohey J in the Federal Court would seem to have approved of accounting practice, suggesting that if the ‘approach was in accord with sound accountancy practice ... I see no reason why the taxpayer should not be allowed a deduction accordingly, unless there is something in the Act which precludes such a course ...’.<sup>8</sup> The general view of the courts had previously been expressed in terms such that ‘[c]ommercial and accounting practice may assist in ascertaining the true nature and incidence of the item as a step towards determining whether it answers the test laid down in s 51(1) but it cannot be substituted for the test’.<sup>9</sup>

The most authoritative statement supporting an accruals recognition of deductions for financial arrangements comes from the High Court joint majority judgement of Mason CJ, Brennan, Dawson, Toohey, and Gaudron JJ in *Coles Myer Finance Ltd v FCT*.<sup>10</sup> The High Court rejected the Federal Court approach in this case, which had allowed a deduction on realisation, but instead apportioned the cost on a straight line basis over the term of the instrument. The Court recognised that the ‘relevance of the present existence of a legal liability ... is that it establishes that the taxpayer has “incurred” in the year of income an obligation to pay an amount ...’, but that ‘it is proper to set against the taxpayer’s gross income or profit for that period the net losses or outgoings referable to that period’.<sup>11</sup> The joint judgement concluded that the ‘apportionment of the cost ... accords with both accounting principle and practice and the statutory prescription’.<sup>12</sup>

The decision in *Coles Myer* was followed by the High Court in *FCT v Energy Resources Australia*,<sup>13</sup> where, having determined that the discount was on revenue account, the High Court had to determine the issue of the timing of the deduction for the discount. The High Court noted that where a financial instrument extended beyond the current financial year, ‘the decision in *Coles Myer* arguably requires that the cost of the discount for that issue should be apportioned on a straight line basis between the two financial years’.<sup>14</sup>

### B *Non-recognition of Time Value of Money*

The accruals approach adopted by the courts is a straight-line accruals approach to spread the amount evenly across the accrual period, with such an approach failing to recognise the time value of money. At its most basic, the concept of the time value of money sees a diminishing value of money over time, the measure of compensation for converting between current and future sums being commonly expressed in terms of interest. From a tax perspective, there is a second element to the time value of money, that is, the timing of the recognition of deferred income and deferred expenditure. This second critical component derives from the first element, thus creating a preference in tax terms for a current deduction as opposed to a future deduction, or a deferred assessment of income as opposed to current assessment of income. In these terms, interest may be characterised as the compensation required for postponing current consumption.

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<sup>7</sup> *FCT v Australian Guarantee Corporation Ltd* (1984) 84 ATC 4642.

<sup>8</sup> *Ibid* 4648.

<sup>9</sup> *FCT v James Flood* (1953) 88 CLR 492, 506–7.

<sup>10</sup> (1993) 25 ATR 95.

<sup>11</sup> *Ibid* 105.

<sup>12</sup> *Ibid* 106.

<sup>13</sup> (1996) 33 ATR 52.

<sup>14</sup> *Ibid* 56.

It may be that there has been some implicit recognition of the time value of money by both the Commissioner and the courts. In *Australian Guarantee Corporation*,<sup>15</sup> the Commissioner argued that a possible 20 year deferment period for payment of interest meant it was not possible to determine a present value, thus implicitly recognising the time value of money. In this same case, McGregor J noted that unless a redemption date was known, calculation of the present value of future amounts would not be possible, again giving implicit recognition to the time value of money, and implying that under different circumstances the court may have been prepared to consider its application.

Historically, however, the courts have applied an alternative ‘compensation for use’ approach to interest and discounts, such amounts taking the ‘substance [of] a payment received for the use by a borrower of the lender’s money’.<sup>16</sup> This compensation for use approach is best illustrated by the decision in *FCT v Myer Emporium*.<sup>17</sup>

In *FCT v Myer Emporium*, the taxpayer assigned the right to a future income stream of AUD 70m in return for consideration of an immediate lump sum payment of AUD 45.37m, representing the present value at the date of assignment of the right to interest payments over the period of the loan. The taxpayer argued that application of the principle of the time value of money would result in no profit arising, as the amount received represented the present value of the right to the interest stream. The Commissioner argued against using discounted present value, suggesting that it would be ‘an error to say that because the interest foregone was “worth” \$45.37 million no profit was made’,<sup>18</sup> the implication being that taxation did not take account of discounting for inflation or the loss of value of money over a period of time.

In the Full Federal Court, Jenkinson J had accepted the taxpayer’s argument that application of business concepts disclosed no profit. The Full High Court however, confirmed the legal principle that interest takes the nature of ‘compensation to the lender for being kept out of the use and enjoyment of the principal sum’.<sup>19</sup> This affirmed that the accounting base would be historical cost and not economic equivalence, and there was no place in taxation for discounting based on the time value of money.

### C *Statutory Provisions*

The limited statutory provisions dealing with financial instruments in the Australian regime are Div 16E, dealing with qualifying securities; and ss 26BB and 70B dealing with traditional securities.

#### 1 *Div 16E - Qualifying Securities*

Division 16E applies to securities issued after 27 January 1994, with a qualifying security having:<sup>20</sup>

- a term greater than one year, and
- an eligible return greater than 1.5 per cent.

The eligible return is the excess of the sum of the payments, excluding interest, over the issue price of the security.<sup>21</sup>

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<sup>15</sup> Above n 6.

<sup>16</sup> *South Australia v The Commonwealth* (1992) 66 ALJR 240, 245.

<sup>17</sup> (1987) 163 CLR 199.

<sup>18</sup> *Ibid* 202.

<sup>19</sup> *Ibid* 218.

<sup>20</sup> *Income Tax Assessment Act 1936* (Cth) s 159GP(1).

Effectively the regime provides for an accrual basis of return calculated for accrual periods of six months each. The accrual amount is determined as:

$$[\text{Implicit interest rate} * \text{opening balance}] - \text{periodic interest.}$$

The implicit interest rate is effectively the yield to maturity for both fixed return securities<sup>22</sup> and variable return securities.<sup>23</sup>

## 2 Traditional Securities

Traditional securities are those which:<sup>24</sup>

- meet the definition of security;<sup>25</sup>
- are held or acquired after 10 May 1989; and
  - have no eligible return; or
  - have an eligible return of less than 1.5 per cent.

The gain on disposal or redemption of a traditional security is included in assessable income on disposal or redemption.<sup>26</sup> A corresponding deduction is allowed for a loss on disposal or redemption of a traditional security in the year of disposal or redemption.<sup>27</sup>

### III PROPOSALS FOR CHANGE

During the 1990s there were three major reports examining the tax treatment to be afforded financial instruments, these reports being:

- the 1993 *Consultative Document*,
- the 1996 *Issues Paper*, and
- the 1999 Review of Business Taxation ('Ralph Review'), the final report of which ('*A Tax System Redesigned*' also known as the 'Ralph Report') had been preceded by discussion papers.

Each of the reports contained recommendations for a statutory approach to the timing issue for recognising the income or deduction for financial instruments which extend across income years, but at this stage none of the recommended approaches has been implemented. It is, however, instructive to briefly outline the main recommendations from these reports, and the underlying rationale for the approaches recommended.

#### A Consultative Document

The first of the reports was a *Consultative Document* issued by the government in December 1993.<sup>28</sup> The *Consultative Document* raised a number of concerns regarding the then existing taxation arrangements for financial instruments. The limited statutory provisions were portrayed as unable to accommodate and reflect the substance of the growing number of

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<sup>21</sup> *Income Tax Assessment Act 1936* (Cth) s 159GP(3).

<sup>22</sup> *Income Tax Assessment Act 1936* (Cth) s 159GQC.

<sup>23</sup> *Income Tax Assessment Act 1936* (Cth) s 159GQD.

<sup>24</sup> *Income Tax Assessment Act 1936* (Cth) s 26BB(1).

<sup>25</sup> Defined in s 159GP(1) *Income Tax Assessment Act 1936* (Cth).

<sup>26</sup> *Income Tax Assessment Act 1936* (Cth) s 26BB(2).

<sup>27</sup> *Income Tax Assessment Act 1936* (Cth) s 70B(2).

<sup>28</sup> ATO, *Taxation of Financial Arrangements: A Consultative Document*, December 1993.

new financial instruments and products, allowing for an unacceptable degree of uncertainty.<sup>29</sup> The surfeit of judicial precedent in the common law was viewed as sanctioning tax planning opportunities by exploitation of the timing mismatch between claiming deductions and declaring income.<sup>30</sup>

Concern was also expressed that different tax treatment based on form rather than economic substance would create a non-neutral environment, with financial decision making being tax driven.<sup>31</sup> The criterion of tax neutrality requires that taxation treatment should not be a factor in finance decision making, with such decisions ignoring taxation consequences and being determined by rate of return. However, if form rather than economic substance determined the tax treatment, then financial arrangements with essentially the same economic outcomes, but structured differently, could attract different tax treatment. The outcome from divergent tax treatment would be non-neutral, in that tax considerations would influence investment decisions, carrying potential risks for the revenue and the economy generally as investment was attracted away from more productive areas in pursuit of a tax benefit.

The *Consultative Document* placed emphasis on economic substance rather than legal form in seeking to achieve the principles of certainty, tax neutrality, flexibility, and clarity. The solution proffered in achieving these aims was an accruals taxation regime for all financial arrangements which were in substance debt arrangements. Uncertainty would be eliminated by including on revenue account all gains and losses from financial arrangements.<sup>32</sup> An arrangement would be in substance a debt arrangement if it involved payment of an amount that gave rise to a right to receive, or an obligation to pay, another future amount that was reasonably likely to equal or exceed the first investment amount. The proposed accruals system would exclude:

- equity arrangements;
- equity and commodity derivatives based on an index;
- life insurance, superannuation, and Approved Deposit Funds ('ADFs'); and
- financial transactions of natural persons, unless there was opportunity for significant tax deferral.<sup>33</sup>

Three possible accruals methods were canvassed in the document, these methods being:

- daily compounding,
- straight line, and
- market value accounting.<sup>34</sup>

Of these, the basis method for taxation purposes would be daily compounding accruals, thus best reflecting the economic substance of the arrangements. Straight line accruals could be used where there was no significant deferral opportunity, and the result would not be materially different from the daily compounding method. Market value accounting would be required in limited cases where daily compounding accruals could not be used, examples including futures contracts and forward agreements. For instruments traded on a market the valuation would be mark-to-market, and if not traded, valuation would be an estimated market

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<sup>29</sup> Ibid 3

<sup>30</sup> Ibid 4.

<sup>31</sup> Ibid.

<sup>32</sup> Ibid 7.

<sup>33</sup> Ibid 30.

<sup>34</sup> Ibid 33.

value. The proposal specifically excluded both the cash method and the due and payable/due and receivable method as acceptable methods for the taxation of financial instruments.<sup>35</sup>

Responses to the *Consultative Document* suggested that two main areas had been overlooked, these being:

- simplicity — which had not been included as a design principle for the proposed accruals taxation system; and
- the purpose of the financial arrangement — which had not been taken into account in determining economic substance.<sup>36</sup>

### B *Issues Paper*

Following responses to the *Consultative Document*, the next instalment in the ongoing saga was the release in 1996 of the *Issues Paper on Taxation of Financial Arrangements*.<sup>37</sup> The *Issues Paper* had an overriding objective of simplicity, with basic design principles of:

- determinacy, to include certainty, clarity, and flexibility; and
- neutrality, so as not to distort economic decisions of taxpayers, and to ensure taxation consistency across financial arrangements with the same economic substance.<sup>38</sup>

Statutory and judicial problems identified in the existing taxation framework included:

- statutory provisions failing to take into account the time value of money; and
- judicial consideration being deficient in failing to give guidance as to the weight to be accorded:
  - financial accounting practice,
  - the nature of the taxpayer and the taxable activity,
  - the type of amount under consideration, and
  - the relationship between financial arrangements.<sup>39</sup>

While the *Issues Paper* concurred with the *Consultative Document* that gains and losses from financial arrangements would generally be on revenue account, other proposals differed significantly from the *Consultative Document*. The scope of financial arrangements in the *Issues Paper* was much more widely defined, and would include not only debt but all derivatives, including non-debt derivatives such as equity and commodity derivatives, thus bringing equity trading within the proposed regime. Identifying factors of debts were seen to include:

- repayment of investment,
- stipulated rate of return,
- non-contingent payments,
- participation in gains and losses,
- priority on winding-up,
- ownership and control, and
- legal form.<sup>40</sup>

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<sup>35</sup> Ibid 38.

<sup>36</sup> Dept of Treasury, *Taxation of Financial Arrangements: An Issues Paper*, December 1996, 25.

<sup>37</sup> Ibid.

<sup>38</sup> Ibid 26–7.

<sup>39</sup> Ibid 31–2.

<sup>40</sup> Ibid 76–9.



Rather than adopting a general approach to all financial arrangements, the *Issues Paper* prescribed tax rules dependent on the purpose of the financial arrangement, the broad recommendations being:

- trading activity — market value accounting;
- hedging — hedge tax accounting, with accruals basis for interest; and
- investing/financing — accruals for interest; retranslation for foreign currency gains and losses.<sup>41</sup>

Market value tax accounting provided the foundation for the preferred option for a trading regime, reflecting financial accounting practice for traded financial instruments. Market value was seen as the most conceptually correct measure of income, the approach being consistent with the Shanz-Haig-Simons income concept.<sup>42</sup> As an accounting measure market value was suggested as being more tax neutral than a realisation basis.<sup>43</sup>

However, because of the practical difficulties associated with market value tax accounting it was seen as inappropriate to recommend a universal market value approach. Where a well-established and liquid market existed for the financial arrangement, the mark-to-market basis was recommended, with the gain or loss from the asset or liability being the increase or decrease in market value between the beginning and end of the period, adjusted for amounts paid or received. If no market existed, or the market was not liquid, the proposal was for calculation on the basis of an estimated market value.<sup>44</sup>

The *Issues Paper* considered that where accrual accounting was used for financial arrangements on preparation of financial statements, and was applied consistently, it might also be used for income tax purposes. However, it did not consider that unqualified acceptance of financial accounting was appropriate for financial arrangements for tax purposes, since the methods could produce results that gave rise to tax deferral opportunities or tax driven arbitrage.<sup>45</sup>

### C *The Report of the Review of Business Taxation ('Ralph Report')*

The Review of Business Taxation report, *A Tax System Redesigned*, in common with the other reports, concluded that the existing law created deferral opportunities and distortion as financial assets and liabilities with the same before tax returns produced different after tax returns because of tax wedges. The report sought to place the taxation of financial assets on a more consistent and neutral basis.<sup>46</sup> The reform measures proposed were designed to ensure that financial instruments were taxed according to economic substance rather than legal form, thus contributing to a more consistent tax treatment and greater integrity for the tax system overall.<sup>47</sup>

The core recommendation from the Ralph Report was for an accrual basis of taxation for financial assets and liabilities, applying a 'rate of return' to the asset or liability's opening tax value, with an adjustment made for cash flows that occurred in the period. The accruals approach would ensure that gains or losses would be allocated on a time value of money basis

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<sup>41</sup> Ibid 64.

<sup>42</sup> Ibid 200.

<sup>43</sup> Ibid 120.

<sup>44</sup> Ibid 198–204.

<sup>45</sup> Ibid 120.

<sup>46</sup> Review of Business Taxation: *A Tax System Redesigned*, Explanatory Notes 117–18.

<sup>47</sup> Review of Business Taxation: *A Tax System Redesigned*, Overview 15.

to the tax period to which they related, thus providing a better reflection of income than the realisation basis.<sup>48</sup>

The Report recommended that certain and uncertain gains and losses need to be distinguished. Certain gains or losses are those where the future payment amount is stipulated in a contract, or linked to a variable which has been determined prior to the time of taxing. Uncertain payments would be those which rely on the discretion of the issuer. Certain future gains and losses, being those where the future payment amount is stipulated, would be accrued where the right to receive or obligation to pay is not subject to a contingency. Uncertain instruments, such as ordinary shares, options, forwards and futures, would be taxed on realisation.<sup>49</sup>

The accruals system recommended was a yield-based accruals methodology. The tax value would be calculated:

- when the taxpayer acquired the asset; and
- when certain events occur, these events being:
  - end of an income year;
  - when an amount is received in respect of the asset during the income year; and
  - when there is a change in one of the components comprising the total return on the asset.<sup>50</sup>

Exceptions to the application of the accruals basis included:

- an election for the mark-to-market method;
- a right to payment within six months for supply of goods and services;
- membership interests, which will be taxed on realisation;
- options; and
- assets which arise from the relationship between the tax entity and its members.<sup>51</sup>

Individuals and small business could choose a cash basis of accounting and not be subject to the accruals regime. Taxpayers would be able to elect to use mark-to-market for tax purposes for financial instruments where the taxpayer uses mark-to-market in its accounting records.<sup>52</sup>

#### D *Comparison of Report Proposals and Common Law*

In broad terms the *Consultative Document* of 1993 and the *Review of Business Taxation* of 1999 would appear to align on the key recommendation regarding the adoption of an accruals regime, with the basis of the proposals broadly being the use of an internal rate of return (yield to maturity) to spread the income/expense over the term of the instrument. The *Issues Paper* adopted a purpose approach, which initially would seem to be at odds with the recommendations of the other reports. However, it may be that, in relation to ‘debt-type’ instruments, the recommendation in the *Issues Paper* does not significantly differ from the recommendations in the other reports. This is suggested because the *Issues Paper* viewed financial arrangements as encompassing a much wider range of transactions than either of the other reports. While the *Consultative Document* and Ralph Report restricted financial

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<sup>48</sup> Ibid 341.

<sup>49</sup> Ibid 343.

<sup>50</sup> Ibid 344.

<sup>51</sup> Ibid ch 9.

<sup>52</sup> Ibid Recommendation 9(1)(a). Note: ‘mark-to-market’ is defined as recording current market value rather than book value.

arrangements in broad terms to debt equivalent arrangements, the *Issues Paper* also included equity arrangements within its purview. If the transactions seen as within the range of investing and financing transactions in the *Issues Paper* are broadly equivalent to the debt equivalent instruments considered in the other two reports, then it may be suggested that in general terms the three reports are in broad accord.

An area on which all reports broadly agreed was in the proposals for an approach which overcame the problem of the failure in taxation to recognise the time value of money, with the *Review of Business Taxation* noting that the accruals approach recommended 'ensures that any gain or loss is allocated on a time value of money basis to the tax period to which it relates'.<sup>53</sup> These recommendations are in broad accord with the accounting approach whereby, for financial and accounting purposes, the interest rate serves as a conversion factor between present and future sums, recognising that all values need to relate to a common time frame to be comparable.

In contrast with the rate of return accruals approaches recommended in the reports, the common law approach applies a narrower, straight-line accruals basis, under which the income/expense is spread evenly on a time basis over the term of the instrument. This failure of the tax regime to recognise the time value of money potentially violates tax policy criteria, particularly in relation to horizontal equity and efficiency or neutrality.

Horizontal equity is potentially breached by the failure to measure a taxpayer's true economic income during a period, allowing the form to dictate the taxation outcome. As noted earlier, a second aspect of the time value of money in relation to taxation is concerned with the timing of the recognition of income and expenditure. Efficiency principles may be breached where taxpayers seek to exploit the non-recognition of the time value of money by deferring recognition of income, thus being taxed in a later period on amounts actually or constructively received in an earlier period; and advancing recognition of expenditure, thus gaining a deduction in an earlier period for an outgoing not actually made until a later period.

Such activities are not in accord with financial and accounting principles which recognise the time value of money by way of present value determinations, and can have an adverse impact on revenue collection.

### E *Government Response*

Despite the recommendations from the three reports described above, there has been a notable lack of action by the government in providing certainty as to tax treatment for financial instruments by way of a statutory regime. To date the only legislative regime introduced in relation to financial instruments has been in the narrow area of foreign exchange transactions.

The reasons behind the government reluctance to legislate in this area can only be subject to speculation. The government may be concerned that when any legislative regime is introduced, it must be seen to 'cover the field' for all financial instruments. The difficulty with any legislative regime intended to have such broad coverage is that it may be seen by financial 'engineers' as a challenge to produce products that would fall outside the scope of the regime, and the government would be desirous of precluding an avalanche of new instruments which would not be within the statutory provisions. Any such concern, however,

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<sup>53</sup> Review of Business Taxation: *A Tax System Redesigned, Recommendations* 341.

would arguably be adequately addressed by using a broad classification approach such as that employed in the debt/equity regime, which itself would lay the basis for constructing a statutory regime for taxation of debt instruments. If the government concern is to 'cover all bases' before introducing a statutory regime, such a regime may be some time coming as the area of financial instruments is unlikely to remain static long enough for legislative drafting to provide for every contingency or eventuality.

Alternatively, it may be that the government is looking to the effectiveness of overseas statutory regimes with a view to streamlining any legislative measures so as to overcome any adverse consequences which the overseas experience has exposed. Comparable tax regimes, such as those in New Zealand and the United Kingdom, have existing legislative provisions for taxation of financial arrangements, and these may be useful as models for any Australian legislation in this area.

A further alternative explanation may be that the government considers that the current common law approach provides a satisfactory outcome, the basis for this view being that if this were not the case then legislation would presumably have been forthcoming to alter heretofore unsatisfactory outcomes. It may be that with a common law regime providing an acceptable outcome, and a government tax reform agenda which shows no signs of slowing, a statutory regime for taxing financial instruments simply does not have a high priority.

#### IV ACCOUNTING TREATMENT

As noted earlier, the approach adopted by courts in relation to commercial and accounting practice was that such practice may — by providing guidance in the determination of the true nature and incidence of an item — assist as a step towards determining the correct taxation treatment. However such practice could not be taken as a replacement for judicial judgement in determining the correct legal position. Toohey J, in the Federal Court decision in *FCT v Australian Guarantee Corporation*, would appear to have come close to endorsing accounting practice by suggesting that if the approach adopted was in accordance with sound accountancy practice, there appeared no reason for the court to act otherwise, short of some specific legislative provision precluding that course and determining some alternative outcome.<sup>54</sup>

The issue emanating from this is the requirement to identify a uniform accounting standard prescribing the treatment for financial instruments, and it is in this area that difficulties would appear to arise. Accounting standards are prescribed by the Australian Accounting Standards Board ('AASB'), with published standards covering a range of accounting issues. Additionally, there are moves for harmonisation of international accounting standards as determined by the International Accounting Standards Board ('IASB'), with Australia moving towards accepting the international standards.<sup>55</sup>

Unfortunately, however, it would appear that accounting standards are currently also unable to proffer certainty as to the correct tax treatment for financial instruments. The previous Australian Accounting Standard AAS6 defined the accruals basis as operating as a

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<sup>54</sup> (1984) 84 ATC 4642, 4649.

<sup>55</sup> Note that since the time of writing this article, Australia has adopted the IFRS Accounting Standards. As part of the transition to IFRS, AASB has released two standards dealing with financial instruments, being AASB 132 Financial Instruments: Disclosure and Presentation, and AASB 139 Financial Instruments: Recognition and Measurement. The comments made in the article predate the release of these Standards, so the article should be read in the light of these consequent developments.

system ‘whereby items are brought to account as they are incurred or earned (and not as money is received or paid)’, which provided little guidance as to the accruals method to apply. The IASB has issued ‘*IAS32: Financial Instruments: Disclosure and Presentation*’ and ‘*IAS39: Financial Instruments: Recognition and Measurement*’, both of which are currently under review.<sup>56</sup> The AASB has issued ‘*AASB 1033: Presentation and Disclosure of Financial Instruments*’, which is based on IAS32, but in relation to recognition and measurement, ‘[t]here is currently no Australian Standard dealing with the recognition and measurement of financial instruments’.<sup>57</sup>

In broad terms *AASB 1033* and *IAS32* provide for a wide definition of financial instruments — covering such traditional items as trade receivables through to options, swaps, and other derivatives — and require that financial instruments be classified as equity or liabilities, largely on the basis of substance rather than legal form. Both standards prescribe disclosure of fair value of financial instruments, with financial assets recognised at an amount exceeding net fair value. *IAS39* provides a choice for financial assets and liabilities remeasured to fair value, with either a recognition of the entire adjustment in profit and loss for the period, or recognising in the current period profits and loss only changes relating to financial assets or liabilities held for trading. The changes in value of those held for non-trading would be reported on sale or realisation. Some further guidance is available from ‘*AASB 1020, Accounting for Income Tax (Tax-effect Accounting)*’, which prescribes the liability method of tax-effect accounting in accounting for timing differences.

At a time when there is much activity in the development of new and innovative financial arrangements, one could expect the courts to look to accounting practice to provide some guidance as to the correct treatment of such instruments to reflect the true economic substance of the arrangement. However it is suggested that it may be in this area that accounting practice falls short of providing unambiguous, prescriptive guidance. This may not be entirely unexpected, given that the accounting profession itself would be having difficulty reacting expeditiously to rapid developments in the nature of financial instruments.

## V OTHER REGIMES

By way of comparison with the recommendations for Australia, the treatment in some comparably taxed countries is examined below.

### A New Zealand

New Zealand has introduced a statutory accruals regime<sup>58</sup> in regard to financial arrangements to ensure the matching of income and expenditure recognition for tax purposes. The regime aims to:

- spread income and expenditure over the term of the agreement;
- ensure all returns on financial instruments are taxable, removing the capital/income distinction; and
- ensure consistency between financial accounting and tax accounting.<sup>59</sup>

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<sup>56</sup> As noted above, AASB has now released IFRS based Standards dealing with financial arrangements.

<sup>57</sup> AASB, *Project Summary – Financial Instruments: Recognition and Measurement* avail <<http://www.aasb.com.au/>> at December 2002.

<sup>58</sup> All legislative references are to the *Income Tax Act 1994* (NZ) Subpart EH.

The accruals regime applies to all financial arrangements which are not excepted financial arrangements, the definition of financial arrangement being very broad to cover every agreement where the giving of consideration is deferred. Essentially financial arrangements are defined to cover two broad classes:

- debts or debt instruments; and
- any arrangement under which a person receives money in consideration for a person providing money to any person
  - at some future time;
  - when an event occurs in the future, or does not occur.<sup>60</sup>

The scope of this definition of a financial arrangement is potentially very broad, and includes sale and buy back, debt defeasance, and assignments of income.<sup>61</sup> Excepted financial arrangements include shares, options, annuities, insurance, and leases, unless these are part of a wider financial arrangement.<sup>62</sup> A cash basis holder is not required to adopt the accruals method, a cash basis holder being a person who derives less than NZD 100,000 from financial arrangements, or who has less than NZD 1m invested in financial arrangements.<sup>63</sup>

The regime provides for four possible categories of accrual accounting:

- the straight line method;
- the yield to maturity approach;
- the prescribed method, where yield to maturity cannot be used; and
- market valuation in the case of dealers in financial arrangements.

The accepted method is the yield to maturity method,<sup>64</sup> although methods not materially different from this method and which comply with commercially accepted accounting practice may be used.<sup>65</sup> The yield to maturity method is based on internal rate of return, this rate then applying as an invariable rate to the principal outstanding in the period to determine the income or expenditure for this period

The straight line option<sup>66</sup> is available to taxpayers with an upper limit of NZD 1.5m invested in financial arrangements, both as a holder and an issuer. If used, the straight line method must be used for all financial instruments to which it can be applied for that person, and must continue to be used for the life of the financial instrument.<sup>67</sup> There are two broad calculation methods for the straight line option. Where the loan is for a fixed amount of principal with any interest payable at regular intervals, the finance charges are allocated equally between each period in the term of the arrangement.<sup>68</sup> If the principal outstanding varies, and payments are irregular, the total finance charges are allocated to each period in proportion to the principal outstanding in the period.<sup>69</sup>

Where the yield to maturity or straight line options cannot be used, the taxpayer may use an alternative method<sup>70</sup> if the method meets all requirements of:

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<sup>59</sup> *New Zealand Master Tax Guide* (CCH, 1999) 267.

<sup>60</sup> *Income Tax Act 1994* (NZ) s EH 22.

<sup>61</sup> *Income Tax Act 1994* (NZ) s EH 22.

<sup>62</sup> *Income Tax Act 1994* (NZ) s EH 24.

<sup>63</sup> *Income Tax Act 1994* (NZ) s EH27.

<sup>64</sup> *Income Tax Act 1994* (NZ) s EH 34(1).

<sup>65</sup> *Income Tax Act 1994* (NZ) s EH 34(2).

<sup>66</sup> *Income Tax Act 1994* (NZ) s EH 35.

<sup>67</sup> *Income Tax Act 1994* (NZ) s EH 35(2).

<sup>68</sup> *Income Tax Act 1994* (NZ) s EH 35(6).

<sup>69</sup> *Income Tax Act 1994* (NZ) s EH 35(6).

<sup>70</sup> *Income Tax Act 1994* (NZ) ss EH 38, EH 39, EH 40.

- having regard to the principles of accrual accounting,
- conforming with commercially accepted practice,
- being consistently adopted for financial reports, and
- resulting in no material difference from yield to maturity.<sup>71</sup>

If the market value option is adopted<sup>72</sup> then the Commissioner must approve the market, method, and source of information used to determine market value, and the option is only available when:

- the method conforms with accepted commercial practice;
- it is consistently adopted for financial reports; and
- either the person is in the business of dealing with financial arrangements, or the financial arrangement is a forward contract for foreign exchange or a futures contract.<sup>73</sup>

### B *The United States of America*

In common with New Zealand, the United States of America ('USA') has taken a statutory approach to accessibility and deductibility of bond discounts and premiums. The amount of any premium on a bond, being the amount by which the issue price exceeds the amount payable on maturity, is treated as corporate income, and is amortised over the life of the bond.<sup>74</sup> Expenses incurred in issuing the bond are amortised over the life of the bond and deducted as a business expense. The treatment of bonds issued at a discount will vary depending on the nature of the bond, the maturity period, and the date of issue. Bonds are broadly seen as being issued at a discount when the issue price is less than the face value of the bond.

#### 1 *Original Issue Discount Rules*

The original issue discount ('OID') on a bond is the difference between the issue price<sup>75</sup> of the instrument and the stated redemption amount at maturity. A zero OID<sup>76</sup> is one where this difference is less than a given fraction of 1 per cent on the redemption price from the date of issue to the date of maturity.<sup>77</sup>

Where a debt instrument originally issued after 1 July 1982 has a term to maturity of more than 12 months, then the holder includes in gross income the sum of the daily portion of the OID calculated for each day that the instrument is held during the tax year.<sup>78</sup> The basis of the evidence of indebtedness in the hands of the holder is increased by the OID included in gross income.<sup>79</sup> The issuer of the instrument is entitled to an allowable deduction for the tax year for an amount equal to the aggregate daily portions of the OID for days it is held by the holder during the tax year.<sup>80</sup> For instruments issued post 27 May 1969 and pre 2 July 1982, the holder of the instrument includes in gross income the rateable monthly portion of OID

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<sup>71</sup> *Income Tax Act 1994* (NZ) s EH 38, EH 39, EH 40.

<sup>72</sup> *Income Tax Act 1994* (NZ) s EH36.

<sup>73</sup> *Income Tax Act 1994* (NZ) s EH 36(3).

<sup>74</sup> Reg 1.61-12(c).

<sup>75</sup> Defined in *Internal Revenue Code* ('IRC') § 1273(b) (1986).

<sup>76</sup> IRC § 1273(a)(3) (1986).

<sup>77</sup> *2002 US Master Tax Guide* (CCH, 2002) para 1952.

<sup>78</sup> IRC § 1272(a)(1) (1986).

<sup>79</sup> IRC § 1272(d)(2) (1986).

<sup>80</sup> IRC § 163(e) (1986); the formula for calculation of the aggregate daily portion is in IRC § 1272(a)(3) (1986).

multiplied by the months (in whole months and fractions) in the tax year during which the instrument was held.<sup>81</sup> This suggests that the USA has moved from a monthly accruals to a daily accruals basis for determining the assessable and deductible amounts for the holder and issuer of OID instruments respectively.

## 2 *Market Discount Instruments*

A market discount bond is one which was purchased at a discount from its face value, excluding:

- obligations that mature within one year of issue,
- US savings bonds,
- instalment bonds, and
- tax exempt bonds acquired before 1 May 1993.<sup>82</sup>

For market discount bonds issued after 30 April 1993, any gain on sale is treated as ordinary income to the extent of the accrued market discount on the bond. The accrued market discount on a bond may be determined using the rateable accrual method,<sup>83</sup> or alternatively the taxpayer may make an irrevocable election to use the constant interest method.<sup>84</sup> As an alternative to recognising interest income on disposal of a market discount instrument, a taxpayer may make an election, revocable only with the consent of the Internal Revenue Service ('IRS'), to include market discount in income currently using either of the above methods, being the rateable accrual method or the constant interest method.<sup>85</sup>

## 3 *Discount on Short-Term Instruments*

Short-term instruments are those with a one-year maturity or less, and such instruments are generally exempt from the OID rules and the acquisition discount rules.<sup>86</sup> Certain holders of short-term instruments — including accrual basis taxpayers, dealers, banks, regulated investment companies, common trust funds, and certain pass-through entities — are required to include acquisition discount from these instruments in their income.<sup>87</sup> The income to be included is calculated on a straight-line basis, and for obligations acquired after 27 September 1983, any interest other than interest taken into account in determining the amount of the acquisition discount, payable on such instruments as it accrues.<sup>88</sup>

For circumstances where mandatory accrual is not required, interest will only be deductible to the extent that it exceeds the sum of the acquisition discount for each day of the year that the instrument is held by the taxpayer, and the amount of any interest payable on the obligation that accrues during the year but is not included in gross income for that year as a result of the accounting method used by the taxpayer. In this case the daily portion of the acquisition discount is determined as the sum of the discount divided by the period in days from acquisition date to maturity date.<sup>89</sup>

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<sup>81</sup> IRC § 1272(b) (1986).

<sup>82</sup> *US Master Tax Guide*, above n 77, para 1958.

<sup>83</sup> IRC § 1276(b)(1) (1986).

<sup>84</sup> IRC § 1276(b)(2) (1986).

<sup>85</sup> IRC § 1278(b) (1986).

<sup>86</sup> *2002 US Master Tax Guide*, above n 77, para 1961.

<sup>87</sup> IRC § 1256(e)(2) (1986).

<sup>88</sup> *2002 US Master Tax Guide*, above n 77, para 1961.

<sup>89</sup> IRC §§ 1282 & 1283 (1986).



## VI INTERNATIONAL COMPARISON

While both New Zealand and the USA have opted for statutory provisions relating to the timing of taxation of financial instruments, the common law regime in Australia has much in common with those statutory provisions.

In their legislative regimes, both New Zealand and the USA require the use of an accruals basis for the recognition of income and deductions, and this is the prescribed common law approach in Australia. However, while the New Zealand approach favours the yield to maturity method, with others being acceptable in certain circumstances, the US approach generally appears to look more to a time based accruals regime, which is more akin to the common law position in Australia. The Ralph Report recommendations broadly accord with the New Zealand regime, preferring a yield basis for accruals.

The New Zealand regime allows as an alternative in specified circumstances the use as a straight-line accruals basis, and the *Consultative Document* in Australia also suggested the use of straight-line accruals, not as the preferred method, but as an acceptable alternative method where no deferral opportunities existed.

The point highlighted by this brief comparison is that even in those regimes where statutory provisions have been introduced to cover the taxation of financial instruments, there is no commonality of approach. This highlights the range of ‘choice’ available to meet individual needs for global enterprises seeking a particular desired result. (Note: A comparison of alternative taxing regimes, both actual and suggested — the former in NZ, the USA, and in Australia as expressed in *Coles-Myer*; and the latter as expressed in the *Consultative Document*, the *Issues Paper*, and the Ralph Report — is included in Appendix 1.)

## VII RECONCILIATION OF OUTCOMES WITH OBJECTIVES

This final section of this article draws on the foregoing discussions in seeking to highlight some fundamental trends which are discernable in the taxation of financial arrangements. These trends are drawn both from the reviews conducted into taxation of financial instruments in Australia, and from the legislative codes introduced in other countries’ regimes. It is suggested that trends identified may provide guidance as to the indicia of importance in the development of any legislative code in the area of taxation of financial arrangements.

### A *Economic Substance*

It should not be seen as surprising that there is a large degree of congruence between the recommendations of all three Australian reviews, as for each of the reviews the common law system in operation was essentially the same, and each of the reviews identified similar concerns with this existing regime.

All of the recommended taxing models for financial arrangements were concerned that the method of taxation should reflect the true economic substance of the transactions, rather than the legal form of the transaction. This trend is becoming more pervasive throughout taxation systems generally as the pendulum in the ‘form and substance’ argument continues to swing away from the form basis which was enshrined by *Duke of Westminster*,<sup>90</sup> and held such sway during the halcyon days for tax avoidance from the 1950s to the 1970s. It may be

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<sup>90</sup> *IRC v Duke of Westminster* (1936) AC 1.

arguable that the trend to globalisation has been one factor driving this ‘substance over form’ approach, as globalised financial markets in conjunction with financial engineering offer greater opportunity for the international movement of money under a range of guises, with the possibility of no tax liability arising in any country. This has been of concern to tax regimes in all countries, and may underlie the strong responses in regimes such as New Zealand, where all debt-type arrangements or loan relationships are taxed as debt. A similar approach is recommended for Australia by the *Consultative Document* and the Ralph Report

Application of an economic substance approach serves both the taxpayer and the national taxing agency (‘the Revenue’),<sup>91</sup> by providing greater certainty in the taxation outcome, and providing for greater efficiency in the making of financing decisions. In circumstances where the form of the transaction will dictate the taxation treatment afforded the transaction, there can be a lack of certainty as to the taxation treatment which will be attracted by the transaction. This uncertainty can arise as the transaction may not attract the same characterisation by the Revenue as intended by the taxpayer, with a consequence that each party will expect different tax treatment for the arrangement. Taxation measures based on economic substance can provide greater certainty through a consistent approach, providing greater integrity for the tax system overall.

Taxation on the basis of form rather than substance can also create inefficiencies in the system, with the system providing an implicit encouragement for arrangements to follow a particular form, regardless of the true economic consequences. By basing taxation on economic substance, the suggestion would be that more efficient financing decisions would be reached as taxation becomes a more neutral factor in the financing decision, with the return being the predominant factor.

### B *Income/Capital Characterisation*

A second trend emerging from the system in New Zealand, and recommendations for the Australian regime, is making the income/capital dichotomy redundant in relation to financial arrangements. The result of this is that both discount and interest are treated as assessable amounts, with no amount escaping accessibility by being characterised as a capital component. However, the inclusion of discount and interest on revenue account runs counter to the bifurcation argument that in discount ‘there are two economic elements, the one the value of the usufruct foregone, as measured by interest, and the other the risk that the money will never be repaid at all’,<sup>92</sup> on which basis, discount would be viewed as being of a capital character by virtue of its association with capital risk. Similarly, Lord Salmon has suggested that ‘discount is different from interest; it is not earned nor does it accrue from day to day’.<sup>93</sup> If discount is not the same as interest, then applying similar tax treatment to these different elements may create distortions in the tax system.

The alternative view — and the view which has been accepted by the Revenue in Australia and overseas — is that discount on a financial arrangement is in the nature of interest, and accordingly should be afforded the same tax treatment. Favouring this view are the distortions which would be created if interest and discount were treated differently for tax purposes. Different tax treatment for discount and interest would act as an incentive for taxpayers to characterise returns as being of a capital nature, thus making them non-

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<sup>91</sup> Australian Tax Office (Australia), Inland Revenue (Great Britain) and Internal Revenue Service (US): ‘the Revenue’.

<sup>92</sup> Lord Sumner in *The National Provident Institution v Brown (Surveyor of Taxes)* 8 TC 57, 96.

<sup>93</sup> *Willingale (Inspector of Taxes) v International Commercial Bank* [1978] All ER 754, 756.

assessable, and infringing both equity and neutrality of the regime. Equity is breached in that the true economic income of taxpayers is not revealed; neutrality is violated in that financing decisions may be unduly driven by tax imperatives, with the consequence that investment may not occur in the most productive areas. The all-inclusive approach of treating discount and interest as equivalent also arguably aids compliance and certainty, with the simplicity of all returns from financial instruments being treated in the same manner.

### *C Time Value of Money*

A third common theme which emerges from the reviews of the Australian taxation of financial arrangements is the recognition by the taxation models of the time value of money. As explained earlier, Australian courts and revenue authorities have been slow to embrace this principle. The courts have traditionally used historical cost as the basis for calculation, and have consistently affirmed the view of interest as being a compensation for use concept. This may be seen as a product of 19<sup>th</sup> Century jurisprudence, when such principles were established by courts in an environment of financial stability and virtually non-existent inflation. This view of interest has stayed with the courts, with the suggestion that ‘no serious attention has been paid by our courts to the possibility of using present values for tax accounting’.<sup>94</sup>

With the increasing trend to recognise the economic substance of transactions, rather than the form used to structure the transaction, the recognition of the time value of money becomes an essential component in a taxation model seeking to spread the true economic effect of a transaction across taxation periods. As noted earlier, a critical element of the concept of the time value of money in taxation is the timing of recognition of income and expenditure. The failure to recognise and apply the time value of money can infringe the criteria of both equity and neutrality in a similar way to that outlined above.

### *D Recognition of Accounting Principles*

A final aspect to consider, and one which has been a theme underlying much of this article, is the extent to which recognition is given to accounting principles and practice in the design of taxation models for taxing financial arrangements. The Australian courts have consistently found that financial accounting practice, while it may provide a guide, should not be determinative of the tax treatment in a particular case, as the taxation treatment is a question of law to be determined by the courts. The role for accounting has, at best, been to assist in determining the nature of an item in question, at which stage the legal tests then apply.

The *Consultative Document* also saw a limited role for accounting principles in the taxation of financial arrangements, arguing that financial accounts had a different purpose, and not all taxpayers covered by the recommended accruals regime would require financial accounts.

However it may be that a discernable trend is emerging which would see the closer alignment of taxation treatment with financial accounting treatment. The New Zealand legislative regime places greater reliance on accounting treatment than had been the case in the past, and the Australian Ralph Report proposals concede a greater role for accounting practice than has previously been accorded to such practice. Greater convergence between

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<sup>94</sup> G Cooper, ‘Tax accounting for deductions’ (1988) 5(1) *Australian Tax Forum* 40.

financial accounting and taxation treatment for financial instruments would provide greater certainty in the tax treatment to be afforded these instruments, and would also reduce complexity and duplication of effort, in that financial and tax accounting would correspond in this area.

Given these early indications that there may be some scope for convergence of financial and taxation treatment in this area of taxation, it is unfortunate that at a time when accounting principles may be able to provide guidance and direction which taxation could follow, there are no firm accounting standards or guidelines in place to provide such direction. It is to be hoped that the development of international accounting standards will be sufficiently timely to fill the void.

#### VIII CONCLUSION

The taxation of financial instruments is one area in the Australian regime in which there was much activity during the 1990s, but arguably little progress, particularly in terms of the development of a legislative code. The reason for the legislative delay can only be the subject of speculation, but whatever the reason such legislation appears not to currently rank as a high priority.

While no legislative code has yet been introduced, it is possible to identify, from the reviews conducted in Australia and from legislative regimes implemented overseas, a number of features which are of significance in the development of any legislative code for the Australian regime. However, even given these common features emerging, in regimes where legislation has been introduced there remain divergences between the provisions, as highlighted by the international comparison. It is suggested that this should not be seen as surprising, as these instruments can be a significant source of finance, and with the mobility of funds in global markets, there will remain an element of competition between regimes in seeking to attract funds.

### Appendix 1

#### International Comparison of Taxation of Financial Arrangements

	<i>Coles Myer Finance – High Court</i>	<i>Consultative Document</i>	<i>Issues Paper</i>	<i>Ralph Report</i>	<i>New Zealand</i>	<i>USA</i>
Issue						
Maturity (Realisation)						
Straight Line Accruals	X	E			E	X
Rate of Return (Yield to maturity)		P	E	P	P	
Mark-to- Market		L	P	E	L	
Other Methods					L	

P = primary method

E = election available

L = limited application

# THE ALIGNMENT OF TAX AND FINANCIAL ACCOUNTING RULES: THE CASE FOR A NEW SET OF COMMON RULES

ALDRIN DE ZILVA\*

**ABSTRACT:** It is a well recognised proposition that the existing Australian tax system is unnecessarily complex and inefficient. The alignment of financial accounting income and taxable income has for many years been suggested as a possible solution to some of the problems. This article examines, in the current climate, the merits of aligning the financial accounting rules and tax laws. Specifically, it proposes that although it is not feasible to have the existing tax laws conform to the financial accounting rules nor the existing financial accounting rules to the tax laws, there is considerable conceptual merit in developing a new set of common rules that is used for both tax and financial accounting purposes.

## I INTRODUCTION

It is a well recognised proposition that the existing Australian tax system is unnecessarily complex and inefficient. The alignment of the ‘financial accounting rules’ and ‘tax laws’<sup>1</sup> has for many years been suggested as a possible solution to some of the problems.<sup>2</sup> Cooper aptly describes the issue as ‘both perennial and pervasive – perhaps even eternal and universal’.<sup>3</sup>

This article examines the potential benefits of the alignment of the financial accounting rules and tax laws and considers the merits and feasibility of requiring: the tax laws conform to the financial accounting rules; the financial accounting rules conform to the tax laws; or the replacement of the existing tax laws and financial accounting rules with a new set of common rules.

In light of current developments, in particular the increasing adoption of accounting concepts by the tax laws and the recent spate of corporate collapses placing considerable pressure on accounting standards, it is suggested that the establishment of a new set of common rules has considerable merit.

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<sup>1</sup> The term ‘financial accounting rules’ is used in this article to refer to both the standards of accounting practice (such as the Australian Accounting Standards) as well as the more fundamental principles (such as the Statement of Accounting Concepts). The term ‘tax laws’ refers to the relevant provisions contained in both the *Income Tax Assessment Act 1936* (Cth) and *Income Tax Assessment Act 1997* (Cth) that are used to calculate taxable income.

<sup>2</sup> These suggestions have been well documented in reports such as the Commonwealth Government of Australia, *Taxation Review Committee Full Report (1975) (‘Asprey Report’)* ch 8; the Joint Committee of Public Accounts, Commonwealth Parliament of Australia, *Report No. 326 An Assessment of Tax – A Report on an Inquiry into the Australian Taxation Office* (1993) para 5.30.

<sup>3</sup> G S Cooper, ‘Some Observations on Tax Accounting’ (1986) 15 *Australian Tax Review* 221.

## II THE PROBLEM WITH THE AUSTRALIAN TAXATION SYSTEM

Under the *Income Tax Assessment Act 1922* (Cth) or the *Income Tax Assessment Act 1936* (Cth), there was little or no difference between the taxable income and net profit of an enterprise.<sup>4</sup> Between the early 1940s and late 1990s there was a divergence of the financial accounting rules and taxation laws largely stemming from a considerable expansion of the coverage of the Australian income tax law from its initial focus on the narrowly defined concept of ‘ordinary income’ to the inclusion of virtually all realised gains and losses of a non-private nature.<sup>5</sup>

The expansion in the tax laws has been undertaken in a largely unstructured ‘piecemeal’ approach whereby new ‘taxing regimes’ (with their own structure and set of rules) have been ‘tacked on’ to the existing system.<sup>6</sup> This lack of a coherent structure has resulted in the existing Australian tax system being unnecessarily complex and inefficient, and requiring substantial restructuring and simplification. This is widely acknowledged.<sup>7</sup> As noted by John Ralph in his foreword to a discussion paper released during the Federal Government’s Review of Business Taxation (the ‘Ralph Review’):

The Australian tax system can be likened to the leaning tower of Pisa. Adding another storey will not reduce the chance of collapse. It would only make it more certain. Like the leaning tower, the business tax system needs a sound and stable foundation before we can start the task of rebuilding.

One of the principal reasons for the widespread dissatisfaction with the current system is that it is not based on a coherent set of principles. The 1936 Act was developed in an Australian economy very different from today’s. This Act has been added to and patched largely in an *ad hoc* manner until it is no longer coherent and is not easily comprehended.

If we are to avoid perpetuating this situation we need to establish a sound foundation and a framework of coherent principles capable of adaptation to meet changing needs and policies without sacrificing the integrity of the system.<sup>8</sup>

It is broadly agreed that a fundamental change to the existing Australian taxation system is required.<sup>9</sup> The issue addressed in this article is whether the alignment of the financial accounting rules and tax laws would provide the solution.

## III THE BENEFITS OF ALIGNMENT

Prior to considering the merits of the various approaches to the alignment of the financial accounting rules and tax laws, it is important to first address the possible benefits of alignment. The proponents of aligning the financial accounting rules and tax laws suggest conformity will provide the following benefits:

- increased simplicity,
- decreased compliance costs,
- greater certainty,

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<sup>4</sup> G L Herring, ‘The Impact of Accounting Principles upon the Determination of Taxable Income’ (Paper presented at the Seventh National Convention of the Taxation Institute of Australia, Hobart, April 1986) 49.

<sup>5</sup> Board of Taxation, *Evaluation of the Tax Value Method: A Report to the Treasurer and Minister for Revenue and Assistant Treasurer* (2002) (‘TVM Evaluation’) 3.

<sup>6</sup> Ibid. See also Commonwealth Government of Australia, *Review of Business Taxation – A Strong Foundation: Discussion Paper. Establishing the objectives, principles and processes* (1998) iii.

<sup>7</sup> Board of Taxation, *TVM Evaluation*, above n 5, iv.

<sup>8</sup> Commonwealth Government of Australia, *Review of Business Taxation – A Strong Foundation: Discussion Paper Establishing the objectives, principles and processes* (1998) iii.

<sup>9</sup> Board of Taxation, *TVM Evaluation*, above n 5, para 100.

- greater durability, and
- an increased ability to undertake future modifications without damaging the underlying framework on which the system is based.<sup>10</sup>

### A *Simplicity*

Currently, public companies, large proprietary companies, registered schemes and certain other taxpayers that are likely to have significant investor interest are required by law<sup>11</sup> to prepare their financial accounts in accordance with the Australian accounting standards.

Other taxpayers, although not bound by law, may prepare a set of accounts (whether or not in compliance with the accounting standards) for managerial purposes. Upon completion of the financial and/or managerial accounts, the taxable income/loss is calculated by making relevant adjustments to the accounting profit/loss for the difference in the accounting rules and the tax laws.

It has been suggested that, the need to understand and apply a single set of laws to calculate both financial accounting income and taxable income — as opposed to having to understand and apply the current voluminous set of accounting standards and overlapping tax laws — would simplify the existing convoluted process involved in the preparation of financial accounts and tax returns.<sup>12</sup>

### B *Compliance Costs*

Proponents of aligning the financial accounting rules and tax laws suggest the ability to produce a single set of accounts for financial accounting and tax purposes would reduce compliance costs. Internal accounting costs as well as costs associated with reliance on external specialist tax and financial accounting advisers should be decreased in the long term.<sup>13</sup>

In a survey conducted by Tran,<sup>14</sup> it was revealed that 57 per cent of listed companies supported complete alignment of tax laws with financial accounting rules. They also estimated the cost savings with complete alignment to be approximately 57 per cent.<sup>15</sup>

Pope,<sup>16</sup> on the basis of a number of studies conducted in the early 1990s, maintains that the estimated aggregate compliance costs of personal and public companies' income taxation in Australia are high, both in absolute dollar terms and as a percentage of tax revenue. They are also high by (an admittedly limited) international comparison.<sup>17</sup> Pope suggests compliance costs could be significantly reduced with the introduction of a simpler and clearer system.<sup>18</sup>

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<sup>10</sup> See T Porcano, D Shull and A Tran, 'Alignment of Taxable Income with Accounting Profit' (1993) 10(4) *Australian Tax Forum* 475, 477, 500 for a discussion of these. It should be noted that Porcano et al conclude that it is not feasible to align the systems: 509.

<sup>11</sup> Refer *Corporations Act 2001* (Cth) ss 292, 296.

<sup>12</sup> For example, the *Asprey Report*, above n 2, recognised that company income tax would become a simple tax if it were levied on the already calculated financial accounting income of a company: para 3.21.

<sup>13</sup> Porcano et al, above n 10, 502.

<sup>14</sup> Alfred Van-Ho Tran, *Relationship of Tax and Financial Accounting Rules — An Empirical Study of the Alignment Issue* (D Phil Thesis, Australian National University, Canberra, 1997) ('1997 Thesis') 146–91: ch 6 'A Survey of Opinions About Alignment' avail <<http://www.rbt.treasury.gov.au/submissions/PlatformForConsultation/html/sub002.htm>> 12 August 2005.

<sup>15</sup> Ibid 171–5.

<sup>16</sup> Jeff Pope, 'The Compliance Costs of Taxation in Australia and Tax Simplification: The Issues' (1993) 18(1) *Australian Journal of Management* 69.

<sup>17</sup> Pope undertook a comparison of the compliance costs in the US, Canada and the UK with those in Australia: ibid 76.

<sup>18</sup> Ibid 81.



### C Certainty

Those in favour of the alignment of the tax and financial accounting rules suggest that this would result in increased certainty by simplifying the treatment of certain items, such as prepaid expenses. Currently the tax laws have separate prepayment rules which apply differently to:

- Simplified Tax System ('STS') taxpayers and non-business individuals,<sup>19</sup>
- non-STS and other taxpayers,<sup>20</sup> and
- tax shelter arrangements.<sup>21</sup>

In addition, there are transitional rules which limit the available deduction depending on the year in which the expenditure was incurred.<sup>22</sup> Some taxpayers may encounter difficulties in applying the appropriate tax prepayment rules.

By aligning the tax laws and financial accounting rules, it is suggested there would be greater simplicity in areas such as the prepayment rules and therefore greater certainty.

### D Durability

The current income tax system places significant emphasis on the legal form of a transaction in establishing the appropriate characterisation of transactions, such as whether a transaction is on revenue or capital account. It is suggested that an alignment of tax and financial accounting rules would provide a greater ability to adopt more of a 'substance over form' approach whereby transactions with the same economic substance receive the same taxation treatment even if the legal form of those transactions differs.

The historic development of the income tax system has meant that the current tax system largely specifies what income and expenses are included in the tax base.<sup>23</sup> Accordingly, income and expenses that do not fall within these regimes may be excluded by default. The difficulties encountered in dealing with 'black hole' expenses are a case in point. Prior to the introduction of section 40-880 of the *Income Tax Assessment Act 1997* (Cth) and subject to proposed amendments,<sup>24</sup> these legitimate business expenses could not be claimed as tax deductions because they did not fall within the boundaries of the relevant tax laws.

It is suggested that an alignment of tax laws and financial accounting rules would result in a more durable system that would potentially alleviate these difficulties.

### E Future Modifications

It is suggested that an alignment of tax laws and financial accounting rules would more easily facilitate changes to the tax law to introduce new policy initiatives. For example, in order to currently change taxation law, parliamentary or court intervention is required. However accounting standards are controlled by the Australian Accounting Research Foundation ('AARF'). Despite the rigorous procedures set by AARF, no parliamentary or court intervention is required to change the accounting standards.

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<sup>19</sup> *Income Tax Assessment Act 1936* (Cth) s 82KZM.

<sup>20</sup> *Income Tax Assessment Act 1936* (Cth) s 82KZMA to 82KZMD.

<sup>21</sup> *Income Tax Assessment Act 1936* (Cth) s 82KZME.

<sup>22</sup> *Income Tax Assessment Act 1936* (Cth) s 82KZMB. This section was repealed on 22 September 2002, however still applies for income years which include 21 September 2002.

<sup>23</sup> Board of Taxation, *TVM Evaluation*, above n 5, 4.

<sup>24</sup> Commonwealth Treasurer, 'Government Decides Against The Tax Value Method' (Media Release No 48, 28 August 2002).

#### IV APPROACHES TO ALIGNMENT

An alignment of the tax laws and financial accounting rules can be achieved by:

- (i) requiring the tax laws to conform to the financial accounting rules;
- (ii) requiring the financial accounting rules to conform to the tax laws; or
- (iii) replacing the existing tax laws and financial accounting rules with a new set of common laws.

Each of these alternatives is discussed below.

##### *A International Perspective*

Prior to evaluating the merits of the approaches to alignment in Australia, it is important to consider whether any particular approach has a level of international acceptance which would commend it to Australian use. In this respect, it is interesting to note the diversity that exists in relation to the application of the above methods internationally.

In a 1987 study conducted by the Organisation for Economic Co-operation and Development ('OECD')<sup>25</sup> three main types of relationship between accounting rules and tax laws were identified in OECD member countries. First, the OECD identified countries — such as France, Germany, and Italy — where financial statements drawn up according to accounting rules were used to determine the basis of income tax assessment (that is, approach one and three above). Secondly, there were a few countries, including Norway, where accounting practices were dictated by tax laws and book entries contrary to tax laws were not permitted (that is, approach two above). Finally, there were countries, such as the USA, the UK, and the Netherlands, where the accounting rules were independent of the tax laws, that is, where the laws were not really aligned.

This diversity clearly demonstrates that there is no international consensus on the 'correct' approach to be followed.

#### V CONFORMITY OF THE TAX LAWS TO THE FINANCIAL ACCOUNTING RULES

To date, the calls for conformity in Australia have focused on the implications of requiring the tax laws to conform to the financial accounting rules.

##### *A The Previous Attempts*

In 1975, the Asprey Committee<sup>26</sup> in its review of taxation reported receiving submissions suggesting tax should be determined on the basis of financial accounting income. Although the alignment of tax and financial accounting was not on the agenda in the major tax reforms which took place in 1985 and 1986, the issue continued to attract considerable attention.<sup>27</sup> For example, an article prepared by Cooper in 1986 noted that 'almost without exception, commentators and law reform authorities see the conformity of tax to financial accounting as a major goal for tax reform'.<sup>28</sup> Boucher, a former Commissioner of Taxation, suggested that,

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<sup>25</sup> Organisation for Economic Co-operation and Development Working Group on Accounting Standards, 'Accounting Standards Harmonisation Report No. 3: The Relationship Between Taxation and Financial Reporting' (1987).

<sup>26</sup> *Asprey Report*, above n 2, ch 8.

<sup>27</sup> C Westworth, 'Accounting Standards: A Framework for Tax Assessment' (1985) 2 *Australian Tax Forum* 243; Ross W Parsons, 'Income Taxation: An Institution in Decay?' (1986) 3 *Australian Tax Forum* 233.

<sup>28</sup> Cooper, above n 3.

if appropriate improvements were made to the accounting rules, it may be possible to levy tax on financial accounting income.<sup>29</sup>

Since the late 1990s, the debate on the conformity of tax laws to the financial accounting rules appeared to become partially intertwined with the extensive evaluation of the 'Tax Value Method' ('TVM'). As outlined in Appendix 1, the debate in relation to the merits of adopting the TVM is clearly distinguishable from the debate on the alignment of financial accounting rules and tax laws.

While there was general acknowledgement during the process of evaluation of the TVM that the current income tax law is overly complex and in need of substantial restructuring and simplification, the overwhelming view was that adoption of the TVM was not the means to achieving these ends.<sup>30</sup> The TVM was formally rejected by the Government on 28 August 2002.<sup>31</sup>

Previous calls to align the tax laws with the financial accounting rules have largely failed to gain the support required to enable a genuine exploration of the alternatives.

### B *Why Have They Failed?*

It is generally considered that aligning the tax laws to the financial accounting rules is not feasible<sup>32</sup> for the following key reasons:

- the perceived difference in the underlying objectives of the two systems;
- the wide discretion and choice provided by the financial accounting rules;
- the reluctance by the relevant authorities to relinquish power; and
- the significant transitional costs.

#### 1 *Objectives*

Although both the tax and financial accounting systems purport to measure income, it has been suggested that the underlying objective of each system is fundamentally different.<sup>33</sup> The primary objective<sup>34</sup> of the tax system in Australia is to raise revenue to enable the government to fund its expenditure programs, such as defence and the social welfare system,<sup>35</sup> whereas the objective of general purpose financial reports is to provide information useful to users for making and evaluating decisions about the allocation of scarce resources.<sup>36</sup>

Similarly, it has been pointed out that there is a fundamental difference in the determination of income for accounting and tax.<sup>37</sup> Essential to the determination of accounting income is the 'matching principle'<sup>38</sup> which requires that in determining the profit for the period, items of expenditure are matched against the revenue for the period. By contrast, the tax law, although approving the use of accrual accounting, disregards the

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<sup>29</sup> Trevor Boucher, 'The Simplification Debate: Too Simplistic?' (1991) *Taxation in Australia* 277, 282.

<sup>30</sup> Board of Taxation, *TVM Evaluation*, above n 5, iv.

<sup>31</sup> Commonwealth Treasurer, above n 24.

<sup>32</sup> Michael D'Ascenzo and Andrew England, 'The Tax and Accounting Interface' (Paper presented at the 15<sup>th</sup> Annual Conference of the Australasian Tax Teachers Association, University of Wollongong, 31 January 2003) 12–13.

<sup>33</sup> Porcano et al, above n 10, 478–80.

<sup>34</sup> Other objectives include economic management, encouraging/discouraging certain activities and political objectives. Refer Porcano et al, above n 10, 478.

<sup>35</sup> Ibid.

<sup>36</sup> Australian Accounting Research Foundation, *Statement of Accounting Concepts SAC 2* (August 1990).

<sup>37</sup> For a comparison of the accounting standards and tax principles, see R Fayle, 'Accounting Standards and their Relevance to Taxation Law' (1990) (Paper presented at the Ninth National Convention of the Taxation Institute of Australia, Adelaide, 1 January 1990).

<sup>38</sup> See Australian Accounting Research Foundation, *Statement of Accounting Concepts SAC 4 – Definition and Recognition Criteria of the Elements of Financial Statements* (March 1995).

matching principle.<sup>39</sup> For example, capital gains are taxed when they are effectively crystallised as opposed to when they accrue.

Given the different objectives of the systems, it is suggested<sup>40</sup> that it is not possible to have the tax laws conform to the financial accounting rules.

## 2 *Discretion*

The financial accounting rules are such that in numerous instances a firm has several choices of methods to account for its transactions.<sup>41</sup> As Herring points out, in trying to prepare accounts that represent a 'true and fair view', there will always be room for honest differences of opinion.<sup>42</sup> Although the same criticism could be levied at the existing tax laws, it is suggested that scope for differences of opinion in applying the relevant accounting standards and principles is significantly greater. It has been suggested<sup>43</sup> therefore that an alignment could only be possible subsequent to the tightening of the existing financial accounting rules.

A further difficulty arising from the alignment of the tax laws to the financial accounting rules is the potential loss of tax revenue as a result of firms exploiting any increased flexibility in the tax laws resulting from such a move.<sup>44</sup>

## 3 *Institutional Arrangements*

The Asprey Committee rejected the proposals recommending an alignment of the tax laws to the financial accounting rules on the basis that the jurisdiction of the revenue-raising authority could not be relinquished to, in effect, the professional accounting bodies and business organisations which had played (and continued to play) a significant role in the formulation of accounting principles and policy.<sup>45</sup>

An empirical study by Tran<sup>46</sup> found that the major causes of the gap between accounting profit and taxable income were caused by deliberate government policies and differing objectives of the two systems.<sup>47</sup> As a result he concluded that a complete book-tax alignment would only be possible in the unlikely event that the government is willing to yield its policy-making power in the tax system and the objectives of the two systems can be reconciled.<sup>48</sup>

## 4 *Transitional Costs and Possible Increased Audit Costs*

Although the alignment of the tax laws to the financial accounting rules may result in longer term cost savings, as discussed above, there will be a relatively significant initial transitional costs.

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<sup>39</sup> Herring, above n 4, 49.

<sup>40</sup> D'Ascenzo and England, above n 32.

<sup>41</sup> Porcano et al, above n 10, 501.

<sup>42</sup> Herring, above n 4, 48.

<sup>43</sup> Blaike questions the attainability of this objective: A W Blaike 'The Relevance of Accounting Principles to the Income Tax Assessment Act' (1981) (Paper presented at the State Convention of the NSW Division of the Taxation Institute of Australia, Sydney, 3 April 1981) 1, 2.

<sup>44</sup> Porcano et al, above n 10, 484.

<sup>45</sup> *Asprey Report*, above n 2, para 8.8. The *Asprey Report* provided an alternative solution, suggesting that the issue in relation to the relinquishment of power could be overcome by providing the Commissioner of Taxation the power to adopt accounting principles if he felt it was appropriate to do so in the circumstances.

<sup>46</sup> A V Tran, 'Causes of the Book-Tax Income Gap' (1998) 14(3) *Australian Tax Forum* 253.

<sup>47</sup> *Ibid.*

<sup>48</sup> *Ibid.*

In terms of long term costs it is also important to note that the relevant statements produced would obviously have to serve two purposes. As such, audit costs may rise as a result of the increase in the responsibility of the auditor.<sup>49</sup>

### 5 *Other Reasons*

It has been suggested that prior attempts to gain sufficient support for tax law conformation to the accounting rules have also failed for the following reasons:<sup>50</sup>

- a radical change to tax policy would be required (for example, under current tax policy not all accounting provisions are recognised for tax purposes) and it is generally more difficult to garner support for radical change;
- most taxpayers do not at present need to comply with the accounting standards;
- the difficulties with accounting recognition of unrealised profits (for example, equity accounting bringing to account the profits earned by entities over which they have a significant influence);
- the inappropriate operation of the concept of materiality in a tax system;
- the accounting concept of conservatism requires an earlier recognition of losses under accounting (such as bad debts);
- tax concessions available to taxpayers could be removed (or limited), again reducing the attraction of the change; and
- the international harmonisation of accounting standards may influence the tax base.<sup>51</sup>

Based on the above factors, D'Ascenzo and England conclude that:

[W]hile there have been significant developments consistent with accounting concepts (e.g. removal of accelerated depreciation), the bottom line is that the practical realities make a comprehensive alignment of tax and accounting difficult, and the potential benefits speculative.<sup>52</sup>

Unfortunately, much of the above mentioned research and commentary does not then proceed to consider alternative approaches to aligning tax laws and financial accounting rules.

## VI CONFORMITY OF THE FINANCIAL ACCOUNTING RULES TO THE TAX LAWS

Despite the benefits of alignment outlined (III above), having the accounting rules conform to the existing tax laws in Australia would not be feasible for much the same reasons as those mentioned above (VB above). Perhaps it is for this reason that previous research and commentary has not addressed this approach.

Specifically, the conformity of the financial accounting rules to the tax laws would not be feasible given:

- the difference in the underlying objectives of the two systems. Specifically, financial statements prepared on the basis of tax laws would not provide a 'true and fair' view of the financial position of the entity for the relevant period and thus would not be useful to the users of the financial statements (see VB1);
- the reluctance by the relevant authorities to relinquish power (see VB3);
- the significant transitional costs (see VB4);
- the necessity for radical change to accounting policy; and

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<sup>49</sup> Porcano et al, above n 10, 503.

<sup>50</sup> D'Ascenzo and England, above n 32.

<sup>51</sup> Ibid.

<sup>52</sup> Ibid 13.

- the possibility that compliance with the international harmonisation of accounting standards may be unobtainable.

## VII THE ESTABLISHMENT OF A NEW COMMON SYSTEM

Previous calls for alignment have focused on the feasibility of levying tax on the existing financial accounting rules. The research correctly concludes that it is not feasible to levy tax on income calculated in accordance with the existing financial accounting rules in Australia.<sup>53</sup> It is the view of the author that nothing has changed in this respect.

However, there has been little or no work to date done on examining the merits of designing a new common system that would accommodate the objectives of both the financial accounting and tax systems. It is submitted that the recent increasing importation of accounting rules into the tax system and the call for a tightening of the accounting rules as a result of the recent spate of significant corporate collapses (discussed below), provides an ideal window of opportunity for the development of a new uniform system that could be used for both financial accounting and tax.

### *A Increasing Adoption of Accounting Principles*

Although there is no explicit reference to financial accounting in the Australian statutory tax laws<sup>54</sup> and, generally speaking, accounting principles have had a limited role in the development of judicial tax precedents in Australia,<sup>55</sup> in recent times there has been an increasing tendency to adopt accounting principles in one form or another. For example, the removal of an immediate deduction for prepayments made by certain taxpayers after 1 July 2001,<sup>56</sup> the removal of accelerated tax depreciation and unification of the capital allowance rules with the introduction of the uniform capital allowance system,<sup>57</sup> and the recent introduction of a tax consolidation regime. This approach of having the Parliament import into the tax system the relevant accounting principles was recommended by the Asprey Committee.<sup>58</sup> Narrowing the gap between taxable income and financial income increases the feasibility of completely aligning the two systems.

### *B Pressure on Accounting Standards*

There has been a recent spate of significant corporate collapses in both Australia and overseas, including:

- HIH Insurance's collapse in Australia in March 2001: the country's largest corporate failure, with debts the liquidators have estimated amounted to AUD 5300 million;<sup>59</sup>
- OneTel's collapse in Australia in May 2001 with debts of more than AUD 600 million;<sup>60</sup> and

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<sup>53</sup> See Tran, *1997 Thesis*, above n 14.

<sup>54</sup> Porcano et al, above n 10, 485.

<sup>55</sup> Blaibe, above n 43, para 2.06. Also refer Dean Hanlon and Les Nethercott, 'Debt Defeasance: An Accounting / Taxation Interface' (Paper presented at the Australian Tax Teachers Association 14<sup>th</sup> Annual Conference, Auckland, New Zealand, 17–19 January 2002).

<sup>56</sup> For a detailed discussion of these amendments, see R H Woellner, S Barkoczy, S Murphy and C Evans, *Australian Taxation Law* (12<sup>th</sup> edition, 2002) 941–62.

<sup>57</sup> *Ibid* 811–57.

<sup>58</sup> *Asprey Report*, above n 2, para 8.8.

<sup>59</sup> K Walker, 'HIH: unprofitable for years' *The Australian* (Sydney), 13 January 2003, avail (subscribers) <<http://www.theaustralian.new.com.au.archives>> at 22 November 2005.

- Enron, the largest US corporate collapse to date, commencing with Enron's announcement on 8 November 2001 of a USD 586 million profit reduction in its earnings since 1997.<sup>61</sup>

Such significant corporate collapses have resulted in a critical assessment of corporate governance rules and of the role of the auditor, and a call for the tightening of the accounting rules.<sup>62</sup> A tightening of the financial accounting rules will also increase the feasibility of aligning the financial accounting and tax laws.

### *C The Benefits of a New Common System*

Theoretically, a new common system could deliver the benefits of alignment outlined earlier (III above), namely:

- increased simplicity,
- decreased long-term compliance costs,
- greater certainty,
- greater durability, and
- an increased ability to undertake future modifications without damaging the underlying framework of the system.

In addition, a new common system could overcome several of the difficulties earlier outlined.

#### *1 Objectives*

The users of financial statements are interested in the 'true' income of the entity (whatever that may be). Similar, the tax system should attempt to tax the 'true' income of the taxpayer. Given this, it is suggested that it should be possible to develop a system which satisfies the objectives of both financial users and the tax authorities.

Currently the tax laws do not, as a general proposition, adopt the accounting 'matching principle'.<sup>63</sup> It has been suggested that this artificially inflates or deflates the income of the relevant business for tax purposes.<sup>64</sup>

One possible explanation for the reluctance of the government to ensure tax laws adopt the matching principle could be the concern that the adoption of the matching principle in the tax laws may result in items such as capital gains being assessed on an accruals basis, which may result in cash flow difficulties for taxpayers in that the tax obligation would need to be satisfied prior to the crystallisation of the gain. A simple solution to this problem would be for taxpayers to be given the right to defer the payment of tax on capital gains until the asset has been disposed of.

In relation to the government using the tax system to implement certain policies (such as encouraging research and development expenditure), it is suggested by the author that these

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<sup>60</sup> A Wood, 'OneTel's Billing Shortfall' *The Courier Mail* (Brisbane), 1 August 2002, avail (subscribers) <<http://www.newstext.com.au>> at 22 November 2005.

<sup>61</sup> Mark Jickling, 'The Enron Collapse: An Overview of Financial Issues' (CRS Report for Congress, 28 March 2002) avail <<http://fpc.state.gov/documents/organization/9267.pdf>> at 22 November 2005.

<sup>62</sup> John C Coffee Jr, 'Understanding Enron: It's About the Gatekeepers, Stupid' (Working Paper No 237, Columbia Law School, The Center for Law and Economic Studies, 30 July 2002) avail <[http://ssrn.com/abstract\\_id=325240](http://ssrn.com/abstract_id=325240)> at 14 August 2005.

<sup>63</sup> The 'matching principle' has been adopted in certain areas such as interest deductibility and the prepayment rules. For a discussion of the adoption of accounting principles by the courts, see Justice D G Hill, 'The Interface Between the Tax Law and Accounting Practice as seen by the Courts' (Paper presented at the 15<sup>th</sup> Annual Conference of the Australasian Tax Teachers Association, University of Wollongong, 31 January 2003).

<sup>64</sup> Cooper, above n 3, 239.

could still be provided by the Government via other means, such as government grants. As noted by Tran:

Alignment of tax laws with [generally accepted accounting practice] means that the government has to use means other than the income tax system to achieve its policy objective.<sup>65</sup>

The use of the of the tax system as a policy tool by the Government clearly increases the complexity of the tax system and should be avoided.<sup>66</sup>

It is therefore suggested that it would be possible to develop a new common system which satisfied the objectives of both financial users and the tax authorities.

## 2 Discretion

The problems alluded to earlier (at VB) in relation the wide discretion and flexibility provided to preparers of financial statements, as well as the current concerns about corporate governance (discussed at VIIB), could both be overcome by developing a new common system which provided a more strict approach to the preparation of financial (and in effect tax) accounts.

## 3 Protecting the Tax Revenue

A key concern is that any change to the tax laws which result in increased flexibility or discretion may result in a loss to the revenue.<sup>67</sup>

Although on the one hand a decrease in reported earnings would result in a decrease in tax payable and an increase in after-tax cash flow, and therefore should have a positive impact on the market, reporting lower earnings may not be viewed favourably by investors. These competing forces have been extensively researched in the accounting arena with mixed results.<sup>68</sup> The greatest difficulty encountered by these studies has been identifying a reasonably accurate proxy for the confidential 'true' taxable income of the sample entities<sup>69</sup> and addressing possible confounding variables.

Whatever the variation in the results of these accounting studies on earnings management, they consistently found that many firms had considerably higher accounting income than projected taxable income as evidenced by the disclosed tax effect accounting entries.<sup>70</sup>

Anecdotal evidence exists to further support this. For example, as reported in the *Financial Times*,<sup>71</sup> Enron's pre-tax profits between 1996 and 2000 totalled USD 1.79 billion

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<sup>65</sup> Tran, 1997 Thesis, above n 14, 34.

<sup>66</sup> Pope, above n 16, 81.

<sup>67</sup> Calvin H Johnson, 'Using GAAP instead of Tax Accounting is a Bad Idea' 1999 *Tax Analyst* 74-119, avail <<http://www.taxorg/readingsintaxpolicy.nsf>> at 22 November 2005.

<sup>68</sup> N Dopuch and M Pincus, 'Evidence on the Choice of Inventory Accounting Methods: LIFO v FIFO' (1988) 26 *Journal of Accounting Research* 28; Myron S Scholes, G Peter Wilson and Mark A Wolfson, 'Firms' Responses to Anticipated Reductions in Tax Rates: The Tax Reform Act of 1986 (1992) 30 *Journal of Accounting Research* (Supplement) 161; S R Matsunaga, T J Shevlin and D Shores, 'Disqualifying Dispositions of Incentive Stock Options: Tax Benefits versus Financial Reporting Costs' (1992) 30 *Journal of Accounting Research* (Supplement) 37.

<sup>69</sup> A V Tran, 'The Gap between Accounting Profit and Taxable Income' (1997) 13 *Australian Tax Forum* 507, 508.

<sup>70</sup> Porcano et al, above n 10, 489. See also Tran (1997), *ibid*, which provides empirical support for the proposition that the extent of the gap between accounting and taxable profit is dependent on the industry classification and size of the firm. These findings contradict the *Asprey Report*, above n 2, para 8.4, which suggests the divergences between financial accounting and tax usually results in income subject to tax being greater than financial accounting income.

<sup>71</sup> Andrew Hill, Joshua Chaffin and Stephen Fidler, 'Enron: Virtual Company, Virtual Profits' *Financial Times* (3 February 2002), avail <<http://specials.ft.com/enron/FT3648VA9XC.html>> at 22 November 2005. This report cites pretax profits of USD 1.79 billion. It should be noted, however, that the US term 'billion' here employed refers to thousands of millions while the UK/Australian 'billion' refers to millions of millions.



and it received US Federal tax rebates of USD 381 million. Yet in only one year did it pay federal tax : USD 17 million in 1997. Enron bolstered profits by:

- booking income immediately on contracts that would take up to 10 years to complete;
- using financial derivatives and other complex transactions;
- shifting debts into partnerships it in effect controlled, yet convincing the auditors it was off balance sheet; and
- masking poorly performing assets with rapid deal-making.<sup>72</sup>

The findings of the accounting studies and anecdotal evidence suggest that there should be no loss to the tax revenue as a result of an alignment of accounting and tax laws. To the contrary, conceptually they suggest a possible increase in tax revenues.

#### 4 *Other Issues*

Several of the other issues earlier highlighted (at VB5) could be overcome by ensuring that:

- the new common system is simple enough to ensure all taxpayers comply with it (as is currently the case with Australia's extremely complex tax system);
- the difficulties with areas such as equity accounting, materiality and the conservatism concept are thoroughly examined and addressed; and
- the new common rules conform to international standards so as to facilitate and promote the international harmonisation process which, no doubt, is also aimed at determining the 'true' income of a business.

#### *D The Difficulties of a New Common System*

Although there is considerable theoretical and conceptual logic in the development of a new common system, practically — the ability to implement such a system — will still depend on the institutional factors and transitional costs earlier discussed (at VB3 and VB4).

An alignment of the tax and financial accounting rules will clearly require a relinquishment of rule-making power by either the Government or alternatively by the relevant professional accounting bodies and business organisations which play a significant role in the formulation of accounting principles and policy. This perhaps poses the greatest challenge for alignment in Australia.<sup>73</sup>

In addition, as was seen with the analysis of TVM, with the formulation of a new common system ultimately 'the devil will lie in the detail'.<sup>74</sup>

### VIII CONCLUSION

The conceptual attractiveness of aligning the financial accounting and tax laws has been well documented, as have the difficulties of trying to levy tax on financial accounting income, however, to date there has been minimal consideration given to the development of a new financial accounting and tax system. It is suggested that with the recent increasing importation of accounting rules into the tax system and call for tighter accounting rules, further consideration should be given to the development of a single financial accounting and tax system.

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<sup>72</sup> Ibid.

<sup>73</sup> Porcano et al, above n 10, 500.

<sup>74</sup> Board of Taxation, *TVM Evaluation*, above n 5, 15.

## APPENDIX 1

### *Distinguishing the TVM*

The Review of Business Taxation ('RBT') process, established by the Government in 1998, proposed two alternative methods for the calculation of taxable income.<sup>75</sup> Option 1 maintained the concepts of assessable income and deductions but recommended modifications to take account of movements in the tax value of assets and liabilities. Option 2 (the TVM approach) recommended the replacement of the existing system with a system that relied on taking account of the movements in both the receipts and payments (cash flow) and the tax value of assets and liabilities.

The previously proposed TVM is clearly distinguishable from the debate on the alignment of accounting rules and tax laws. The TVM was intended to have a neutral impact on taxation revenue.<sup>76</sup> The objective was to change the legislative framework for determining taxable income without having a material impact on the final taxable income amount.<sup>77</sup> The TVM was simply a different way to calculate taxable income. In accounting parlance, it was an attempt to move from a profit and loss based approach to a cash flow and balance sheet approach, with relevant tax law and tax loss adjustments, and had the objective that it would result in the calculation of an identical or very similar taxable income amount.<sup>78</sup>

It is important to recognise that the alignment of tax to financial accounting income requires the establishment of a different methodology that will, more often than not, result in a materially different taxable income figure. For example, the TVM did not aim to tax unrealised gains, although with an alignment of tax to financial accounting income, such gains may be subject to tax.

Following an extensive evaluation of the TVM, which involved a wide-ranging process of consultation with tax experts, business and the broader community, on 28 August 2002 the Treasurer of the Commonwealth of Australia, the Honourable Peter Costello, announced that the Government had accepted a recommendation by the Board of Taxation not to proceed with the TVM.<sup>79</sup> It was considered that, while the TVM may offer benefits in some areas, it would generate greater complexity and uncertainty in others and would result in substantial transitional costs.<sup>80</sup>

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<sup>75</sup> Review of Business Taxation, *A Platform for Consultation* (22 February 1999) 41–2.

<sup>76</sup> Board of Taxation, *TVM Evaluation*, above n 5, 17.

<sup>77</sup> *Ibid.* For a further elaboration of the differences and difficulties with the TVM, see Graeme Cooper and Michael Wenzel, 'An assessment of the Asserted Increase in 'Certainty' Arising from the Introduction of the Tax Value Method (TVM)', 6 June 2002, avail <[www.taxboard.gov.au](http://www.taxboard.gov.au)> at 12 August 2005; A O'Connell, 'Option 2: Will it Change What is Included in Taxable Income' (2000) 29(2) *Australian Tax Review* 68.

<sup>78</sup> See Graeme S Cooper, 'How Well Does TVM Express the Current Income Tax Base' (2001) (Paper presented at the NSW Tax Value Method Consultative Conference, Sydney, 23–24 July 2001, for a discussion of how the TVM would have changed a taxpayer's taxable income.

<sup>79</sup> Commonwealth Treasurer, above n 24.

<sup>80</sup> *Ibid* iv.

# ACCOUNTING PRINCIPLES AND TAXATION RULES FOR SMALL BUSINESS: THE IMPACT OF RALPH

PAUL KENNY\*

## I INTRODUCTION

The income tax laws currently run to over 8000 pages of legislation in stark contrast to the relatively succinct accounting rules. This highlights the many differences between these rules in determining and calculating net income. The *Ralph Report*, however, sought to 'align more closely taxation law with accounting principles wherever possible'.<sup>1</sup> This article seeks to examine the appropriateness of such an approach, using the new Simplified Tax System<sup>2</sup> ('STS') for small business as a case study.

In doing so this article firstly provides a background to the STS provisions and sets out the eligibility requirements. Secondly, this article compares the tax accounting features of the STS system with both the non-STS income tax laws and the accounting rules. This comparison finds that the STS exacerbates departures between the accounting and tax rules. Additionally, this article examines the justification for the STS with regard to the taxation policy goals of simplicity, equity or efficiency. This article finds that the STS fails these generally accepted taxation policy benchmarks. The article concludes that it would be better for policy makers to work toward reducing the volume of income tax law for small business by aligning the income tax laws more closely with the accounting rules.

## II BACKGROUND

Given the complexity burdens placed on small business from the massive income tax reforms flowing from the 1999 Ralph Report<sup>3</sup> and the introduction of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) ('*GSTA 1999*'),<sup>4</sup> the Government stated that it would also introduce measures to help simplify the tax system for small business:

1.4 The STS modifies the method of determining taxable income for certain businesses with straightforward, uncomplicated tax affairs. Eligible businesses that choose to use the STS will have access to simpler depreciation, trading stock and accounting arrangements (although the remaining tax rules apply outside these areas).

1.5 The Review of Business Taxations report *A Tax System Redesigned* recommended the STS and the Government supported that recommendation (Treasurers Press Release Nos. 58 and 59 of 21 September 1999). The Review of Business Taxation estimated that around 95% of all businesses, and 99% of farming businesses, would be eligible for the STS.

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<sup>1</sup> Review of Business Taxation (John Ralph, chair), *A Tax System Redesigned: more certain, equitable and durable* (Final Report, 1999) ('*Ralph Report*')155.

<sup>2</sup> *Income Tax Assessment Act 1997* (Cth) div 328.

<sup>3</sup> *Ralph Report*, above n 1.

<sup>4</sup> Note, however, this symmetry is far from perfect. The annual turnover for GST purposes per *GSTA YEAR* (Cth) div 188 is different to that defined as STS average turnover in s 328-375 of the *Income Tax Assessment Act 1997* (Cth).

1.6 Consistent with the Governments approach to business tax reform, the detailed design of the STS has benefited from extensive consultation with business representatives and professional bodies.

1.7 The object of the STS is to provide the following benefits to those businesses eligible to enter the STS:

- a reduction in effective tax burden; and
- simplified record keeping and reporting requirements.

The STS also contains integrity measures to ensure that ineligible businesses cannot structure or restructure their affairs to take advantage of these benefits. These measures reinforce that the STS is designed for small businesses with straightforward and uncomplicated affairs.<sup>5</sup>

Indeed the *ITAA 1997* states that STS would not only simplify the law but would reduce the tax burden for small business.<sup>6</sup>

### III ELIGIBILITY TO JOIN THE 'SIMPLIFIED' TAX SYSTEM

The STS commenced on 1 July 2001 and is optional for small business taxpayers. To be eligible to join the STS<sup>7</sup> a taxpayer must carry on a business during the year and meet the following two small business threshold tests.

The annual business turnover must be less than AUD 1 000 000 net of GST credits.<sup>8</sup> Entities that are unable to meet this general eligibility test have the option of recalculating their STS average turnover by either using actual turnover for the current year, or estimating their group turnover for the current year plus the estimated group turnovers for the following two years.<sup>9</sup> This provides some symmetry with the small business cash accounting turnover threshold of AUD 1 000 000 in *GSTA 1999* s 29-40.<sup>10</sup> This calculation is far from simple as seen by draft taxation ruling TR 2002/11 which runs for some 125 paragraphs.

Additionally, there are anti-avoidance rules<sup>11</sup> to prevent large businesses dividing their businesses into smaller parts so as to claim the benefits of the STS. As commentators have noted, these rules are extremely complex.<sup>12</sup> For example, there are rules for: defining STS group turnover, defining the value of the business supplies, grouping of an entity's turnover, working out what entities are STS affiliates, defining control and indirect control of an entity, and working out STS group turnover. For an example of the complexity involved, see the rules for grouped entities in s 328-38 of the *ITAA 1997*.<sup>13</sup> Further, the annual turnover test has a number of anomalies. Firstly, the AUD 1 000 000 threshold appears to be somewhat arbitrary. There will be some very small businesses with high turnover and low gross margins, such as service stations and liquor outlets, that will be ineligible.

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<sup>5</sup> Revised Explanatory Memorandum ('*Revised EM*'), *New Business Tax System (Simplified Tax System) Act 2000*, paras 1.4-1.7.

<sup>6</sup> *Income Tax Assessment Act 1997* (Cth) s 328-50(1).

<sup>7</sup> *Income Tax Assessment Act 1997* (Cth) s 328-365.

<sup>8</sup> *Income Tax Assessment Act 1997* (Cth) s 328-365(1)(b).

<sup>9</sup> *Income Tax Assessment Act 1997* (Cth) s 328-370.

<sup>10</sup> Note, however, this symmetry is far from perfect. The annual turnover for GST purposes per *GSTA YEAR* (Cth) div 188 is different to that defined as STS average turnover in s 328-375 of the *Income Tax Assessment Act 1997* (Cth).

<sup>11</sup> *Income Tax Assessment Act 1997* (Cth) s 328-375 – 328-380.

<sup>12</sup> Robert Douglas and Roan Fryer, 'Tax simplification for small to medium business' (2000) (Taxation Institute of Australia, New South Wales State Division, Convention, 25 May 2000) 8, 10; Michael Hine, 'Small business tax system (STS)' (Taxation Institute of Australia, Western Australian Division, State Convention May 2001), 24, 29; Ian Snook, 'Simplified Tax System: a favourable current, a riptide or just plain dead calm?' Taxation Institute of Australia, South Australian Division, State Convention 3 May 2001, 75,75; Paul L Kenny, 'A "Simplified Tax System" for small business: Or, just another tax preference?' (2002) 6(1) *Taxation Specialist* 36, 43.

<sup>13</sup> See TR 2002/6 which explains the complexity of the grouping rules in some 177 paras.

Also, to join the STS, business depreciating assets must be less than AUD 3 000 000.<sup>14</sup> The limit on the total value of depreciating assets that an entity and its grouped entities can have at the end of an income year will ensure that entities with low turnover in early years of operation, but with large investments in capital assets, are not eligible to enter the STS.<sup>15</sup>

The value of a depreciating asset for an income year means basically the cost of the asset less any amounts representing decline in value that have been deducted or are deductible against it under Division 40 or Division 328. In establishing whether the value of an entity's assets and its grouped entities total less than AUD 3 million, the closing pool balance of each pool will need to be added to the adjustable value of any depreciating assets of the entity and its grouped entities which have not been subject to the pooling arrangements.<sup>16</sup> Again, these calculations could become very complicated for small business groups.

Entry into the system is optional and a business joins by completing an application to the Australian Taxation Office ('ATO').<sup>17</sup> If you leave the system you must wait five years before you can re-enter and must apply to the ATO to rejoin.<sup>18</sup> Complex entry and exit adjustment rules ensure that taxpayers in the STS do not double count or omit income and deductions.<sup>19</sup>

Comparison will be made below between the tax and accounting perspectives of the following features of the STS system: accounting method adopted for income and expenses; treatment of prepaid expenses; depreciation of plant, equipment and trading stock.

#### IV ACCOUNTING METHOD FOR INCOME AND EXPENSES

##### A *The 'Non-Simplified' Income Tax Regime*

Because the *ITAA 1997* is based on a tax income year ended 30 June,<sup>20</sup> it is necessary for taxpayers to allocate income and expenses to the appropriate tax year. The judicial interpretation of the Act's key words related to income and expense, namely 'derived' and 'incurred', has generally<sup>21</sup> resulted in an accruals type system of tax accounting for business income and expenses as described below. Taxpayers do not have a choice between using cash or accruals accounting. Rather, the tax accounting method is dictated by such factors as the type and scale of the small business activity and the circumstances of the transactions.

##### 1 *Timing of Income*

Business income is generally included as income in the accounting period when it is 'derived'.<sup>22</sup> Derived is not defined in the *ITAA 1997*, so the method of accounting adopted must reflect the taxpayer's true income per *Commissioner of Taxes (SA) v The Executor, Trustee and Agency Company of South Australia Ltd* ('*Carden*');

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<sup>14</sup> *Income Tax Assessment Act 1997* (Cth) s 328-365(1)(c).

<sup>15</sup> *Revised EM*, above n 5, para 2.7.

<sup>16</sup> *Income Tax Assessment Act 1997* (Cth) s 328-365(2).

<sup>17</sup> *Income Tax Assessment Act 1997* (Cth) s 328-435(b).

<sup>18</sup> *Income Tax Assessment Act 1997* (Cth) s 328-440(3).

<sup>19</sup> *Income Tax Assessment Act 1997* (Cth) s 328-110, 328-115.

<sup>20</sup> *Income Tax Assessment Act 1997* (Cth) s 4-10.

<sup>21</sup> Paul Kenny, *Australian Tax 2004* (2004) 124. Note: there are exceptions. See, eg, *FCT v Woolcombers (WA) Pty Ltd* (1993) 47 FCR 561.

<sup>22</sup> *Income Tax Assessment Act 1997* (Cth) s 6-5 includes most business income as assessable income, although there are exceptions to this rule. Eg, capital gains will be caught by the timing rules in Part 3-1.

derived is to be determined by the application of ordinary business and commercial principles and that the method of accounting to be adopted is that which is calculated to give a substantially correct reflex of the taxpayer's true income.<sup>23</sup>

There are two principles that emerged from *Carden* in respect of the derivation of business income. The first is that accruals accounting basis is generally appropriate for business income. That is, income is derived not upon receipt but when it is earned.<sup>24</sup> This will generally<sup>25</sup> occur where a business issues an invoice to a customer or a customer enters a contract to make payments for goods or services supplied.<sup>26</sup>

The second principle states that a cash receipts basis may be appropriate for the derivation of income for certain small sole professional practitioners.<sup>27</sup> Whilst there may be some difficulty in determining whether a small professional practice should use cash or accruals, it is submitted that this problem could not be considered as significant as it applies to relatively few taxpayers and is addressed by the Commissioner's taxation ruling TR 98/1.

## 2 Timing of Expenses

The timing of deductions for business are generally<sup>28</sup> governed by when an expense is 'incurred' under s 8-1. However, incurred is not defined in the *ITAA 1997* and the courts have consistently declined to give any exhaustive meaning of 'incurred'. Rather the courts have developed a number of principles governing the meaning of incurred. It is clear that an expense does not have to be paid to be incurred under s 8-1. In *Federal Commissioner of Taxation v James Flood Pty Ltd*<sup>29</sup> it was held that deductions were not incurred unless 'the taxpayer has completely subjected himself to them'.<sup>30</sup> In *New Zealand Flax Investments Ltd v Federal Commissioner of Taxation*<sup>31</sup> Dixon J stated:

"Incurred" does not mean only defrayed, discharged, or borne, but rather it includes encountered, run into, or fallen upon. It is unsafe to attempt exhaustive definitions of a conception intended to have such a various or multifarious application. But it does not include a loss or expenditure which is no more than impending, threatened or expected.<sup>32</sup>

*RACV Insurance Pty Ltd v Federal Commissioner of Taxation*<sup>33</sup> and *Commercial Union Assurance Co of Australia Ltd v Federal Commissioner of Taxation*<sup>34</sup> both involved insurance companies that were successful in obtaining deductions for estimated insurance claims since the liability had arisen in the income tax year.

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<sup>23</sup> (1938) 63 CLR 108, 154; 5 ATD 98, 131.

<sup>24</sup> *Fincon (Constructions) Ltd v IRC (NZ)* [1970] NZLR 462; see taxation ruling TR98/1.

<sup>25</sup> Exceptions apply to invoices that carry a discount, ignore the discount as income: *Ballarat Brewing v FCT* (1951) 82 CLR 364. An invoiced amount may also not be income is subject to some future contingency or subject to a refund: *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314.

<sup>26</sup> *FCT v Australian Gas Light Co* 83 ATC 4800: ie, to be earned and therefore derived, a recoverable debt must be created such that a taxpayer is not required to take further steps before becoming entitled to payment.

<sup>27</sup> *Commissioner of Taxes (SA) v The Executor, Trustee and Agency Company of South Australia Ltd* (1938) 63 CLR 108 ('*Carden*'), *FCT v Firstenberg* 76 ATC 4141; *FCT v Dunn* 89 ATC 4141.

<sup>28</sup> Most business expenses are deductible under s 8-1 when incurred, although there are exceptions where a specific deductions provisions applies. For example, borrowing costs are deductible over the lesser of five years or the life of the loan per s 25-25.

<sup>29</sup> (1953) 10 ATD 240, 244.

<sup>30</sup> *Ibid.*

<sup>31</sup> (1938) 61 CLR 179.

<sup>32</sup> *Ibid.* 242.

<sup>33</sup> 74 ATC 4169.

<sup>34</sup> 77 ATC 4186.

### 3 *Prepaid Expenses*

Previously prepaid expenses were generally deductible when incurred under s 8-1<sup>35</sup> the Government moved to limit this timing loophole by limiting the deductibility of prepayments in 1988.<sup>36</sup> The prepayment rules were further amended in 1999.<sup>37</sup> For businesses that do not enter the STS and incur expenditure for doing a thing that is not to be done wholly within the income year in which the benefit is incurred, the expenditure is apportioned over the eligible service period.<sup>38</sup> This is the period over which the services are to be provided up to a maximum of ten years.

## B *Accounting Treatment*

### 1 *Timing of Income*

The accounting conceptual framework calls for an accruals treatment of revenue and expenses. Statement of Accounting Concept SAC 4 *Definition and Recognition of the Elements of Financial Statements* ('SAC 4') requires that a revenue should be recognised in a reporting period when and only when:

- (a) it is probable that the inflow or other enhancement or saving in outflows of future economic benefits has occurred; and
- (b) the inflow or other enhancement or saving in outflows of future economic benefits can be measured reliably.<sup>39</sup>

This correlates very closely with the non-STS income tax law requirements that ordinary income is generally derived when earned.

### 2 *Timing of Expenses*

SAC 4 requires that an expense be recognised in a reporting period when and only when:

- (a) it is probable that the consumption or loss of future economic benefits resulting in a reduction in assets and/ or an increase in liabilities has occurred; and
- (b) the consumption or loss of future economic benefits can be measured reliably.<sup>40</sup>

The accounting treatment of timing of expenses thus generally equates with the income tax concept of 'incurred'.

### 3 *Prepaid Expenses*

Clearly a prepaid expense will fall outside an expense under SAC 4 since such 'expense' will be recognised as an asset under SAC 4. SAC 4 requires that an asset should be recognised in the statement of financial position when and only when:

- (a) it is probable that the future economic benefits embodied in the asset will eventuate; and
- (b) the asset possesses a cost or other value that can be measured reliably.<sup>41</sup>

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<sup>35</sup> *FCT v Brand* 95 ATC 4633.

<sup>36</sup> *Income Tax Assessment Act 1936* (Cth) s 82KZM.

<sup>37</sup> *Income Tax Assessment Act 1936* (Cth) s 82KZMA – 82KZMD.

<sup>38</sup> *Income Tax Assessment Act 1936* (Cth) s 82KZMA – 82KZMD. Note transitional rules apply for expenditure incurred from 22 September 1998 to 21 September 2002.

<sup>39</sup> The Institute of Chartered Accountants in Australia, CPA Australia, *Accounting Handbook* (2001) 37.

<sup>40</sup> *Ibid.*

Again the accounting treatment will generally correlate with the non-STS income tax law requirements that an expense is generally deductible when incurred and that generally a prepaid expense be accrued over the relevant period of the prepayment.

### *C STS Rules*

#### *1 Timing of Income*

Under the STS, a taxpayer is not be required to bring to account, at year end, income when it is derived under s 6-5;<sup>42</sup> rather, ordinary income will be calculated on a cash basis.<sup>43</sup> Thus business sales for which payment has not been received will not constitute income. The cash accounting method does not apply to ordinary income if another provision of income tax law includes the amount at a different time.<sup>44</sup> Also, the cash accounting method does not extend to statutory income such as capital gains.

#### *2 Timing of Expenses*

Under the STS business expenses will only be deductible under ss 8-1 (general deductions), 25-5 (tax related expenses) and 25-10 (repairs), when paid.<sup>45</sup> Expenses owing at year end will not be deductible until paid. However, the cash accounting method does not apply to other specific deduction provisions.<sup>46</sup> As previously noted, entry adjustment rules ensure that when a business enters the STS and uses the new accounting arrangements business income and expenses affected by the new accounting arrangements are not recognised twice or omitted<sup>47</sup>.

#### *3 Prepaid Expenses*

Under the new 12-month prepayments rule, an advance payment made by an STS taxpayer will be immediately deductible where it is incurred in respect of a period of service not exceeding 12 months and the period of service ends no later than the last day of the income year following the date on which the payment is made.<sup>48</sup> Small business taxpayers not entering the STS will move to the general scheme of the prepayments provisions.<sup>49</sup> This means that their deductions for incurred deductible prepayments expenditure will be apportioned over the service period or ten years, which ever is the lesser.

### *D Comparison*

The non-STS accruals system of tax accounting substantially mirrors the treatment under accounting standards. The STS, however, produces a number of departures from accounting standards. Firstly, the cash system of tax accounting for income and expenses conflicts with SAC4. Secondly, the treatment of prepaid expenses also clashes with SAC4.

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<sup>41</sup> Ibid 36.

<sup>42</sup> *Income Tax Assessment Act 1997* (Cth) s 328-105(1)(a).

<sup>43</sup> *Income Tax Assessment Act 1997* (Cth) s 328-105(1)(a).

<sup>44</sup> *Income Tax Assessment Act 1997* (Cth) s 328-105(2)(a); eg, if s 385-135 applies to defer the profit on sale of a second wool clip.

<sup>45</sup> *Income Tax Assessment Act 1997* (Cth) s 328-105(1)(b).

<sup>46</sup> *Income Tax Assessment Act 1997* (Cth) s 328-105(2)(b).

<sup>47</sup> *Income Tax Assessment Act 1997* (Cth) s 328-110, 328-115.

<sup>48</sup> *Income Tax Assessment Act 1936* (Cth) s 82KZM.

<sup>49</sup> *Income Tax Assessment Act 1936* (Cth) s 82KZMA – 82KZMD.



## V DEPRECIATION

### A *The 'Non-Simplified' Income Tax Regime*

The uniform capital allowance system<sup>50</sup> applies to depreciating assets that are acquired or constructed on or after 1 July 2001. Under these rules depreciating assets can be written off as deductions generally over the effective life. For assets costing less than AUD 1000 ('low cost assets') taxpayers may depreciate assets at accelerated rates in a low value pool.<sup>51</sup> Assets acquired prior to 1 July 2001 are transferred into the new system at the old depreciation rates. Under this system taxpayers have to work out: the effective life of assets; depreciation rates; provide annual depreciation calculations; and account for any disposal of depreciating assets.

### B *Accounting Treatment*

Accounting Standard AASB 1021 provides the rules for calculating the depreciation for non-current depreciating assets as follows:<sup>52</sup>

5.1 The depreciable amount of a depreciable asset must be allocated on a systematic basis over its useful life. The depreciation method applied to an asset must reflect the pattern in which the asset's future economic benefits are consumed or lost by the entity. The allocation of the depreciable amount must be recognised as an expense, except to the extent that the amount allocated is included in the carrying amount of another asset.

5.2 In estimating the useful life of a depreciable asset, consideration must be given to the following factors:

- (a) expected physical wear and tear;
- (b) obsolescence; and
- (c) legal or other limits on the use of the asset.

5.3 The depreciable amount must be allocated from the time when a depreciable asset is first put into use or held ready for use...

### C *STS Rules*

Under the STS small business taxpayers can obtain 100 per cent deductions for depreciating assets costing less than AUD 1000 to the extent of taxable use.<sup>53</sup> Simplified pooling arrangements provide accelerated depreciation deductions for assets costing more than AUD 1000.<sup>54</sup> Under the pools, assets with less than a 25 year life use a 30 per cent diminishing value rate, and assets longer than 25 years use a 5 per cent rate.<sup>55</sup> A further benefit is provided for depreciating assets acquired during the year since those assets are depreciated at half the pool rate (either 15 per cent or 2.5 per cent).<sup>56</sup>

A type of balancing charge offset is retained under the STS.<sup>57</sup> Under the STS sales proceeds from the disposal an asset are written off against the pool.<sup>58</sup> This will generally also result in assessable income if the proceeds exceed the pool balance.

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<sup>50</sup> *Income Tax Assessment Act 1997* (Cth) div 40.

<sup>51</sup> *Income Tax Assessment Act 1997* (Cth) s 40-420 to 40-445.

<sup>52</sup> ICAA, above n 39, 826.

<sup>53</sup> *Income Tax Assessment Act 1997* (Cth) s 328-180.

<sup>54</sup> *Income Tax Assessment Act 1997* (Cth) div 328-D.

<sup>55</sup> *Income Tax Assessment Act 1997* (Cth) s 328-190.

<sup>56</sup> *Income Tax Assessment Act 1997* (Cth) s 328-190.

<sup>57</sup> *Income Tax Assessment Act 1997* (Cth) s 328-215.

<sup>58</sup> *Income Tax Assessment Act 1997* (Cth) s 328-215.

The rules governing in which pool an asset is to be placed, however, are complex.<sup>59</sup> Also, considerable complexity arises when a change in the business use of a depreciating asset occurs. For example, s 328-225(4) provides the following formula:<sup>60</sup>

$$[1 - (\text{rate}/2)] \times [1 - \text{rate}]^{n-1}$$

#### D Comparison

Again, the non-STS depreciation regime is very similar to the treatment under accounting standards, that is, depreciation is generally expensed over the effective life of an asset. The STS, however, results in departures from accounting standards with its accelerated depreciation regime conflicting with AASB 1021.

### VI TRADING STOCK

#### A The 'Non-Simplified' Tax Regime

Under the trading stock provisions, if you carry on a business and have trading stock on hand, the excess of closing stock over opening stock is included in assessable income.<sup>61</sup> If the value of opening stock exceeds closing stock, the excess is deductible.<sup>62</sup> Thus business must carry out an annual physical stock-takes to account for trading stock, and must also make elections on the value of closing stock<sup>63</sup> and in revaluing obsolete stock.<sup>64</sup>

#### B Accounting Treatment

Accounting Standard AASB 1019 provides the rules for accounting for inventory. Paragraph 5.1 requires that inventories must be measured at the lower of cost and net realisable value.<sup>65</sup> Further, para 9.1 requires that 'the carrying amount of inventories sold must be recognised as an expense in the financial year in which the related revenue is recognised'.<sup>66</sup> This means that excess of closing stock over opening stock will increase revenue and the excess of opening stock over closing stock will increase expenses.

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<sup>59</sup> See Hine, above n 12, 34; *Income Tax Assessment Act 1997* (Cth) s 328-185.

<sup>60</sup> Lachlan R Wolfers and J Miller, 'The Simplified Tax System: Is this Governmentspeak for "complex"?' (2001) 35 *Taxation In Australia* (Taxation Institute of Australia) 374, 374. The authors stated: 'Maybe for a mathematically gifted small business operator, a formula such as this provides no challenge. However, for the average lawyer with a limited mathematical knowledge, it is not so simple.'

<sup>61</sup> *Income Tax Assessment Act 1997* (Cth) s 70-35.

<sup>62</sup> *Income Tax Assessment Act 1997* (Cth) s 70-35.

<sup>63</sup> *Income Tax Assessment Act 1997* (Cth) s 70-45.

<sup>64</sup> *Income Tax Assessment Act 1997* (Cth) s 70-50.

<sup>65</sup> ICAA, above n 39, 695.

<sup>66</sup> *Ibid* 701.

### C STS Rules

Where the difference between the value of the trading stock on hand at the start of an income year and the reasonably estimated value at the end of the year is AUD 5000 or less, an STS taxpayer does not have to value each item of trading stock at year end and account for any changes in the value of trading stock.<sup>67</sup> If the change in trading stock is greater than AUD 5000 the normal trading stock rules apply.<sup>68</sup>

### D Comparison

The non-STs trading stock provisions are closely aligned to the treatment under accounting standards. The STS trading stock provisions again result in significant departures from accounting standards by ignoring trading stock variations in the calculation of income and expenses. This directly conflicts with the requirements of AASB 1019.

## VII POLICY JUSTIFICATION FOR STS

Ideally the STS provisions should substantially meet the requirements of the three canons of good taxation policy: equity, economic efficiency and simplicity. As the *Ralph Report* notes, because the tax system ‘can significantly influence the efficiency with which Australia’s natural resources, capital and labour are used’, economic efficiency is important.<sup>69</sup> On equity the Report asserts it is ‘a basic criterion for community acceptance of the tax system’.<sup>70</sup> In respect of simplicity:

A major consideration in the formulation of the Review’s recommendations has been to remove anomalies and inequities between the treatment of economically similar transactions. This will allow significant simplification of the tax system.<sup>71</sup>

### A Equity

Tax equity is generally defined in terms of horizontal equity and vertical equity.<sup>72</sup> Horizontal equity demands equal treatment for people in similar circumstances.<sup>73</sup> This requires the determination of a tax base which is able to determine ‘similar circumstances’ so that an appropriate amount of tax can be imposed on a taxpayer. Accordingly, most commentators<sup>74</sup> have defined the tax base in terms of a taxpayer’s ‘ability to pay’.

Thus horizontal equity requires those having an equal ability to pay bear an equal tax burden.<sup>75</sup> Because horizontal equity concerns the equal treatment of equals, as a corollary, vertical equity is required to ensure that tax imposed on people in different circumstances is also fair. Most countries have progressive rates of income tax<sup>76</sup> so as to try to ensure that a person with a greater ability to pay, pays not only more tax, but at a higher income tax rate.

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<sup>67</sup> *Income Tax Assessment Act 1997* (Cth) sub-div 328-E.

<sup>68</sup> *Income Tax Assessment Act 1997* (Cth) s 328-90.

<sup>69</sup> *Ralph Report*, above n 1, 13.

<sup>70</sup> *Ibid* 105.

<sup>71</sup> *Ibid* 16.

<sup>72</sup> Jeffrey Waincymer, *Australian Income Tax: principles and policy* (2<sup>nd</sup> edition, 1993) 30.

<sup>73</sup> P L Kenny, ‘Capital gains taxation for New Zealand’ (2001) 7(4) *New Zealand Journal of Taxation Law and Policy* 265, 269.

<sup>74</sup> David F Bradford, *Untangling the Income Tax* (1986) 150–1.

<sup>75</sup> Noël B Cunningham and Deborah H Schenk, ‘The Case for a Capital Gains Preference’ (1993) 48 *Tax Law Review* 319, 365.

<sup>76</sup> J Norregaard, ‘The Progressivity of Personal Income Tax Systems’ in P Shome (ed), *Tax Policy Handbook* (1995) 130.

Vertical equity requires both progressive income tax rates and a tax based on the ‘ability to pay’. It is apparent from the following analysis of winners and losers that the STS breaches horizontal and vertical equity.

Certain small businesses, however, are clear winners under STS. For example, businesses that satisfy the eligibility criteria are ahead because they can choose whether to enter the STS and thus optimise their tax planning opportunities. In particular, capital intensive small businesses appear to have the most to gain through accessing the accelerated depreciation regime. As set out above, the STS general pooled depreciation rate is 30 per cent for assets with a less than 25 year expected life use. For example, farmer outlays for tractors and harvesters will enjoy a 30 per cent depreciation rate under STS as opposed to a 22.5 per cent non-STs rate.<sup>77</sup> Under the STS, an immediate deduction is available for assets costing less than AUD 1,000.<sup>78</sup> Further, businesses can acquire an asset on the last day of an income tax year and obtain an immediate 15 per cent deduction. Miners, manufacturers and tradespeople are also among those likely to benefit from higher depreciation rates under the STS.<sup>79</sup>

Taxpayers with large amounts of debtors compared to creditors will also benefit from the STS given the tax deferral from cash accounting. Previously, business income included debtors; under the STS only cash receipts are included as business income.<sup>80</sup> This benefit, however, will generally only provide a one-off cash saving for small business. Certainly this will be the case where small business retains a similar debt profile. For example, grape growers that are paid in three instalments over April, July and September will defer income on a cash basis.<sup>81</sup> Builders, professional firms and manufacturers are also likely to be in the same situation.<sup>82</sup> This tax deferral benefit, however, is ameliorated to some extent by the Pay As You Go (‘PAYG’) instalment regime.

Further, such taxpayers can take advantage of the 12 month prepayment rule that provides full deductions for prepaid expenses incurred in respect of a period of service not exceeding 12 months.<sup>83</sup> For taxpayers outside the STS such prepayments are subject to restrictions and deductions must be apportioned. The trading stock rules, however, will only provide a benefit to very small businesses given the AUD 5000 trading stock variation threshold.<sup>84</sup>

Of course, the greater the amount of depreciable assets, debtors and prepayments that a business has, the greater the tax savings under the STS. Well-established and larger small businesses in certain industries emerge as the clear winners under the STS.

Other small businesses are losers in the STS. Businesses that fail the eligibility criteria cannot take advantage of the tax savings from the STS. For example, small business with an annual business turnover of AUD 1 000 000 or greater cannot take advantage of the STS.<sup>85</sup> Also, highly capital intensive small businesses with depreciating assets of AUD 3 000 000 or more do not qualify.<sup>86</sup>

Taxpayers with large numbers of creditors compared to debtors will incur a cash flow problem from entering the STS because deductions for creditors are generally excluded.<sup>87</sup>

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<sup>77</sup> Snook, above n 12, 89–90; Fiona Martin, ‘STS Implications’ (2001) 36 *Taxation In Australia* 245, 251.

<sup>78</sup> Accounting Standard AASB 1019, para 5.3.

<sup>79</sup> Ibid.

<sup>80</sup> Ibid para 4.3.

<sup>81</sup> Snook, above n 12, 89–90; Martin, above n 77, 251.

<sup>82</sup> Ibid.

<sup>83</sup> Accounting Standard AASB 1019, para 4.3.

<sup>84</sup> Ibid para 6.3.

<sup>85</sup> Eg, Small businesses with high turnover and low margin are affected, such as liquor outlets and service stations.

<sup>86</sup> Accounting Standard AASB 1019, para 3.

<sup>87</sup> Ibid para 4.3.

Many retailers will fit into this situation.<sup>88</sup> For taxpayers that have a number of entities and complex structures the grouping rules may be so complex that compliance costs outweigh any benefits.<sup>89</sup> Additionally taxpayers with capital gains on pre- 21 September 1999 depreciable assets will lose any indexation benefit when such assets are placed into the STS depreciation pool.<sup>90</sup>

Businesses with low levels of depreciable assets, debtors and prepayments will obtain little benefit from the STS. Thus small retailers, new small businesses and struggling small business emerge as the losers under the STS.

Horizontal equity is violated, as can be seen in the following example that compares a small business with high levels of depreciable assets (A) and a small business with low levels of depreciable assets (B). Outside the STS provisions, these two small business taxpayers (A and B) have the same taxable income, AUD 100 000, and pay the same amount of income tax. Under the STS regime, however, A elects to join and obtain depreciation benefits that reduce the taxable income to AUD 80 000. B obtains no depreciation benefits under the STS. This is inequitable since both taxpayers have the same ability to pay but now pay different amounts of income tax. The STS rules also breach horizontal equity between small businesses within the same industry. A clothing retailer with AUD 900 000 of sales income is eligible to join, whilst a nearby competitor with AUD 1 100 000 falls outside the STS. Further, horizontal equity is also breached since the STS regime excludes taxpayers who are not carrying on a business.

Vertical equity is also damaged because a taxpayer on the top marginal tax bracket obtains a greater benefit from the STS rules than a lower income taxpayer. STS benefits that reduce assessable income by AUD 20 000 for a top marginal rate taxpayer would save AUD 9700 income tax. Whereas for a taxpayer with a taxable income of AUD 50 000 would only save AUD 6300 income tax from the same STS benefit. Given that most larger small businesses would be operated by the high income and wealthier taxpayers,<sup>91</sup> the breach of vertical equity must be substantial. The STS provisions clearly damage the integrity of the tax laws.

### B *Economic Efficiency*

There is an extensive body of research that demonstrates the economic virtues of a neutral tax system and the ideal of a *comprehensive* income tax base.<sup>92</sup> The *Ralph Report*'s business taxation design principles advocated that 'the tax base adopted should be as close as possible to comprehensive income'.<sup>93</sup> Similarly, the 1975 *Asprey Report*<sup>94</sup> and Government's 1985 *Draft White Paper*<sup>95</sup> preferred this tax base.

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<sup>88</sup> Snook, above n 12, 89–90; Martin, above n 77, 251.

<sup>89</sup> Accounting Standard AASB 1019, para 3.

<sup>90</sup> *Income Tax Assessment Act 1997* (Cth) s 328-185(7).

<sup>91</sup> Simon Kelly, 'Wealth on Retirement – Latest Estimates for Australia' (Paper presented to the 9<sup>th</sup> Annual Colloquium of Superannuation Researchers, University of New South Wales, 9–10 July 2001) 15, avail NATSEM (National Centre for Economic Modelling), Online Conference Paper - CP2001\_004, <[www.natsem.canberra.edu.au](http://www.natsem.canberra.edu.au)> at October 2005. The top 10% of the Australian population have 43% of the total wealth, while the wealthiest 50% have 90% of the wealth: Paul Kenny, 'Australian Taxation, Ethics and Social Capital' (2002) 21 (3) & (4) *Business and Professional Ethics Journal* (Florida) 109, 112–13.

<sup>92</sup> *Ralph Report*, above n 1, 112: comprehensive income, defined as the sum, over an annual period, of a taxpayer's current revenue less current costs, and the net change in value of the taxpayer's assets and liabilities; Graeme S Cooper, 'An optimal or comprehensive income tax?' (1995) 22 *Federal Law Review* 414, avail <<http://uniserve.edu.au/law/pub/edinst/anu/flrv22/anoptima.htm>> at 27 June 2002.

<sup>93</sup> *Ralph Report*, above n 1, 111–12; however, the Report states:

The preferential tax treatment of depreciation by allowing accelerated depreciation rates and other concessions under STS impedes economic efficiency as it provides departures from the taxation of comprehensive income. This is evident from the above analysis of winners and losers under STS. The *Ralph Report*<sup>96</sup> noted that accelerated depreciation provides significant benefits to capital intensive industries, such as mining and manufacturing, rather than service industries. Thus it also distorts the economy as scarce resources are diverted away from activities that would have otherwise attracted them. This breaches neutrality because the STS tax system favours capital intensive small businesses. Further, the cash accounting and prepayments rules will also result in a further tax preference because certain small businesses will have a once-off tax saving from the tax deferred. It is submitted that the trading stock provisions, however, would have an insignificant impact given the low threshold of AUD 5000.

### C Simplicity

Simplicity is an attribute that appears to have never sat very well with taxation laws<sup>97</sup> and is a difficult concept to define.<sup>98</sup> There is however, general agreement that simplicity is considered in terms of administration costs of the government and the compliance costs of taxpayers.<sup>99</sup>

#### 1 Compliance Costs

Compliance costs can be defined as the costs ‘incurred by taxpayers, or third parties such as businesses, in meeting the requirements laid upon them in complying with a given structure and level of tax’.<sup>100</sup> These costs will include the costs of keeping records, preparing taxation financial statements and taxation returns, obtaining tax advice, undergoing tax audits, tax planning and disputes. Taxes, however, can provide a number of benefits to taxpayers that may offset these costs.

Managerial benefits are provided as a result of improved business decision-making flowing from tax law compliance.<sup>101</sup> The record keeping and financial information requirements of the tax laws provide taxpayers with better information to make business and

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While the comprehensive income tax base may never be implemented in practice, most successful market economies use that base in designing and evaluating the performance of their operating income tax systems.....Not surprisingly, the prospect of unbridled application of the conceptual comprehensive income tax base in all circumstances attracts taxpayer concern – especially in relation to liquidity, valuation, volatility, loss offset and effects on international competitiveness. (at 2)

<sup>94</sup> Commonwealth Taxation Review Committee (K W Asprey, chair), *Full Report* (1975) (*Asprey Report*) paras 3.23–3.26.

<sup>95</sup> Australian Government, *Reform of the Australian Taxation System, Draft White Paper, Reform of the Australian Taxation system* (1985) 15.

<sup>96</sup> *Ralph Report*, above n 1, 305–6.

<sup>97</sup> See, eg, United Kingdom Parliament, *Parliamentary Debates*, 27 May 1853, col. 722. Gladstone said:

the Honourable Gentleman said that laws of this kind ought to be made intelligible to all persons who has not received a legal education. To bring the construction of these laws within the reach of such persons, was no doubt extremely desirable, but very far from being easy ... The nature of property in this country, and its very complicated forms, rendered it almost impossible to deal with it for the purpose of the income tax in a very simple manner.

See also: H H Monroe, QC, ‘Intolerable inquisition? Reflections on the law of tax’ (1981) 33 where the United Kingdom Special Commissioner of Taxation is quoted as stating in 1980 that: ‘the plea today is that it would be some advance if laws of this kind were intelligible to those who have received a legal education’.

<sup>98</sup> Boris I Bittker, ‘Tax reform and simplification’ (1974) 29 *University of Miami Law Review* 1, 1.

<sup>99</sup> Ruth Woellner, Stephen Barkoczy and Shirley Murphy, *Australian Taxation Law* (12<sup>th</sup> ed, 2002) 32.

<sup>100</sup> C Sandford, M Godwin and P Hardwick, *Administrative and compliance costs of taxation* (1989), 10.

<sup>101</sup> Binh Tran-Nam, Chris Evans, Michael Walpole and Katherine Ritchie, ‘Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia’ (2000) 53 *National Tax Journal* 229, 232–3.

investment decisions although, notably, this information falls short of proper accounting reports. Additionally, taxpayers obtain a benefit since these compliance costs are generally tax deductible<sup>102</sup> under ss 8-1 and 25-5.

There will also be cash flow benefits<sup>103</sup> to taxpayers that are able to defer the payment of tax. These tax savings to one section of the community, however, create substantial on-costs for other taxpayers. This includes: higher levels of taxes for other taxpayers (the need for this having been created by tax revenue leakage), diversion of investment to tax-advantaged arrangements, promotion of possible corruption, creation of case law complexity and taxation ruling complexity, greater numbers of disputes, ‘ring fencing’<sup>104</sup> and the loss of integrity to the tax system.

The following analysis shows that the STS does not appear to bring any considerable compliance cost reduction for small business.

(a) *STS Eligibility*

Generally, ascertaining eligibility to join will be quite simple for many small business taxpayers who easily fall within the STS parameters. Taxpayers at the margin, however, will encounter considerable complexities in dealing with the threshold tests and grouping rules.

Aside from the trading stock rules, the features of the STS are not optional, thus many taxpayers will have to make a rather complex calculation of the costs and benefits of joining. For example, a capital intensive business may obtain depreciation benefits as set out previously,<sup>105</sup> but will have to adopt cash accounting and prepayment rules even though they may obtain little benefit and incur greater compliance costs. Commentators<sup>106</sup> note that given the complexities of the STS and the trade-offs involved, there may be little benefit at all to small business.

(b) *Entering and Leaving*

Entering and leaving the STS is not a simple matter: taxpayers leaving must apply to rejoin the STS; for businesses voluntarily leaving the STS they have to wait five years to rejoin; taxpayers will plan to become ineligible taxpayers rather than leave voluntarily;<sup>107</sup> once in the STS a taxpayer may have difficulty in leaving the system because the debtors will now have to be brought to account;<sup>108</sup> and a small business may not be able to afford the cash flow costs of opting out.

(c) *Cash Accounting*

The cash accounting change will remove much of the need to account to debtors, creditors and work in progress until realisation. It is submitted that this will not result in a significant compliance saving for a number of reasons. Firstly, many small businesses prepare accounting reports on an accruals basis; using a cash accounting basis will only increase their compliance costs. Secondly, under the STS, businesses will not operate on a pure cash basis because accruals will apply to certain amounts of income and expenses as detailed above.

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<sup>102</sup> Ibid.

<sup>103</sup> Ibid.

<sup>104</sup> ‘Ring fencing’ refers to a government’s practice of introducing a growing number of complex, specific anti-avoidance rules to combat the manipulation of tax loopholes.

<sup>105</sup> Accounting Standard AASB 1019, para 5.3.

<sup>106</sup> Hine, above n 12, 31; Wolfers and Miller, above n 60, 374.

<sup>107</sup> Hine, above n 12, 1.

<sup>108</sup> *Income Tax Assessment Act 1997* (Cth) s 328-115(2).

Also, the GST cash accounting thresholds are different to the STS thresholds this may result in a taxpayer running two accounting systems, one for GST and one for income tax.

(d) *Prepayment*

Prepayment provisions may make the tax accounting process slightly easier because such expenses would not need to be accrued. This provides no real benefit, given that a business will still need to accrue such expenses for accounting reporting reasons and that these are only transitional benefits.

(e) *Capital Allowances*

The pooling system for depreciable assets will remove the need to calculate the depreciation separately for each individual asset and provide some simplicity. This, however, appears to be offset by a number of factors: the benefit is insignificant as business will still need to use effective life depreciation for accounting reporting reasons; and complex depreciation rules apply for pooling assets and for calculating changes in the private use of depreciable assets.

(f) *Trading Stock*

There may be a small simplicity benefit in the cost savings from not having to account for trading stock. This benefit, however, is considered to be minute for the following reasons:

- Many small businesses have no or insignificant levels of trading stock and thus the benefit is negligible.
- Businesses with trading stock will still have to calculate a reasonable estimate of trading stock each year. How is this done without a stocktake?<sup>109</sup>
- Most small business with trading stock will have variations in opening and closing stock that exceed AUD 5000, and so this provision may have little impact.

(g) *Managerial Benefits to Taxpayers*

There appear to be few managerial benefits from better record keeping and accounting flowing from the STS. The STS — by using a cash basis instead of accruals, accelerated depreciation instead of effective life, and by not carrying out stock-takes — encourages taxpayers to abandon proper financial reporting. Yet, for example, small business will still be required to furnish financial accounts in order to obtain finance. Additionally, where a small business elects to take up the STS it will still have to use accruals for most types of statutory income and deductions. Using both cash and accruals will only add to complexity. Small business involved in primary production, for example, will be affected, given the multitude of special primary production provisions in respect of income and expenses.<sup>110</sup>

(h) *Tax Deductibility Benefits*

If the STS results in greater compliance costs, this will be offset by the tax deductions obtained. Conversely, if the STS achieves its aim and reduces compliance costs, the tax deduction benefit will fall.

(i) *Cash Savings From Tax Preferences*

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<sup>109</sup> Snook, above n 12, 84.

<sup>110</sup> See, eg, special capital allowance write-offs in div 40.



The primary compliance benefit for small business taxpayers appears to be cash flow savings from tax deferral by utilising the cash accounting and accelerated depreciation rules. There will also be tax savings for STS taxpayers with significant levels of prepaid expenses. Indeed the Revised Explanatory Memorandum to the *New Business Tax System (Simplified Tax System) Act 2000* estimates these savings to be AUD 280 million in the 2001/02 year increasing to AUD 337 million in the 2004/05 year.<sup>111</sup>

(j) *On-Costs of Tax Preferences*

The STS however, imposes considerable on costs for non-STS taxpayers.<sup>112</sup> Firstly, the tax saved will only result in higher levels of taxes or additional taxes for non-STS taxpayers. Secondly, the STS integrity rules add to the ring fencing in the *ITAA*.<sup>113</sup> As noted above, businesses will try to work around these integrity rules to maximise the benefits of the STS. Affluent taxpayers engage in a ‘tax audit lottery’, exploiting grey areas of tax law and risking the chances of being audited. It also encourages corruption in the administration and practice of tax law. Further, under the STS, it will be likely that case law complexity will increase because the STS brings new terminology into the tax laws<sup>114</sup> and provides many borderlines for turnover, trading stock and depreciable asset thresholds. The sheer complexity of the anti-avoidance measures are likely to lead to disputes. Indeed the Australian Taxation Office has produced two long and complex taxation rulings on the integrity measures in the STS.<sup>115</sup>

2 *Administration Costs*

The STS imposes costs on a Government aside from the loss of a significant amount of tax revenue. Loopholes damage the integrity of the tax system, encourage avoidance and evasion as taxpayers seek to exploit the depreciation and cash accounting tax benefits. This leads to disputes, increased case law complexity, taxation ruling complexity and ‘ring fencing’ as noted above.

Furthermore, the STS results in considerable set up costs of bringing in the new legislation. The Australian Taxation Office also needs to provide ongoing private rulings, fact sheets, taxpayer advice, educational seminars and incur costs of dispute resolution associated with the STS. Also, entering and leaving the STS is not a simple matter and brings significant maintenance costs to the Australian Taxation Office because the STS requires that taxpayers make application to the Australian Taxation Office to re-enter the STS.

VIII CONCLUSION

The STS experience provides a number of valuable lessons for policy makers. Firstly, such tax preferences add to the volume and complexity of tax law and damage equity and efficiency. Secondly, aligning the income tax laws more closely with accounting rules achieves real simplification and would remove tax law anomalies and inequities. If the

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<sup>111</sup> *Revised EM*, above n 5, 1–2.

<sup>112</sup> Jonas Agell, Peter Englund and Jan Södersten, ‘Tax reform of the century – the Swedish experiment’ (1996) 49 *National Tax Journal* 643, 659. Such transactional costs are reflected in the results of a 1994 survey on the 1991 Swedish tax reforms that broadened the tax base and lowered income tax rates. The survey found that households actually spent less time on tax compliance in the years after the tax reforms. The more comprehensive the income tax base and fewer the tax preferences, the lower the compliance costs.

<sup>113</sup> See *Income Tax Assessment Act 1997* (Cth) s 328-375 to 328-380.

<sup>114</sup> Eg, *Income Tax Assessment Act 1997* (Cth) s 328-205(3) (‘taxable purpose proportion’), s 328-370(1) (‘STS average turnover’).

<sup>115</sup> TR 2002/6; TR 2002/D3.

government's goal is to compensate small business for the regressive compliance costs of the new tax system, then a direct government grant is a superior method of assisting all small business.

## FOREIGN CURRENCY TRANSLATION: THE BEGINNING OF A NEW ERA

DEAN HANLON\* AND LES NETHERCOTT<sup>†</sup>

**ABSTRACT:** In recent times, much consideration has been given to the merits of reducing the divergence between accounting practice and taxation law. To illustrate, the Review of Business Taxation in *A Tax System Redesigned* (1999) recommended, ‘appropriate regard be had to accounting principles in the development of taxation legislation...’ (Recommendation 4.23). One area that has received particular attention is the taxation of financial arrangements and, more specifically, foreign exchange gains and losses.

At present, the taxation of foreign currency denominated transactions is largely governed by common law and, in particular, the High Court decision in *Federal Commissioner of Taxation v Energy Resources of Australia Limited* (1996) 96 ATC 4536, whilst from an accounting perspective such transactions are regulated by Statement of Accounting Concepts SAC 4 *Definition and Recognition of the Elements of Financial Statements* and Australian Accounting Standards Board AASB 1012 *Foreign Currency Translation*. It is the intention of this article to undertake a comparative analysis of the accounting and taxation treatment of foreign currency denominated transactions and, in doing so, highlight the disparate recognition of any resultant foreign exchange gain or loss. Furthermore, consideration will be given to recent proposals concerning the taxation of foreign exchange gains and losses, in particular those detailed in the Exposure Draft of the New Business Tax System (Taxation of Financial Arrangements) Bill (Cth) 2002, to establish whether the implementation of such recommendations will contribute to reducing the divergence between accounting practice and taxation law.

### I INTRODUCTION

The merits of comparability between accounting practice and taxation law have been recognised by academics,<sup>1</sup> courts of law and governments. In particular, history illustrates the

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<sup>1</sup> See, eg. A W Blaikie, ‘The Relevance of Accounting Principles to the Income Tax Assessment Act’ (1981) 15 *Taxation in Australia* 690; Trevor Boucher, ‘The Simplification Debate - Too Simplistic?’ (1991) 26 *Taxation in Australia* 277; Graeme S Cooper, ‘Some Observations on Tax Accounting’ (1986) 15(3) *Australian Tax Review* 221; C F Farleigh, ‘The Accountant as Expert’ (1979) 8 *Australian Tax Review* 64; Richard Fayle, ‘Accounting Standards and Their Relevance to Taxation Law’ (Paper presented at the Ninth National Convention of the Taxation Institute of Australia, Adelaide, 1–4 May 1990); G L Herring, ‘The Impact of Accounting Principles Upon the Determination of Taxable Income’ (Paper presented at the Seventh National Convention of the Taxation Institute of Australia, Hobart, April 1986); Justice G Hill,

relevance of accounting evidence in a court of law, particularly in the resolution of issues concerning the intended operation of Australia's income tax legislation.<sup>2</sup> The relevance of accounting practice in taxation law has also been recognised by both the Commonwealth Parliament and the Australian government. Public inquiries initiated by Parliament have recommended the alignment of accounting practice and taxation law in an attempt to simplify Australia's income tax legislation.<sup>3</sup>

Furthermore, governments of the day have recommended a reduction in the divergence between both accounting and taxation practices in order to reform Australia's taxation system. To illustrate, the 1975 Asprey Committee proposed 'to narrow, as far as possible, the differences between net income as determined under the revenue legislation and as determined by commercial standards'.<sup>4</sup> The Howard government, as a result of its tax reform plan, titled *Tax Reform: Not a New Tax, A New Tax System - The Howard Government's Plan for a New Tax System* (1998),<sup>5</sup> also advocated that taxation law more accurately reflect commercial reality, which culminated in the recommendation by the Review of Business Taxation in *A Tax System Redesigned* (1999) ('Ralph Report') that 'appropriate regard be had to accounting principles in the development of taxation legislation...'.<sup>6</sup>

One area that has received particular attention is the taxation of financial arrangements and, more specifically, foreign exchange gains and losses. At present, the taxation of foreign currency denominated transactions is largely governed by common law and, in particular, the High Court decision in *Federal Commissioner of Taxation v Energy Resources of Australia Limited* (1996) 96 ATC 4536 ('*ERA*'), whilst from an accounting perspective these transactions are regulated by Australian Accounting Standards Board AASB 1012 *Foreign Currency Translation* ('AASB 1012').<sup>7</sup> Statement of Accounting Concepts SAC 4 *Definition and Recognition of the Elements of Financial Statements* ('SAC 4'),<sup>8</sup> whilst not mandatory, also assists in accounting for foreign exchange gains and losses, as it offers guidance in the definition and recognition of financial statement elements. It is the intention of this article to undertake a comparative analysis of the accounting and taxation treatment of foreign currency

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'Tax and Accounting - Whether the Twain Will Meet?' (Paper presented at the Fourth National Retreat of the Taxation Institute of Australia, Noosa, 1-3 August 1996); Ross W Parsons, 'Legal Recoverability and Accruals Accounting' (1972) 1(4) *Australian Tax Review* 219; Ross W Parsons, 'Income Taxation - An Institution in Decay?' (1986) 3 *Australian Tax Forum* 233; Chris N Westworth, 'Accounting Standards - A Framework for Tax Assessment' (1985) 2(3) *Australian Tax Forum* 243.

<sup>2</sup> See, eg, *Sun Insurance Office v Clark* [1912] AC 443; *C of T v The Executor Trustee and Agency Company Of South Australia Ltd* (1938) 63 CLR 108; *FCT v James Flood Pty Ltd* (1953) 88 CLR 492; *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314; *J Rowe & Son Pty Ltd v FCT* (1971) 71 ATC 4157; *FCT v Australian Guarantee Corp Ltd* (1984) 84 ATC 4642; *Hooker Rex Pty Ltd v FCT* (1988) 88 ATC 4392; *Woolcombers (WA) Pty Ltd v FCT* (1993) 93 ATC 4342; *Coles Myer Finance Ltd v FCT* (1993) 93 ATC 4214; *FCT v Citibank Ltd* (1993) 93 ATC 4691; *Australia and New Zealand Banking Group Ltd v FCT* (1994) 94 ATC 4026; *FCT v Unilever Australia Securities Ltd* (1995) 95 ATC 4117.

<sup>3</sup> To illustrate, in 1993 the Joint Committee of Public Accounts suggested that 'the possible alignment of the taxation law with accounting concepts and standards would be a fundamental change to be considered' in achieving more simplified income tax legislation: Joint Committee of Public Accounts, Commonwealth Parliament of Australia, 'An Assessment of Tax - A Report on an Inquiry into the Australian Taxation Office', *Report No.326* (1993) para 5.30; while in 1997 the Joint Committee of Public Accounts (1997) specified that the Tax Law Improvement Project ('TLIP') sought to not only clarify Australia's income tax legislation, but also 'bring the operation of the law more in line with commercial or actual practice': Joint Committee of Public Accounts, Commonwealth Parliament of Australia, 'An Advisory Report on the Tax Law Improvement Bill 1996', *Report No.348* (1997) para 3.5.

<sup>4</sup> Commonwealth Taxation Review Committee (K W Asprey, chair), *Full Report* (1975) para 8.8.

<sup>5</sup> Commonwealth Government of Australia, *Tax Reform: Not a New Tax, A New Tax System - The Howard Government's Plan for a New Tax System* (1998).

<sup>6</sup> Review of Business Taxation (John Ralph, chair), *A Tax System Redesigned: more certain, equitable and durable* (Final Report, 1999) ('*Ralph Report*'), Recommendation 4.23.

<sup>7</sup> Australian Accounting Standards Board, *AASB 1012 Foreign Currency Translation* (2001) ('AASB 1012').

<sup>8</sup> Public Sector Accounting Standards Board and Australian Accounting Standards Board, *Statement of Accounting Concepts SAC 4 Definition and Recognition Criteria of the Elements of Financial Statements* (1995) ('SAC 4').

denominated transactions and, in doing so, highlight the disparate recognition of any resultant foreign exchange gain or loss.

Furthermore, consideration will be given to recent recommendations concerning the taxation of foreign exchange gains and losses, in particular those detailed in the Exposure Draft of the New Business Tax System (Taxation of Financial Arrangements) Bill 2002,<sup>9</sup> to establish whether the implementation of such recommendations will contribute to reducing the divergence between accounting practice and taxation law.

The structure of the article is as follows. Section II discusses the facts of *ERA*, and the decision reached by the High Court. Section III examines whether the *ERA* decision is consistent with SAC 4, while Section IV analyses the decision of the High Court in relation to AASB 1012 stipulations. Section V determines whether recent recommendations regarding the taxation of foreign exchange gains and losses will reduce the divergence between taxation law and accounting practice. Finally, conclusions are drawn in Section VI.

## II *FCT v ENERGY RESOURCES OF AUSTRALIA LTD* (1996) 96 ATC 4536

This case was originally considered by the Federal Court,<sup>10</sup> which decided in favour of the taxpayer and ordered the Commissioner to pay the costs of the proceedings. The Commissioner appealed to the Full Federal Court,<sup>11</sup> which partially allowed the appeal by a minor change to the order of costs. The Commissioner, however, was dissatisfied with this outcome and sought special leave to appeal to the High Court. Leave was granted by the High Court, and it is the judgement of the High Court that will now be considered.

### A *Description of the Case*

In January 1986, the taxpayer, Energy Resources of Australia Ltd ('ERA'), issued a series of 90-day promissory notes at a discount pursuant to an agreement made between the taxpayer, the Commonwealth Bank and a number of foreign banks. That agreement allowed the taxpayer to instruct one of the foreign banks to issue promissory notes in the taxpayer's name. A panel of banks would then tender for the notes at a price less than the face value of the notes. The proceeds received from the issue of the promissory notes were in US dollars. Under the agreement the taxpayer agreed to pay the face value of the notes to the holders when the notes matured. This amount was paid in US dollars.<sup>12</sup>

Prior to entering into the agreement, the taxpayer had the use of a finance facility under which certain banks raised money and on-lent to the taxpayer. The taxpayer used the funds raised to finance the development and operation of a uranium mine in the Northern Territory. Proceeds received from the issue of the first series of promissory notes were used to discharge the liabilities under the finance agreement. Such liabilities were in US dollars. Funds from the subsequent issues of the promissory notes were used to discharge the liabilities of the taxpayer under each preceding issue of the notes. As mentioned above, these were also in US dollars.

In its income tax returns for the 1987 and 1988 years of income, ERA claimed the discount on the notes as an allowable deduction under s 51(1) of the *Income Tax Assessment Act 1936* (Cth) ('*ITAA 1936*')<sup>13</sup> — that is, ERA claimed the difference between the proceeds

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<sup>9</sup> Since the time of writing this has been enacted as the *New Business Tax System (Taxation of Financial Arrangements) Act (No. 1) 2003* (Cth).

<sup>10</sup> *Energy Resources of Australia Ltd v FCT* (1994) 94 ATC 4225.

<sup>11</sup> *FCT v Energy Resources of Australia Ltd* (1994) 94 ATC 4923.

<sup>12</sup> *FCT v Energy Resources of Australia Limited* (1996) 96 ATC 4536, 4538.

<sup>13</sup> Such an amount would now be considered under s 8-1 of the *Income Tax Assessment Act 1997* (Cth).

received upon issue and the payment of the face value of the promissory notes as an allowable deduction.

Furthermore, ERA argued that as the obligation to pay the face value of the promissory notes did not arise until payment, the allowable deduction was incurred at the maturity date of the notes. As a consequence, the amount of the allowable deduction was the value of the discount, converted from US dollars ('USD') to Australian dollars ('AUD'), at the time the notes matured.

To illustrate, consider the following hypothetical example. Assume that ERA issued a promissory note at a face value of USD 1 000 000 repayable in 90 days' time. At the time of issue ERA received USD 900 000, being the proceeds of the issue. Expressed in US dollars the amount of the discount is USD 100 000. However, to determine the amount of the allowable deduction for Australian tax purposes it is necessary to express this discount in Australian dollars.<sup>14</sup> The argument advanced by ERA is that the discount constituted an allowable deduction under s 51(1) as soon as it became obliged to pay the face value of the notes, and ERA argued that this obligation arose when the notes matured.<sup>15</sup> As a result, it is necessary to convert the discount to Australian dollars at that point in time — that is, upon payment of the USD 1 000 000 face value after 90 days. Thus, if one Australian dollar is worth USD 0.80 at that date, the value of the discount in Australian dollars, and consequently the amount of the allowable deduction as per s 51(1) is AUD 125 000 (USD 100 000 / 0.80).

The Commissioner allowed the discount under s 51(1) but assessed the taxpayer on the basis that, as a result of currency fluctuations within the 90-day period, ERA had made a foreign exchange gain upon payment of the face value of the promissory notes, and this constituted assessable income under s 25(1) of the *ITAA 1936*.<sup>16</sup> The Commissioner argued that due to the frequency and regularity of the transactions, the issue of promissory notes represented an integral part of the taxpayer's operations and therefore any foreign exchange gains derived in respect of these transactions constitute income derived in the ordinary course of the taxpayer's business. As a result, the foreign exchange gain derived was on revenue account and therefore assessable under s 25(1).<sup>17</sup>

Thus, the Commissioner did not dispute that the discount, converted to Australian dollars, was an allowable deduction, but rather disputed the way in which ERA determined the amount of the allowable deduction. The Commissioner contended that the obligation or liability to pay the face value of the promissory notes arose when the promissory notes were issued and not when the face value is repaid at maturity. An allowable deduction, therefore, was incurred when the notes were issued. As a result, the Commissioner argued that the discount incurred when the notes were issued must be offset against any foreign exchange gains derived when the notes were repaid to determine a net allowable deduction. As a consequence, the amount of the allowable deduction was to take into account any exchange rate movements that occurred between the time of the obligation arising and the time of settlement.<sup>18</sup>

Specifically, the value of the discount in Australian dollars was to be calculated by deducting from the proceeds of the notes (converted into Australian dollars at the issue date of the notes), the cost of discharging the notes (converted into Australian dollars at the maturity

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<sup>14</sup> Section 20(1) of the *Income Tax Assessment Act 1936* (Cth) states: 'For all purposes of this Act, income wherever derived and any expenses wherever incurred shall be expressed in terms of Australian currency'.

<sup>15</sup> *FCT v Energy Resources of Australia Limited* (1996) 96 ATC 4536, 4538.

<sup>16</sup> *Ibid* 4537. Note: such an amount would now be considered under s 6-5 of the *Income Tax Assessment Act 1997* (Cth).

<sup>17</sup> Australian Taxation Office, *Taxation of Financial Arrangements: An Issues Paper* (1996) ('*TOFA IP*') para 11.9 reiterates that it is the view of the ATO that this is the appropriate way to deal with foreign currency denominated debt.

<sup>18</sup> *FCT v Energy Resources of Australia Limited* (1996) 96 ATC 4536, 4540-1.

date of the notes).<sup>19</sup> Such a method of calculation takes into account any exchange rate movements within this 90-day period.

To illustrate, continuing with our above example, the Commissioner argued that the value of the discount in Australian dollars was to be calculated by first converting the proceeds on issue of the note into Australian dollars at the issue date. If one Australian dollar is worth USD 0.75 at that date, this equates to AUD 1 200 000 (USD 900 000 / 0.75). It was then necessary to convert the face value of the note into Australian dollars at the time of ERA paying this amount, being the date of maturity. This equates to AUD 1 250 000 (USD 1 000 000 / 0.80). The value of the allowable deduction as per s 51(1) is then determined by deducting the Australian dollar equivalent, calculated at maturity, of the face value of the note from the proceeds upon issuing the note, converted into Australian dollars at the issue date. This equals AUD 50 000 (AUD 1 250 000 – AUD 1 200 000).<sup>20</sup>

In light of the above arguments forwarded by the parties to the action, two issues required resolution:

1. When did the obligation or liability to pay the face value of the promissory notes arise? It is at this point in time that an allowable deduction for the purpose of s 51(1) also arises; and
2. Did ERA make any foreign exchange gains as a consequence of the issue of the promissory notes, and if so when did they arise?

### B *Decision of the High Court*

The High Court, comprising Dawson, Toohey, Gaudron, McHugh and Kirby JJ, held that ERA incurred a liability in respect of the promissory notes when they were issued rather than when they were repaid. At the time of issue, ERA received or was entitled to receive the proceeds of the sale of the notes in US dollars and incurred a present obligation to pay the face value of the notes in US dollars in 90 days' time.<sup>21</sup>

Furthermore, it was held that an allowable deduction for the purpose of s 51(1) arose at the same time as the creation of the obligation. In terms of calculating the amount of the allowable deduction, the High Court determined that this was equal to the difference between the proceeds ERA received or was entitled to receive and the face value of the notes expressed in Australian dollars at the date of issue. Thus, as the allowable deduction arose when ERA incurred the obligation to pay the face value of the notes, the expression of the discount in Australian dollars is to take place at the time of issuing the notes.<sup>22</sup> Continuing with our

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<sup>19</sup> Ibid 4538.

<sup>20</sup> The Commissioner also submitted an alternative argument whereby the allowable deduction may be calculated by converting the discount into Australian dollars at the maturity date of the notes and deducting from it the reduced value of the proceeds received as at the date of maturity: at 4538. To illustrate, continuing with the above example, converting the discount of USD 100 000 to Australian dollars at the maturity date would give rise to a discount, in Australian dollars, of AUD 125 000 (USD 100 000 / 0.80). At the date of maturity the value of the proceeds received, expressed in Australian dollars, is AUD 1 125 000 (USD 900 000 / 0.80). At the date of issue the value of the proceeds received, expressed in Australian dollars, is AUD 1 200 000 (USD 900 000 / 0.75). The difference between these two amounts is AUD 75 000 and represents the reduced value of the proceeds received as at the maturity date of the note (AUD 1 200 000 – AUD 1 125 000). The Commissioner argued this amount must be deducted from the discount converted into Australian dollars at the date of maturity (AUD 125 000) to give the amount allowable as a deduction under s 51(1). This is AUD 50 000 (AUD 125 000 – AUD 75 000). The High Court, however, did not consider this method of determination.

<sup>21</sup> *FCT v Energy Resources of Australia Limited* (1996) 96 ATC 4536, 4540.

<sup>22</sup> Ibid. In contrast, consider the High Court decision in *Coles Myer Finance Ltd v FCT* (1993) 93 ATC 4214, which held that an allowable deduction, being the difference between the selling price and face value of the notes issued, was to be apportioned over the life of the notes. Thus, unlike ERA, Coles Myer Finance was not entitled to an immediate allowable deduction, but rather was required to spread the deduction over the life of the notes issued. It is argued that this is because the High Court, in the ERA decision, held that as the proceeds from the note issue were used in the current income year, an immediate allowable deduction within that year was appropriate. It appears, therefore, that the High Court in the ERA

example above, the High Court advocated expressing the discount (being USD 100 000) in Australian dollars at the time of issuing the promissory notes. At this point in time one Australian dollar is worth USD 0.75. The allowable deduction is, therefore, AUD 133 333 (USD 100 000 / 0.75).

It was also held ERA did not derive a foreign exchange gain as a consequence of the issue of the promissory notes because it did not convert any of the proceeds received into Australian dollars. ERA dealt only in US dollars. The proceeds received and the payments made by ERA were all in US dollars. As conversion did not occur, no exchange gains or losses could have resulted.<sup>23</sup>

The proceeds received from the promissory notes issued were not converted to Australian dollars at the time of issue, but rather used directly to discharge liabilities expressed in US dollars. Furthermore, the repayment of the promissory notes did not require conversion of the funds to US dollars to satisfy the liability outstanding, as such funds were already expressed in US dollars. As conversion was not necessary, any exchange rate movement between the time of issue and the time of repayment was irrelevant to ERA.<sup>24</sup>

The *ERA* decision warrants comparison with the recording and reporting of foreign currency denominated transactions for accounting purposes so as to highlight any incompatibility which exists between the two. In particular, four questions require consideration from an accounting perspective:

1. When did the liability to repay the face value of the promissory notes arise under SAC 4?
2. Was revenue derived due to the issue of promissory notes under AASB 1012?
3. If so, what amount is revenue under AASB 1012?
4. When was the discount/loss incurred under AASB 1012?

### III COMPARABILITY OF ERA CASE WITH SAC 4 DEFINITION AND RECOGNITION OF THE ELEMENTS OF FINANCIAL STATEMENTS

The High Court in the ERA case held that when the obligation to repay the face value of the promissory notes was established, an allowable deduction for the purposes of s 51(1) was incurred. The creation of such a liability was taken to be when the notes were issued and not when they matured. It is necessary to consider whether this decision is consistent with the creation of a liability in accounting practice.

Whilst not mandatory, SAC 4 provides guidance as to the characteristics which are to be present for a liability to be recognised for accounting purposes. More specifically, SAC 4 defines liabilities as ‘the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events’.<sup>25</sup> This

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decision interpreted the need for apportionment as being dependent upon the use of the proceeds received from the notes issued, as opposed to the life of the notes themselves.

<sup>23</sup> *FCT v Energy Resources of Australia Limited* (1996) 96 ATC 4536, 4540. See also D Hanlon, ‘Foreign Currency Translation: The Beginning of a New ERA’ (Paper presented at the AAANZ Conference, Adelaide, 3–6 July 1998).

<sup>24</sup> *Ibid* 4540. In contrast, consider the High Court decision in *International Nickel Australia Ltd v FCT* (1977) 77 ATC 4383, which held that as the repayment of the outstanding liability was less, when expressed in Australian dollars, than the value of the liability when the obligation arose, due to a favourable exchange rate movement, the foreign exchange gain was assessable income under s 25(1). It is argued this is because the liability was on revenue account and, unlike ERA, International Nickel converted Australian dollars, at the current exchange rate at the time, into pounds sterling to discharge the outstanding liability. As a result, any exchange rate fluctuation had an impact on the amount of Australian dollars required to discharge the liability.

<sup>25</sup> SAC 4 para 48. As of 1 January 2005, Australian Accounting Standards Board AASB *Framework for the Preparation and Presentation of Financial Statements* (‘AASB Framework’) superseded SAC 4 in defining financial statement elements. In particular, a liability is now defined as ‘a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (AASB



definition identifies three features of a liability that must be present. These are now considered in the context of the ERA case.

### *A Existence of a Present Obligation*

An essential characteristic of a liability is the existence of a present obligation, which represents ‘a duty or responsibility of the entity to act or perform in a certain way’.<sup>26</sup> Such an obligation ‘implies the involvement of two separate parties, namely the entity and a party external to the entity’<sup>27</sup> and most commonly ‘stems from legally binding contracts’.<sup>28</sup>

When the promissory notes were issued, ERA entered into an agreement with an external entity to repay the face value of the notes after 90 days had expired. The commitment to fulfil this duty arose when the agreement was entered into, which was at the time of issue — that is, the obligation itself arose when the commitment was made to repay the sums of money. Whilst this obligation was not satisfied until 90 days had passed, we are not concerned with when the liability was settled. Rather we are concerned with when the liability was created — that is, at the time of issue. At that point in time ERA was bound to fulfil its obligation, irrespective of such an obligation not being satisfied until 90 days had elapsed. Furthermore, failure to meet this commitment would ultimately represent a breach of the agreement and, as specified in SAC 4, ‘there is no doubt that legally enforceable obligations of an entity are liabilities’.<sup>29</sup>

### *B Future Sacrifice of Economic Benefits*

Another essential characteristic of a liability is that it has adverse financial consequences for the entity — that is, the entity is obliged to sacrifice economic benefits to another entity. Thus:

the existence of a liability depends on the present obligation being such that the ... consequences of failing to honour the obligation leave the entity little, if any, discretion to avoid the future sacrifice of economic benefits to another entity.<sup>30</sup>

ERA issued promissory notes under the condition that the face value of the notes would be repaid in 90 days’ time. Such an agreement had adverse consequences for ERA as it represented an obligation to disburse, or sacrifice, economic benefits in the form of cash at a future point in time. Furthermore, external parties to the agreement had the capacity to enforce repayment by ERA upon the commitment being created, as discussed above, thereby removing any discretion for ERA to avoid the future sacrifice.

Settlement of an obligation on a specified date does not prevent the existence of a liability.<sup>31</sup> Thus, the requirement of ERA to repay the face value of the notes in 90 days’ time does not prevent a liability from being recognised until such payment occurs. For a liability to exist there must be an obligation imposed on an entity to sacrifice future benefits that the entity has little or no discretion to avoid. As illustrated above, such discretion does not exist.

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Framework para 49). Despite the change in terminology, the essential characteristics of a liability remain. As such, the following analysis remains relevant.

<sup>26</sup> SAC 4 para 51.

<sup>27</sup> Ibid.

<sup>28</sup> SAC 4 para 54.

<sup>29</sup> SAC 4 para 57.

<sup>30</sup> SAC 4 para 61.

<sup>31</sup> SAC 4 para 63.

### *C Past Transactions or Other Past Events*

The third essential characteristic of a liability for accounting purposes is that the transaction or event creating the present obligation to sacrifice economic benefits must have occurred. As detailed above, the transactions giving rise to the commitment or obligation for ERA to repay the face value of the promissory notes was at the time of their issue. This constitutes the past transaction or past event for SAC 4 purposes and is consistent with the point in time at which the High Court held a liability was created.<sup>32</sup>

Based on the above analysis, it is concluded the definition of a liability under SAC 4 is satisfied at the point in time at which the High Court determined a liability to exist. However, additional criteria must be satisfied for a liability to be recognised under SAC 4. A liability shall be recognised only when ‘it is probable that the future sacrifice of economic benefits will be required; and the amount of the liability can be measured reliably’.<sup>33</sup> These are now considered in the context of the ERA case.

### *D Probability of Future Sacrifice of Economic Benefits*

One of the essential characteristics of a liability is that a future sacrifice of economic benefits will be required. However, such a sacrifice must be probable. In the present case, the obligation imposed upon ERA is termed ‘unconditional’ — that is, ‘only the passage of time is required to make their performance due’.<sup>34</sup> As a consequence, such an obligation ‘clearly satisf[ies] any criterion regarding the probability of the future sacrifice of economic benefits being required...’.<sup>35</sup>

### *E Reliable Measurement*

For a liability to satisfy the recognition criteria it is necessary that the amount of the liability can be measured reliably. The amount recorded as a liability represents the ‘monetary expression of the obligation to sacrifice economic benefits’.<sup>36</sup> In the present case, the amount of the obligation facing ERA is equal to the face value of the notes issued. Whilst the face value is expressed in US dollars, such an amount may be reliably converted to Australian dollars by examining the exchange rate at the date the obligation arose.<sup>37</sup>

In light of the above analysis, the High Court’s decision that a liability for taxation purposes is created when the promissory notes are issued is consistent with the definition and recognition criteria of SAC 4 and, as a consequence, also constitutes a liability for accounting purposes.

## IV COMPARABILITY OF ERA CASE WITH AASB 1012 FOREIGN CURRENCY TRANSLATION

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<sup>32</sup> Hanlon (1998), *Foreign Currency Translation: The Beginning of New Era*, above n 23, 21.

<sup>33</sup> SAC 4 para 65. This is restated in AASB Framework, as a financial statement element ‘should be recognised if: (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and (b) the item has a cost or other value that can be measured with reliability’ (AASB Framework para 83).

<sup>34</sup> SAC 4 para 66.

<sup>35</sup> Ibid.

<sup>36</sup> SAC 4 para 69.

<sup>37</sup> It is questionable whether this value remains a reliable measure of the amount of the outstanding liability. The face value of the notes issued, converted to Australian dollars using the exchange rate at the date the obligation arose, is no longer accurate if exchange rate fluctuations subsequently occur. It is unfeasible, however, to adjust the value of the liability subsequent to each exchange rate movement in order to provide a reliable measure of the amount outstanding.

AASB 1012<sup>38</sup> specifically governs foreign exchange gains and losses on both foreign currency denominated transactions and the translation of the accounts of foreign subsidiaries.<sup>39</sup> For the purposes of this article, emphasis is placed on foreign currency denominated transactions. It is perhaps easiest to illustrate the inconsistencies of the decision reached in *ERA* and accounting practice as per AASB 1012 by outlining the journal entries necessary to comply with both the *ERA* judgement and accounting practice:

- (a) when the promissory note is issued; and
- (b) when the face value of the promissory note is repaid.

#### A Operation of AASB 1012 Foreign Currency Translation

Continuing with the example outlined previously, according to the High Court, *ERA* is entitled to an allowable deduction of AUD 133 333, that being the discount determined when the promissory note was issued. The discount is recognised at the time of issue because the taxpayer is deemed to have incurred a liability to repay the face value of the promissory note when it is issued.<sup>40</sup> Based on this, the journal entry at the time of issue would be as follows:

		AUD	AUD	
DR	Cash	1 200 000		
DR	Discount expense	133 333		
CR	Liability		1 333 333	(1)
	(Cash: USD 900 000 / 0.75)			
	(Discount expense: AUD 1 333 333 – AUD 1 200 000)			
	(Liability: USD 1 000 000 / 0.75)			

As the above entry illustrates, the proceeds from the note issue (AUD 1 200 000) are less than the obligation to repay the face value of the promissory note (AUD 1 333 333). The difference between the proceeds and the obligation at the time of issue (AUD 133 333) represents a discount, which is an allowable deduction at that point in time under s 51(1).

Furthermore, in complying with the *ERA* decision, no foreign exchange gains or losses exist as there was no conversion into Australian dollars — that is, any movement in the exchange rate between the time the obligation to repay the face value of the promissory note arises and the time of repayment is not recognised. Given this, the liability, as expressed in Australian dollars, will remain constant over the 90-day period. The appropriate journal entry when repayment takes place, therefore, would be:

		AUD	AUD	
DR	Liability	1 333 333		
CR	Cash		1 333 333	(2)
	(Liability: USD 1 000 000 / 0.75)			
	(Cash: USD 1 000 000 / 0.75)			

As this entry illustrates, there is no recognition of the exchange rate movement over the 90-day period. Thus, despite the movement in the exchange rate from USD 0.75 at the time of issue to USD 0.80 at the time of repayment, the liability and the cash outlay to satisfy this obligation are based on the exchange rate at the time of issue.

<sup>38</sup> Effective 1 January 2005, Australian Accounting Standards Board AASB 121 *The Effects of Changes in Foreign Exchange Rates* ('AASB 121') supersedes AASB 1012. As illustrated by the following analysis, the accounting treatment of foreign currency denominated transactions does not alter.

<sup>39</sup> It must be noted that, in accordance with s 296(1) of the *Corporations Law 1991* (Cth), accounting standards have the force of law.

<sup>40</sup> D Hanlon, 'Foreign Currency Translation: Accounting and Tax Practices', *CPA Communiqué*, September 1998, 1.

In terms of accounting practice, AASB 1012 states:

Subject to paragraph 5.2, each *asset, liability*, item of *equity, revenue* or *expense* arising from entering into a *foreign currency transaction*<sup>41</sup> must be *recognised* and translated using the *spot rate* at the date of the transaction.<sup>42</sup>

In light of the above, when the proceeds of the promissory note issue (USD 900 000) are received ERA is to measure this in Australian dollars at an exchange rate of 0.75. This equates to AUD 1 200 000. Furthermore, as a liability also arises at this point in time (USD 1 000 000) ERA is to measure the obligation to repay the face value of the note in Australian dollars at an exchange rate of 0.75. This gives rise to a liability of AUD 1 333 333. As a consequence, a discount expense arises, equal to AUD 133 333 (AUD 1 200 000 – AUD 1 333 333). The journal entry at the time of issue to recognise this is as follows:

		AUD	AUD	
DR	Cash	1 200 000		
DR	Discount expense	133 333		
CR	Liability		1 333 333	(1)
	(Cash: USD 900 000 / 0.75)			
	(Discount expense: AUD 1 333 333 – AUD 1 200 000)			
	(Liability: USD 1 000 000 / 0.75)			

This entry is consistent with the journal entry necessary to comply with the *ERA* decision. AASB 1012, however, allows for the retranslation of outstanding foreign currency monetary items, as it states:

Subject to paragraph 5.4, *foreign currency monetary items*<sup>43</sup> outstanding at the *reporting date* must be translated at the *spot rate* at *reporting date*. Other items outstanding at the *reporting date* must not be retranslated subsequent to the initial *recognition* of the transaction.<sup>44</sup>

Upon a monetary item existing, AASB 1012 states:

Subject to paragraphs 5.6 and 6.5,<sup>45</sup> *exchange differences* must be *recognised* as *revenues* or *expenses* in the *net profit or loss/result* in the reporting period in which the *exchange rates* change.<sup>46</sup>

<sup>41</sup> Encompassing the issue of promissory notes by ERA, a foreign currency transaction means ‘a transaction that is denominated in or requires settlement in a *foreign currency*’ (AASB 1012, para 10.1).

<sup>42</sup> AASB 1012 para 5.1. AASB 121 is consistent with this, stating a ‘foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the *spot exchange rate* between the functional currency and the foreign currency at the date of the transaction’ (AASB 121 para 21).

Note: Paragraph 5.2 of AASB 1012 stipulates that where a foreign currency contract fixes an exchange rate for translation purposes, such a rate must be used. As the promissory note issue by ERA did not specify a fixed exchange rate, it does not impact on our analysis.

<sup>43</sup> A foreign currency monetary item is defined as ‘money held and assets and liabilities to be received or paid in fixed or determinable amounts of money’ (AASB 1012, para 10.1). In the present case, the outstanding promissory notes repayable by ERA at face value represent a liability repayable at a fixed or determinable amount.

<sup>44</sup> AASB 1012 para 5.3. AASB 121 para 23 reiterates this, stating ‘[a]t each reporting date: (a) foreign currency monetary items shall be translated using the *closing rate*’, which is defined as ‘the spot exchange rate at the reporting date’ (AASB 121 para 8).

Note: Paragraph 5.4 of AASB 1012 stipulates that monetary items arising under a foreign currency contract, which fixes an exchange rate for translation purposes, must be retranslated at the exchange rate fixed in the contract. As the promissory note issue by ERA did not specify a fixed exchange rate, it does not impact on our analysis.

<sup>45</sup> As paragraph 5.6 of AASB 1012 is concerned with a foreign currency monetary item attributable to the acquisition of a non-current asset, and paragraph 6.5 of AASB 1012 relates to hedging commitments, neither affects the foreign currency contract entered into by ERA.

It is necessary, therefore, to recognise separately from the discount expense any revenue or expense due to exchange rate movements. To illustrate, the liability to repay the face value of the promissory note arose when it was issued. At that time one Australian dollar was worth USD 0.75. However, it was not until 90 days later that this liability was settled — that is, when ERA repaid the USD 1 000 000. At that point in time one Australian dollar was worth USD 0.80. Based on the new exchange rate value, USD 1 000 000 is equivalent to AUD 1 250 000 (USD 1 000 000 / 0.80). Recall, however, that at the time the liability was incurred, the liability was equivalent to AUD 1 333 333. Thus, due to an upward exchange rate movement, the cash outlay necessary to settle the liability is reduced by AUD 83 333 (AUD 1 333 333 – AUD 1 250 000). This represents a foreign exchange gain as it is a reduction in the amount payable, expressed in Australian dollars, as a consequence of an upward movement in the exchange rate. The journal entry to recognise this at the time of repayment is thus:

		AUD	AUD	
DR	Liability	1 333 333		
CR	Foreign exchange gain	83 333		
CR	Cash		1 250 000	(2)
	(Liability: USD 1 000 000 / 0.75)			
	(Foreign exchange gain: AUD 1 333 333 – AUD 1 250 000)			
	(Cash: USD 1 000 000 / 0.80)			

The above entry illustrates the effect an upward movement in the exchange rate has on the obligation to repay the face value of the promissory note issued. The obligation, as determined at the time the obligation arises, is equal to AUD 1 333 333. However, due to a movement in the exchange rate the amount payable to settle the obligation at the time of repayment is AUD 1 250 000. The reduction in the amount payable represents a foreign exchange gain as per AASB 1012.<sup>47</sup>

Accordingly, in accounting practice, the taxpayer incurred an overall cost of AUD 50 000 — this being a combination of the discount expense and a reduction in the value of the amount payable due to a favourable movement in the exchange rate. Ultimately, this is consistent with the argument advanced by the Commissioner in the ERA case.

Thus, based on the above analysis, disparity exists in the decision of the High Court in *ERA*, and accounting practice, as per AASB 1012, concerning foreign currency denominated transactions. This is best illustrated by summarising the journal entries from both an accounting and taxation perspective, when the promissory note is both issued and repaid, in table format, as shown in Table 4.1:

<sup>46</sup> AASB 1012 para 5.5. This is consistent with AASB 121, which states '[e]xchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in a previous financial report, shall be recognised in profit or loss in the period in which they arise' (AASB 121 para 28).

<sup>47</sup> Hanlon (1998), *Foreign Currency Translation: Accounting and Tax Practices*, above n 40, 3.

**Table 4.1**  
**A SUMMARY OF THE JOURNAL ENTRIES CONCERNING THE ISSUE AND REPAYMENT OF**  
**PROMISSORY NOTES FROM AN ACCOUNTING AND TAXATION PERSPECTIVE**

<i><b>ERA High Court decision</b></i>	<b>AASB 1012/AASB 121</b>				
<i><b>Upon Issue</b></i>					
	AUD	AUD		AUD	AUD
DR Cash	1 200 000		DR Cash	1 200 000	
DR Discount expense	133 333		DR Discount expense	133 333	
CR Liability		1 333 333	CR Liability		1 333 333
<i><b>Upon Repayment</b></i>					
	AUD	AUD		AUD	AUD
DR Liability	1 333 333		DR Liability	1 333 333	
			CR Exchange gain		83 333
CR Cash		1 333 333	CR Cash		1 250 000

It is important to recognise that from an accounting perspective there is:

1. A discount expense of AUD 133 333 upon issue of the promissory notes; and
2. A foreign exchange gain of AUD 83 333 upon maturity of the promissory notes.

From a taxation point of view, however, there is:

1. A discount expense of AUD 133 333; and
2. A non-taxable gain of AUD 83 333

It seems, therefore, that while there is an alignment of accounting and taxable concepts in measuring the discount expense of AUD 133 333 upon issuing the promissory notes, there is a different outcome in assessing the gain of AUD 83 333 upon maturity of the notes. This is because, while AASB 1012 stipulates the gain is to be treated as revenue, from a tax perspective this amount is non-taxable. As indicated earlier, such disparity arises due to the fact that ERA dealt only in US dollars. As conversion did not occur, no exchange gains or losses could have resulted.

In light of the above, the implication of the High Court is that the *ERA* decision would have been decided differently if ERA had converted the proceeds received into Australian dollars and, subsequently, reverted back to US dollars to discharge the outstanding liability. Continuing with our example, it may be argued that if an amount of Australian currency had been converted to US dollars to repay the liability upon maturity, a foreign exchange gain of AUD 83 333 would have been realised.<sup>48</sup>

### *B Different Income Years*

In determining the foreign exchange gain or loss arising upon discharge of the outstanding liability, the analysis has been based upon a comparison in time when a promissory note issue, and subsequent discharge, has taken place in one income year. It is worthwhile extending this analysis to consider the situation in which the period between issuing and discharging the promissory notes straddles two income years.

<sup>48</sup> On 17 December 2002, an Exposure Draft of the New Business Tax System (Taxation of Financial Arrangements) Bill 2002 was released, which proposed removing the need for actual conversion for a foreign exchange gain to arise. This will be discussed further in Section V of this article.

Continuing with the above example, assume that, in between the note issue and repayment, the income year comes to an end on 30 June 20X2 and one Australian dollar is worth USD 0.77. In accordance with para 5.5 of AASB 1012 / para 28 of AASB 121, there is a need to:

1. Recognise a discount expense of AUD 133 333 upon issue of the notes;<sup>49</sup>
2. Recognise a foreign exchange gain of AUD 34 632 at the end of the reporting period, despite it being unrealised (USD 1 000 000 / 0.75 – USD 1 000 000 / 0.77);<sup>50</sup> and
3. Recognise a foreign exchange gain of AUD 48 701 upon maturity of the notes (USD 1 000 000 / 0.77 – USD 1 000 000 / 0.80). Across both reporting periods, this gives rise to a foreign exchange gain totalling AUD 83 333 (AUD 1 333 333 – AUD 1 250 000).

Based on the above, the journal entries in accordance with AASB 1012/AASB 121 are as follows:

(1) Upon Issue

	AUD	AUD
DR Cash	1 200 000	
DR Discount expense	133 333	
CR Liability		1 333 333
	(Cash: USD 900 000 / 0.75)	
	(Discount expense: AUD 1 333 333 – AUD 1 200 000)	
	(Liability: USD 1 000 000 / 0.75)	

(2) 30 June 20X2

	AUD	AUD
DR Liability	34 632	
CR Foreign exchange gain		34 632
	(Liability: USD 1 000 000 / 0.75 – USD 1 000 000 / 0.77)	
	(Foreign exchange gain: USD 1 000 000 / 0.75 – USD 1 000 000 / 0.77)	

(3) Upon Maturity

	AUD	AUD
DR Liability	1 298 701	
CR Foreign exchange gain	48 701	
CR Cash		1 250 000
	(Liability: USD 1 000 000 / 0.75 – AUD 34 632)	
	(Foreign exchange gain: USD 1 000 000 / 0.77 – USD 1 000 000 / 0.80)	
	(Cash: USD 1 000 000 / 0.80)	

By way of comparison, the tax consequences as at 30 June 20X2 would be to recognise the discount expense of AUD 133 333 as a deduction under s 8-1 of the *ITAA 1997*, while the unrealised gain of AUD 34 632 would not be recognised. Thus, the accounting and taxation

<sup>49</sup> In accordance with the matching principle, it is arguable that the discount expense is to be spread over the life of the promissory notes. If the life of these notes straddles more than one income year, this may require the discount expense to be apportioned across these income years. Continuing with the above example, and assuming the life of the promissory notes is evenly spread across both income years, a discount expense of AUD 66 667 would be recognised in the income year ending 30 June 20X2 and AUD 66 666 in the following period.

<sup>50</sup> This is consistent with SAC 4, as '[t]he inflows or other enhancements of future economic benefits or savings in outflows of future economic benefits that constitute revenues may be of various kinds. For example, revenues in the form of savings in outflows of future economic benefits can arise ... where liabilities are forgiven and where exchange gains arise on translation of loans denominated in a foreign currency' (SAC 4 para 113).

measures of income vary significantly when a promissory note issue straddles two income years.

## V PROPOSALS FOR CHANGE

In recent times, considerable debate has surrounded the appropriate taxation of financial arrangements, a component of which is the tax treatment of foreign exchange gains and losses. In 1993, *Taxation of Financial Arrangements: A Consultative Document* ('*TOFA CD*')<sup>51</sup> was released and recommended a retranslation basis of recognising foreign exchange gains or losses. This was subsequently endorsed in *Taxation of Financial Arrangements: An Issues Paper* ('*TOFA IP*'),<sup>52</sup> which was issued in December 1996. While consistent with AASB 1012, the tax consequences of the retranslation approach would be to tax unrealised gains at the end of an income year arising from exchange rate movements.

In July 1999, the Ralph Report recommended the adoption of a mark to market basis of valuing financial assets and liabilities.<sup>53</sup> Also consistent with AASB 1012, the mark to market approach involves the conversion of a foreign currency denominated financial asset or liability to Australian dollars at the exchange rate prevailing at the end of the relevant income year. However, like the retranslation approach endorsed in *TOFA CD* and *TOFA IP*, the mark to market approach recognises and taxes unrealised foreign exchange gains or losses where the holding of the asset or liability straddles more than one income year.

On 17 December 2002, an Exposure Draft of the New Business Tax System (Taxation of Financial Arrangements) Bill 2002 was released, which considers the taxation of foreign exchange gains and losses. Later enacted as the *New Business Tax System (Taxation of Financial Arrangements) Act* (No. 1) 2003 (Cth) ('*NBTS FA 2003*'), two principles are of particular interest.

First, sub-div 775-B of the *ITAA 1997* identifies points in time at which foreign exchange gains or losses are to be realised for taxation purposes. In particular, foreign exchange gains or losses will be treated as assessable or deductible upon the occurrence of a 'realisation event'. One such realisation event is when the taxpayer ceases to have a liability to pay an amount of foreign currency.<sup>54</sup> This will arise where the taxpayer repays the liability.<sup>55</sup> Upon satisfying the liability, the taxpayer has made a foreign exchange gain if the amount paid is less than the amount outstanding when the liability was created due to exchange rate movements.<sup>56</sup>

Second, a general conversion rule exists that converts foreign currency denominated amounts into Australian dollars irrespective of whether actual conversion took place.<sup>57</sup> It is, therefore, a departure from the *ERA* decision, which held actual conversion must occur to recognise a foreign exchange gain.<sup>58</sup> A liability to pay an amount of foreign currency must be

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<sup>51</sup> Australian Taxation Office, *Taxation of Financial Arrangements: A Consultative Document* (1993) ('*TOFA CD*').

<sup>52</sup> *TOFA IP*, above n 17.

<sup>53</sup> *Ralph Report*, above n 6, Recommendation 9.1(a).

<sup>54</sup> *Income Tax Assessment Act 1997* (Cth) s 775-55(1).

<sup>55</sup> John Morgan and John Riley, 'Taxation of Financial Arrangements Bill – Exposure Draft' (2003) 37(8) *Taxation in Australia* 417.

<sup>56</sup> *Income Tax Assessment Act 1997* (Cth) s 775-55(3). It is only when a realisation event has occurred that a taxpayer may be assessed on a foreign exchange gain. As the end of an income year is not included as a realisation event, it prevents a taxpayer being assessed on unrealised foreign exchange gains because a financial asset or liability straddles more than one income year. This overcomes the deficiencies of the retranslation approach proposed in *TOFA CD* and *TOFA IP*, and the mark to market approach recommended in the Ralph Report.

<sup>57</sup> *Income Tax Assessment Act 1997* (Cth) s 960-50(6) Item 1.

<sup>58</sup> *FCT v Energy Resources of Australia Limited* (1996) 96 ATC 4536, 4540. The Explanatory Memorandum, New Business Tax System (Taxation of Financial Arrangements) Bill (Cth) 2002 recognises the departure, stating that without realising



converted to Australian dollars under the general conversion rule when the liability is created.<sup>59</sup> A foreign exchange gain will arise if the amount paid, in Australian dollars, which triggers the realisation event is less than the amount originally owing as determined under the general conversion rule.

With respect to the ERA case, upon payment of the face value of the promissory notes at maturity ERA ceased to be obliged to pay US dollars to the promissory note holders. Furthermore, the amount paid to satisfy the liability was less than the amount outstanding upon issue of the notes when expressed in Australian dollars.<sup>60</sup> Continuing with the example outlined previously, *NBTS FA 2003* would treat as assessable income the foreign exchange gain of AUD 83 333 derived by ERA. This, as illustrated above, is equal to the amount of revenue recognised under AASB 1012/AASB 121.

## VI CONCLUSION

The High Court decision in *ERA* is a hallmark decision concerning the tax consequences of holding foreign currency denominated debt where there is a variation in the exchange rate. The decision establishes that a discount on debt, which is in the form of promissory notes, is a deduction to be determined at the time of issue using the prevailing exchange rate. Furthermore, where there is a favourable movement in the exchange rate between the time of issue and maturity this does not give rise to a foreign exchange gain if the taxpayer deals only in foreign currency. That is, if actual conversion to Australian dollars does not occur.

From an accounting perspective, however, it is apparent that, in accordance with the retranslation of foreign currency monetary items that are outstanding at reporting date, a foreign currency denominated transaction under AASB 1012/AASB 121 may give rise to a foreign exchange gain. Thus, even if a firm deals only in foreign currency and does not convert to Australian dollars, a favourable exchange rate movement will generate revenue for the firm. Moreover, AASB 1012/AASB 121 also recognises a foreign exchange gain at the end of a reporting period when the outstanding liability extends to more than one reporting period.

In the context of recent tax reform initiatives, with particular respect to *NBTS FA 2003*, a departure from the *ERA* decision is apparent. It is argued there is a recognised need to assess as income favourable exchange rate movements on foreign currency denominated transactions. In particular, *NBTS FA 2003* states that a taxpayer convert foreign currency denominated amounts to Australian dollars, irrespective of whether actual conversion occurs, and assess the taxpayer on any foreign exchange gain arising from such conversion. This is consistent with AASB 1012/AASB 121, and represents a shift to reduce the divergence between accounting practice and taxation law.

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gains and losses on foreign currency denominated transactions, irrespective of whether actual conversion to AUD occurs, 'foreign currency gains and losses arising out of "business" transactions may fall outside the income tax net. This possibility is illustrated by *FCT v Energy Resources of Australia Ltd* (1996) 185 CLR 66 ('the ERA case') (ch 2, para 2.7).

<sup>59</sup> *Income Tax Assessment Act 1997* (Cth) s 775-55(7).

<sup>60</sup> *FCT v Energy Resources of Australia Limited* (1996) 96 ATC 4536, 4540.

## ***AUSTRALASIAN JAM CO PTY LTD V FEDERAL COMMISSION OF TAXATION — A RETROSPECTIVE***

DAVID M SMITH\*

ABSTRACT: On 9 September 1953, Mr Justice Fullagar of the High Court of Australia handed down his judgment in the most significant case dealing with the valuation of trading stock under the Australian federal income tax legislation.<sup>1</sup> This case, *Australian Jam Co Pty Ltd v FCT* ('*Australasian Jam*')<sup>2</sup> is significant in that it settled most of the issues concerned with the application of the relevant provisions of the *Income Tax Assessment Act 1936* (Cth).<sup>3</sup> It clarified how the choice between permitted methods is to be made and considered major issues dealing with the meaning of the valuation methods permitted for income tax purposes.

This article firstly considers the state of law prior to the handing down of the decision so that its impact can be seen in its contemporary context. Secondly, it considers *Australasian Jam* and the clarification of the legislative scheme for the valuation of trading stock for taxation purposes and the issues the case resolves with respect to the to this legislative scheme,<sup>4</sup> and the relationship with commercial business practice and the taxation requirements. Thirdly it applies the reasoning of the case to settle unresolved questions as to the valuation of trading stock in the Australian context. These issues include the use of the 'Last In, First Out' ('LIFO'), 'Next In First Out' ('NIFO') and 'datum value' methods for determining 'cost price' and the meaning of 'the price at which it can be replaced' (now 'replacement value').

The article then compares the tax situation to the accounting practices with respect to the valuation of trading stock at the time in Australia as reflected in surveys of published accounts, the accounting literature and pronouncements of the accounting profession.

### I INTRODUCTION

On 9 September 1953, Mr Justice Fullagar of the High Court of Australia handed down his judgment in the most significant case dealing with the valuation of trading stock under the federal income tax legislation. This case, *Australian Jam Co Pty Ltd v FCT* ('*Australasian Jam*'),<sup>5</sup> is significant in that it settled most of the issues concerned with the application of the

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<sup>1</sup> The relevant sections were ss 28 to 31 of the *Income Tax Assessment Act 1936* (Cth).

<sup>2</sup> (1953) 88 CLR 23; 5 AITR 566; 10 ATD 217.

<sup>3</sup> There were two remaining issues. The first — whether direct or absorption cost was to be used to determine cost — was settled for manufacturers in *Philip Morris Limited v FCT* (1979) 10 ATR 44; 79 ATC 4352. The second issue — the meaning of the price at which it can be replaced (now referred to as 'replacement value' in s 70-45 of *Income Tax Assessment Act 1997*(Cth) — is still to be determined by the Australian courts.

<sup>4</sup> The case also considered whether the Commissioner had the power to make the amendments to the original assessments.

<sup>5</sup> *Australasian Jam* (1953) 88 CLR 23; 5 AITR 566; 10 ATD 217. Note: the author always advises students that any question of whether a particular method valuation of trading stock is permissible for taxation purposes can be answered directly from this case or indirectly by way of analogy.

relevant provisions of the *Income Tax Assessment Act 1936* (Cth), namely ss 28–31.<sup>6</sup> In a mere 3,330 words<sup>7</sup> Fullagar J’s judgment clarified how the choice between permitted methods worked and considered major issues dealing with the valuation methods permitted for valuing trading stock for income tax purposes. One point that is not usually associated with the case was that it gave some clarification to the meaning of the term ‘trading stock’ as defined by s 6(1) of *ITAA 1936*. Fullagar J also considered the operation of s 29 of the Act.

## II BACKGROUND

The main provision with which Fullagar J was primarily concerned was s 31 of the *Income Tax Assessment Act 1936* (Cth) which provided that:

31(1) [Value of trading stock]

Subject to this section, the value of *each article* of trading stock (not being live stock) to be taken into account at the end of the year of income shall be, *at the option* of the taxpayer, its *cost price or market selling value or the price at which it can be replaced*<sup>8</sup>

The first Australian federal income tax legislation was enacted in 1915 (Act No 34 of 1915), namely the *Income Tax Assessment Act 1915* (Cth) (*‘ITAA 1915’*). The relevant provisions dealing with the valuation of trading stock were in s 14(a), which provided:

14 The income of any person shall include-

(a) profits derived from any trade or business and converted into stock-in-trade or added to the capital of or in any way invested in the trade or business:

Provided that for the purpose of computing such profits *the value* of all live-stock, produce, goods and merchandise (not being plant used in the production of income) not disposed of at the beginning and end of the year in which the income was derived shall be taken into account;<sup>9</sup>

Thus, under s 14(a) of the *ITAA 1915* ‘the value’ of trading stock on hand at the end of the year had to be taken into account in determining income for taxation purposes. However, no guidance was given as to how such trading stock was to be valued.

The *Income Tax Assessment Act 1922* (Cth) (*‘ITAA 1922’*) was far more specific in its treatment of the valuation of trading stock. The relevant provision is s 16 which provided:

16. The assessable income of any person shall include-

(a) profits derived from any trade or business and converted into stock-in-trade or added to the capital of or in any way invested in the trade or business:

Provided that for the purpose of computing such profits the value of all live stock (not being live stock used as beasts of burden or as working beasts), and trading stock (not being live stock), not disposed of at the beginning and end of the period in which the

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<sup>6</sup> There were two remaining issues. Firstly, whether direct or absorption cost was to be used to determine cost. This issue was settled for manufacturers in *Philip Morris Limited v FCT* (1979) 79 ATC 4352; 10 ATR 44 but see comments of David M Smith, ‘Direct Cost or Absorption Cost: The Choice for Income Tax Purposes’ (1998) 17(1) *Australian Tax Review* 9. Obst and Smith question the application of absorption cost method to primary producers. The second issue is the meaning of the price at which it can be replaced: Wes Obst and David M Smith, ‘A critical analysis of ED 5 - the proposed simplification of Trading Stock Provisions’ (Paper presented at the Australasian Tax Teachers Association Conference, 19–20 January 1996, Brisbane). This issue is still to be determined by the Australian courts. The decision in *Parfew Nominees v FCT* (1986) 17 ATR 1017; 86 ATC 4673, settled little, if anything, as to the meaning or application of the words, and its significance has been vastly over rated by most commentators. The current author has grave reservations about the reasoning in the case.

<sup>7</sup> This concise judgment can be compared to the 120 page reasoning of Deputy President Mr J Block in [2002] AATA 746 *Re Ciprian and Others v FCT* 50 ATR 1257, the 12 000 words of Lindgren J in *Energy Resources of Aust Ltd v FCT* [2003] FCA 26 (2003) 52 ATR 120, 2003 ATC 4024 and the 6400 words used in Jenkinson J’s judgment in *Philip Morris Limited v FCT*, (1979) 10 ATR 44; 79 ATC 4352.

<sup>8</sup> Emphasis added.

<sup>9</sup> Emphasis added.

income was derived shall be taken into account: For the purposes of this paragraph “Value” means-

- (i) in the case of live stock (not being live stock used as beasts of burden or as working beasts) the values as prescribed; and
- (ii) in the case of trading stock (not being live stock) - the actual *cost price* or *market selling value* of each article of trading stock, or *the price at which each article of trading stock can be replaced, at the option of, the taxpayer in respect of each article;*<sup>10</sup>

The reason for allowing these three methods for valuing trading stock for taxation purposes is difficult to discover. None the standard works on Australian income tax give any clue as the origin of the choice of these methods, however A A Fitzgerald has stated that:

When the present Section 31 was inserted in the Income Tax Assessment Act in 1922, the then treasurer, Mr. S. M. Bruce, said that it “contemplates all the possible and reasonable bases upon which trading stock could be taken with justice ‘to the individual taxpayer and the Department’.” It was believed for many years that the options given by Section 31 were satisfactory to the taxpayer<sup>11</sup>

### III CONTEXT OF *AUSTRALASIAN JAM* — THE PRIOR LAW

Other than *Australian Jam* there are only a handful of court cases in the Australian jurisdiction which deal with the proper methods of valuing ‘trading stock’ under s 31 of the *ITAA 1936*. A discussion of the relevant sections of the judgments in these cases will put Fullagar J’s judgment in *Australian Jam* in its proper context.

In *Moreau v FCT*,<sup>12</sup> the taxpayer had purchased goods from France and, when they were delivered into stock, the cost price in French francs was entered into the records; beside the actual price was a conversion to pounds sterling. The contract price was specified in francs and unalterable. Isaacs J described the facts and concluded his findings as follows:

When goods were purchased from France, the price was agreed upon in francs, and as francs the price was inalterable. On arrival into stock, the cost price in francs was entered but alongside that actual price there was a conversion into pounds sterling at the rate of 25 francs to the pound. ... It happened that before the price became payable, the value of the franc fell so that fewer pounds sterling had to be taken out of the business in order to provide the necessary number of francs. ... The taxpayer’s contention is that the number of pounds sterling originally reckoned at 25 francs to the pound is the proper cost price for income tax purposes; the Commissioner contends that the number of pounds sterling eventually and actually used to pay for the goods is the true cost price. I agree with the Commissioner. ... but the important and only relevant fact in this connection is the actual amount of Australian money used for the purpose.<sup>13</sup>

Thus, it is the actual price paid that is the actual cost price incurred and not the anticipated cost price when the goods were ordered or delivered, which is relevant in determining the cost of trading stock under s 31.<sup>14</sup> It can also be argued to the contrary that on the basis of the foreign exchange cases where the payment takes place in a later year of income the full amount should be shown as the cost of the items of trading stock: see *Texas*

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<sup>10</sup> Emphasis added.

<sup>11</sup> A A Fitzgerald, ‘A Further Note on the Valuation of Trading Stock’ (1944) 14 *The Australian Accountant* 424, 270. Although Fitzgerald gives no citation for this quote, it is from the Second Reading Speech of the Treasurer Mr Bruce to the *Income Tax Assessment Bill 1922: Commonwealth, Parliamentary Debates*, House of Representatives, 2 October 1922, 2724.

<sup>12</sup> (1920) 39 CLR 65; R&McG 84.

<sup>13</sup> (1920) 39 CLR 65, 70. (Note: the ‘Commissioner’ here and below is the Federal Commissioner of Taxation)

<sup>14</sup> These comments fit well with the decision of Fullagar J in *Ballarat Brewing Company Limited v FCT* (1951) 82 CLR 365; 5 AITR 151; 9 ATD 254, and may be contrasted with the comments of Jenkinson J in *FCT v Cadbury-Fry Pascal (Aust) Ltd (In vol liq)* (1979) 10 ATR 55; 79 ATC 4346.

*Co (Australasia) Ltd v FCT*.<sup>15</sup>

In *Farnsworth v FCT*,<sup>16</sup> Latham CJ rejected the Commissioner's contention that the taxpayer's share of the estimated proceeds of the sale of the dried fruits (£A 684) could not be regarded as any measure of value:

The amount of £ 648 was not an estimate of the value of any fruit owned by the taxpayer which was then on hand. It was an estimate of what she would probably receive after 30th June 1943 so as to pay her on a pooling basis the total amount which she would be entitled to receive for all her fruit from the total proceeds of all pooled fruit. The amount of £ 648 was an estimate of probable future income. Each grower had on 30th June 1943 a right to receive further progress payments and a final payment, but that right was not stock in trade. It was not something produced for the purpose of being sold. Nor was the separate interest of each grower in the mass of pooled fruit something produced for the purpose of being sold. These separate interests did not become the subject of sale. Such interests are not "articles" within s.31....

... These statements refer to debts owed to a taxpayer continuously carrying on a trading business which upon any system of accounting would be regarded as book debts.... But the amount of £ 648 in the present case was not a debt owed by any person to the taxpayer. It represented only an estimate of what the taxpayer would probably be paid if the mass of fruit were all sold and paid for. Accordingly, in my opinion, this amount should not be included as if it were a debt owed to the taxpayer.<sup>17</sup>

Summing up, Rich J noted:

In my opinion, when the appellant handed over her fruit and it was processed she ceased to be the owner of it and it was not part of her stock in trade. If and when stock is sold and the proceeds of sale are received by the owner, such proceeds become assessable income from the date of sale. The sum in question was merely a prophetic estimate of the share of the net proceeds of sale she might receive after the sale.<sup>18</sup>

Thus once again, one must deal with real values, not anticipated values when determining the value of trading stock for income tax purposes.

In *The Commissioner of Taxation of Western Australia v D & W Murray Ltd*,<sup>19</sup> the High Court considered the effect of particular rebates received by the taxpayer with respect to the certain cost of acquiring their trading stock, that is, purchasing expenses, insurance in transit et cetera. The Court in its judgment decided as follows:

We think that in a proper ascertainment of the profits of the business in Western Australia the rebates would be thrown against the expenditure or payments in respect of which they were made and received, and therefore treated as a mere diminution of expenses.<sup>20</sup>

Cost price was also considered by the Commonwealth Taxation Board of Review in (1947) 14 CTBR(Reprints) *Case 10*, where by default the taxpayers ( a department store) had chosen to value all their trading stock at cost and then applied uniform mark ups to the cost price of the trading stock to determine the stock's selling price. The selling prices were reviewed regularly and the prices of slow-moving items reduced, with the consequential reduction of the 'cost price' used by the taxpayer for taxation purposes. This reduced 'cost price' being calculated by applying the uniform mark-up to the reduced selling price. The facts in this case are remarkably similar to those in United Kingdom case of *B.S.C. Footwear*

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<sup>15</sup> (1940) 63 CLR 382; 2 AITR 4; 5 ATD 298.

<sup>16</sup> (1949) 78 CLR 504; 4 AITR 258; 9 ATD 33.

<sup>17</sup> (1949) 78 CLR 504, 512-13; 4 AITR 258, 262-3; 9 ATD 33, 36-7.

<sup>18</sup> (1949) 78 CLR 504, 515-16; 4 AITR 258, 264; 9 ATD 33, 38.

<sup>19</sup> (1929) 42 CLR 332; (1928-1930) R&McG (Supplement) 340.

<sup>20</sup> (1929) 42 CLR 332, 351 (Knox CJ, Rich and Dixon JJ), [1928-29] R&McG(Supp) 354.

*Ltd (Formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)*,<sup>21</sup> except, of course, that the taxpayer having elected to value its trading stock using the ‘cost price’ method, they could not use any of the other permitted methods of value under s 31(1) to value its trading stock in the relevant years. The Chairman<sup>22</sup> of the Board of Review, Mr H H Trebilco, commented that:

It was made clear at the hearing that the purpose of the writing down of the value of stock was not an attempt to arrive at replacement cost. It had no relation whatever to market selling value.<sup>23</sup>

It was also clear from the evidence that the directors of the company in this case took no cognisance of the taxation consequences when they decided upon using this method of valuation for its trading stock.

It was held that as the taxpayer had elected to use the ‘cost price’ method to value their trading stock, the Commissioner was at liberty to adjust the figures in the taxpayer’s return, in order to give effect to that election.

Member of the Board of Review, Mr R A Cotes, commented:

A taxpayer has a duty each year to value any stock correctly for purposes of his return or to disclose the quantum of any variation to the Commissioner. [quoting from 12 CTBR *Case 19*] ... “it is obvious that the right represented by the option under s31 is coupled with a duty to exercise it”.<sup>24</sup>

In (1946) 12 CTBR(Reprints) *Case 19*, the Board of Review had to determine what ‘cost price’ meant in s 31(1), the taxpayer having elected to use that method of valuation. The taxpayers in their return for the relevant year had deducted certain amounts from the cost of their inventory, to make allowance for certain alleged contingencies. The taxpayers claimed in their appeal that the term ‘cost price’, as used in s 31(1), meant the invoice cost of the trading stock or the landed, Free On Board,<sup>25</sup> cost of the trading stock, and that they were at liberty to ignore any other associated costs.

The Board of Review in its deliberations considered a statement issued by the Institute of Chartered Accountants in England and Wales which defined the elements comprising cost to be:

(i) the purchase price of goods, stores, and in the case of processed stock, materials used in manufacture; (ii) direct expenditure incurred in bringing stock-in-trade to its existing condition and location; and (iii) indirect or overhead expenditure incidental to the class of stock-in-trade concerned....<sup>26</sup>

Having taken that definition into consideration, the Board decided the taxpayer’s contention was unfounded, and that ‘cost price’, as used in s 31(1), did not mean invoice price, nor did it mean purchase price. It was also noted that in s 39 the words ‘purchase price’ had been used showing that, after discussing the relevant provision, the words ‘cost price’ should be equated to the full cost of gaining the trading stock.

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<sup>21</sup> [1969] 1 WLR 1488; [1971] Ch 427 (CA) and [1971] 2 WLR 1313 (HL); (1971) 47 TC 495.

<sup>22</sup> Note: chairman is the correct legal title under relevant legislation.

<sup>23</sup> (1947) 14 CTBR(Reprints) *Case 10*, 413

<sup>24</sup> (1947) 14 CTBR(Reprints) *Case 10*, 436.

<sup>25</sup> ‘Free On Board’ (‘FOB’), is generally defined as loading at port of origin being at sellers expense, while freight etc is at buyers expense. However US/Canadian practice may involve additional terms FOB Origin (both loading and freight etc at sellers expense; FOB Destination, all above at buyers expense: see, eg, Export 911, ‘International Commercial Terms (Incoterms) (2000) avail <<http://www.export911.com/e911/export/comTerm.htm>> 14 September 2005.

<sup>26</sup> *The Accountant* (London) 16 June 1945, 302/3. This was *Recommendation X*. This recommendation also formed the basis of *Recommendation VII* issued by the Institute of Chartered Accountants in Australia in 1946. This recommendation is discussed below.

This can be distinguished from the later case (1953) 4 CTBR(NS) *Case 2*; (1953) 4 TBRD *Case D95*, where it was held by a majority of the Board that where no method of valuation appears on the return, the Commissioner was entitled to adopt an appropriate basis of valuation. In this case the taxpayer had merely inserted the net income of the business, without supporting figures, nor was the trading stock shown or valued on the accompanying accounts, there being merely a note to the balance sheet which showed wool shorn but not sold had not been accounted for and that it had an approximate value of £A 7,500.

The majority of the Board of Review went on to hold that the taxpayer's income tax return having been assessed by the Commissioner, on what he thought was the appropriate method of valuation, it was open to the taxpayer, on objection, to have another or others of the allowed methods of valuation substituted for the one chosen by the Commissioner.

Member of the Board Mr F C Bock used different reasoning to find that the cost price method had been adopted. He felt that the note to the balance sheet indicated a choice having been made by the taxpayer not to elect the use of the 'market selling value' under s 31(1), rather the taxpayer was exercising an option to value using cost price.<sup>27</sup> However the reasoning he uses is rather difficult to follow.

In (1951) 1 CTBR(NS) *Case 120*; 1 TBRD *Case 115*, the Board of Review was called upon to determine how 'market selling value' should be ascertained where there was no true selling market for the item, and because the election of 'replacement price' could not consequently be made. The items in question were stocks of labels, containers, and packing material — all of which items were printed with the names of the products and the name of the manufacturer.

All the members of the Board held that the 'market selling value' should be estimated as though the trading stock had been sold in the normal course of business and not, as the company contended, a break up sale, thus relying on the dicta of Rowlatt J in *Brigg Neumann & Co v The Commissioners of Inland Revenue* ('*Brigg Neumann*').<sup>28</sup> Member Mr A C Leslie described how such a valuation should be determined:

that it is proper to consider all circumstances and ascertain the price a willing but not anxious vendor could reasonably expect to obtain and a *hypothetical willing but not anxious purchaser* could reasonably expect to pay.<sup>29</sup>

The Chairman of the Board of Review, Mr R H Gibson, said that the trading stock should be valued in the following manner:

It follows that the market selling values of the goods must be determined by reference to some hypothetical sale, or sales at or about the material time, of each and all of the goods in their character of labels, containers, packing materials and the like, as distinguished from their intended character as parts of other goods. Is it necessary to suppose "a break-up sale, or a forced sale or anything of that sort"? ... the answer is definitely in the negative ...<sup>30</sup>

In *Rowntree v FCT*<sup>31</sup> Davidson J in New South Wales Supreme Court had to determine if the taxpayer's method of calculating the average cost of his live stock was correct for income tax purposes under *ITAA 1922*. During the 1929/30 tax year the taxpayer purchased six stud cattle at a total cost of £A 1639.16.2, and had included this amount in calculating the average cost of his trading stock, that is, all of the cattle. This gave an average figure of approximately £A14.7.6. The Commissioner, in assessing the value of closing trading stock,

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<sup>27</sup> (1953) 4 CTBR(NS) *Case 2*, 14/15; (1953) 4 TBRD *Case D95*.

<sup>28</sup> (1928) 12 TC 1191.

<sup>29</sup> (1951) 1 CTBR(NS) *Case 120*, 587; 1 TBRD *Case 115*. The emphasis is mine.

<sup>30</sup> (1951) 1 CTBR(NS) *Case 120*, 579; 1 TBRD *Case 115*.

<sup>31</sup> (1934) 3 ATD 32.

excluded the six stud cattle and calculated an average cost of approximately £A 9.4.11 of the taxpayer's other cattle and the six stud animals at the £A 1639.16.2 paid for them. This increased the closing value of the taxpayer's trading stock by some £A 375. The taxpayer appealed to the Supreme Court of New South Wales. Davidson J rejected the taxpayer's method as follows:

It then appears to me that the position must be this, that as the appellant sent in from year to year as the value of his stock a figure which he ascertained, not by taking their *true cost price but by some other method of his own*, and as the Commissioner had seen fit to accept that price over a number of years, that they had acted as if the agreement made by the election of the taxpayer had been carried into effect. The latter had elected to take as his basis of value the cost price for the beginning and end of the period; he had sent in something which must have represented that it was the cost price, and the Commissioner was pleased to accept it until he arrived at a certain stage when he proposed to bring into force what he considered to be, and what I think to be, a *proper method of assessing the values* under the terms of the section.<sup>32</sup>

Thus, the taxpayer's use of the average cost method was rejected because the method used to calculate the average cost did not reflect the 'actual cost price' of the trading stock on hand at the end of the tax year. This was caused by the inclusion of the six high valued stud cattle in the calculation of the average cost. Davidson J approved the Commissioner's method for calculating the average cost of the cattle excluding the six high valued stud cattle. Though the average cost method is particularly appropriate for calculating the cost of live stock, it is far from clear whether Davidson J's approval of the average cost method would extend to other types of trading stock so the general acceptability of the average cost method for determining cost was still open to debate.<sup>33</sup>

To conclude this discussion on permissible valuation methods for trading stock under s 31 of *ITAA 1936*, a short comment with respect to the 'cost price' method is appropriate. It is important that we remember the comments of the Full High Court in *Ronpibon Tin No Liability v FCT*, expounding the following principal of income tax law:

It is important not to confuse the question how much of the actual expenditure of the taxpayer is attributable to the gaining of assessable income with the question how much would a prudent investor have expended in gaining the assessable income. The actual expenditure in gaining the assessable income, if and when ascertained, must be accepted.... It is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent.<sup>34</sup>

This principal was of course applied by Menzies J with whom the rest of the Court agreed, with respect to trading stock in the *Cecil Bros Pty Ltd v FCT*.<sup>35</sup>

#### IV SUMMARY OF PRIOR STATE OF THE LAW

Most of the cases were concerned with what costs were to be included in the calculation of cost of trading stock for traders. In each case a comprehensive meaning was given to the

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<sup>32</sup> (1934) 3 ATD 32, 35–6 (emphasis added).

<sup>33</sup> The reason the average cost method is particularly appropriate for live stock has been explained elsewhere by the current author (*Australian Tax Practice* para [25/50]) where it is stated that: it is more common in broad acre farming conducted in Australia and the most appropriate to use the weighted average cost flow assumption for the valuation of livestock. This approach is the most appropriate because the majority of individual animals are not identifiable and therefore a FIFO assumption cannot be proved. Death rates are generally much higher among young animals than older animals and most primary producers sell their youngest animals rather than the oldest. For instance, lambs are usually sold for export or slaughter and not older sheep.

<sup>34</sup> (1949) 78 CLR 47; 8 ATD 431, 4 AITR 236, 247.

<sup>35</sup> (1962–1964) 111 CLR 431, 441; 9 AITR 246, 249; 13 ATD 261, 264.



word, including all costs incurred in bringing the trading stock into the possession of the taxpayer.<sup>36</sup> For a manufacturer, it does not include the cost of consumable supplies used in the production process and such items are not trading stock themselves.<sup>37</sup> Methods of determining cost must give real values not distorted ones.<sup>38</sup> And ‘market selling value’ is to be determined on the basis of a willing vendor who was not anxious and a hypothetical willing but not anxious purchaser.<sup>39</sup>

## V AUSTRALASIAN JAM

### A *The Facts*

Fullagar J set out the relevant facts of the case as follows:

As long ago as 1914 or even earlier, the company, for fairly obvious business reasons, adopted the practice of taking into its accounts, at the beginning and end of each trading period, its stocks of jams, canned fruits and tins, at “standard” values....

The values adopted by the company in or before 1914 have never been changed, and in all the years now in question the company’s opening and closing stocks of jams, canned fruits and tins, at “standard” values. ...

The values adopted by the company in or before 1914 have never been changed, and in all the years now in question the company’s opening and closing stocks of jams, canned fruits and tins were taken into account at 4s. per unit, 5s. per unit, and 20s. per unit respectively.<sup>40</sup>

The standard values (costs) used by the taxpayer were not based on each variety of jam produced by the company. Rather standard values were calculated for a standard box of a dozen tins of fruit, a standard box of a dozen jars of jams and a standard ‘base box’ for tins. The standard costs for jams and fruit did not take into account the particular variety, instead an average of all varieties was used to set the standard. In its own accounts and in the returns for taxation purposes these items were shown as being valued ‘at or under cost’.

The taxpayer’s valuation methods came to the attention of the Australian Tax Office as a result of an amendment contained in s 124(1) Victorian *Companies Act 1938* which required companies to disclose the method used to value their trading stock. The Commissioner amended the company’s return for each of the tax years from 1936/37 to 1946/47.<sup>41</sup> The Commissioner calculated the cost price for each standard box for each of the years using a similar method to that used by the taxpayer when they originally calculated their standard cost except that the Commissioner undertook this calculation yearly. The Commissioner calculated the cost of a standard box of jam by averaging the cost of producing all the 20 individual types of jam. The reason for this rough average is that it appears that for stocktaking purposes the taxpayer simply counted the number of boxes overall not the number of boxes for each individual variety still on hand at the balance date.

### B *Australasian Jam and the Meaning of Trading Stock in s 6(1) of ITAA 1936*

*Australasian Jam* is not normally cited as an authority on what can constitute trading stock for income tax purposes. None of the standard works on taxation law refer to it in this

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<sup>36</sup> *The Commissioner of Taxation of Western Australia v D & W Murray Ltd* (1929) 42 CLR 332; 1 ATD 340; *Moreau v FCT* (1920) 39 CLR 65; R&McG 84; (1946) 12 CTBR(Reprints) Case 19.

<sup>37</sup> (1951) 1 CTBR(NS) Case 120; 1 TBRD Case 115.

<sup>38</sup> *Rowntree v FCT* (1934) 3 ATD 32, and (1947) 14 CTBR(Reprints) Case 10.

<sup>39</sup> (1951) 1 CTBR(NS) Case 120; 1 TBRD Case 115.

<sup>40</sup> (1953) 88 CLR 23, 28–9; 5 AITR 566, 568–9; 10 ATD 217, 218–19.

<sup>41</sup> (1953) 88 CLR 23, 28–9; 5 AITR 566, 570; 10 ATD 217, 219. Excluding the 1944/45 and 1945/46 tax years.

context.<sup>42</sup> Fullagar J noted that ‘s. 6 defines “trading stock” as including anything produced, manufactured, acquired or purchased for purposes of manufacture, sale or exchange’.<sup>43</sup> There is nothing exceptional in this comment and it adds nothing to the state of knowledge, however, Fullagar J a page or so later in his judgment notes that:

Its “trading stock” at any given time consists partly of goods manufactured or processed but not yet sold, and partly of raw materials such as fruit, sugar, and tinplate.<sup>44</sup>

This short sentence unequivocally demonstrates that both raw materials and work in progress are both capable of being trading stock for tax law purposes.

### C *Australasian Jam and the Application of s 29 of ITAA 1936*

It was essential to the acceptance of the Commissioner’s calculations of the cost of the company’s trading stock that he considered the application of s 29 of *ITAA 1936*. This is because of the way the Commissioner had approach the amendments of the taxpayer’s returns. Fullagar J noted that:

The basis of the Commissioner's calculations was, as I understand it, as follows. With regard to jams, *he began by accepting for the first income year (1936-37) the company's own opening stock figure*. Then for that and each succeeding income year he endeavoured to arrive at a closing stock figure which would represent as nearly as possible actual cost. From figures supplied by the company, and in no way challenged before me, he worked out the cost per dozen tins of each of twenty varieties of jam manufactured by the company.<sup>45</sup>

Thus Fullagar J had to consider the operation of s 29 of the *ITAA 1936*, and concluded that it required that ‘the opening figure of any year must be identical with the closing figure of the preceding year’.<sup>46</sup> This is a clear and unambiguous statement of the operation of s 29.<sup>47</sup>

### D *Australasian Jam and the Application of s 31 of ITAA 1936*

When considering the company’s method of valuing their trading stock Fullagar J noted:

Regarded as a matter of business discretion and wise management, the policy of stock valuation adopted by the company appears to me to have been unexceptionable.<sup>48</sup>

Fullagar J enunciated this concise explanation of the effect of s 31(1) and its importance in

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<sup>42</sup> This includes the author’s numerous publications in this area. Nor is it referred to in *FCT v St Hubert's Island Pty Ltd (in liq)* (1978) 138 CLR 210; 8 ATR 452; 78 ATC 4104 when considering if land in course of development was trading stock (being work in progress). Many of the texts do not even deal with the general issue of work in progress and/or raw materials being trading stock for income tax purposes or deal with the issue only indirectly when discussing *St Hubert's Island*.

<sup>43</sup> (1953) 88 CLR 23, 26; 5 AITR 566, 568; 10 ATD 217, 218.

<sup>44</sup> (1953) 88 CLR 23, 28; 5 AITR 566, 570; 10 ATD 217, 219. The emphasis is mine.

<sup>45</sup> (1953) 88 CLR 23, 28; 5 AITR 566, 569; 10 ATD 217, 218.

<sup>46</sup> (1953) 88 CLR 23, 27; 5 AITR 566, 568; 10 ATD 217, 218.

<sup>47</sup> The argument that this might not be the case where an improper value had been used in the previous year was recently given short shrift by Deputy President Block J in [2002] AATA 746 *Re Ciprian and Others v FCT*, 50 ATR 1257 relying on the words of Fullagar J in *Australasian Jam*. The comments of Lindgren J in *Energy Resources of Aust Ltd v FCT* [2003] FCA 26, (2003) 52 ATR 120, 136, 2003 ATC 4024, 4039 that in making these comments:

His Honour was not directing his mind to a situation in which there was a difference between an erroneous figure not sanctioned by the ITAA, which had in fact been brought to account as representing the value of the stock on hand at the end of the immediately preceding year, and a correct figure which the ITAA had required be brought to account as representing the value of the stock on hand at that time.

<sup>48</sup> This is a complete misrepresentation of the facts in *Australasian Jam* which Fullagar J was dealing with. (1953) 88 CLR 23, 30; 5 AITR 566, 570; 10 ATD 217, 220.

*Australasian Jam:*

It is on s.31 that the present cases primarily turn. The section in terms allows to the taxpayer considerable freedom of choice. He may adopt one method of valuation for one part of his stock, and another method for another part.... On the other hand, the section is imperative in that it requires him to adopt for each article of his stock one or other of the three prescribed bases of valuation. He is not at liberty to adopt some other basis of his own.<sup>49</sup>

Thus s 31(1) allows a taxpayer the choice of market selling value, cost or replacement cost for valuing their trading stock. Other bases of valuation are not permitted. Secondly, the method selected does not need to be consistent from item to item or from year to year.

*E Australasian Jam and the Meaning of 'Cost Price'*

Fullagar J noted that the words 'cost price' used in s 31(1) are:

perhaps not literally appropriate to goods manufactured, as distinct from goods purchased, by a taxpayer, but I feel no difficulty in reading them as meaning simply "cost".<sup>50</sup>

Fullagar J agreed with the Commissioner that at one time the method adopted by the taxpayer had represented the approximate cost of the trading stock, but concluded that:

In any case, I am not able to read s.31 otherwise than as requiring, at the end of every accounting period, a valuation, on one or other of the specified bases, of stocks actually on hand, and I cannot regard "cost" as meaning anything other than *actual cost*.<sup>51</sup>

Thus, because the standard costs based upon average costs had not been reviewed for many years, they were no longer a meaningful measure of the item's actual cost. Fullagar J accepted the Commissioner's calculation of the cost of each of the standard boxes as being correct. Thus His Honour approved of the use of the 'average' cost method although he showed reservation about using the rough average rather than a weighted average by enclosing the word in quotation marks.<sup>52</sup> In addition, by using these averages as standards in the Commissioner's calculation, His Honour also approved of the use of the standard cost for determining cost for the income tax purposes.<sup>53</sup>

*F Australasian Jam and Cost Flow Assumptions and the Calculation of Cost*

As can be seen from the above discussion, the method of calculating the cost of the company's trading stock used by the Commissioner and accepted by Fullagar J was first to apply costs on a First In First Out ('FIFO') basis to determine the cost that related to a particular year. Second, to use these figure to ascertain an average (unweighted) cost for each tin of jam and so forth. This average cost was then used as the standard cost for determining the cost of each box of jam at the end of each year. Thus Fullagar J approved of the FIFO, average cost and standard cost methods of determining cost of trading stock under s 31 of the *ITAA 1936*.

*G Australasian Jam and the Meaning of 'Market Selling Value'*

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<sup>49</sup> (1953) 88 CLR 23, 26-7; 5 AITR 566, 568; 10 ATD 217, 218.

<sup>50</sup> (1953) 88 CLR 23, 29; 5 AITR 570, 570; 10 ATD 217, 219-20.

<sup>51</sup> (1953) 88 CLR 23, 31; 5 AITR 566, 571; 10 ATD 217, 221. The emphasis is added.

<sup>52</sup> (1953) 88 CLR 23, 29; 5 AITR 566, 570; 10 ATD 217, 219.

<sup>53</sup> It may be argued that Fullagar J had little choice as actual quantities of each variety were not known and he had to accept a standard value based upon an average of all varieties. Any doubt was removed later by Jenkinson J in *Philip Morris Limited v FCT*, (1979) 10 ATR 44; 79 ATC 4352.

Fullagar J went on to consider the meaning and application of the words ‘market selling value’, as used in s 31(1).

If one supposes such a sale - by auction or otherwise - I am quite prepared to accept the evidence that much lower values than those taken by the Commissioner would have been realised. But it is not to be supposed that the expression “market selling value” contemplates a sale on the most disadvantageous terms conceivable. It contemplates, in my opinion, a sale or sales in the ordinary course of the company’s business - such sales as are in fact effected.... In arriving at market selling value, it is legitimate to make allowance for the fact that normal selling will take place over a period. But the supposition of a forced sale on one particular day seems to me to have no relation to business reality.<sup>54</sup>

Fullagar J then quoted from the judgment Rowlatt J in *Brigg Neumann*,<sup>55</sup> where he found that in determining the meaning of the words ‘market value’:

It is not to be supposed that you would value – and it would not be right, of course, to do so – the cloth at a figure which you could get by having a break-up sale, or a forced sale, or anything of that sort.<sup>56</sup>

It is to be noted that number of commentators and the Board of Review have stated incorrectly that Rowlatt J found that ‘market value’ meant replacement cost.<sup>57</sup> Fullagar J, similarly to Rowlatt J in *Brigg Neumann*, concludes with respect to the words ‘market selling value’ that:

[t]o attempt to arrive at market selling value on the supposition that the whole of the stock in hand must be offered for sale and sold on the last day of the accounting period is, in my opinion, to proceed on a wrong basis.<sup>58</sup>

With respect to the taxpayer’s argument that because it had sold all the jam it could within Australia, the market selling price of the remaining jam should be valued at the price they could obtain on the export market, and arrive at the market selling value by deducting from export price the estimated cost of taking from store to the FOB point, Fullagar J found that in his opinion it was not ‘correct to arrive at market selling value by reference *exclusively* to an export price.’<sup>59</sup> This follows from his earlier note that the wording of s 31(1) regarding market selling value that it ‘contemplates, in my opinion, a sale or sales in the ordinary course of the company’s business - such sales as are in fact effected’.<sup>60</sup>

These comments recognise that ‘market selling value’ takes into account each of the actual markets in which each item would be expected to be sold and the actual quantities expected to be sold in each market. In addition, it shows that if some items are subject to a specific sales contract, though still in stock, those items should be valued at the contract

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<sup>54</sup> (1953) 88 CLR 23, 31–2; 5 AITR 566, 572; 10 ATD 217, 221.

<sup>55</sup> (1928) 12 TC 1191.

<sup>56</sup> (1928) 12 TC 1191, 1202.

<sup>57</sup> See, eg, (1953) 4 CTBR(NS) *Case 5*; 4 TBRD *Case D65* at paras 20 and 21 although these comments appear to be inconsistent with the comments at para 18 (Chairman Mr A Fletcher); C J Allan Macleod ‘The Institute and the Valuation of Stock-in-Trade’, letter to the editor, *The Accountant*, 1 September 1945, 107; John H Burton, *Costing for Control* (1948) 46–7; *The Accountant Tax Supplement*, 14 July 1928, 361–2, 362; ‘Valuation of Stock for Income Tax’ *The Accountant Tax Supplement*, 22 November 1941, 293–5, 293–4; Max England, ‘Stock Valuation’, *The Accountant*, 28 January 1956, 80–2, 80. The reason for this error has recently been canvassed by the author in ‘Stock-in-trade valuation for UK taxation purposes 1925 to 1971 (Has it been all the accountants way?)’ (Paper presented at the 14th Annual Accounting, Business and Financial History Conference, Cardiff University (Cardiff Business School), 11–12 September 2002). This paper has recently been published in (2005) 1 *Journal of Australasian Tax Teachers Association* 342–413.

<sup>58</sup> (1953) 88 CLR 23, 32; 5 AITR 566, 572; 10 ATD 217, 221.

<sup>59</sup> (1953) 88 CLR 23, 32; 5 AITR 566, 572; 10 ATD 217, 221. The emphasis is added.

<sup>60</sup> (1953) 88 CLR 23, 31–2; 5 AITR 566, 572; 10 ATD 217, 221.

price, rather than the general or normal market for selling for such items. This approach is consistent with that of Rowlatt J in *Brigg Neumann*, where defective cloth which was contractually liable to be returned to weavers or dyers<sup>61</sup> at specified prices had market value as determined by the contract.<sup>62</sup> Indeed all Fullagar J's reasoning on the meaning of 'market selling value' is consistent with the reasoning by Rowlatt J as to the meaning of 'market value' in *Brigg Neumann*.

#### H 'Base Stock' or 'Datum Value' Method for Valuing Trading Stock

For many years the importance of the following passage of Fullagar J's judgment had escaped the current author and all other commentators with respect to an argument put forward by Mr D I Menzies QC on behalf of the taxpayer. Mr Menzies argued that:

He went on to say that in the present case the company's valuation per unit of closing stock had been originally based on cost, having been adopted at a time when it did represent approximate cost. I think, as I have said, that the evidence established that there was a time when it did represent approximate cost. The next step was to say that, stock being *once established and valued at cost, what took place from year to year was merely a drawing on that stock and a replacement of that stock*, so that *it was legitimate to regard the stock on hand at any given time*, so far as it did not in fact consist of the "original" stock, as substituted for, and the *equivalent of, "original" stock* taken out and sold. Therefore, it was said, the stock on hand at the end of each of the accounting periods in question could be said with truth to have been valued at cost.<sup>63</sup>

This passage is clearly an argument for the use of the 'base stock' method, or at least a variation of it — such as the 'datum value' method for valuing trading stock. Under the base stock method it is assumed that a minimum quantity of trading stock ('base stock') is necessary at all times in order to carry on business. The base stock is valued at the cost current when the base stock was established. Trading stock in excess of the base stock is valued in accordance with some other method. Ian M Bowie explains the use of the base stock method as being:

founded on the principle that a business requires always to hold in stock a certain basic quantity of stock which is more in the nature of a fixed asset than a current asset. For example, an estimate may be made of the minimum "pipe-line" stocks plus a reasonable reserve stock, the total of which would be considered to be the base stock which should always be held if economic production is not going to be interrupted. It is held that that portion of the stock which constitutes this base stock should be valued at the *cost of the equivalent quantity of stock originally purchased at the commencement of the business, or at the cost of the equivalent quantity of stock on hand when the base stock method of valuation was first introduced*. By so doing, in times of rising prices the increased cost of replacing the base stock is written off to profit and loss account and accordingly that portion of the capital of the business which was utilised in providing the base stock remains intact.<sup>64</sup>

Under the 'datum value' method, all or part of the closing trading stock is valued at the lowest possible value to which the trading stock is estimated to fall, so as ensure that there will be no loss at the time of sale and that the final sale price will be above the 'datum value'.<sup>65</sup>

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<sup>61</sup> Or alternatively they were indemnified for any loss on sale due to the defect so that they had a guaranteed total income from the sale to third parties.

<sup>62</sup> (1928) 12 TC 1191, s 1205–6.

<sup>63</sup> (1953) 88 CLR 23, 30–1; 5 AITR 566, 671; 10 ATD 217, 220. Appendix III contains the full paragraph and demonstrates why Mr Menzies' argument is not immediately obvious even to the most careful reader. Emphasis added.

<sup>64</sup> Ian M Bowie, 'The Basis of Valuation of Stock and Work-in-Progress', *The Accountants' Magazine*, October 1954, 570–92, 573–4 (emphasis added).

<sup>65</sup> This method is discussed in 'STOCK Datum Values', [Finance and Commerce], *The Accountant*, 8 January 1938, 59;

Rejecting Mr Menzies' argument, Fullagar J stated that:

The conception behind the argument may possibly be regarded as a sort of theoretical justification for a practice which does not seem to me in itself to stand in need of justification. But I am quite unable to accept the conclusion which is said to follow. It does not seem to me to bear any relation to the real situation or to the actual requirements of s.31. There were, as I have said, very wide fluctuations, up and down, in the stock on hand from year to year ...<sup>66</sup>

Fullagar J concluded that:

In any case, I am not able to read s.31 otherwise than as requiring, at the end of every accounting period, a valuation, on one or other of the specified bases, of stocks actually on hand, and I cannot regard "cost" as meaning anything other than actual cost.<sup>67</sup>

Thus it can be seen that methods similar to the base stock method are not acceptable for income tax purposes as they do not reflect the item of trading stock's actual cost.

#### *I Accounting Practice — Valuation Methods Used for Valuing Trading Stock in Published Company Accounts*

The author's good friend and colleague for many years, Dr Robert W Gibson has demonstrated that, with the exception of one brief period, there has been minimal disclosure in published company accounts of the methods used to value trading stock.<sup>68</sup> The exception is caused by the very same factor that brought Australasian Jam Co's method of valuation to the attention of the taxation authorities: s 124(1) Victorian *Companies Act 1938*.<sup>69</sup> The current author has compiled a summary table of the methods of valuation disclosed in the sources cited by Dr Gibson and the results appear in APPENDIX I of this article. The presumed normal method of valuation the 'lower of cost and market rule', or variations, was used by relatively few of the companies. One of the researchers noted by Dr Gibson was moved to comment that:

Thus two only of the companies expressly used the so-called "golden rule." [The lower of cost and market rule.] The descriptions used by the others suggest that in the great majority of cases "cost" determines the ceiling value, whilst the floor is some indeterminate value less than cost not necessarily determined by market replacement value.

It seems, therefore, that the guiding rule is caution (in accounting terminology usually erroneously rendered as "conservatism") but that nothing even so precise as the "golden rule" – with all its uncertainties and obscurities – is in fact practised. Perhaps in view of this, it would be better if we were to speak of the "golden mean" (the old Greek ideal of moderation in all things) - rather than the "golden rule."<sup>70</sup>

There is little indication what is meant by the words 'cost', 'market value', 'replacement cost' etc in the reports or how they have been calculated. Comparison with the permitted

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'STOCK Valuation', [Finance and Commerce], *The Accountant*, 1 February 1947, 78. This method is also highlighted by Thomas Henry Sanders, 'British Accounting Practices and the Profession', *The Accountant*, (Reprinted from Harvard Business Review), 9 March 1940, 265–73, 267, where he notes that in a few cases 'an equivalent of the base stock' was used, the 'datum value' method.

<sup>66</sup> (1953) 88 CLR 23, 31; 5 AITR 566, 671; 10 ATD 217, 220.

<sup>67</sup> (1953) 88 CLR 23, 31; 5 AITR 566, 671; 10 ATD 217, 220–1.

<sup>68</sup> Robert W Gibson *Disclosure by Australian Companies* (1971), ch 24. A later paper by Robert W Gibson and Peter Downey, 'The Acceptance of Professional Statements on the Valuation of Inventory' (1980) 51 *The Chartered Accountant in Australia* 27–9, shows there was little change in disclosure of methods of valuation up until the mid 1970s.

<sup>69</sup> This provision was not included in the Uniform Companies Acts of 1961.

<sup>70</sup> A A Fitzgerald, 'A Further Note on the Valuation of Trading Stock' (1944) 14 *The Australian Accountant*, 424, 425.

methods for taxation purposes is therefore not easy, except to say that cost and replacement cost were used. One variation of the lower of cost and market value rule used realisable value for market value. This could be argued to be similar to the term ‘market selling value.’

*J Accounting Practice — Valuation Methods Used for Valuing Trading Stock in the Contemporary Literature*

R Keith Yorston et al<sup>71</sup> state that normally trading stock is to be valued at cost and that in limited ‘certain circumstances’ the lower of cost and market rule can be used and that whatever method is used should be applied consistently. They note that precious metal may be valued above cost. They later list possible cost flow assumption for determining cost as follows:

These assumptions have resulted in a number of more or less recognized methods of valuing stock which may be listed as follows;

- (a) First-in first-out (Fifo)
- (b) Last-in first-out (Lifo)
- (c) Average Cost
- (d) Unit Cost [specific identification]
- (e) Last Cost<sup>72</sup>
- (f) Adjusted Selling Price [retail inventory method]
- (g) Standard Cost
- (h) Base Stock system
- (i) Replacement Cost.<sup>73</sup>

This list is a good example of the methods of determining cost. In APPENDIX II the methods discussed in a number of publications from 1938 to 1954 are summarised in tabular form.

The method used by the Australasian Jam Co is consistent with the conservative methods of determining cost, particularly the base stock method, LIFO method and ‘last purchase price’ (‘last cost’) method. Average cost and standard cost are also common in the table. As quoted above, Fullagar J remarked that:

Regarded as a matter of business discretion and wise management, the policy of stock valuation adopted by the company appears to me to have been unexceptionable.<sup>74</sup>

From the evidence contained in the table, this comment by Fullagar J is a justifiable assessment of the company’s valuation method from the point of view of business and accounting practices.

VII ACCOUNTING PRACTICE — VALUATION METHODS USED IN RECOMMENDATION VII OF THE INSTITUTE OF CHARTERED ACCOUNTANTS IN AUSTRALIA

In 1946 the Institute of Chartered Accountants in Australia issued *Recommendation on Accounting Principle VII – Treatment of Stock-in-Trade and Work in Progress in Financial Accounts*. The recommended description in the accounts should normally be at lower of cost or market value and market value:

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<sup>71</sup> R Keith Yorston, E Bryan Smyth and S R Brown, *Advanced Accounting* (3<sup>rd</sup> ed, 1953) vol 3, 45.

<sup>72</sup> This method applies the most recent purchase cost to each use or sale of an item. In times of rising prices this will have the effect of undervaluing the cost of closing trading stock. However, as with the LIFO method, when prices fall consistently over time it will lead to an excessively valued cost of closing stock. The author has found no reference to this method as such in the accounting literature of the United Kingdom of the time, but can be seen a variation of the NIFO method.

<sup>73</sup> Yorston, Smith and Brown, above n 71, 48. These methods are explained at 48–50.

<sup>74</sup> (1953) 88 CLR 23, 30; 5 AITR 566, 570; 10 ATD 217, 220.

... should be calculated by reference to the price at which it is estimated that the stock-in-trade can be realised, either in its existing condition or as incorporated in the product normally sold, after allowing for expenditure to be incurred before disposal.

In estimating this price, regard should be had to abnormal and obsolete stocks, the trend of the market and the prospects of disposal.<sup>75</sup>

Where replacement cost is used as the market value the description in the accounts should be described as ‘at the lower of cost or replacement value’.

Market value here is different to ‘market selling value’ used in s 31 which does not permit deduction of selling expenses etc. The meaning of replacement cost in paragraph (b)(ii) of the recommendation is similar to that enunciated by Rowlatt J in *Brigg Neumann*.<sup>76</sup>

The methods of computing cost are set out in paragraph (a) as being:

- (1) The ‘unit’ cost method (specific identification)
- (2) The ‘First In, First Out’ basis
- (3) ‘Average cost’ (weighted)
- (4) ‘Standard cost’
- (5) ‘Adjusted selling price’ (retail inventory method)<sup>77</sup>

In *Australasian Jam Fullagar J* had approved the use of determining cost in listed in (2), (3) and (4). Other methods noted but not specifically sanctioned were the LIFO and base stock methods.

#### VIII APPLYING THE REASONING OF FULLAGAR J — THE USE OF OTHER COST FLOW ASSUMPTIONS

Should the reasoning of Fullagar J that the method used must reflect the actual cost of the trading stock held be accepted, then it would follow that the LIFO method, the datum value method, the last purchase price method and the Next In First Out (‘NIFO’) cost flow assumptions would not be permitted, as the amount calculated does not represent the actual cost of the remaining items of trading stock. However in some circumstances the LIFO method may be permissible, that is, where the method reflects the actual flow of goods.<sup>78</sup>

##### *A Applying the Reasoning of Fullagar J — the Determination of ‘the Price at which it Can Be Replaced’*

Fullagar J’s observation as to the correct method of ascertaining ‘market selling value’ can also be applied in determining how to calculate the price at which it can be replaced, that is, that it is to be calculated by assuming purchases are made in normal quantities and, where the item is sourced from different suppliers, it would be based upon the supplier who would normally supply the goods in the circumstances or in the proportion of actual purchases made.<sup>79</sup> As with market selling value, it would be improper to assume that all would be

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<sup>75</sup> Recommendation (3).

<sup>76</sup> (1928) 12 TC 1191, 1404. Discussed and quoted above.

<sup>77</sup> *The Accountant* (London) 16 June 1945, 302.

<sup>78</sup> Eg, a bin containing bulk nails where individual nails are removed from the top of the bin and new supplies placed on the top of the nails already present.

<sup>79</sup> This is consistent with the rejection of the taxpayer’s method of calculating the price at which it can be replaced in *Parfew Nominees v FCT* (1986) 17 ATR 1017; 86 ATC 4673, where Gobbo J rejected the replacement cost figure of the taxpayer (a quantity surveyor) as the surveyor did not have access to the plans of the building when calculating the replacement cost, relying only on contract schedules; thus the figure did not represent the actual replacement cost and merely applied an index to original cost. Gobbo J found that a more relevant approximation of the price at which it could be replaced was the selling price. This valuation was part of a s 36A election scheme and the case should be read in this context. Gobbo’s decision that replacement cost was not open to the taxpayer in the given circumstances is suspect and not at all convincing. In the author’s view Gobbo’s reasoning was merely a device to frustrate the taxpayer’s s 36A



sourced from one supplier.<sup>80</sup>

There has been some difference of opinion in the accounting literature as to how to calculate replacement cost, that is, whether it is the cost of ordering on the balance date or the cost of having the item in stock on the balance day. Fullagar J's insistence on using actual cost would lead to the adoption of the latter method. This is consistent with the approach of Rowlatt J in *Brigg Neumann* where he said that replacement cost means the cost to have the item in stock on the balance date. Rowlatt J continued with this analogy:

When one is seeking to get what in building or engineering is called the constructional value of an edifice or engineering work based upon current prices three months ago of a building, *it is the price that you have to pay which will give you the building here now, not the price that you have to pay now to give you a building at some future time.* So that, I think, is really the result of that part.<sup>81</sup>

Given the similarity of the reasoning of Fullagar J and Rowlatt J on the meaning of market value and other similarities in their reasoning, it is the author's view that the above argument is almost unassailable.

#### IX CONCLUDING REMARKS:

*Australasian Jam* continues to be the most significant case on the valuation of trading stock for income tax purposes and is as relevant to day as it was just over fifty years ago.<sup>82</sup> The richness of the reasoning and the application of Fullagar J's reasoning to solve other problems with respect to the valuation of trading stock has not been fully appreciated either by either tax practitioners or academics.<sup>83</sup> It is the author's view that reading the case should be an essential part of any taxation law course and particularly so for accounting students.

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scheme.

<sup>80</sup> An exception might occur which there is only a small amount on hand, however in the author's view this simply means applying the replacement cost based upon a normal purchase quantity.

<sup>81</sup> (1928) 12 TC 1191, 1404 (emphasis added).

<sup>82</sup> As is demonstrated by the recent case of [2002] AATA 746 *Re Ciprian and Others v FCT* 50 ATR 1257.

<sup>83</sup> Many case book extracts give scant attention to the full impact of this case, a situation which is greatly to be regretted.

APPENDIX I:

Summary of Findings of K C Keown,<sup>84</sup> A Fitzgerald,<sup>85</sup> Raymond J Chambers,<sup>86</sup> R K Yorston,<sup>87</sup> of the disclosed methods used for valuing trading stock.<sup>88</sup> (See overleaf).

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<sup>84</sup> K C Keown, 'Stock on Hand in the Balance Sheets of Victorian Companies' (1951) 21 *The Australian Accountant* 265, 265-6.

<sup>85</sup> A A Fitzgerald, 'A Further Note on the Valuation of Trading Stock' (1944) 14 *The Australian Accountant* 424, 424-6.

<sup>86</sup> Raymond J Chambers, 'The Spice of Accounting', First published in (1949) 19(11) *The Australian Accountant* 398, 398-401.

<sup>87</sup> R K Yorston, 'Stock-in-Trade' (1945) 16 *The Chartered Accountant in Australia* 199, 199-200.

<sup>88</sup> Other methods noted but not enumerated by Yorston were included:

- at usual trade values
- at cost or replacement
- at cost or valuation
- at or under market value
- at cost less allowance for depreciation

Valuation Method	Chambers				Yorston		Keown		Fitzgerald	
	1938		1948		1945					
At Cost	6		5		10		27		2	
At Cost plus Overhead		6		5		10	1	28		2
At or Below Cost					32		79		5	
Cost or Deprecated Cost	1									
Cost or Under as Certified by, etc	3		3							
Cost Less Amounts Written Down	1									
Cost or Under (or Lower, or Less, At or Below Cost, At and Under Cost)	9		12							
At or Below Cost, Less Depreciation			1							
At Valuation not Exceeding Cost			1				11		1	
At Cost or Under							6		16	
Not Exceeding Cost			1		3				2	
At Cost or Under after Providing for Prices Fluctuation							1			
At Prime Cost less Provision		14		18		35	2	99		24
At Cost and/or Valuation	1		1				12		2	
Cost or Market Values as Certified	1		1							
Cost, Replacement Value or Under	1									
Cost or Replacement as Certified etc	1		1							
Cost and/or Replacement Value	1		1							
Cost or market	1	4	1	4	2	2				
At Lower of Cost or Market Value (variations)	7		9		6		16		2	
At Cost or Replacement Value (whichever is less)	3		2				1		1	
At Valuation not exceeding the Lower of Cost, Market or Replacement Value	1						1			
At Cost, Market or Valuation, whichever is lowest		11		11			2	20		3
At Lower of Market or Replacement Value							2			
Lower of Cost and Valuation	1		0						1	
Fair Market Value	1		0							
Sales Value Less 29% to reduce to present market value									1	
At Valuation	7		5				11		3	
As Certified by the Managing Director etc	2		2				4			
Valuation after Allowing for Obsolescence / Diminution	1		1							
As Valued by a Director	1	10	1	8			2	17		3
At or Under Market Value							2		1	
Companies did not give any basis of valuation			2		19				3	
	50		50		72		180		40	

APPENDIX II

Cost Flow Assumptions and Calculation of Cost - Methods Referred to in the Accounting Literature.

Method	Yorston et al	Ballantyne et al	Scott	Fitzgerald			Brad-dock	CARS (Vic)†
				1938	1946	1954		
First-in first-out (Fifo)	T	T	T	T	T	T	T	
Last-in first-out (Lifo)	T	T	T	T	T	T	T	
Highest cost first		T				T*	T	
Average Cost	T	T	T	T	T	T	T	T
Unit Cost [specific identification]	T	T	T			T	T	T
Last Cost	T							
Adjusted Selling Price [retail inventory]	T		T					
Standard Cost	T		T	T		T*	T	T
Base Stock	T		T					
Replacement Cost			T					

\* indicates method is stated to be rarely used in Australia

† Chartered Accountants Research Society (Victoria)

**Sources:**

- A Fitzgerald, 'Problems of Accounting Valuation of Stock in Trade' (1946) 16 *The Australian Accountant* 261, 261–72.
- A Fitzgerald, 'Balance Sheet Problems - I. The Valuation of Stock on Hand' (1938) 6 *The Australian Accountant* 1, 1–14.
- A Fitzgerald, *Fitzgerald's Accounting - Stage I* (2<sup>nd</sup> ed, 1954) 107–9.
- Australian Chartered Accountants' Research Society (Victorian Division), 'Stock-on-Hand of a Major Manufacturer', *Chartered Accountant in Australia*, April 1953, 522, 522–78.
- L A Braddock, 'Accounting profits and Taxable Income' (1949) 19 *The Australian Accountant* 6, 6–25.
- W M Scott, 'Accounting for Stock in Trade' (1947) 17 *The Australian Accountant* 464, 466, 471–2.
- R Keith Yorston, E Bryan Smyth and S R Brown, *Advanced Accounting*, vol 3, (3<sup>rd</sup> ed, 1953), 48–50.
- J R Ballantyne, L H Dillon, Louis Goldberg, V R Hill, K C Keown and V L Solomon, A Fitzgerald (eds), *Intermediate Accounting* (1948) 28–9, 99–100.

### APPENDIX III

#### The Context of the Unsuspected Importance of Mr Menzies' Argument.

Mr. Menzies sought to maintain that the closing stock values stated in the company's returns for the years in question did conform to what is required by s. 31. His argument did not, I think, differ in substance from a view put by Mr. Robinson, a director of the company who gave evidence before me, in a letter written by him to the Commissioner during the progress of the investigation. He said that s. 31 was framed in the light of recognised practices adopted in businesses honestly and efficiently conducted. He said that a precise ascertainment of the cost of every article comprised in stock manufactured by a taxpayer must often be impracticable, and that a careful and honest estimate of the total cost of a quantity of stock was all that s. 31 really required. So far, I do not know that I would be disposed to differ from him. It is common knowledge that in many matters of accounting an honest and careful estimation is the most that can be expected or achieved. He went on to say that in the present case the company's valuation per unit of closing stock had been originally based on cost, having been adopted at a time when it did represent approximate cost. I think, as I have said, that the evidence established that there was a time when it did represent approximate cost. The next step was to say that, stock being once established and valued at cost, what took place from year to year was merely a drawing on that stock and a replacement of that stock, so that it was legitimate to regard the stock on hand at any given time, so far as it did not in fact consist of the "original" stock, as substituted for, and the equivalent of, "original" stock taken out and sold. Therefore, it was said, the stock on hand at the end of each of the accounting periods in question could be said with truth to have been valued at cost. The conception behind the argument may possibly be regarded as a sort of theoretical justification for a practice which does not seem to me in itself to stand in need of justification. But I am quite unable to accept the conclusion which is said to follow. It does not seem to me to bear any relation to the real situation or to the actual requirements of s. 31. There were, as I have said, very wide fluctuations, up and down, in the stock on hand from year to year at 30th September. Moreover, so far as jams and canned fruits are concerned, Mr. Robinson said in cross-examination that "in general, the maximum time that the company would carry stock would be two years". In any case, I am not able to read s. 31 otherwise than as requiring, at the end of every accounting period, a valuation, on one or other of the specified bases, of stocks actually on hand, and I cannot regard "cost" as meaning anything other than actual cost.<sup>89</sup>

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<sup>89</sup> (1953) 88 CLR 23, 30-1; 5 AITR 566, 571; 10 ATD 217, 220-1.