BY GEOFFREY GUNN, BRISBANE

BEWARE OF *Option*

Summary

Under proposed changes, lawyers[1] may be assessed on unbilled work. Unbilled work in progress (WIP), expected to be realised in more than 12 months time will be brought to account to calculate income. Pre-payments of advertising, interest, rent, stationery and the like will be disallowed to the extent that they represent an asset at year end.[2] If enacted the changes will restrict access to justice, cause serious funding problems in legal firms, and if assessments are pursued, bankruptcies.

Option 2

On a track seldom crossed 'cept by folk that are lost, the Ralph Committee has made a recommendation. It goes by the name of Option 2.[3] By now you have heard the prophets of Y2K doom, responded, and survived. You are diligently trying to fathom the GST proposals. Well unfortunately the New Tax System may have a sting in its tail for the plaintiff lawyers who are holding work in progress on cases likely to settle in more than 12 months.

The Greatest Change in Tax History

The Taxation Institute of Australia says ... "*Option 2... represents the greatest change to the tax system this country has even (sic) seen or is likely to see. It seeks to provide the 'theoretical platform' for the business tax reform by removing over 100 years of case law (and 60 years of application of the Income Tax Assessment Act 1936 in respect of the income/capital dichotomy and the incurred concept in relation to deductions.*"[4]

Cashflow / Tax Value Approach

In essence, Option 2 seeks to tax increases in net wealth, and applies to all resident taxpayers. For businesses with a turnover less than $1M per annum, simplified measures[5] will be available. It is proposed that net income be calculated as follows:

- All income received during the year,
- Minus all amounts paid during the year,
- Plus the closing value of each non monetary asset,
- Minus the opening value of each non monetary asset,
- Minus the closing value of each liability owed,
- Plus the opening value of each liability owed.

Accounting Concepts

Have your eyes glazed over yet? Well the worst is yet to come. Each business owner will have to sit down and apportion values according to accounting concepts. Expenditure which provides an enduring benefit (ie it is an asset such as a year's supply of something) will not be allowed. Consider for a moment the compliance problems with the time spent on these processes.

Work in Progress

Firms who have work in progress (WIP) valued at zero, nominal, or historical cost will have to bring the value of WIP to account as income. A specific exemption applies to matters likely to settle within 12 months.

An Example

A Personal Injuries practice starts 1 July, 2000, and by 30 June, 2001, has 500 speculative files in various stages of completion. Direct wages, and overheads paid are $375,000 to 30 June, 2001. Outlays are $225,000. Value of professional costs[6] at 30 June, 2001 and outlays are $2,225,000. Of this, $850,000 will be settled by 30 June, 2002. $1,375,000 is more than 12 months from settlement. The Practice pays advertising, interest, rent, and leases in advance of $65,000.

UNDER THE EXISTING SYSTEM:	
Assessable income	nil
Less Wages and overheads	375,000
Outlays	225,000
Prepayments	65,000
Total Expenses	665,000
Taxable Income (Loss)	**$665,000**

Tax Payable nil, carried forward loss of $665,000. Under the cash basis of accounting the income is assessed as it is collected over the next few years.

Geoffrey Gunn is a Chartered Accountant and Barrister, GPO Box 2100 Brisbane QLD 4001
PHONE (07) 3832 0000 **FAX** (07) 3832 0001
EMAIL gngunn@powerup.com.au

Under Option 2:	
Income received during the year	nil
Less amounts paid during the year 375,000 + 225,000 + 65,000	(665,000)
Plus closing value of non monetary assets (2,225,000[7] - 850,000[8] + 65,000[9])	**1,440,000**
Minus the opening value of each non monetary asset held at beginning of year	nil
Minus the closing value of each liability you owed at year end	nil
Plus the opening value of each liability owed at the beginning of the year	nil
Taxable Income	**$775,000**

Difference between the old and proposed scenarios is $1,440,000, and at the practitioner's marginal rate of say 48.5% is $698,400 tax payable.

Problems for Practitioners

This will cause cash flow problems for all firms who work on a no win no fee basis, and carry large amounts of unbilled WIP. The compliance costs of valuing WIP will be substantial. A practitioner may argue that a speculative file cannot be assessed as to value or likely settlement date, and in any event the effect is a deferral, not avoidance of tax. This could be resisted by file costing and taking an analytical approach to success rates, with WIP write downs in subsequent years for unsuccessful matters.

Problems for Plaintiffs

With many plaintiffs relying heavily on either complete or partial funding of actions by their lawyers, particularly in the speculative matters, a restriction of working capital within firms will see a restriction of the access to justice for the impecunious injured. On public policy grounds alone the proposals could be opposed.

The Government is still taking submissions on Option 2. PL

Footnotes:

1. And other professionals for that matter.
2. Review of Business Taxation Report - A Tax System Redesigned
3. Option 2 is a new basis for determining taxable income, proposed by The Ralph Committee, as part of the Federal Government's tax reform package.
4. Letter to Federal Treasurer dated 10 November 1999, paragraph 16 from Senior Vice President Taxation Institute of Australia. www.taxia.com.au
5. The Simplified Tax System or STS seeks to provide relief for smaller businesses.
6. Party and party costs and solicitor own client costs, as assessed.
7. $2,225,000 at assessed value.
8. $850,000 likely to be receipted within 12 months of the year.
9. The $65,000 prepayment is viewed as an asset, not an expense of this tax year.