

**University of NSW ATAX
& Board of Taxation**

**Tax Value Method
Consultative Conference**

**Sydney
23 and 24 July 2001**

**Tax Value Method:
What, Why and Why Now?**

Presented by:

Paul Abbey

Shaddick & Spence

Level 32, 101 Collins Street
Melbourne Vic 3000

Ph: 03 9650 4451 Fax: 03 9650 4467
abbey@shaddickspence.com.au

Martin Keating

Australian Taxation Office

45 Francis Street
Northbridge WA 6003

Ph: 08 9268 5963 Fax: 08 9268 5250
Martin.Keating@ato.gov.au

Tax Value Method: What, Why and Why Now?

Contents

1.	INTRODUCTION.....	1
2.	THE CURRENT INCOME TAX BASE.....	3
2.1	WHAT IS THE CURRENT INCOME TAX BASE?	3
2.1.2	<i>Revenue Side.....</i>	3
2.1.2	<i>Expenditure Side.....</i>	5
2.1.3	<i>A Universal Tax Base</i>	6
2.2	HOW IS THE ASSESSING REGIME FOR THE INCOME TAX BASE CURRENTLY STRUCTURED?	7
2.2.1	<i>Structure of Income Tax Law.....</i>	7
2.2.2	<i>Problems of Current Income Tax Law Structure.....</i>	10
3.	THE OPPORTUNITY PROVIDED BY THE GROWTH OF THE TAX BASE: WHAT, WHY AND WHY NOW?.....	12
4.	THE PRINCIPLES WHICH UNDERLIE THE TVM.....	14
4.1	IMPLICIT PRINCIPLES	14
4.2	EXPLICIT PRINCIPLES OF REVIEW OF BUSINESS TAXATION	15
4.2.1	<i>Realised Gains.....</i>	15
4.2.2	<i>Expenditure Relief.....</i>	15
4.2.3	<i>Timing of Relief.....</i>	16
4.2.4	<i>Economic and Financial Accounting Principles.....</i>	16
4.2.5	<i>Revenue Neutrality.....</i>	17
4.2.6	<i>Observations on the Explicit Principles.....</i>	17
4.3	OPERATIONAL PRINCIPLES	18
4.3.1	<i>The Operational Principles Set TVM Apart.....</i>	18
4.3.1	<i>The Analytical Tool.....</i>	19
5.	WHAT IS THE TVM?	21
5.1	THE TVM PROVISIONS	21
5.2	THE ARCHITECTURE OF THE TVM.....	22
5.3	THE TVM IN PRACTICE	23
5.4	CONTEXT AND COMPARISON	30
5.4.1	<i>Cardin's Case.....</i>	31
5.4.2	<i>British Income Codification Committee.....</i>	31
5.4.3	<i>Rewriting the Income Tax Act: The New Zealand Experience.....</i>	32
6.	CONCLUSION	35

1. INTRODUCTION

The Tax Value Method (“TVM”) is a methodology for the calculation of taxable income¹. Under TVM, taxable income comprises the net annual cash flows of a taxpayer and the net annual change in the tax value of assets and liabilities held or owed by the taxpayer. The TVM legislation, if enacted, would replace much of the law currently used to determine what is assessable income, including capital gains, and allowable deductions and the law which determines when assessable income is derived and allowable deductions are incurred². More fundamentally, the replacement of this law with the TVM legislation would mean that current concepts such as income according to ordinary concepts, derivation and the revenue-capital distinction and tests such as the nexus test for deductibility would no longer be a feature of the income tax law³.

In previous discussion of the TVM, a number of misunderstandings have arisen regarding its nature. To dispel some of these concerns, it is important to make the early statement that the TVM is not a cash flow or expenditure tax. The TVM is not a market value taxation system nor a means of taxing unrealised profits nor a means to introduce an accrual-based capital gains tax. Equally, the TVM is not a comprehensive Haig-Simons income tax under which the income tax base would be the amount a taxpayer could spend on consumption in any year, leaving real wealth unchanged. Indeed, the TVM is not even a new type of tax; it is merely a change of the assessment methodology and principles of the income tax law⁴.

The obligations for this paper are to explain the TVM, why the opportunity for its development has only arisen now and why that opportunity is being pursued. To meet these obligations, we do not propose to provide a detailed explanation of the structure of the TVM legislation which is contained in the current prototype, nor to address its assorted and asserted benefits. The detailed explanation of the legislation can be found in the Explanatory Material currently available on the website of the Board of Taxation. The benefits of the TVM have already been asserted⁵ and to do so again would not be a profitable exercise for this paper.

This paper will address three matters.

First, it will examine the breadth and development of the current income tax base. It is not reasonable to assert that the base of the Australian income tax law is merely income under ordinary concepts. The introduction of capital gains tax in 1985 and the proposal of the Review of Business Taxation (“RBT”) to ensure relief for all business expenditure⁶ have (or

¹ Proposed by the Review of Business Taxation (“RBT”) in *A Tax System Redesigned* at Recommendation 4.1.

² The concept of incurrence would effectively be retained if the current prototype legislation was enacted (refer Section 7-23 (Item 1)) and the current jurisprudence would continue to be relevant. However, the current jurisprudence on other issues would cease to be relevant.

³ These assertions seem to attract controversy. This seems to be because tests which, at first blush, look similar to the income/capital distinction or the nexus test appear to exist in the TVM. Proper review will indicate that the tests, as they exist in the current law are not replicated in the TVM. For instance, interest on a loan incurred by a company is not tested under TVM to determine if the funds borrowed were used for income producing purposes (the nexus test).

⁴ As discussed in this paper, one of the principles of the TVM, as proposed by the RBT is that its introduction should be revenue neutral for taxpayers

⁵ Refer *A Tax System Redesigned* at pages 155-163.

⁶ Recommendation 4.14, *A Tax System Redesigned*.

will be seen to have) significantly altered the nature of the income tax base. The current (and proposed) scope of the tax base is fundamental to the TVM proposal. This matter is covered in Section 2 and Section 3 of the paper.

Secondly, this paper will discuss the principles which underlie the TVM. One of the operational (or practical) principles which underlies TVM is a three part analytical tool which comprises tests as to the nature, ownership and value of things⁷. This tool is drawn from the current income tax law and finds usage in both legislative and judicial expressions of assessable income and allowable deductions. This three part analytical tool can be used to characterise amounts as assessable or worthy of tax relief and to determine the timing of that assessment or tax relief. Indeed, this is its current usage. This matter is covered in Section 4 of the paper.

Thirdly, this paper will outline the nature and structure of the proposed TVM legislation. This will be done through a practical application of the TVM to examples rather than an abstract discussion of its provisions. This paper will also demonstrate that TVM is not even a new idea or an idea unique to Australia. These matters are covered in Section 5 of the paper.

* * * * *

⁷ If the prototype legislation demonstrates the architecture of TVM, this analytical tool should be recognised as its engineering.

2. THE CURRENT INCOME TAX BASE

Two of the issues addressed in this paper are why the TVM proposal is being considered and why the consideration has only occurred now. An easily anticipated response to the TVM proposal is to observe that if it is such a good idea it should have been considered at some earlier time. The argument made in this paper is that one of the significant reasons to pursue the TVM is the current state of the income tax base in Australia, or perhaps more correctly, the nature that this income tax base would have if the recommendations of the RBT were adopted. The further argument made by this paper is that the time for this consideration has only now arisen following the release of *A Tax System Redesigned*.

For simplicity the discussion of the income tax base in this paper focuses on non-individual taxpayers conducting a business. This focus allows the paper to refer to the income tax base without repeated qualifications for the affairs of individuals. It is acknowledged that the income tax base of individuals excludes items of a private or domestic nature. The TVM prototype legislation will include provisions which exclude private or domestic transactions, assets and liabilities from the income tax base. When this paper discusses the income tax base, it should be thought of as the business component of the affairs of individual.

2.1 What is the current income tax base?

2.1.2 Revenue Side

Although the 1936 Act⁸ and the 1997 Act⁹ collectively seek to assess taxable income and found this approach upon a calculated amount called “assessable income”¹⁰, both Acts contain provisions which extend the tax base beyond mere “gross income” or “ordinary income”. In undertaking this extension, each Act has infringed upon the domain of capital with a range of provisions which ultimately seek to assess virtually all capital gains.

When originally introduced, the 1936 Act had the general intent of taxing income according to ordinary concepts, rather than capital receipts, although income was to include certain items specified by the Act. In the Third Report of the Royal Commission which preceded the introduction of the 1936 Act, the Royal Commissioner’s commented on the existing State Income Tax Acts and the Commonwealth Income Tax Acts in the following manner:

“513. *The intention of the Acts of the various Governments is to impose a tax on ‘income’ as distinct from capital receipts. The meaning assigned to income in the various Acts is, generally speaking, its plain and ordinary meaning, subject to certain reservations which will be dealt with in the proper place. But it must be made clear that the income subject to tax is the statutory income measured in a particular way, and not either income or profits in the sense that those terms are used by the business man. It should be noted, however, that none of the Acts contain a complete and satisfactory*

⁸ Income Tax Assessment Act 1936.

⁹ Income Tax Assessment Act 1997.

¹⁰ The words “assessable income” are merely a label.

definition of income but that the procedure adopted in all cases is merely to state that the expression 'income' includes certain specific receipts, in order that there may be no doubt that such receipts are taxable."

The 1936 Act, as originally enacted, already included provisions which sought to assess certain capital receipts, eg. Section 26(a) and Section 26(f). Equally, a provision such as Section 44(1) which was primarily enacted in the 1936 Act to assess income amounts, being the dividends earned from equity investments, assessed capital receipts such as bonus shares (and subsequently Section 6(4) dividends).

Subsequent amendments to the 1936 Act operated brought to bring other capital receipts within the income tax base. For instance, Section 26AAA included profits made on the sale of assets which occurred within 12 months of their purchase. To the same effect, judicial interpretation of Section 25(1) extended to its operation into the "non-mere-realisation" profits of the owners of land, shares and securities¹¹.

The most profound extension of the tax base was the introduction of Part IIIA of the 1936 Act, the capital gains tax provisions, in 1985. These provisions were introduced with the intention of extending the tax base to all capital gains. This intention was stated in the second reading speech of the then Treasurer, as follows:

*"Capital gains contribute to taxable capacity no less than wages and salaries, interest and dividends, and business trading profits. It has been particularly inequitable that those who receive their income primarily or wholly in forms such as wages and salaries have been taxed more heavily than those who have been able to arrange for much or all of their income to be taken in the form of capital gains. The absence of a capital gains tax has also undermined the intended progressivity of the tax system since the distribution of the ownership of capital is more heavily concentrated among the higher income groups."*¹²

The introduction of capital gains taxation was outlined by the Government in the Draft White Paper issued in June 1985. This White Paper acknowledged that Australia had provisions which operated to tax gains made on the disposal of property including Section 26AAA and Section 25A, provisions which taxed balancing adjustments on the disposal of depreciable assets and other assets that have attracted special write-offs and Section 47 which taxed liquidators' distributions. Nevertheless, the Draft White Paper concluded that there was a compelling argument to have a comprehensive income tax through the inclusion of capital gains into the income tax base. This was said to address issues of horizontal inequity, investment distortion and anti-avoidance. The Draft White Paper recommended a capital gains tax which had the characteristics of being, *inter alia*:

¹¹ That is, Section 25(1) was said to apply to profits which were not the mere realisation of capital assets.

¹² Second Reading Speech, Income Tax Assessment Amendment (Capital Gains) Bill 1986, 22 May 1986.

- applied on a realisation basis;
- applied only to gains accruing after its commencement;
- imposed on real gains calculated after indexing asset cost bases;
- levied at ordinary rates; and
- subject to capital loss offsets.

However, to call or consider what was enacted in Part IIIA as provisions which tax “capital gains” would be to accept a fallacy. First, the provisions, as is well known, did not introduce a capital gains tax but rather included capital gains amongst the various items of assessable income. Secondly, the provisions enacted did not merely apply to gains of a capital nature. Rather, the provisions sought to tax all realised, real gains which fell within their specific purview, whether the gains were of a revenue or capital nature, so long as the gains arose on or after 20 September 1985¹³. Indeed, the provisions applied to some gains which individual taxpayers would consider to be of a private nature. Part IIIA did not contain any requirement that an asset subject to capital gains tax have a capital nature. Equally, Part IIIA was not limited to the mere disposal of assets, in any ordinary meaning of those words. And, although Part IIIA was intended to tax realised gains, it could operate to assess amounts before the taxpayer received anything more than a promise to be paid.

Part IIIA, as originally introduced, had the potential to eliminate the operation of many of the existing provisions of the 1936 Act. However, the enactment of Section 160ZA(4) meant that these provisions were not rendered redundant. Nevertheless, the introduction of the capital gains tax provisions meant a fundamental realignment of the nature of the income tax base on the revenue side because it provided a determination and impetus to establish a universal tax base founded upon all realised gains and receipts¹⁴. Indeed, it can now be asserted that the income tax base of a business conducted by an entity or partnership includes all of the kinds of profits or gains generated by the business¹⁵.

2.1.2 Expenditure Side

On the expenditure side of the income tax base, limitations were originally created by the income-capital distinction.

¹³ There were some specific exclusions from this operation, eg. trading stock.

¹⁴ This observation is relevant to a business which would not have gains of a private nature.

¹⁵ Prior to the introduction of the 50% CGT discount, the tax base was admittedly schizophrenic in that income and certain capital gains were assessed on a nominal basis while the remaining capital gains were assessed on a real or indexed basis. With the denial of indexation for assets acquired after 21 September 1999, this distinction is eliminated and the tax base is clearly more universal.

The 1936 Act denied an immediate deduction for capital expenditure but allowed depreciation for the costs of plant and articles. Subsequently, the 1936 Act provided relief for other forms of capital expenditure through an accretion of amortisation regimes. The available relief was substantially enhanced by the capital gains tax provisions because it captured as cost base an array of expenditure which previously did not get relief. However, the introduction of capital gains tax could be said to be the cause of the “blackhole” problem because a tax base with a universal capture of revenue should relieve all business expenditure. It is not credible to argue that all business expenditure should be relieved if all business gains are not taxed.

The RBT addressed this issue in Recommendation 4.14 which proposed:

“General Principle

- (a) That blackhole expenditures under the current law be either expensed, amortised or capitalised where incurred after 30 June 2000.*
- (b) That, consistent with this principle, write off be provided for assets such as lease premiums, franchise fees and the cost of acquiring indefeasible rights of use (see section 10).”*

This recommendation was part of the proposals for the introduction of the TVM. It was accepted by the Treasurer on 11 November 1999¹⁶.

2.1.3 A Universal Tax Base

Recommendation 4.14, like the earlier introduction of capital gains tax, is fundamental to the TVM proposal. Following this recommendation, it can be argued that the income tax base of a business taxpayer comprises all of the realised profits and receipts of the taxpayer and that relief will be provided for all of the expenditure incurred by the taxpayer. That is, the taxpayer has an entirely universal tax base in which all receipts, payments, assets and liabilities are relevant to its calculation of taxable income. Until this recommendation was made by the RBT, these observations did not hold because various expenditures incurred by taxpayers could be denied relief because they were either not revenue expenditure or did not qualify for relief under any specific amortisation regime or did not form part of cost base for capital gains tax purposes.

Given the width of this proposed income tax base, it is appropriate to consider whether the current regime of assessing and deducting provisions is an appropriate vehicle to bring it into taxation.

¹⁶ Attachment L, Press Release No. 74.

2.2 How is the assessing regime for the income tax base currently structured?

The starkest contrast in any examination of the Australian income tax system must be between the income tax base and the legislative structure used to include that tax base in taxable income. Whereas the income tax base is virtually universal as discussed at 2.1¹⁷, the legislative structure used to assess this universal tax base is circuitous, disjunctive, repetitive and overlapping.

2.2.1 Structure of Income Tax Law

The perverse legislative structure of the current tax base is demonstrated by the early Divisions of the 1997 Act. This Act commences by specifying how taxable income and the income tax liability are to be calculated¹⁸. As we know, it requires you to add up all your assessable income, add up all your deductions and subtract the deductions from the assessable income. It then proceeds to specify assessable income¹⁹ and allowable deductions are²⁰. The provisions which specify what assessable income and allowable deductions contain both a general rule which relies on ordinary concepts, and a statutory rule which states that a collection of items specifically listed in the legislation are also included in, respectively, assessable income and allowable deductions.

The confusions of this structure are demonstrated by what comes next. First, for both assessable income and allowable deductions, there are provisions to stop double counting²¹. Then, the drafters of the 1997 Act seek to assist its users in comprehending its structure by providing three divisions:

- Division 10 which lists provisions which vary or replace rules in regard to ordinary income or contain rules which specify amounts of statutory income;
- Division 11 which lists provisions which determine exempt income; and
- Division 12 which lists provisions which contain rules about specific types of deductions.

These Divisions are intended to assist in the comprehension of the 1936 Act and 1997 Act. In essence though, the Divisions are really an indictment of the expression of the tax base in each Act.

¹⁷ Or will be universal under *Recommendation 4.14*.

¹⁸ Division 4.

¹⁹ Division 6. Assessable income comprises ordinary income and statutory income.

²⁰ Division 8. Allowable deductions comprises general deductions and specific deductions.

²¹ Sections 6-25 and 8-10, 1997 Act.

The Divisions demonstrate the lack of any logical structure to the manner in which the tax base is presented on both the gain and tax relief sides. Although these Divisions list sections under relevant headings such as “investment” or “compensation”, the actual provisions which deal with these subjects are found indiscriminately within each Act. There is no apparent pattern or relationship to these provisions and they are not systematic. Indeed, the lack of a plan or structure to the operation of assessing provisions is demonstrated by Section 10-5 which admits that some of the provisions listed in Division 10 vary or alter the effect of other provisions listed in that Division.

The perversity of the expression of the current tax base can also be demonstrated by attempting to provide a guide to its operation. This guide, although far from complete, would need to include the following elements:

- The 1997 Act specifies the tax base by firstly seeking to include in assessable income what is called “ordinary income” which is defined as income according to ordinary concepts;
- The 1997 Act then extends the concept of assessable income by including amounts which are not ordinary income but which are included in assessable income by some other provision of the 1997 Act or the 1936 Act. These items are called “statutory income” although some items are already ordinary income and so not included again;
- There is no plan as to what is statutory income. Section 10-5 provides a list of specific items which are included. Division 15 covers “some items that are included in your assessable income”²² although the reference to “some items” is essentially acknowledgment that all items of statutory income cannot be brought under one roof;
- Care must be taken because the statutory income provisions often have the potential to overlap and so arbitrary distinctions arise in their coverage. For example Section 15-15 of the 1997 Act, the successor provision to the illustrious Sections 26(a) and 25A of the 1936 Act provide that the provision does not apply to anything which is ordinary income under Section 6-5 (this is to allow for the extension of the concept of ordinary income which is exemplified by the decision of the Full High Court in *FCT v Whitfords Beach Pty Ltd*) or in respect of property acquired on or after 20 September 1985 (to avoid overlap with statutory income arising under the capital gains tax provisions); and
- Then there are the capital gains tax provisions. These provisions seek to assess any gain of any nature which comes within their ambit. They are only restrained by Division 118 of the 1997 Act which excludes the operation of capital gains tax from a range of assets and, most importantly, where a capital gain is included in statutory income

²²

Refer Section 15-1.

by another provision of either Act²³. Nevertheless, in many instances their effect is to render the concern as to whether an amount is ordinary income irrelevant.

When the income tax law seeks to provide relief for the taxpayers' expenditure, the means by which that relief is provided is equally perverse:

- Section 8-1 which currently expresses the general deduction provision was taken from Section 51(1) of the 1936 Act. It is founded on the nexus of income and expenditure although arguably Section 51(1) was never interpreted properly if it is compared to Section 23(a) of the 1922 Act;
- The nexus structure in Section 8-1 is crucial because any expansion in assessable income necessarily expands the range of items which qualify for relief. This expansion of relief often leads to requirements in the legislation to restrict the availability of relief. Thus, provisions like Section 51AAA develop and, as statutory income expands, so this provision itself has needed to expand;
- The negative limbs of Section 8-1 then function to exclude items of capital or of a capital nature but without indicating any further relief which may be available for these items;
- That relief arises in other provisions of the Act which make no effort to establish any relationship with the general deduction provisions. The availability of relief (prior to the Capital Allowances Act) was spasmodic and depended upon the item of capital expenditure achieving specific recognition in the legislation. In the original 1936 Act, the major items of capital expenditure to earn further relief were expenditure on plant or articles which were depreciated. The Review of Business Taxation noted that this relief extended until the time of Review to 37 different regimes for capital expenditure;
- In addition to the general deduction provision and the capital relief regimes, there are also a large number of specific deduction provisions, many of which are undoubtedly completely unnecessary. These can overlap with the operation of the general deduction provision and to stop double deductions it is necessary for the legislation to have provisions to ensure that double deductions do not arise; and
- Finally, expenditure which gets no other relief may be treated as the cost base of an asset.

²³ Refer Section 118-20.

2.2.2 Problems of Current Income Tax Law Structure

With the income tax base expressed in this manner, the following difficulties arise:

2.2.2.1 Blackholes

Notwithstanding a general intent to provide relief for all forms of business expenditure, if the particular item of business expenditure does not fall within one of the specified categories of relief, or does not form part of the cost base of an asset for capital gains tax or amortisation purposes, it will be ignored by the income tax law. The blackholes are the gaps between the regimes of immediate deduction, capital amortisation and capital gains tax cost base.

2.2.2.2 Overlap

Different provisions can operate to deduct or assess the same amounts and it is necessary then for the legislation to contain numerous provisions which ensure that double deductions or double assessment does not occur. For example, Section 26AAA which taxed capital gains on assets held for 12 months was obliged to provide that it did not tax amounts of ordinary income: refer Subsection 26AAA(5). Division 118 of the capital gains tax provisions now prevents overlap for, *inter alia*, ordinary income, trading stock and gains on the disposal of depreciable assets.

2.2.2.3 Disjunctive Operation

Disjunctive operation is an equally damaging part of the structure of both Acts. For instance, one provision may treat the receipt of an asset such as a bonus share or an employee share as assessable income. The ownership of the share is relevant for capital gains tax purposes but the same provision which specified the assessable amount does not also specify the share's cost base for capital gains tax purposes. Rather, it is necessary to have another provision which is either cross-related or which specifies the same amount to ensure that double taxation does not occur or that no amount slips through the tax base. The interrelationship between the capital gains tax provisions and the traditional security provisions as they apply to convertible notes is a strong example of the problems that disjunctive operation creates.

2.2.2.4 Conceptual Inconsistency

The wide variety of provisions in the legislation use different theoretical or conceptual bases to specify amounts which should be assessed or relieved. For instance, different concepts, legislative rules

and practises determine the timing of derivation of interest income compared to preference share dividends. Another example is Section 26(g) which appears to defer the recognition of a bounty until actual cash receipt rather than when it is receivable.

These problems (and this list of problems is probably not complete) are the product of the structure of the income tax law rather than its purpose. Nevertheless, these problems are the reason for many of the complaints attracted by the income tax system.

* * * * *

3. THE OPPORTUNITY PROVIDED BY THE GROWTH OF THE TAX BASE: WHAT, WHY AND WHY NOW?

The purpose of the discussion at 2. is to explain that we are now in a position where:

- the income tax base for a business proposed by the RBT is virtually universal in its treatment of both revenue and expenditure; and
- the structure of the legislative mechanism to assess the current tax base and the tax base proposed by the RBT is flawed and inappropriate.

By analogy, if you intend to include every citizen in a census, then legislation to establish the census would not be expected to specify this coverage by identifying some people by name, groups of people by characteristic and the remainder collectively, including those already specified, and then to provide that no person should be subject to the census twice. Yet this is what the income tax law currently does.

The current circumstances, which effectively have only been crystallised by the issue of *A Tax System Redesigned*, provide the opportunity to restate the tax base in legislation that is more accordant with its nature. If the income tax base is universal, without exclusions or distinctions, then the legislation to bring that tax base to taxation should obviously seek to have the same nature. It seems obvious that a universal tax base should be assessed, if possible, by using a single calculation of realised net profit rather than the aggregate of many discreet calculations of income and realised profits. Equally, relief under a universal tax base should be provided by a single discreet regime rather than through a myriad of general and specific reliefs.

The TVM proposal is an attempt to provide a single calculation which recognises all the elements of the revenue and expenditure side of the income tax base. The TVM methodology is founded upon the concept of “net income” which comprises all of the net annual cash flows of a business and the net movement in the tax values of all of the asset and liabilities of the business²⁴. This concept can be expressed in the following formulation:

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

Although this calculation of net income is based upon wide notions of asset and liability, these assets and liabilities are only recognised where they are considered to be held or owed by a taxpayer pursuant to specific rules, which are contained in the prototype legislation. Additionally, the value placed on assets and liabilities is not their market value, nor any other value calculated for accounting purposes. Instead, each asset and liability is recognised at a specified tax value, which is generally the historic cost or the wasted historic cost of the particular asset or liability. The use of this specified tax value means that, except in the

²⁴ Although the operating principle of the TVM is to capture the net movement in the tax values of all assets and liabilities, policy constraints, the need to mirror current tax outcomes and *de minimus* concerns mean that some assets and liabilities are excluded.

particular circumstances of trading stock and certain financial assets, unrealised gains are not recognised in the net income calculation²⁵.

To calculate taxable income, net income is combined with specified adjustments provided for by the tax law (such as additional research and development deductions or the denial of deductions for entertainment expenditure or non arm's length international payments). In addition, relief is provided for prior year losses in the same manner as available under the current income tax law.

The genesis of the opportunity to present the calculation of taxable income in this manner was first, the introduction of the capital gains tax legislation in 1985. The scope of the capital gains tax legislation together with the ordinary income concept make the income-capital distinction, at the highest level, essentially irrelevant in the determination of assessable income. Indeed, its relevance is only pursued in the current legislation to the extent to which there are distinctions in concessions for taxpayers provided under each regime. As we have argued above, the RBT recommendation for complete expenditure relief crystallises this opportunity: it is the second major development. In our view, the adoption of this recommendation will mean a universal income tax base; it is the existence of this universal base which makes recasting the income tax law inevitable.

* * * * *

²⁵ We have provided a more detailed explanation of this net income concept and its operation at 5. in this paper.

4. THE PRINCIPLES WHICH UNDERLIE THE TVM

Why discuss the principles which underlie the TVM? There are two immediate answers to this question. The first answer is the obvious observation that a proper understanding of the TVM requires an understanding of its principles. The more important second answer is that TVM seeks to be a methodology for the determination of taxable income founded upon “high level principles” which unify the structure of the income tax law. The RBT states that TVM is a “principle-based framework for a reformed income taxation system”²⁶.

The intent of the TVM is to establish a series of principles for the expression of taxable income which can then be applied to the specific provisions of the income tax law. These principles need to resolve the treatment of different things and transactions in a consistent manner. They also need to be of sufficient strength and clarity that they can govern and control any amendments or the developments which occur to the legislation once it is operative.

Tax legislation inherently encounters tinkering due to, *inter alia*, policy (political) redirection, economic development and taxpayer response (avoidance activities). One of the fundamental difficulties with the current income tax law is that it has not had principles of sufficient strength to govern its development and so the legislation has often been amended in a manner which is inconsistent with its basic structure. The TVM should be founded upon principles which prevent this problem arising. If it is, it will substantially achieve one of the criteria for good tax legislation, being durability.

We propose the existence of three types of principles which underlie the TVM, being:

- Implicit Principles – principles which underlie both the current income tax system and the TVM;
- Explicit Principles – principles which the RBT has identified as being relevant to the development of a methodology to determine taxable income; and
- Practical or Operational Principles – the functional principles which govern the design of the TVM (ie. its engineering).

These principles are explained in greater detail below.

4.1 Implicit Principles

There is a range of principles which underlie both the current income tax law and the TVM prototype legislation which are implicitly recognised in the TVM proposal. These principles include:

- the use of historical cost measures for the determination of taxable income;
- the taxation of nominal realised gains, without any inflation adjustment;

²⁶ A Tax System Redesigned, Page 155.

- the taxation of receipts and gains that are not in monetary form;
- the determination of taxable income on an annual basis; and
- the allowance of loss carry-forwards but not loss carry-backs (which means that volatility in the economic cycle is dealt with from a tax perspective only prospectively).

The TVM adopts the implicit principles of the current income tax law implicitly, as would any attempted restatement of the current income tax base.

4.2 Explicit Principles of Review of Business Taxation

In Chapter 4 of *A Tax System Redesigned*, the RBT explicitly identified the following principles as the basis of the TVM.

4.2.1 Realised Gains

Only realised gains would be assessed and included in taxable income.

At page 160 of *A Tax System Redesigned*, the RBT emphasises that:

“taxpayers will generally not be taxed on unrealised gains. Gains on most assets will continue to be taxed on a realisation basis”.

An important element of this principle is that, with the exception of the treatment of trading stock (for which unrealised gains can be taxed at the taxpayer’s option) and certain financial transactions under the taxation of financial arrangements regime (“TOFA”), unrealised gains are not subject to taxation.

The RBT also proposes that all relevant assets would be recognised in the calculation of net income and all non-private receipts would be included²⁷.

4.2.2 Expenditure Relief

All expenditure would qualify for tax relief.

At page 157 of *A Tax System Redesigned*, the RBT states “all non-private expenditure, including existing blackhole expenses, will be recognised in the calculation of taxable income – unless specifically excluded by the law for policy reasons”. This principle is the essence of Recommendation 4.14(a) of the RBT which states:

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

²⁷ *A Tax System Redesigned*, Page 159.

Although this recommendation focuses on the treatment of blackhole expenditure, it really confirms that all expenditure incurred by a business will obtain either immediate or deferred tax relief. This principle allows the TVM to provide relief for all business payments or liabilities and to ensure that virtually all assets with a limited life which arise from a business expense can be amortised with that amortisation being effectively deductible in the calculation of taxable income²⁸.

4.2.3 Timing of Relief

The timing of relief for expenditure would be commensurate with the period over which the expenditure generates economic benefits for the business.

At page 157 of *A Tax System Redesigned*, the RBT states:

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

...

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

4.2.4 Economic and Financial Accounting Principles

The recognition of income would reflect economic and financial accounting principles. The RBT proposes defining income in a manner which is:

“structurally consistent with both economic and accounting approaches to income measurement”²⁹.

The RBT also proposes that expenditure would be treated consistently with the accounting approach by classifying it by reference to the life of the benefits which the expenditure generates.

²⁸ The amortisation is “effectively deductible” because under TVM there is no concept of an allowable deduction. Rather, the amortisation is subtracted in the calculation of net income through the annual reduction in the closing tax value of the relevant asset.

²⁹ Page 157, *A Tax System Redesigned*.

4.2.5 Revenue Neutrality

At Recommendation 4.1(c) of *A Tax System Redesigned*, the RBT states:

“That the [TVM] approach be implemented in a revenue neutral manner – except to the extent that other recommendations in this report expressly propose variations to the existing law.”

This recommendation indicates that where a conflict arises with any of the earlier principles, those principles will prevail over the principle of revenue neutrality. This is an important design concession. The TVM does not have a fanatical commitment to revenue neutrality and so different tax treatments may arise.

4.2.6 Observations on the Explicit Principles

The explicit principles of the RBT are important because they state the width of the income tax base and say what the income tax law needs to do. The principles set out above make it clear that the income tax law needs to:

- capture all realised gains, profits and receipts;
- relieve all expenditure; and
- ensure the timing for the recognition of both relief and revenue accords with the period of benefit.

Once the explicit principles of the tax system make it clear what the income tax law needs to do, consideration can then be given to the structure to do that. The explicit principles of the RBT make it clear that the current income tax law is unnecessarily complex. Australia’s income tax system does not need a revenue/capital distinction, it does not need provisions which tax separately ordinary income and statutory income and it does not need a nexus test.

If we propose to have a universal tax base based on realised gains, then characterisation provisions are inherently unnecessary. Apart from provisions that ensure that the income tax base has sufficient width to cover its specified range, the only other necessary aspect of the income tax law is timing provisions, which of course are a necessary element of any income tax system. In the past, the capital-income distinction has had a timing role, although this has not been its direct focus. Adopting the explicit principles of the RBT, the TVM really only needs rules to ensure revenue or expenditure recognition accords with the actual flow of value and rules to specify the width of the tax base (ie. realised gains, not private or domestic items, residence and source, etc).

4.3 Operational Principles

4.3.1 *The Operational Principles Set TVM Apart*

The principles set out at 4.1 and 4.2 above do not necessarily lead to the introduction of the TVM contained in the prototype legislation. These principles could be applied under a methodology for the calculation of taxable income which is not dramatically different from the current assessing and relief provisions. However, the operational principles of the TVM alter the means by which it calculates taxable income. The two significant operational principles of the TVM are:

- that taxable income will be aggregation of net annual cash flows and the annual change in net assets as measured for tax purposes; and
- the measurement of the change in net assets will be made using a three-part analytical tool which seeks to assess economic events by reference to their nature (asset or liability), ownership and value.

As an aside, it should be recognised that the separate recognition of net cash flows is a mere side-show in the TVM proposal. To recognise net cash flows, it is necessary to deem cash and near cash assets such as bank accounts with authorised deposit institutions to be “non-assets” for the purposes of the application of TVM. This deeming effectively eliminates the double counting which would arise if both cash assets and cash movements were recognised under the TVM model. An alternative approach for the TVM model could be to ignore cash movements and simply operate by reference to the net movement in all assets and liabilities including cash assets and liabilities (ie. cash assets and liabilities would not be excluded from the TVM net asset calculation).

As explained at 3., the adoption of these two operational principles is made possible by the proposed universal income tax base. Under a universal tax base all flows of money will be relevant and so can be measured. Equally, all assets and liabilities can give rise to assessable amounts and so the income tax law can cover them all uniformly without any need for income–capital distinctions³⁰.

Most importantly, the adoption of these operational principles allows the TVM methodology to pursue benefits which cannot be achieved by the current income tax law. If the implicit and explicit principles set out above were expressed in a legislative format which did not diverge significantly from the current income tax law, it would not be possible to argue that a tax system had been developed which would be either simple or durable³¹. Rather, the difficulties of the current income tax law would essentially be retained. These principles are the vehicle by which the TVM can seek to eliminate the existence of blackholes, overlap, disjunctive operation and

³⁰ Distinctions for capital gains tax assets will exist under the TVM but only because of two policy prescriptions: the 50% discount and the quarantining of capital losses.

³¹ Or simple and more durable than the current law.

conceptual inconsistency. The assertions which have been made by the RBT in regard to the improvements that can be achieved through the adoption of the TVM methodology are based upon these operational principles and the changes they achieve in the operation of the tax system.

4.3.2 The Analytical Tool

The current income tax law contains many provisions which operate by classifying a transaction, an asset or liability, giving a cost or an amount to the specified item and providing that tax consequences can arise.

An example is the trading stock provisions. They specify which assets of a business constitute trading stock for tax purposes and then give this trading stock a value for tax purposes (which may differ from its book value). While the stock is held this value is a component of taxable income. On disposal, that value is deducted as a cost and the consideration received on sale is brought into taxable income.

Equally, the former depreciation provisions specified what was plant and articles and whether they were used in the required circumstances. Those plant or articles could then be written off, and for that purpose they were given a cost by the depreciation provisions³². The write-off was, in essence, a specified annual reduction of their value for tax purposes. Similarly, Section 25-25 of the 1997 Act specifies certain outgoings as borrowing expenses, sets an amount for those borrowing expenses and then allows the amortisation of that amount by reference to the effluxion of time. In this manner, the borrowing expenses are recognised as an asset whose value for tax purposes declines each income year³³.

All of these provisions (or their forbears) were found in the 1936 Act when it was originally enacted. Each of these provisions performs the same basic function, being:

- they establish the existence of a particular asset;
- they specify when the taxpayer commences to hold and ceases to hold the asset, so that, for example, trading stock is no longer held when it is not “on hand”; and
- they set a value for that asset, for example its cost, and provide, for some assets, that this value should decline in each income year.

More sophisticated provisions in the 1936 Act and 1997 Act have a similar operation. For instance, the traditional security provisions identify certain financial assets and then in certain circumstances where the debt is no longer

³² Other capital asset amortisation provisions operated in the same manner.

³³ The Capital Allowances Act is probably the part of the 1997 Act with the strongest relationship to TVM concepts. This is due to the fact that it has been written on a TVM platform and expressly uses the analytical tool discussed in this paper.

held, taxation consequences arise. Strangely, these provisions do not have explicit value rules but rather rely on a common law cost concept. Division 16E applies to debts of a particular nature, specifies a present and future value for these debts and deems the value of the debt for taxation purposes to increase as a result of the effluxion of time.

The debt forgiveness provisions apply to certain liabilities owed by taxpayers, specify a value for these liabilities and specify tax consequences in circumstances where the liability is reduced (ie. ceases to be held).

This analytical tool is applied in more fundamental areas of the 1936 Act. In *Whitfords Beach Pty Ltd v FCT*³⁴, the Full High Court stated that where an asset was ventured into a profit making undertaking or scheme, it received at that time a tax value equal to its then market value. Any assessable gain arising was the difference between this tax value and the amount received by the taxpayer on disposal of the asset.

In *RACV Insurance Pty Ltd v FCT*³⁵, Menhennitt J stated that a liability incurred, but not reported, had a tax value equal to its estimated dollar value and that this tax value would be deductible in the year in which the liability commenced to be held by the taxpayer. If it was established in a later income year that the tax value of the liability was different to the amount originally estimated, the difference between the later amount and its original estimate would become assessable or deductible in the later income year.

Of course, the description of these jurisprudential examples is not presented in the language in which they were decided, but they demonstrate that the concepts expressed were merely the application of this analytical tool.

In many circumstances, the analytical tool is the intuitive basis for assessing income and allowing deductions. Under the accruals method for income recognition, income is assessed when it is derived. In essence, this means that where a taxpayer holds a receivable at year end (which was not held at the beginning of the year), the value of that receivable (its tax value) should be included in the taxpayer's assessable income. Under the general deduction provision, a taxpayer is allowed a deduction for a loss or outgoing incurred. Restated, where a liability exists at year end, the amount of the liability (its tax value) should be an allowable deduction in the calculation of the taxpayer's assessable income. Indeed, the TVM proposes to use virtually the same words to achieve the same function in regard to the recognition of liabilities³⁶.

* * * * *

³⁴ 82 ATC 4,031.

³⁵ 74 ATC 4,169.

³⁶ Section 6-75.

5. WHAT IS THE TVM?

The earlier parts of this paper have explained the reasons for the development of the TVM, why that development is now appropriate and the principles upon which the TVM is based. In this final part of the paper, we explain the nature of the TVM provisions and how they operate. We also place the TVM in the context of other attempts at income tax reform and show that the TVM is not a uniquely Australian proposal.

5.1 The TVM Provisions

Under the TVM, taxable income is calculated using the following formula:

$$\text{Taxable Income (Loss)} = \text{Net Income} + \text{Taxable Income Adjustments} - \text{Tax Losses}$$

A taxable income adjustment is an adjustment to net income required for policy, tax base, jurisdictional or anti-avoidance reasons. It will comprise upward adjustments, which add to taxable income (and could arise in circumstances where, for example, entertainment expenditure is treated as not giving rise to tax relief) or downward adjustments which reduce taxable income (which could arise where, for instance, an additional relief is provided for expenditure of a certain character, eg. research and development expenditure).

The key element of the formula is the calculation of net income which will be made in the following manner:

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

This formula comprises net cash flows for the relevant income year and the movement in net assets calculated by reference to their tax value over the relevant income year.

In the application of this formula, the prototype legislation provides that:

- receipts and payments are limited to amounts of money. However, the exchange of assets or liabilities will also be deemed to be receipts and payments;
- the notions of “asset” and “liability” are wide and embrace, respectively, anything that embodies future economic benefits or that consists of one or more obligations to provide future economic benefits;
- a taxpayer only recognises assets that are legally owned by the taxpayer and effectively only recognises liabilities where the taxpayer has a present legal obligation to provide economic benefits; and
- the tax value of assets and liabilities is generally their historic cost or wasted historic cost, producing the effect that unrealised gains are not subject to taxation.

The adoption of this formula has the following immediate consequences:

- the TVM prototype legislation does not include any provisions to prevent double deductions or double assessability;
- the prototype legislation contains no gaps on the revenue side nor blackholes on the expenditure side except where explicitly required by tax policy;
- the prototype legislation adopts a consistent conceptual basis to assess and deduct all relevant amounts;
- the prototype legislation adopts the same recognition rules for all amounts of revenue and expenditure; and
- the disjunctive operations in the current legislation are eliminated – the same provisions which include an amount in net income on the receipt of an employee share will establish the cost base (tax value) of that employee share.

5.2 The Architecture of the TVM

TVM proposes to use the asset/liability structure to ensure the tax base achieves the necessary width and to establish the appropriate timing rules. Conceptually, this approach is consistent with accounting practise which uses asset and liability rules to determine the recognition of income and expenditure for book purposes.

The use of the asset/liability structure to determine the timing of income and expenditure recognition for tax purposes makes it easy to suggest that the legislation retains a capital-income dichotomy. In effect, this observation may have some truth but in essence it is a fallacy. The income-capital dichotomy was intended to establish the scope of the tax base on both the revenue and expenditure side. On the revenue side, for a long time, many items of a capital nature fell outside the tax base; all capital items that were assessed were captured by provisions which had a limited assessing range, eg. Section 26AAA. On the expenditure side, the general deduction provision knocked capital expenditure out of the category of expenditure which qualified for immediate relief under the tax base. Capital expenditure could then be picked up by other regimes which operated under a “specific identity model”. That means that capital items which had a specified identity were picked up by particular regimes and given either immediate relief or an amortisation relief.

Under the TVM, all items of realised profit or receipt and expenditure are recognised as part of the income tax base and the work that the capital-income dichotomy previously performed is no longer required. What is required is an accurate recognition of the benefit or return that an asset generates over a period and an equally accurate recognition of the costs that a liability imposes over a period. This is the explicit RBT principle discussed at 4.2.3 above. Although it mimics the effect of the revenue-capital dichotomy, it is fundamentally a different principle and may, in certain situations, generate different outcomes³⁷.

³⁷ This is easily generated. An interest expense will usually be income item, even if prepaid. Yet the prepayment will generate an asset for TVM purposes which defers the tax recognition of the expense.

Under the TVM, the recognition of profits or receipts and expenditure is achieved through the hold and value rules. Simply, if the hold rules provide that an asset is held, then at that time an amount will be brought into net income. Conversely, if the hold rules provide that an asset is no longer held an amount will be subtracted in the calculation of net income. The value rules, by allowing that certain assets (or liabilities) can have a reduction in tax value over a period of time or that other assets can appreciate in value, also apply the recognition principle of the TVM.

5.3 The TVM in Practice

To understand how the net income formula works, we propose to consider the examples set out in Chapter 1 of the *Tax Value Method Working Draft Explanatory Material*. This material is extracted below:

“Simple revenue expense

1.19 *First, let’s look at the simple case of a revenue expense. It can sometimes be difficult under the current law to work out which expenses are revenue expenses (and, therefore, deductible) and which are capital expenses (and usually not deductible). But there are some expenses that are clearly revenue, so the first case chooses one of those.*

Example 1.1

Suppose you pay someone \$500 to clean your office. You pay the amount, the cleaning is done and, under the current law, you can claim a deduction for the \$500.

In the same transaction, the net income formula would apply like this:

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

$$[0 - 500] + [0 - 0] - [0 - 0] = -500$$

The payments side of the formula has increased, so that ‘deductions’ have gone up. The result is the same because a payment under the Tax Value Method is treated in exactly the same way as a revenue expense under the current law.

Prepayments

1.20 *Now, let’s look at simple cases where the revenue expense is paid in one year for something to be done in a later year. Assuming that a revenue expense remains a revenue expense even it is prepaid, the current law would allow an immediate deduction.*

1.21 *However, that result is not sustainable from a taxation policy perspective because divorcing the timing of deductions from the time the benefits of the expenditure are consumed may lead to a focus on taxation, rather than commercial, advantages. To address that concern, the current law contains*

a number of special rules to defer the deduction until the intended benefit is obtained. Those rules apply except in some limited circumstances.

Example 1.2

In the same transaction, suppose you pay the cleaner this income year for cleaning to be done in later income years. Without the special rules, the outcome would be the same as the payment for the current year's cleaning. However, the special rules (section 82KZM et al) defer the deduction until the year(s) that the cleaning is done.

The Tax Value Method will produce the same outcome more directly as part of its generic rules dealing with depreciating assets and liabilities. In the year of the transaction, the pre-payment has this effect on net income:

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

$$[0 - 500] + [500 - 0] - [0 - 0] = 0$$

The payment is matched by an asset with a tax value equal to the payment. That asset is the right to the future cleaning services. The 'deduction' is obtained as the services are provided because the tax value of that right will decline as services are consumed. That might take several years but let's suppose the services are being provided entirely in the second year:

$$[0 - 0] + [0 - 500] - [0 - 0] = -500$$

The 'deduction' appears because the tax value of the right has declined from \$500 to nil during that year. A decline in the tax value of assets produces a 'deduction'.

- 1.22 *The result is that the current law's special prepayment rules are not needed to get the same policy outcome under the Tax Value Method.*
- 1.23 *However, under the Tax Value Method a special rule is needed to get to the result achieved by the current law's limited exceptions to the prepayment rules (eg. for people who elect into the STS). That special rule is to give a zero tax value to the right to future benefits for taxpayers in those limited circumstances. Effectively, this puts them on a cash receipts basis.*
- 1.24 *It is also worth looking at the position from the viewpoint of the taxpayer who receives a payment for providing future benefits.*

Example 1.3

Under the current law, the decision in *Arthur Murray (NSW) Pty Ltd v FCT*³⁸ would support the cleaner deferring assessment of the prepayment until the cleaning was done. The issue would be whether the income was 'derived' before the cleaning was done or, indeed, whether it was 'income' at all before that time.

The Tax Value Method will get the cleaner to the same result without having to interpret the words 'derived' and 'income'. In the income year of the prepayment, the net income result would be:

³⁸ (1965) 114 CLR 314

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

$$[500 - 0] + [0 - 0] - [500 - 0] = 0$$

The receipt would be matched by the liability to provide the future cleaning services. In the income year that the services are provided, the result would look like this:

$$[0 - 0] + [0 - 0] - [0 - 500] = 500$$

The tax value of the liability declines as the services are provided. A decline in the tax value of a liability produces a taxable gain under the Tax Value Method.

Credit transactions

- 1.25 *Now let's look at cases where current benefits are paid for, not with cash, but with a promise to pay later. This is a credit transaction. It does not much matter here whether there is a direct promise to pay, or an indirect promise via a credit card.*
- 1.26 *The current law would probably treat you as having 'incurred' the outgoing and give you a deduction immediately (subject to the prepayment rules). It would not give you another deduction when you made the payment because you would not have incurred anything at that time.*
- 1.27 *How would the Tax Value Method work in these cases? Again, it gets to the same result because, even though there is no increase in payments, there is an increase in liabilities.*

Example 1.4

Suppose you promise to pay the cleaner next year for this year's cleaning rather than paying straight away. The effect of the transaction on net income in the first income year is:

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

$$[0 - 0] + [0 - 0] - [500 - 0] = -500$$

As you can see, the \$500 'deduction' comes, not from the payment part of the formula (as it would under the current law), but from the liability part. In the next income year, when you make the payment, there would be no tax effect, just as under the current law:

$$[0 - 500] + [0 - 0] - [0 - 500] = 0$$

The \$500 payment you make in the second income year is negated by the \$500 decline in the tax value of your liabilities.

Capital gains

- 1.28 *A claim sometimes made about the Tax Value Method is that it will tax unrealised gains. Indeed, if the ‘value’ part of the net income formula meant ‘market value’ it would do exactly that. It would also allow deductions for unrealised losses. But this is the Tax Value Method, not the market value method, and therein lies a world of difference.*
- 1.29 *In most cases, the tax value of an asset will be its cost. That will achieve the same outcomes as the current law. For instance, if you make a capital gain or loss under the current law, you only make it (usually) when you dispose of the CGT asset.*

Example 1.5

Let’s say that you buy a block of land for \$100,000 and hold it for 10 years. At that time, its market value has risen to, say, \$250,000. The current law doesn’t tax you as the value goes up, it only taxes you when you realise the gain by, typically, selling the land.

The Tax Value Method would treat the land as an asset with a tax value equal to its cost, \$100,000. And it would stay at that tax value until you stopped holding the land because the tax value of CGT assets under the Tax Value Method is their cost³⁹. So, applying the net income formula to the transaction in the income year you bought the land would look like this:

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

$$[0 - 100,000] + [100,000 - 0] - [0 - 0] = 0$$

Note how, instead of deciding deductibility by asking whether an expense was income or capital, the Tax Value Method allows a ‘deduction’ for all payments but brings any matching asset to account, thus producing a neutral effect. This, in effect, gives the correct treatment to ‘capital’ items.

In the second year of this transaction, you would get this result:

$$[0 - 0] + [100,000 - 100,000] - [0 - 0] = 0$$

Because there is no change between the opening and closing tax values of the land, there is no gain or loss to account for. It makes no difference what has happened to the market value of land during the year - only the tax value is accounted for.

Now see what happens when the land is sold in the tenth year:⁴⁰

$$[250,000 - 0] + [0 - 100,000] - [0 - 0] = 150,000$$

The gain is brought to account on disposal of the land, exactly as the current law would do.

- 1.30 *In the case of capital gains, though, a number of special rules are needed to achieve particular policy objectives. The 2 main ones are:*

³⁹ The tax value of such an asset could increase (because its cost would increase) if payments are made to improve it. However, this increase is *matched* by the payments, so there is no effect on net income.

⁴⁰ Assume the sale proceeds go into cash on hand and are not used to buy a new asset.

- *capital gains made by individuals and some other entities should be discounted if the asset has been held for at least 12 months; and*
- *capital losses should be quarantined to prevent them offsetting non-capital gains.*

1.31 *Like most policy variations, those objectives would be achieved under the Tax Value Method by taxable income adjustments. So, in the example above, if the taxpayer was eligible for the 50% CGT discount on the asset, there would be a downwards adjustment to taxable income of \$75,000 to ensure that only half the gain was taxed.*

Depreciation

1.32 *Although most assets will maintain a tax value equal to their cost, some types of asset will have variable tax values. Depreciating assets are a key example. Under the current law, plant and some other assets ‘depreciate’. The present system recognises appropriate capital expenses by allowing the amount of depreciation as a deduction.*

Example 1.6

Suppose you buy a printing press with a 10 year life for \$15,000 and depreciate it using the prime cost (or straight line) method. Under the current law, you would get a \$1,500 deduction in each of those 10 years.

The Tax Value Method achieves exactly the same result. However, rather than making the amount of depreciation a deduction, it reduces the tax value of the press by that amount. Applying the net income formula, the decline in the press’s tax value produces a net ‘deduction’ in the year you acquired it.⁴¹

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

$$[0 - 15,000] + [13,500 - 0] - [0 - 0] = -1,500$$

The deduction is equal to the difference between the amount paid for the press and its tax value at the end of the income year after it has been depreciated. And, in the next year:

$$[0 - 0] + [12,000 - 13,500] - [0 - 0] = -1,500$$

Here, the deduction arises because the press’s tax value has declined. And so on for each of the next 8 years until the tax value reaches zero.

Now suppose that you sell the press in the third year for \$12,500. The current law would work out a balancing charge equal to the difference between the press’s depreciated value and the \$12,500 sale price. It would treat that amount as assessable income.

Under the Tax Value Method, you would get the same outcome because any gain or loss on disposal of the press would be recognised simply as the difference between what is received for the disposal and the tax value

⁴¹ These calculations assume that the press got a full year’s depreciation in each year. In the first year, that means that you began to use it, or had it installed ready for use, on the first day of the year.

the press had at the start of the year. So, being sold for \$12,500 during the third year, the transaction would look like this:⁴²

$$[12,500 - 0] + [0 - 12,000] - [0 - 0] = 500$$

The \$500 gain is a normal incident of the Tax Value Method. No special balancing adjustment rules are needed.

Trading stock

- 1.33 *Trading stock under the Tax Value Method requires relatively little explanation, because the current law already uses similar rules (see paragraphs 2.24 to 2.26). It produces a net amount for trading stock that is either added to assessable income or is a deduction. Little will change in the treatment of trading stock under the Tax Value Method.*
- 1.34 *However, one area that does require a special rule under the current law is where you pay for stock that is neither sold nor 'on hand' at the end of the year. Without that special rule, such cases would produce a deduction that would not be matched by proceeds or by an increase in stock on hand. The special rule defers the deduction until you get the stock.⁴³*
- 1.35 *The Tax Value Method achieves the same result without the need for a special rule.*

Example 1.7

Suppose you pay \$1,000 in an income year for trading stock that is delivered in the next year. Applying the net income formula, you get this outcome:

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

$$[0 - 1,000] + [1,000 - 0] - [0 - 0] = 0$$

Here the closing asset figure represents your right to get the stock, not the stock itself. When you actually get the stock, the right vanishes but is replaced by the actual stock at the same \$1,000 tax value.

- 1.36 *As with the present trading stock regime, the tax value of trading stock is variable. At the taxpayer's choice, the closing tax value of each item of stock on hand at the end of a year can be set at cost, replacement price or market selling value⁴⁴."*

One issue of concern with the TVM was whether its principles (and provisions) would appropriately deal with tax planning activity, especially activity based on timing advantages. As the examples discussed in the Explanatory Material indicate, the TVM is well placed to deal with this activity because fundamentally its focus is on the timing issue to be addressed by the income tax law. Many tax planning schemes will

⁴² Again, assume the sale proceeds go into cash on hand and are not used to buy a new asset.

⁴³ See subsection 70-15(3) of the ITAA 1997.

⁴⁴ This assumes a continuation of the current trading stock valuation methods. *ATSR* recommended different valuation methods (see recommendation 4.17).

be ineffective under the TVM because expenditure intended to generate immediate relief will give rise to an asset with an offsetting tax value. Reductions in taxable income sought by the tax scheme will only occur as (and if) this asset declines in tax value.

5.4 Context and Comparison

The consideration of methodologies for the expression of the income tax base is not a new idea. The matter has been the subject of rumination by the Courts and consideration by committees of review established in this country, New Zealand and the United Kingdom.

This paper does not intended to provide an exhaustive survey of these efforts. However, to provide some context to the development of the TVM, we have focussed on the following instances.

5.4.1 Cardin's Case

An early expression of this issue can be found in the decision of the Full High Court in the *Commissioner of Taxes (SA) v Executor Trustee & Agency Company of South Australia Limited* ("Cardin's Case") 5 ATD 98. This case considered the South Australian Taxation Acts 1927-1933. The issue for consideration was the basis upon which income was derived.

In discussion of the basis on which income should be brought to account as derived, Dixon J commented (at page 130):

"Income, profits and gains are conceptions of the world of affairs and particularly of business. They are conceptions which cover an almost infinite variety of activities. It may be said that every recurrent accrual of advantages capable of expression in terms of money is susceptible of inclusion under these conceptions. No single formula could be devised which would effectually reduce to the just expression of a net money sum the annual result of every kind of pursuit or activity by which the members of a community seek livelihood or wealth. But in nearly every department of enterprise and employment the course of affairs and the practice of business have developed methods of estimating or computing in terms of money the result over an interval of time produced by the operations of business, by the work of the individual or by the use of capital. The practice of these methods of computation and the general recognition of the principles upon which they proceed are responsible in a great measure for the conceptions of income, profit and gain and, therefore, may be said to enter into the determination or definition of the subject which the legislature has undertaken to tax."

Justice Dixon expressed an early scepticism that about whether the TVM could be effectively developed. However, the TVM can be understood in the context which Justice Dixon observes. The TVM is an attempt to draw general principles and methodologies from the methods of estimating or computing profits and gains used in business and then to apply those general principles across all of the possible circumstances which may arise. The challenge the TVM takes up is to identify a single formula to do this. Justice Dixon recognises that the concepts of income or profit relevant for tax purposes arise from the general business conceptions of gain. The TVM goes further by attempting to generalise operating principles out of the tax concepts of profit, income and gain.

5.4.2 British Income Codification Committee

In 1927, the United Kingdom formed a committee:

"To prepare a draft of a Bill or Bills to codify the law relating to Income Tax, with the special aim of making the law as intelligible to the taxpayer as the nature of the legislation admits, and with power for that purpose to suggest any alterations which, while leaving substantially unaffected the liability of a taxpayer, the general system of administration and the powers

and duties of the various authorities concerned therein, would promote uniformity and simplicity.”⁴⁵

This Committee reported in 1936⁴⁶.

Like the issue addressed by the TVM, the Committee considered, amongst other issues, how the income tax base could best be expressed in the income tax law.

As part of its deliberations, the Committee considered the computation of trading profits. The Committee noted that judicial criticism of the existing income tax legislation was that it contained no general direction as to the ascertainment of business profits apart from specifying a number of particular deductions to be taken into account in any calculations. After deliberation, the Committee decided **not** to adopt any express form of legislative statement of the calculation of trading profits. The Committee stated at paragraph 77 of its report:

“We considered in detail these and other judicial pronouncements, and we decided that, in dealing with the computation of profits from businesses, our draft Bill should first contain a statement that the computation is to be made on ordinary commercial principles, and should then set out a list of specific matters allowed or disallowed in computing profits for income tax purposes, introduced by words making it clear that, if there is in any case a conflict between ordinary commercial principles and the provisions of the Bill, the latter are to prevail.”

This is contrary to the TVM approach by relying upon general principles and judicial interpretation rather than specific statutory formula. The Committee prepared draft legislation which it appears was never enacted.

5.4.3 Rewriting the Income Tax Act: The New Zealand Experience

The publication, “Rewriting the Income Tax Act: Parts C, D and E” is a discussion document issued by the Treasurer of New Zealand in September 1997 as part of the rewrite of New Zealand’s Income Tax Act 1994. The discussion document deals with the parts of the Income Tax Act 1994 which specify gross income, allowable deductions and their timing.

In regard to the specification of what is gross income and what are allowable deductions for income tax purposes, the Rewrite proposes an approach which is broadly similar with the structure of our current income tax law. However, in specifying a methodology for the timing recognition of gross income and

⁴⁵ Paragraph 2, Report of British income Codification Committee (1936).

⁴⁶ It is interesting to note that whereas the RBT had nine months to report the English were prepared to allow their Committee nine years. It appears that the Committee although appointed in 1927 only properly constituted itself in 1932 and still took four years to present its report. From 1932 until 1936 the Committee held 154 separate meetings.

allowable deductions, the discussion document proposes an approach which bears close relation to the TVM approach.

This approach is set out in the following extract from the discussion document:

“The valuation method

- 10.6 *A valuation method of allocation is proposed for provisions that defer amounts of gross income or allowable deductions to a later income year.*
- 10.7 *An amount of gross income that is derived in one income year but recognised for income tax purposes in a later income year is treated as a liability. Similarly, an allowable deduction for which the expenditure is incurred but recognised for income tax purposes in a later income year is treated as an asset.*
- 10.8 *The valuation method adopts the financial accounting method for measuring the cost of trading stock allocated to a financial year (the cost of goods sold). By adopting the financial accounting method for measuring the cost of goods sold, the valuation method should lead to tax accounting better reflecting the approach set out in the Statements of Concepts for General Purpose Financial Reporting, issued by the Institute of Chartered Accountants, for the measurement of net income. This leads to greater harmonisation of tax and financial accounting.*
- 10.9 *Accountants treat the cost of goods sold as an expense for a financial year. The financial accounting method for calculating the cost of goods sold addresses the allocation of the cost of trading stock to the year in which the trading stock is sold. The amount of the cost of goods sold is measured by subtracting the closing value of trading stock from the sum of the opening value of trading stock and purchases of trading stock made in that year. This approach can be applied to all timing provisions that defer completely, or in part, the recognition of an amount of gross income and allowable deductions to years after the gross income is derived or the expenditure or loss that gives rise to the allowable deduction is incurred.*
- 10.10 *A transaction may give rise to an amount of deferred gross income or allowable deduction. For any transaction, the allocation of an amount of gross income is made separately from the allocation of an allowable deduction.*
- 10.11 *The allocation method for the valuation method in the year in which the transaction occurs is as follows:*
- *The closing value of the deferred gross income is subtracted from the gross income derived in that year.*
 - *The closing value of the deferred allowable deduction is subtracted from the allowable deduction for expenditure incurred in that year.*
- 10.12 *In subsequent years, unless there are further amounts of gross income or allowable deductions relating to the transaction in question, the valuation approach will normally determine the amount to be allocated. This will be done by measuring the*

difference in the opening and closing values of the deferred gross income or allowable deduction.

10.13 If there are further amounts of gross income or allowable deduction relating to the transaction in question in a subsequent income year, they must be taken into account in the allocation process. This will apply to transactions such as purchases of trading stock and capital additions to depreciable property.

10.14 The valuation method will value most assets or liabilities by reference to historic cost principles. Generally, this method assumes that the value of a deferred amount of gross income or allowable deduction will decline over time. However, for some types of gross income or allowable deductions (for example, trading stock valued at market value) the closing values are not determined by reference to historic cost principles, and it is possible that the closing value may exceed the opening value. The new section EC 1 provides for this possibility by permitting the result of the calculation of the amount of gross income or allowable deduction to be allocated to an income year to be more or less than zero.”

It would appear like many tax reform ideas, New Zealand thought of it first. The New Zealand idea is essentially consistent with the TVM idea for the recognition of income and expenditure on depreciating assets and liabilities (although its scope is not as encompassing as the TVM idea because New Zealand only deals with timing issues). For instance, Arthur Murray-type income would be dealt with in the same manner by the TVM and under the proposals explained in the extracted paragraphs 10.10 to 10.12 above. A comparison between these paragraphs and paragraphs 1.20 to 1.24 of the Explanatory Material extracted at 5.3 suggests that the same methodology is proposed. The difference in the New Zealand proposal to the TVM methodology is that it can not be applied universally because of the nature of that country's tax base.

* * * * *

6. CONCLUSION

In concluding this paper, a number of observations should be made about some of the things the TVM cannot do.

It is an inherent aspect of taxation systems that there will be disagreements between the revenue collector and the revenue payer. The TVM cannot stop these disputes although it may reduce them.

All taxation systems involve arguments regarding characterisation and taxpayers will always want to defer revenue recognition and accelerate expense recognition. This can be expected to continue.

There will always be arguments regarding the boundary of the income tax base. In the future, these arguments will primarily be made by individuals as for businesses no boundary issue should arise. Nevertheless, it is interesting to note that after 65 years of the current income tax law there is still litigation regarding what is private or domestic expenditure. Thus, the precedent in terms of uncertainty should not be too difficult to improve upon. Indeed, the Commissioner has recently argued that certain items, such as sunscreen, if purchased by an individual must have an inherent private or domestic nature. This argument might be hard to maintain: if an individual purchases a ream of paper is it possible to tell by the inherent nature of the paper whether it has a business or private or domestic purpose.

Nevertheless, the TVM cannot and still not stop dispute.

* * * * *

Paul Abbey & Martin Keating

Melbourne/Perth
July 2001