

**COMMENTS ON ISSUES RAISED IN TONY BAXTER'S PAPER
PRESENTED AT TAX BOARD/ATAX CONFERENCE OF 23-24
JULY 2001**

BY

BOARD OF TAXATION'S TVM LEGISLATIVE GROUP

STATUS OF THE REJOINDER

1. This rejoinder reflects the proposed TVM legislation as developed to July 2001. Readers should note that the legislation is still under development.
2. The rejoinder has not been endorsed by the Treasurer or any other Minister, nor does it reflect the official views of the Treasury, the Australian Taxation Office, the Office of the Parliamentary Counsel or the Board of Taxation.
3. Comments on the rejoinder and/or the paper which it addresses are welcome. Comments in writing should be addressed to:

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4. Alternatively, comments can be e-mailed to the Board of Taxation Secretariat at taxboard@treasury.gov.au.

1. Baxter, A.J.; 'TVM Issues Testing Report'

Overview

- 1.1 The Legislative Group found Mr Baxter's report both encouraging and useful. It is encouraging because it indicates that various hypothesised benefits under TVM may well be capable of realisation and it is useful because it draws attention to matters that need to be considered in the development process. It both indicates that continued development of TVM is worthwhile and assists in that process.
- 1.2 We acknowledge the difficult task that Mr Baxter and his testing team were confronted with in their attempt to reach conclusions about the simplicity, transparency, durability and certainty of the proposed TVM system when that system was legislatively incomplete (e.g. no international rules and no rules about depreciation, CGT or TOFA), and, even to the extent that there was draft legislation, it was subject to substantial review even as the testing was proceeding.

- 1.3 We suspect that, in some cases, drawing conclusions about simplicity, transparency, etc. on the basis of the limited scope of the testing has invited a measure of subjective extrapolation that may have exceeded its limitations. That is, that much of the discussion and conclusions in the report (replicated in Mr Baxter’s paper at the conference), sound or otherwise, does not follow from the testing itself.
- 1.4 These comments respond to the most significant of those matters discussed in Mr Baxter’s conference paper.

Income/capital dichotomy

- 1.5 One of the claims made for TVM is that it will eliminate the income/capital dichotomy and it is assumed that that would be a good thing.
- 1.6 Some commentators have misunderstood that claim, apparently interpreting it as meaning that there would no longer be distinctions between immediate gains and longer term (‘capital’) gains (or between immediately relieved outgoings and longer term (‘capital’) outgoings). Obviously, such a proposition would not be compatible with retaining an “income tax” system.
- 1.7 Instead, the claim is that TVM removes the income/capital tests, the need for the case law that interprets them and, indeed, the need for any interpretation of those terms. This is still a significant claim. The heavy reliance the current law places on understanding the case law principles¹ to make sense of what the law means by ‘income’ and ‘capital’ would be largely replaced by the requirement to simply understand the facts (in particular how much of this receipt or that payment can be traced into that liability or this asset).
- 1.8 It is worth observing that the case law on the income/capital distinction records the concept that was developed by the courts to establish the width of the tax base for the purposes of sections 25 and 51 of the Income Tax Assessment Act 1936 (the 1936 Act).² That distinction is no longer relevant because, in a post-CGT, post-RBT world, the tax base brings in all gains and relieves all non-private expenditure.³ Therefore, you no longer need rules about the width of the tax base, you merely need rules about timing.
- 1.9 The Legislative Group was pleased to see that the paper (unlike many others) does show an understanding of the claim that is made and believes that it is largely achieved.⁴ However, it makes a number of related comments.

Case law

- 1.10 First, it says that the author is not convinced that the loss of the case law is necessarily an advantage.⁵ By this it seems to be questioning whether the capital/income tests we have

¹ On the Legislative Group’s analysis, 1 in 6 litigated income tax cases relates (at least in part) to whether a receipt or an outgoing was income or capital.

² Now Divisions 6 and 8 of the 1997 Act.

³ These issues were discussed in some detail in another paper at the conference, P. Abbey & M. Keating, *Tax Value Method: What, Why and Why Now?*

⁴ A.J. Baxter, ‘TVM Issues Testing Report – Presentation to the TVM Conference’, at p. 7.

⁵ *Ibid*, at p. 4.

now, even with all the inherent ambiguity that has led to all the case law, might not after all be better than what TVM proposes.

1.11 That is one of the issues that must be considered in weighing up whether or not to proceed with TVM. However, the view of the RBT, and that of the Legislation Group, is that TVM is offering an improved system here because:

- judicial decisions about revenue/capital are sometimes in conflict with each other and can be reversed;
- whether an item is revenue or capital can often turn on points of fact so fine that they cannot reliably be predicted;⁶
- fully understanding the revenue/capital issue requires familiarity with a lot of cases decided over more than a century;⁷
- the TVM equivalent involves questions that should usually be simpler to answer (is a payment or receipt matched by an asset or a liability; is it ‘held’ and at what value?). Therefore, they should produce many fewer marginal instances that would require consideration by the courts.⁸

Some areas remain

1.12 Second, the paper points out that many difficult income/capital issues will remain. It gives as examples, repairs and capital gains and losses⁹ The repair issue will remain but it will be no more difficult than it is under the present law because identical wording is used.

1.13 The income/capital test in the current law will not be used to determine which assets get capital gains treatment under TVM. Rather, the assets getting capital gains treatment will simply be either goodwill or those that have a tax value determined exclusively on the basis of cost.¹⁰ The issue is expected to be simpler to resolve than under the current law because it is determined on the basis of a residual category, rather than the difficult characterisation test that we currently have.¹¹

⁶ A view shared by some judges. For instance, this view about the income/capital distinction from Sir Wilfred Greene MR in *IRC v British Salmson Aero Engines Ltd* (1938) 22 TC 29 at p. 43:

“Indeed, in many cases it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons.”

⁷ A problem with case law in issues, such as this. For instance, this was the view of Pollock MR in *Atherton v British Insulated and Helsby Cables* (1925) 10 TC 155 at pp. 179-180:

“Now what is capital and what is attributable to revenue account I suppose is a puzzling question to many accountants and I do not suppose that it is possible to lay down any satisfactory definition.”

⁸ This last point is impossible to demonstrate, so is no more than informed opinion. Some though, including Mr Baxter, do not share that opinion (see, p. 7).

⁹ Baxter, *op cit*, at p. 7.

¹⁰ That is, those covered by items 8 and 9 of the tax value table in subsection 6-40(1) of Prototype 2, except acquired commercial secrets (see Chapter 19 of the explanatory materials to that draft).

¹¹ The characterisation test can be found in the case law applicable to sections 6-5 and 8-1 of the 1997 Act which determines whether a gain or loss is taxed under the ordinary income rules or the CGT rules.

Complexity of provisions

- 1.14 The paper says that the complexity of provisions will increase in some instances.¹² While this may well be true, the real question must be whether complexity is increased or reduced overall and that, we would submit, cannot be decided until the legislation is drafted.

Mineral exploration expenditure

- 1.15 An example the paper gives is of mineral exploration expenditure that is just deductible under the current law but under TVM would be a payment matched by assets that would need zero tax values to return the same tax outcome as the current law.
- 1.16 The current law achieves that outcome only by enacting a special rule.¹³ A similar special rule would do the job in TVM.
- 1.17 The Legislative Group also wonders if the statement, “currently it is simply a deductible outgoing”, might be presenting an inaccurately rosy view of the current law. For instance, it doesn’t mention the interpretational difficulties involved in distinguishing assets used for normal mining activities from those used for “*exploration or prospecting for *minerals, or quarry materials, obtainable by *mining operations”.

Accounting compatibility

- 1.18 The paper dismisses the claim that TVM produces a greater degree of compatibility with accounting.¹⁴ But the claim was only to have achieved a greater degree of compatibility, not to have become compatible. For instance, the explanatory material accompanying the legislation in the RBT Report stated:¹⁵

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

- 1.19 Similarly, the Treasury/ATO discussion paper of February 2000 said:¹⁶

“While consistent with accounting concepts..., the tax value method will not recognise every asset recognised for accounting purposes and will not always measure the value of recognised assets in the same way. This accommodates tax policy and, importantly, the practical considerations that underlie a workable and certain taxation system.”

- 1.20 That the TVM is more compatible with accounting principles can be demonstrated. For instance, it explicitly recognises that profit is the change in net assets over a year, and therefore adopts the conceptual basis for determining profit found in accounting (see Statement of Accounting Concepts 4) and the paper itself recognises that TVM’s asset

¹² Baxter, op cit, p. 4.

¹³ Paragraph 40-80(1)(a) of the recently enacted *New Business Tax System (Capital Allowances) Act 2001*.

¹⁴ Baxter, op cit, p. 4.

¹⁵ *A Tax System Redesigned: Explanatory Notes*, July 1999, p. 41.

¹⁶ Paragraph 2.8. The paper is available at www.treasury.gov.au.

and liability definitions do draw on those of accounting, as do its cost and proceeds rules.¹⁷

Accruals treatment

- 1.21 The Legislative Group disagrees with the paper's comment that TVM is a system based on cash received and paid and is therefore moving away from accruals accounting.¹⁸ TVM brings to account rights to receipts and liabilities to make payments. The actual receipt or payment in satisfaction of a right or liability has no tax effect under TVM. Indeed, a special rule is necessary to prevent a taxpayer being taxed on an accruals basis (e.g. rights to receipts and payments will have to be zero valued to move individuals and STS taxpayers to a cash receipts system).

The "incurred" test

- 1.22 The paper notes that the TVM approach to 'deductions' increases certainty but then criticises it as reducing flexibility relative to the present 'incurred' test.¹⁹ The Legislative Group thinks some of the main advantages of TVM are that recognition of all non-private expenditure is certain and that the timing of that recognition is more certain than under the current law.

The cost rules

- 1.23 The paper criticises the use of cost rules under TVM as being based on Philip Morris Ltd v FC of T 79 ATC 4352, which he says is "generally considered to be unsatisfactory".²⁰ The principles set forth in the Philip Morris case would be relevant to determining the cost of trading stock under TVM, just as they are under the current law.
- 1.24 To the extent that TVM uses cost rules that would be interpreted by reference to the Philip Morris case, it merely replicates the current law. In areas of the tax base where TVM faces the same issues as the current law, TVM must accept current jurisprudence.
- 1.25 The paper suggests that one alternative would be to adopt the accounting standard in full.²¹ The accounting standard is a very general statement:²²

"6.1 Production overheads that relate to bringing *inventories* to their present location and condition must be systematically allocated in determining the *cost of inventories*. The systematic allocation of those production overheads must be based on the normal operating capacity of the production facilities."

¹⁷ Ibid, p. 4.

¹⁸ Ibid, p. 4.

¹⁹ Ibid, p. 8.

²⁰ Ibid, p. 9.

²¹ Ibid, p. 9. However, he only says that this is a good idea "if cost becomes a more critical area of the tax law, as it would under TVM where the cost of every asset comes up for consideration (not just trading stock, depreciation and CGT assets as at present)." The only other such asset is long-term financial assets, whose tax value would be based on cost under the Taxation of Financial Arrangements (TOFA) proposals. TOFA assets are a new category that will be as applicable to the current law as to TVM.

²² AASB 1019.

- 1.26 In the Legislative Group's opinion, using this standard would not add to certainty. Its only arguable advantage would be the lengthy experience of accountants in applying it for accounting purposes. How relevant that experience would be if exposed to legal analysis must remain largely the subject of speculation.
- 1.27 But the paper itself speculates about one aspect of it. It cites the Treasury/ATO paper of February 2000 in support of the view that determining what expenditure was incurred to hold and/or bring an asset to its present condition and location (the proposed TVM rules²³) would be a question of fact and degree. It proceeds:
- Questions of fact and degree always leave considerable room for debate. Unless this area can be tightened up it will be fruitful ground for disputes under TVM.²⁴
- 1.28 The TVM rules the paper is criticising here are essentially the same as the accounting rules. It is also worth noting that the cost rules in both the CGT and the depreciation provisions of the current law express the same concepts (often in much the same words) as are proposed for TVM's cost rules.

²³ Subsection 7A-20(1) of TVM Prototype 2.

²⁴ Baxter, *op cit*, p. 9.