How Well Does TVM Express the Current Income Tax Base?*

Graeme S Cooper
Professor of Taxation Law
Melbourne University Law School

1. Introduction – TVM as Presentation

When the Review of Business Tax eventually proposed what we now think of as Option 2 or the Tax Value Method (TVM),[1] we were assured it was not intended to lead to any major change to the current income tax base. Rather, it was to said to be a better way of expressing what the current income tax base already captures. The

---

* This a revised version of the paper delivered at the conference in July 2001, amended to correct some errors, clarify some misunderstood passages, and take into account comments made at the conference and by others who have kindly read the paper. The TVM team kindly gave me the opportunity to read their comments on the conference version prior to this publication and I have made some changes where I had fallen into error. I have not attempted to address their remaining comments seriatim (although I have alluded to a few of the disagreements in the text), but leave this document to stand on or fall on its own merits or shortcomings.

I make only two general comments by way of response. Some of the team's comments misunderstand the point I am trying to make in this paper and so challenge an assertion I am not actually making. And on other occasions the response to my mind does not touch on what I am arguing, again suggesting that the response is to something I am not saying. But since it is rarely instructive when debates occur at cross-purposes, I will leave these matters for readers to decipher.

Second, for the most part I am happy to agree with and even adopt the review of the cases which forms the bulk of the team's comments. In general, the team's own review of the application of TVM to the cases discloses exactly the kinds of changes to current tax treatment (be they to amounts, tax unit, timing or treatment) I am arguing will occur. We seem to be in heated agreement that the results will change from the current outcomes, and though we might disagree just how. Which of is correct about *how* the answers change is interesting but unimportant here.

1 The proposal that is now the tax value method underwent some transformations during its gestation. The version that I am examining is based mostly on the proposal in, Review of Business Taxation, *A Tax System Redesigned* (Canberra, 1999) [referred to as *ATSR*] ch. 4.

In this paper, in instances where it is desirable to refer to a statutory provision, I will have to adopt the unsound practice of using an amalgam of the Exposure Draft Bill, *A New Tax System (Income Tax Assessment) Bill* 1999, [indicated by the suffix ED] released for consultation together with *ATSR*, and updated where possible by the current "Prototypes" released by the Board of Taxation [the most recent being indicated by the suffix P2]. The obvious example of the dilemma is Division 12 which exists only in Exposure Draft.

reassurance in the Report was that TVM represents just another, but a markedly better, way of writing the tax base, and that is all. Recommendation 4.1(a) was,

> That to achieve a more robust and durable tax system, taxable income be calculated on the basis of cash flows and changing tax values of assets and liabilities — with increasing and decreasing adjustments to reflect tax policy effects.[2]

The text of the Report went on to assure us that "of itself, it [Recommendation 4.1(a)] will not imply a broadening of the tax base: variations to the base should occur only by express intention."[3]

Indeed, the Report went even further in its efforts to reassure taxpayers that no change-by-stealth subterfuge was involved. Recommendation 4.1(c) of the Report provides,

> That the cashflow/tax value 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.[4]

While the use of the term "revenue neutral" is less than apt, commentary in the body of the Report again confirms this is meant to imply no change to the tax base:

> As noted earlier, some transactions will either not be recognised or will be specifically exempted from being treated as assets or liabilities often through the assignment of a zero tax value – whether for reasons of compliance cost or policy. In this regard, the Review emphasises (see Recommendation 4.1(c)) its intention that the cashflow/tax value approach be implemented in a revenue-neutral manner. ***Unless other recommendations in this report expressly propose variations to the existing law, the presumption should be that identifiable variations to existing policy will not be implemented by stealth***.[5]

This passage, I take it, is an earnest of the first assertion – to show how confident the writers were that TVM "will not imply a broadening of the tax base" during the transition from "income according to ordinary concepts and usages" to TVM, we would have the same kind of "no detriment" approach that was announced for the transition from ITAA 36 to ITAA 97.

So I think we can confidently understand the Report to mean that TVM is mere drafting – it is a way of expressing the current tax base but it expresses it in a way that is, to borrow a phrase, "more certain, equitable and durable." The purpose of this paper is to test the first part of that assertion. So, in so far as I can, I will try to resist the

---

2 *ATSR*, *supra* note 1, at 155.

3 *ATSR*, *supra* note 1, at 156. See also, *ATSR*, *supra* note 1, at 39-40 ("both options are intended to, and would produce the same outcomes as derived by current methods of calculation").

4 *ATSR*, supra *note* 1, at 155.

5 *ATSR*, *supra* note 1, at 156, 159 (emphasis added).

temptation to ask other questions: how well TVM does accomplish its goal, are the reasons for doing it sufficient to justify its cost, what assurance can there be that it will be "more certain, equitable and durable," does it require more and more onerous tasks to comply with, will it be more or less easy to administer, and so on. Rather, I have set myself a limited question: if we write the tax base in this way, will it get the same outcomes that we have now?[6] And by 'the same outcomes,' I mean the same amounts, in the same years, taxed to the same taxpayer, and afforded the same treatment in that year. That is, will "taxable income" in any year under TVM be the same as "taxable income" under ITAA 97?[7] *

---

6 I call this a limited question, but I venture to suggest there is an important dimension to the task that is a bit more conjectural. I take it that not only should the tax base be the same, but most of the pivotal ideas that go to make up the tax base should also be the same. In other words, timing rules should look and function like timing rules, and not be hidden say in valuation rules, and valuation rules should look and operate like valuation rules, and not be hidden say in attribution rules, and so on. I readily concede that no-one, so far as I can tell, has asserted that ***the way*** the tax base gets to the same result is important. But it seems plausible to me to argue that reaching the same answer but only after a tortuous, unfamiliar and counter-intuitive process is also an important departure from the current tax base deserving some mention.

7 Having drawn attention to the claim, there is now some debate about exactly what the RBT asserted. The argument of the conference version of this paper was that we were meant to understand it to say, 'TVM expresses ordinary income minus general deductions.' As a result of the conference discussion it was suggested that the claim is, 'TVM expresses ordinary income plus statutory income minus general deductions and specific deductions'- in other words, 'TVM expresses taxable income' – and this is the version I will examine here.

The version of the RBT claim presented in the paper by Abbey and Keating in this volume is that, 'TVM expresses taxable income as it will shortly be (once the Government fixes black holes)' – because their view of taxable income is 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." P Abbey and M Keating, Tax Value Method: What, Why and Why Now? (this volume) para 2.1.3. This may be the tax base that TVM creates but I disagree that it is taxable income as that term is defined under current law.

The difficulty with the version that 'TVM expresses taxable income (as it currently is)' is that it makes tax law adjustments core to TVM, rather than a means of handling only tax expenditures, policy choices and the like, that they are no longer "adjustments to reflect tax policy effects." Anything can be cured by a tax law adjustment, so the answer to any demonstrated difference degenerates to – 'yes, there is a difference, and so we will have to have a tax adjustment to reverse it, and see, it now equals taxable income under current law.' This makes the claimed advantage of TVM almost meaningless, since there would be nothing inherently robust about TVM – it could capture little of the tax base, have everything added by tax law adjustments, and still purport meet the claim of producing "the same outcomes as derived by current methods of calculation."

Hence, a closer approximation of the spirit of the RBT assertion would be that the claim is, 'the net income part of TVM (ie, cash flows and asset / liability movements but stripped of tax law adjustments and tax losses) equals taxable income.'

The paper will try to argue (simultaneously) that TVM will undoubtedly change a taxpayer's taxable income in a variety of ways in areas where we would be led to believe there will be no change (either by inclusion/exclusion, change of time of recognition, change of taxpayer or change of treatment on recognition) but in doing so, TVM will rarely remove any of the most contentious tax base issues (which, I take it, is the reason for TVM). We will in short have new answers to the old problems, but we will still have the same old problems. TVM will *solve* little – it will just *change* things.

In addition to the 'no-change' proposition, other and rather more grand claims have been made for TVM. For example it has been claimed that, "it will no longer be necessary to consider … whether the payment is capital or revenue,"[8] that "the structure of the cash flow / tax value method will ensure that expenses / payments made in the course of commencing a taxable income activity will receive recognition from the tax system,"[9] that "under the tax value method, the distinction between identifiable and unidentifiable assets for income tax purposes is made definite"[10] and that "Option 2 has the effect that concepts such as … the nexus concept are all abandoned."[11] I am not interested in directly evaluating these claims here although as, we will see, the proposition that I am putting forward must challenge some of them. To give a hint of what is to come, my reaction to each of these claims is: the capital income distinction will exist under TVM it will just be drawn in another way; pre-commencement expenditures by individuals at least will likely be treated as private and may not give rise to a cost that is carried into the tax world; whether there is one asset or many is not solved by TVM, although it is made more critical, though eliminating the need to ascribe a value in some cases can be helpful; and while one nexus test will certainly be abolished for one group of taxpayers, other nexus tests will always exist (a) for individuals through the private test, (b) for employers in applying the nexus

---

I will persevere with 'TVM expresses taxable income as currently defined' and so would consider the paper's argument proved if on any transaction, a different amount would be included / excluded from taxable income, it would be taxed in different years, it would be taxed to a different person, or it would be afforded different treatment when taxed.

* The position now being advanced in the TVM team's response seems to be that TVM is its own exception to the claim, in whatever form. As I read the RBT assertion, that is not an accurate reflection of it, although it may be the position that the current proponents wish to advance. The RBT claim was that there would be no change to taxable income except in so far as "***other*** recommendations" of ATSR required them. If TVM is its own other recommendation – its own exception to the no-change proposition – then there is no no-change proposition.

8 A O'Connell, Option 2: Will it Change What is Included in Taxable Income (2000) 29 *Australian Tax Review* 68, at 70-71.

9 D Boccabella, Australia's Tax Reform Rejects or Modifies Fundamental Tax Principles (2000) 29 *Australian Tax Review* 81, at 92.

10 ATO and Treasury, *The Tax Value Method – Discussion Paper on Issues Raised in Consultation During December 1999 and January 2000*, unpublished, para. 3.24.

11 P Abbey, Observations on Option 2 (2000) 4 *Tax Specialist* 101, at 103, O'Connell, *supra* note 8, at 70.

tests expressed in the FBT (as in *J&G Knowles v. FCT*[12]) which is just the correlative of (a), and (c) for all taxpayers in the various demarcations that will survive because of policy judgments affording different treatment to businesses rather than investors, some kinds of businesses rather than others, and some kinds of receipts or payments rather than others. The reason why various nexus tests will survive is because characterisation for most of these rules is done using nexus tests. I will have cause to return to these matters more fully later.

Before leaving this introduction, it is worth pausing to remark, nowhere in the Report that I can find is it suggested, there will be implicit changes, they will be sensible changes, they will improve the tax base, and will cure a current failing in the ordinary concepts notion. That is a plausible and entirely commendable position, and will, I am sure, be the position next taken by the proponents of TVM. This more sober, limited and qualified version is a more realistic (and I would say more accurate) assessment of what can be accomplished through this proposal. TVM will be neither panacea nor leviathan.

2. Writing "Taxable Income"

One of the most famous quotes in the English tax literature is Lord Macnaghten's observation that, "income tax … is a tax on income."[13] It is a nice aphorism, but it masks the real problem. While there is a clear core of agreed meaning, there are also areas of disagreement on what the word "income" means. The late Professor Ross Parsons put it this way, "the income tax lacks any single underlying principle which is relevant to its function of sharing command over resources between individual and Government and which can give it coherence …"[14]

Division 6 ITAA 97 suggests that a taxpayer's "assessable income" comes in two varieties: his or her "ordinary income" and his or her "statutory income." There is no useful definition of income according to ordinary income in the law, so it is the opinions of judges interpreting the word "income" which create the ordinary income made assessable in s. 6-5 ITAA 97. Indeed, that is what the term "ordinary income" implies: it is of course a reference to a famous passage in *Scott v Commissioner of Tax (NSW)*.[15] In that case, Jordan CJ pointed out, the word "income" was not a term of art – that is, it is not a term with a defined and technical meaning given by law. Consequently, what receipts are "income," depends on the dictionary meaning of that

---

12 *J&G Knowles v. FCT* (2000) 44 ATR 22.

13 *A-G v. London County Council* (1900) 4 TC 265, at 293.

14 RW Parsons, Income Taxation – An Institution in Decay (1986) 3 *Australian Tax Forum* 233, at 235.

15 *Scott v Commissioner of Tax (NSW)* (1935) 35 SR (NSW) 215, at 219. He said,

> The word 'income' is not a term of art, and what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usages of mankind …

word, or in his words, "in accordance with the ordinary concepts and usages of mankind."

There is no similar totemic authority proclaiming the common law idea of a deduction, but the test in s. 8-1 ITAA 97 approximates what would be the common law notion of a current deduction – an outlay that is relevant to the earning of currently (previously or potentially) taxable income and does not procure an enduring asset.[16] Section 8-1 would capture this idea better if the term "capital" when used in section served simply as the label to describe an outlay that secures an advantage which lasts beyond the current tax year, such that its entire cost should not be recovered immediately.

By way of contrast, TVM expresses the idea of taxable income as follows:

(a)		cash received
(b)	*less*	cash payments
(c)	*plus / minus*	changes to the tax value of assets during the year
(d)	*plus / minus*	changes to the tax value of liabilities during the year
(e)	*plus / less*	income tax law adjustments
(f)	*less*	tax losses[17]

Division 12 of the Exposure Draft Bill (which has since disappeared from the Prototypes but will no doubt re-emerge) then excludes from the calculation amounts paid and received and also any asset or liability which are of a "private or domestic nature." In other words, no entry at lines (a) to (d) should include an amount that is "private or domestic." Private or domestic items might perhaps be entered at (e), along with much else.

Under this formula, a taxpayer:

- makes income if he or she receives an amount of (non-private) cash but does not suffer a corresponding liability with an equal tax value, and
- makes income if (without a receipt or payment) the tax value of his or her assets increases or the tax value of liabilities decreases
- is entitled to a deduction if he or she spends (non-private) money provided he or she does not acquire a corresponding asset with an equal tax value
- is entitled to a deduction if (without a receipt or payment) the tax value of his or her liabilities increases or the tax value of his or her assets decreases

Income

---

16 Some of the overlays that have developed in the interpretation of s. 8-1, such as the contemporaneity notion are, in my view, unfortunate errors that have crept into the system. Contemporaneity is not a valid part of the conceptual framework, but it is effectively entrenched.

17 Sections 5-15 and 5-55 (P2). It is not obvious why a tax loss could not be dealt with as another tax law adjustment, but the designers have not chosen this option.

Despite the large volume of words generating the elements of statutory income, most income which is taxed in Australia enters the calculation of taxable income via s. 6-5 as "income according to ordinary concepts and usages" or ordinary income. It seems to me that if TVM is to live up to the claim its proponents make, it too must capture (almost) all of, and little or no more than, what we currently understand to be within "income according to ordinary concepts" together with the supplements and variations that are made to it in the Acts.

I will start with income according to ordinary concepts. There is general agreement that the judicial concept of income means three broad classes of amount:

1. gross amounts received as a reward for performing services (usually as an employee)
2. net amounts which are the profits from carrying on a business,
3. gross amounts which are received as a return from investments (dividends, interest, rent, royalties and so on).

These three classes are not dictated by the statute – they are simply the accepted meaning of the word "income" driven largely by the classification work of tax scholars. Indeed, it is one of the nice ironies of the income tax law that nowhere in either Act does it ever say expressly that "interest is taxable" or "rent is taxable." These core transactions in an income tax are just captured by an interpretation of the word "income." But it is not possible to fit all decided cases into this framework. Professor Ross Parsons in *Income Taxation in Australia*[18] adds two further categories of ordinary usage income:

4. amounts which are received in compensation for an amount that would have been income if it had been received instead,
5. amounts which are received periodically.

If an amount does not fall within one of these ideas, it is not ordinary income. Some common omissions from ordinary income are:

- gifts and other windfalls received (sometimes) – the qualification arises because payments received by employees[19] or by a business owner[20] or investor[21] may in

---

18 RW Parsons, *Income Taxation in Australia* (Sydney, Law Book Co. Ltd, 1985).

19 Contrast *Hayes v. FCT* (1956) 96 CLR 47 (gift from grateful employer not taxable to employee), *FCT v. Rowe* (1997) 187 CLR 266 (payment from State government to former employee to assist with legal bills not income) and *FCT v. Harris* (1980) 10 ATR 869 (cash payment made to impoverished former employee not taxable) with *FCT v. Dixon* (1952) 86 CLR 540 (payment to make up for reduced wages while in military service taxed to employee) and *FCT v. Holmes* (1995) 31 ATR 71 (bonus paid to seaman for bravery displayed during salvage was taxable).

20 Contrast *FCT v Squatting Investments* (1954) 88 CLR 413 (unexpected distribution of surplus from wool pool was taxable to producer) and *Re Pope and FCT* (2001) 46 ATR

some cases be regarded as connected to the employment or business, and so form part of the employment income or business profits, or may be viewed as income under the periodicity or compensation receipts principle,

- inheritances received,
- treasure trove, such as money found buried under a house,
- prizes (sometimes) – again the qualification arises because some prizes received by an employee[22] or by a business owner[23] may be regarded as connected to the employment or business, and so form part of the employment income or business profits,[24]
- gambling winnings (sometimes)[25] – here the qualification arises because gambling winnings are business profits for some "professional gamblers" such as the so-called "high-rollers", and prizemoney also forms a major part of the remuneration of racehorse owners and trainers (paid to them under prize sharing deals, rather than as gamblers) and so are regarded as connected to the business of the trainer (if not the owner),

---

172 (compensation payment for poor administration by ATO was taxable to firm of accountants) with *Scott v. FCT* (1966) 117 CLR 514 (gift not taxable to family solicitor).

21 *IRC v. Falkirk Ice Rink* (1975) 51 TC 42 (contribution from club members to lessor taxed as income).

22 Contrast *Kelly v. FCT* (1985) 16 ATR 478 (cash payment to winner of Sandover medal taxable) with *Moore v. Griffiths* [1972] 3 All ER 399 (cash payments to winners of World Cup not taxable).

23 Contrast *FCT v. Cooke & Sherden* (1980) 10 ATR 696 (prize of free holiday was income of soft drink distributor but not taxable because not convertible into money) with *IRC v. Falkirk Ice Rink* (1975) 51 TC 42 (contribution from club members to lessor taxed as income).

24 The ATO finds this area similarly confused. Contrast taxation ruling IT 167 – Treatment of Radio and TV Prizes, para 2 ("Because of the varying circumstances under which these competitions are conducted, it is not practicable to make general observations which would adequately cover the numerous possibilities likely to be encountered in practice. Whether or not a prize or an award won in a particular competition is liable to tax is a matter for determination in the light of the facts of each case"); with taxation ruling TR 1999/17 – Receipts and Other benefits Received by Sportspeople, para 21 ("payments which are assessable income include … cash prizes and cash awards") and para 14 ("an award in medal or trophy form will not be assessable income as it is given and received on purely personal grounds, recognising and recording a particular achievement of the person").

25 The dominant outcome from the reported cases is that the gambler is not viewed a carrying on a business, and so not taxable on winnings, nor entitled to utilise losses. See *Martin v. FCT* (1953) 90 CLR 470, *Evans v. FCT* 91989) 20 ATR 922, *Babka v. FCT* (1989) 20 ATR 1251 and *Brajkovich v FCT* (1989) 20 ATR 1570. The ATO's view in TR 93/26 – Issues Relating to the Racehorse Industry (para 15) is that an activity or training other people's horses makes it more likely that the activity is a business, which would make the prizemoney shared with the trainer income.

- the proceeds of crime (sometimes),[26]
- damages and compensation for loss or injury (sometimes),[27]
- the principal of a loan,
- gains made on the redemption of liabilities including repayment of the principal of a loan (sometimes),[28]
- gains made on the disposal of capital assets (sometimes) – again the qualification arises because sometimes assets realised by a business owner or investor will be regarded as generating ordinary income.[29]

Notwithstanding various extensions to the tax base made by the ITAA 36 and 97, many of these transactions remain outside taxable income as it is currently defined, both for business taxpayers and especially non-business taxpayers.[30]

---

[26] Contrast *AAT Case 4946* (1989) 20 ATR 3340, at 3346-47 (company director not assessable on funds embezzled because "his pattern of activity during 1982 … [was not] the carriage of a systematic business of defrauding his own company. Such a finding would be necessary to support the respondent's argument") and *Zobory v. FCT* (1995) 30 ATR 412 (employee not assessable on embezzled funds because he held as constructive trustee) with *AAT Case 625* (2000) ATR 1019 (drug dealer allowed deduction for stolen money because he was carrying on drug dealing business) and the ATO view Taxation Ruling TR 93/25, para 9 ("where a taxpayer systematically engages in an illegal activity and the elements of a business are present such as repetition, regularity, view to a profit and organisation, the proceeds from the activity have an income character").

[27] Contrast *C. of T. (Vic.) v. Phillips* (1936) 55 CLR 144 (compensation for lost wages taxed as income) with *FCT v. Slaven* (1984) 15 ATR 242 (compensation for loss of opportunity to earn). Similarly contrast *Californian Oil Products Ltd v. FCT* (1934) 52 CLR 28 (compensation received for cancellation of supply contract not taxable) with *Heavy Minerals Pty Ltd v. FCT* (1966) 115 CLR 512 (compensation received for cancellation of supply contract taxable).

[28] Contrast *British Mexican Petroleum v. Jackson* (1931) TC 570 (gain on redemption of liabilities not income) and *FCT v. Orica Ltd* (1998) 194 CLR 500 (nominal gain on securing another party to meet its obligations for a fee not income) with *Mututal Acceptance Ltd v. FCT* (1984) 15 ATR 1238 (gain on redemption of liability by finance company was income).

[29] Contrast *FCT v. Cyclone Scaffolding* (1987) 19 ATR 674 (profit made on sale of leased equipment not ordinary income) and *FCT v. Hyteco Hiring Pty Ltd* (1992) 24 ATR 218 (profit made on sale of leased equipment not ordinary income) with *Memorex Pty Ltd v. FCT* (1987) 19 ATR 553 (profit on sale of leased equipment was taxable) and *FCT v. GKN Kwikform Services Pty Ltd* (1991) 21 ATR 1532 (profit made on sale of leased equipment not ordinary income). Similar examples could be given using other types of assets or other types of companies, such as investment companies.

[30] In making this claim, I obviously have to disagree with the paper by Abbey and Keating. I have no doubt that the current tax base could be modified to include the items listed below, and so make it congruent with what TVM will capture, but I do not agree that they are currently included.

- Gifts, windfalls and treasure trove which do not already give rise to ordinary income will rarely give rise to a capital gain taxable under ITAA 97. The sections of the CGT which tax mere receipts will not be triggered unless the recipient has created rights in the donor in exchange for the payment (which is inconsistent with the notion of a gift, windfall or treasure trove) or it "occurs in relation to an asset that you own."[31] As we will see, at least in the case of entities, TVM will potentially capture these items and thus have to provide similar exclusions, presumably by way of tax law adjustment.
- Non-ordinary-income prizes and gambling winnings remain outside the tax base even in a post-CGT world and not just because of the specific exclusions from CGT.[32] The sections of the CGT which tax mere receipts will not be triggered unless the recipient has created (not released) rights in the provider in exchange for the prize or it "occurs in relation to an asset that you own."[33] Again, at least in the case of entities, TVM will potentially capture these items and thus have to provide similar exclusions, presumably by way of tax law adjustment, if it is not to extend taxable income.
- The treatment of the making and repayment of loans is more complicated because of the deliberate policy change that gains and losses on liabilities be included in assessable income in full. This is a deliberate change to the current treatment in Schedule 2C ITAA 36, and so TVM is not responsible for the change that will arise.[34] But there will still be interesting areas of difficulty created by the new rules for debt where omissions or inclusions can arise.

TVM is likely to include some of these transactions on the income side of its method, unless the receipts are either accompanied by a liability with a positive tax value (such as a full-recourse loan) or else are diminished in effect by the disappearance of an asset (such as the sale of a capital asset or the relinquishment of rights to insurance). Gifts, windfalls and treasure trove are the immediately obvious examples, but there could be others. No doubt they can all be reversed in TVM where appropriate by tax law adjustments. But I take it as axiomatic that a tax law adjustment is the kind of device that is meant to be reserved for dealing with the expression of government policy or administrative constraint, because every tax law adjustment detracts from the purity of the 'net income' concept under TVM – ie, lines (a) – (d).

Expenses

If TVM is over-inclusive on the income side, it is also over-inclusive on the deductions side. It will be necessary to have a series of rules that are not currently needed to reverse the effect of some payments. Every payment under TVM is a deduction unless it procures an asset that has a positive tax value (or else is diminished in effect by the

---

31 Sections 104-35 and 104-155 ITAA 97

32 Section 118-37 ITAA 97.

33 Sections 104-35 and 104-155 ITAA 97

34 Recommendation 6.8 ATSR.

discharge of a liability) and so it is necessary to reverse the effect of many payments through myriad tax law adjustments. Examples will be payments of local (though perhaps not foreign) income tax,[35] expenses for work in meeting one's own income tax obligations,[36] payments of dividends or other profit distributions,[37] some fines and penalties,[38] some gifts made to non-deductible entities,[39] and so on. These do not currently impact on taxable income and not just because of specific exceptions made in ITAA 36 or ITAA 97. Rather it is because except for fines, they represent an application of derived income, rather than an expense incurred in deriving income, and for fines they represent an imposition that is "personal" to the perpetrator.[40] Similarly, by making payment alone sufficient, I take it TVM cannot innately capture the nuances of difficulties presented by dual purpose outlays in cases like *Cecil Brothers*,[41] *South Australian Battery Makers*,[42] *Isherwood and Dreyfus*[43] or *Phillips*.[44] Rather these kinds of dilemmas will have to be dealt with by specific reversal. I will have cause to return to this issue later.

I take it, perhaps with the exception of tax return expenses, none of these outlays can properly be labeled as a "black hole" which ought to be, but is not currently, reflected in the tax base.[45] If they were, TVM's immediate recognition would be a clear benefit. So, because these payments might be recognised by TVM, all would have to be reversed by a tax law adjustment, the kind of device that is meant to be reserved for dealing with tax incentives.

3. That old gain v. flow conundrum

One of the enduring structural problems underlying the current formulation of income according to ordinary concepts and usages is the irreconcilable tension between income as flow and income as gain. It is made more complex because running alongside ordinary concepts and usages notions are statutory provisions which also deal with

---

35 *Smiths Potato Crisps (1929) Ltd v. IRC* [1948] AC 508.

36 *FCT v. Green* (1950) 81 CLR 313, at 319.

37 *C. of T. (WA) v. Boulder Perseverance* (1937) 58 CLR 223.

38 *Strong & Co. of Romsey Ltd v. Woodifield* [1906] AC 448

39 The qualification arises because some gifts made to employees as retiring allowances may be deductible as a business expense on the basis that they serve the function of reinforcing current morale: *W Nevill & Co Ltd v. FCT* (1937) 56 CLR 290.

40 See generally, Parsons, supra note 16, at 414.

41 *Cecil Bros Pty Ltd v. FCT* (1964) 111 CLR 430.

42 *FCT v. South Australian Battery Makers Pty. Ltd.* (1978) 140 CLR 645.

43 *FCT v. Isherwood & Dreyfus Pty Ltd* (1979) 9 ATR 473.

44 *Phillips v. FCT* (1947) 75 CLR 332.

45 This term might be applied, on the other hand, to expenses such as incorporation or reorganisation expenses (*FCT v. Swan Brewery Co. Ltd*. (1991) 22 ATR 295) which TVM would recognise innately, but will only be recognised in current taxable income as a result of s. 40-880 introduced in the *NBTS (Capital Allowances) Bill* 2001.

transactions sometimes on a gain basis and sometimes on a flow basis. The classic example of this dilemma is the *Myer Emporium* case.[46] That case held that the proceeds of a coupon stripping operation gave rise to ordinary income in the gross amount received (either as the proceeds of business or as a substitute for an amount that would have been income (interest) had it been received instead of sold). It also establishes by implication that all of a lender's cost in a security is locked into the right to repayment of the principal. This is the source of the gain v. flow difficulties. Myer simply stripped and sold the income rights from an interest-bearing instrument. One would think that it ought to have been entitled to have some cost in that part of its security and indeed, this outcome would have followed had s. 159GZ ITAA 36 or s. 160R ITAA 36 been applicable. These provisions essentially spread the original cost of an asset over its constituent parts where an asset is split. Hence they tax gain. On the other hand, s. 25(1) as interpreted by the High Court, s. 102CA ITAA 36 and s. 160M(6) essentially tax flows because the income stream is regarded as having no cost. The two approaches exist both in ordinary income and statute, they conflict and cannot be reconciled.[47]

The same kind of thing happens under TVM. It explicitly incorporates receipts and payments (ie, flows) in lines (a) and (b) with movements in tax value (ie, gains) in lines (b) and (d). So we have the old "gain v. flow" problem again, although the

---

46 *FCT v. Myer Emporium Ltd* (1986) 163 CLR 199.

47 I note that the same kind of dilemma over when costs are split and when costs are quarantined will emerge under the current TVM draft, though it is not really a TVM-generated issue. Section 7B-130 (P2) re-allocates costs when "an asset … is split into two or more assets …" Other rules in Division 7B (P2) deal with assets that are "merged," "transformed" or "substituted." One can only speculate when these rules will apply since the transactions being described are so nebulous.

Take for example, the granting of an easement over a parcel of land. Current ATO practice views this not the splitting of an interest out of the existing freehold estate but rather as the creation of a new estate in the land – see TD 93/235 para 6 ("the grant of an easement … constitutes the disposal of an asset created by the grantor within subsection 160M(6)") although the ATO only moved to this view in 1989 (see IT 2561.) Similarly, it is a plausible explanation of the *Myer* transaction that it simply involves the splitting of an existing security into two parts though the analysis of the High Court does not approach the transaction in this manner. Rather it constructs the transaction as if a new security has been created (at no cost). It will be interesting to see if the ATO and the High Court would be able to see their way clear to re-conceptualise the transaction from creation to division so that Division 7B would apply to shift cost from the land into the easement or from the entire security into the income stream.

A similar issue arises for bonus shares – is the bonus issue to be viewed as a cost split occurring to the original parcel of shares or as the creation of a new (cost-free) interest? Until 1998, the flow notion prevailed (through para (c) of the definition of dividend) with the amount paid up on the bonus share taxed as a dividend, although a cost step-up and cost-split then occurred under s. 6BA ITAA 36 for taxed dividends. After 1998, the cost-split paradigm prevails with bonus shares being taxable as flows only in limited circumstances.

conflict will manifest itself in a slightly different form. Under ordinary concepts income, the problem for the system is how to deal with flows that do not involve gains, as I take it the intended tax base is gains not flows.[48] Under TVM the problem is how to deal with flows that are also assets or liabilities.

It has been suggested that receipt and payment entries are simply the opening and closing cash in the accounts of a company, but I will argue that this is not so. The receipts item plays a critical part in the TVM formula but it changes what could be a gain-based computation into one based on flows as well. That is, without the item "receipts" and "payments", we could operate TVM on the basis of "two snapshots" – that is, a comparison of two fictitious Balance Sheets drawn up under these odd tax-only rules. Instead, "receipts" and "payments" turns TVM into both a gain and flow notion – that is, more akin to a movie than two snapshots.

Cash receipts that are also assets

Because the TVM structure includes both gains and flows it is necessary to make various accommodations if chaos is not to result. It is necessary to decide whether to treat a transaction as involving a receipt which will be taxed as a receipt (and not again as an asset), or to treat the transaction as involving a receipt which is taxed as an asset (and not as a receipt). The same is true of payments and liabilities. In other words, it is necessary to perform an allocation between lines (a) and (c) and between lines (b) and (d).

To see the point, consider this example: a house painter agrees to paint a house for $15,000 paid by cheque that will be deposited into a bank account (obviously, this is not a real world example!) It is necessary to decide whether to ***include*** the $15,000 in the painter's income (a) as an asset being the receivable, so that he or she pays tax when the receivable arises or is met, or (b) as a receipt and pays tax only when the cash is received. It is also necessary to decide how to ***exclude*** the $15,000 when it shows up as part of the closing value of another asset at the end of the year, being cash on hand or a credit in a financial account.

Of course, the excluding part of the discussion also implies another question – which asset would be the relevant one, assuming we are to be taxed on assets, not receipts, and only one is to be considered? Is it the receivable, as I have inferred, or is it the bank account? The answer would be important where the transaction spanned a single tax period, be it an income year, a PAYG quarter or PAYG month. There is no self-

---

[48] Standard examples of this problem are *Egerton-Warburton v. FCT* (1934) 51 CLR 568 (vendor taxed on gross amounts received for sale of asset with no recognition of cost of the income stream paid for by transferring ownership of property), *Just v. FCT* (1949) 4 AITR 185, and *Moneymen Pty Ltd v FCT* (1990) 21 ATR 1142. Section 27H ITAA 36 exists to try to solve the problem for purchased flows in the form of an annuity, but it is of limited application. Another rule that attempts to solve a similar difficulty is s. 104-115 ITAA 97. It equates the position of a lessor of property under a long term lease with that of a vendor so that the lessor is able to recover some of its cost in the land on the grant of the lease.

evident answer to this problem as both are good candidates for the label "asset." If it were intended that every taxpayer went to accrual accounting, the right answer would be that the receivable was the relevant asset; if not, the bank account could be the relevant asset.[49] So we have a potential dilemma between one flow and two assets, but we will ignore the receivable-as-asset complication for the moment and focus just on how to reconcile (a) the cash payment as receipt and (b) the bank account as asset.

The apparent scheme of the legislation is that the world of finance is divided into two things: money and financial assets. It seems intended that money is not an asset for TVM [see s 5-55 Steps 3, 4 (P2)] and so does not need to be assigned a tax value, but a financial asset is an asset for TVM and has the tax value assigned by Division 45 (P2). This raises the classification question, which financial things are classified as "money" and which ones as "financial assets"? Section 995-1 (P2) provides that money means "money in hand (whether or not in Australian currency) and a credit balance in a money account." These definitions seem to suggest that (a) a receivable might be an asset but is not money, (b) when the money is received it is a receipt and not an asset and (c) when deposited is neither a receipt nor an asset. If that schema is correct, the house painter is taxed on the cash either as receipt or as receivable (asset), but is not again taxed on the money as (bank account) asset.

---

[49] The current draft makes the right to receive an amount that is due and payable under a financial asset an asset with a tax value equal to the amount – s. 6-40(1) Item 5 (P2), and s. 6-40(2) (P2) defines a financial asset as "a right to be paid an amount." The consequence would seem to be that the painter would be taxed on the receivable as asset when the amount becomes due and payable. Whether that is when the contract is signed, completed, on a progressive basis, or an invoice rendered presumably depends on the terms of the contract. That is, unless the asset is a routine right to the painter (perhaps because it is still executory?), in which case it would be attributed a tax value of 0 – s. 6-40(1) Item 1.

I take it the effect of this position is that every taxpayer will have to operate on accrual accounting in the sense that income will be reported when it becomes "due and payable" after the taxpayer's rights go "non-routine." I note, however, in para 6.64 of the EM to P2, the income calculation "will need to be modified to accommodate those taxpayers who, for policy reasons, will be taxed on a cash basis."

If the contract is unperformed at the end of the tax period, one presumably then has to ask whether the painter has an offsetting liability under the contract for the work still to be performed and whether it has a positive tax value or is instead a routine liability. I take it the painter has a presently existing liability under the contract. It is unlikely to be routine if the painter has done some of the work but not been paid, or has been paid but not done the work. Whether it has a tax value or not is more doubtful. If it were an Item 9, there may be no "proceeds" from assuming that liability. But the EM to P2 (see para 1.24) suggests that this kind of contract might be treated as creating a depreciating liability which would be covered by Item 2. If that is so, again the issue would be whether there are proceeds of assuming the liability – s. 40-50(2) (P2). Para 9.78 of the EM suggests that proceeds can include "deemed receipts arising under the non-cash transaction rules" and the promise (by the homeowner) to pay money might be viewed as a non-cash benefit. The value of this item would be the proceeds of assuming the liability to paint the house.

I assume this is the design, but let us look at the drafting. Section 5-60 (P2) is a curious provision. It states that, "if an amount is credited to a money account you have, you are taken to have ***received*** the amount." The implication of this provision seems to be that without it, no amount of income would arise from depositing an amount to a bank account. Thus, if an employer deposited wages into a bank account, it seems s. 5-60 (P2) is needed to create "receipt." Read in this way, it is a deeming provision – deeming a receipt to occur where it otherwise would not.

An alternative construction of s. 5-60 (P2) is possible. That is, that the purpose of s. 5-60 (P2) is simply to perform an allocation to either line (a) or line (c): wages might be taxed as receipts or else as additions to the closing value of an asset. This alternate construction of the provision as an allocation provision is supported by the Note to the section. It provides,

> Note: A credit balance in a money account is money (as defined in section 995-1) and so is not taken into account as an asset under section 5-55. This is because subsection (1) of this section treats the amounts credited to the account as receipts, which are taken into account under section 5-55.

This would be consistent with what appears to be the scheme of the section – that is, the world of finance is dividend two things, money and financial assets. One could read s. 5-60 (P2) as performing this allocation.

That position is sensible, but is confounded by s. 5-60(4) (P2). It provides that a bank account is a money account, only "if the taxpayer chooses to treat the account as a money account for that income year …" which suggests that a taxpayer who does not make the election will have its bank account treated as an asset. (Section 5-60(5) (P2) provides that even though the election is made, some bank accounts will not be allowed to treated as money.)[50]

This fundamentally re-conceives the issue from the way it would appear under current tax law. At present, I take it, we would ask – is the painter operating on cash or accruals basis tax accounting? This timing-based approach would solve the issue, how to reconcile flows with assets, albeit by implication. That is, if the taxpayer were operating on cash accounting, only the receipt would matter; if operating on accruals accounting, only the receivable would matter. The tax accounting rules tell us there is only one relevant tax event, either the receipt or the rendering, not two events, and it is largely fixed in concrete once it occurs and is recorded. (There are some areas where we depart from this model and will re-examine another part of the event or the original event, but we do so only on a prospective basis not by re-writing the tax outcome previously happening. These areas are bad debts, foreign exchange gains and losses, and debt forgiveness rules.)

---

[50] Notice that if the transaction spans a tax year, it will be necessary to deal with the transaction as a credit sale. As we will see, this would mean that the transaction is instead to be dealt with as a non-cash transactions under Div 8 (P2) – because the promise to pay cash is not a cash receipt, apparently.

Non-cash receipts that are also assets

This problem of receipts that are also assets arises in other ways as well. It arises for fringe benefits, shares and options under employee share schemes, non-cash business benefits, the non-cash income of investors, bonus shares (on the odd occasions where they are now taxable), and so on – that is, transactions which under current law would generate "income" but income that is derived in the form of an asset. Again, under TVM there is this double counting issue – it is necessary to decide whether to treat the transaction as involving a (cash equivalent) receipt which will be taxed as a receipt (and not again as an asset), or to treat the transaction as involving an asset (and not as a receipt). And in either case, it is necessary to ascribe a cost to the asset in case it is later sold in a transaction that is not "private or domestic."

To see the point, consider a variation of my prior example: a house painter agrees to paint a house in exchange for a gold ring (value $15,000). It is necessary to decide whether to ***include*** the value of the ring in the painter's income (a) as money (ie, a cash equivalent) or (b) as an asset. If it is taxed as money, it is also necessary (c) to decide how to ***exclude*** some value for the ring when it shows up as part of the closing value of assets at the end of the year. In either case, it is also necessary (d) to decide what cost to allocate to the ring so that the value already taxed is not again taxed if the ring is sold.

Under current law the first issue would be one of valuation – that is, current tax rules would give one of three values to the non-cash receipt.[51] The second issue would be one of cost – that is, the ring would be viewed as having a cost which is the amount of income on which the taxpayer was taxed – which would be important if the ring were later to be sold.

Under TVM, the non-cash transaction rules in Division 8 (P2) are intended to deal with this transaction. We would have a "2-sided non-cash transaction." This approach differs by having to deem payments and receipts to occur involving the assets so that these deemings can be fed into concepts into the main rules in Divs 5 and 6 (P2). The need to do this arises because of the significance attaching to the words "receipt" and "payment."

So under current law, we would say he derived non-cash income valued at $15,000 for performing the service. It would also be the case that the amount taxed would be the cost of the item at least for income tax purposes (though perhaps not for CGT purposes as the value of services provided cannot enter the cost base of a CGT asset). Under Div 8 (P2) we would say the taxpayer is taken to receive cash and the amount of the cash is the market value of the ring [s. 8-28(3) (P2)]. So this step is the same as under current law and is also different – we are given a deemed value for the ring, but it is re-characterised as being a cash receipt, not an asset. Second, the taxpayer is deemed to

---

[51] The answer in this case would be the value given by s. 21A ITAA 36. The other two possible valuation systems, FBT and the common law convertibility rule, would operate for (most) income received in asset form by employees and income received in asset form by investors, respectively.

make a payment equal to the market value of the ring that it brought into account [s. 8-29(1) (P2)]. This step has the effect of removing the value of the ring from being counted again because when the taxpayer adds up its payments for the year, there will be another one that is deemed to have occurred. Second, it gives a cost to the ring to the taxpayer under s. 7A-20(1)(a) (P2).

I make the passing observation that TVM requires four steps to do what current law does in two, and moreover some of those steps are imaginary steps that have to be created in order to make system work.

And if the unmodified model is difficult enough, there will have to be further qualifications to the Div 8 (P2) analysis. First, as was remarked above, for CGT assets, this position will likely have to be amended. No cost will be allowed for CGT calculations for transactions that involve the acquisition of an asset for services. Next, it is inevitable that fringe benefits will be treated as under current law – that is, the employer will pay an excise tax on a value for the item it provides to the employee, with a tax law adjustment needed to eliminate any amount of income representing the receipt of the asset. (Notice that it will be necessary to rewrite the FBT rules to make the otherwise deductible rule work at the employer level but based on the employee's fictional "payment with no asset arising.") The employee will usually thereafter hold an asset. It will presumably be necessary to have another rule that the value of the asset for FBT grossed up for GST but not for income tax or FBT will be the asset's cost for future TVM calculations.[52]

Excising receipts and payments?

So, would it be possible to exclude the receipts and payments elements (lines (a) and (b)) from the equation and rely instead just on movements in the tax value of assets and liabilities (ie, lines (c) and (d)) and tax adjustments (line (e))? The argument is that for businesses at least, these two entries could be replaced with opening and closing cash balances – ie, asset accounts, not receipts and payments. In my view, the answer is no both for businesses and especially for individuals. The reason is that there are some things that should be taxed but will only be taxed correctly if they are taxed as receipts and payments. If we worked with a two snapshots view of income, rather than a flow concept of income, the system won't work properly.

To see why this might be so, consider the position of spent wages, ie, wages that do not appear in the closing balance of the bank account. Assume a worker receives $1,000 per week from his or her employment directly deposited into his or her bank account. If the taxpayer elects for the bank account to be a money account, the wages are taxed as receipts. So the wages received turn up at line (a) as a receipt and are then excluded from line (c) if the taxpayer treats the bank account as a money account. If the employee spends the wages on clothes or food or holidays we assume these are all

---

[52] I note that the present Prototype proposes to exclude the first $300 of non-cash business benefits, presumably by a tax law adjustment. How then is it intended to defeat the odd outcome that every credit sale for less than $300 is not taxable?

private matters and so the payments are ignored. This much is good and works properly from combining assets and flows.

But what happens if the employee chooses to treat the bank account as an asset, rather than as money? The wages must be taxed in the closing tax value of an asset, but no amount will appear if the wages are spent (on non durables or on private assets) by 30 June. So the taxpayer's income appears to be misrepresented if the "two snapshots" view of the world is used – ie, using assets alone without the receipts and payments element. It would be possible to construct transactions for TVM which fix this problem, but it may be considered easier to leave the receipts and payments elements in the equation rather than add the further deemings needed to make the exclusively assets-based approach work.[53]

Another example shows a further aspect of this problem – characterisation mismatches – which will arise for business taxpayers and investors, as well as employees. Assume a trading business receives cash from inventory sales which it deposits into a bank and the bank goes bankrupt. If the two snapshots view of the world were taken, the taxpayer's lost asset would presumably not appear in either snapshot and so no income would emerge for the year. That is a satisfactory outcome provided no characterisation issues are important. But I assume we would expect the receipt to be taxed as ordinary income, while the loss would more likely be a quarantined capital loss.[54] And if it is an employee who deposits their cash into a bank that goes bankrupt, the same problem arises – the employee's income would be misrepresented if it were allowed to operate on the basis of "two snapshots" rather than gross receipts throughout the year because the loss would likely not be one that could available to reduce the tax on wages.

So it seems to me there are good reasons for doubting that the two snapshots idea, unaided by receipts and outgoings, will capture the tax base easily.

But running both gains and flows does undoubtedly create difficulties. A taxpayer which suffers losses through theft[55] or embezzlement[56] would not be taxed on its stolen

---

53 Even for corporate business taxpayers, using the balance sheet approach will not work for distributions. Under TVM without a receipts and payments line, interim distributions out of current year profits would not be taxed to the corporation first. They would not appear in opening cash and would not appear in closing cash. So a tax law adjustment is necessary. The current version would create a tax law adjustment to reverse the effect of the payment (s. 5-100, Item 3, P2). If the two snapshots approach were taken, the tax law adjustment would have to add back a non-existent asset – a credit entry in the company's financial statements. Creating a fictitious asset seems to me a less intuitive way of dealing with the issue.

54 I note that *FCT v. Marshall and Brougham Pty Ltd* (1987) 18 ATR 859 recognises in this context the loss of an investment may be deductible as a revenue loss but I suggest this case is unusual. One would expect to see non-quarantined revenue loss treatment applied to the limited cases of a money-lending business, a bank or an insurance company.

55 *Charles Moore & Co (WA) Pty Ltd v. FCT* (1956) 95 CLR 344.

56 *C. of T. (NSW) v. Ash* (1938) 61 CLR 263.

receipts under a two-snapshot model, which is entirely appropriate ignoring characterisation issues. But taxing the taxpayer on these lost receipts raises the problem of how to find a "payment" or an asset the tax value of which has now declined to zero, which will accommodate this loss. The way the rules are constructed at present, the loss of the cash represented by the bank account cannot be the relevant matter because neither money nor a money account is an asset (s. 5-55 Steps 3, 4 (P2)). So we have to find a transaction by the victim which meets the term "payment."

Assets and liabilities that were not purchased

Before leaving this area I want to mention one last issue, though it is rather the reverse of the previous topic. The question concerns assets and liabilities that fall into a taxpayer's lap without a cash outlay. It is said that TVM is not a tax on unrealised gains (in most instances) because it does not tax movements in the market value of assets, only their tax value, and usually only at the time of disposal. That will be true on an ongoing basis, but what happens when an asset has to appear in the closing account and at a positive tax value but it was not present in the opening account? The difference is taxed unless the asset comes with a liability attached or some fictional payment for it can be constructed to offset the tax on gross value.

I concede it may be unlikely that an asset will just appear without being purchased but consider the position of a beneficiary of a fixed trust established during the year by settlement. I take it that the beneficiary has an asset which is its interest. In the absence of some special provision, the taxpayer could be liable to pay tax on some positive closing tax value for this asset. The tax treatment of the beneficiary might be massaged in one of three ways. It is plausible that the interest in the trust could be left out of the system because it is private or domestic, although if the system wants to tax trust distributions, this may be a dangerous line to assert. Alternatively, the interest might be afforded a tax value of nil because it has no actual cost to the taxpayer (although this will require special provisions if the transaction occurs between associates to negate the inevitable deemed market value rules). Finally, some fictional payment might be constructed to offset the tax on a positive closing tax value. I am even less confident how the system might work for the object of a discretionary trust.

The same issue could arise with liabilities. Consider a large corporate collapse like HIH. One assumes the directors of the company would not regard their directors fees as coming with a liability attached, but the directors might be found to have large liabilities to creditors of the company if their behaviour warrants it and liabilities far larger than their assets admit. If these liabilities cannot be excluded as being private and emerge not from a receipt, there is a potentially large and immediate loss because the tax value of the closing liability will not have appeared in the opening liabilities balance. One might have to wait many years for the reversal of this entry through the eventual discharge of the liability by payment or bankruptcy. Or consider a taxpayer who has a liability as a guarantor for another. This liability may have been assumed without explicit payment within a corporate group but may emerge in the company's accounts if the principal obligee becomes insolvent – indeed it may have to be recognised earlier. Is the company to be regarded as having a liability with a positive

tax value without having received consideration for it? The same three solutions are possible: deny the existence of the liability unless it is purchased, ascribe it a zero tax value unless it is purchased, or find a fictitious payment to the guarantor to offset the liability. And then what is the position of the other company? Does it cease to have a liability any more?[57]

No doubt solutions to prevent odd outcomes would be found. But they both expose a question: must an asset or liability be connected to some observable cash flow? There is a formal link expressed in TVM between cost and asset, and between proceeds and liability described in Chapter 9 of the Explanatory Memorandum to the current Prototype.[58] This link looks in one direction, to ask whether and when an identified payment which has admittedly occurred can be traced to any particular asset or liability. But it highlights the next question that there seems to be no formal link in the system between lines and (a) and (d) or (b) and (c). That is, it seems to me quite possible for TVM to throw up assets and liabilities which just emerge without being purchased or sold for cash. The solution to these items may have to be that they are denied any existence, they are treated as having no cost or in some other way ascribed a zero tax value, or a fictitious payment is manufactured to reverse their appearance. Some such measure is needed to eliminate their effects.

4. How robust is the "private or domestic" tag?

A great deal of work has to be performed by the "private or domestic" label to turn TVM into something like the correct tax base for individuals. And, it ought to be remarked, individuals are by far the most significant players in the tax system in terms of numbers and tax paid – they are at the heart of the tax world, not the periphery.[59] The private or domestic term will presumably appear for two groups of taxpayers – those who are employees or retired employees, and in drawing the hobby v. business distinction.

It is this concept of "private or domestic" which alone excludes some receipts and not others, and recognises some expenses and not others. A detailed jurisprudence on the meaning of "private or domestic" exists in our legislative framework only for outgoings, and even here it is quite arguable that there is actually no jurisprudence on these words at all. There is good authority that the words "private or domestic" are not operative in the interpretation of s. 8-1 ITAA 97 – it is rather the words "incurred in earning the assessable income …" that are at the heart of all the employee deduction

---

57 Clearly jointly-owed liabilities (such as the position of partners) and liabilities that are contingent and successive (such as guarantees and indemnities) will require special rules, as will liabilities that are non-recourse or limited recourse.

58 See Explanatory Memorandum to P2, paras 9.32, 9.66 and 9.80.

59 ATO statistics routinely show that individuals account for about 85% of all income tax returns filed and 75% of all income tax paid. Companies, partnerships and trusts represent the remaining 15% of income tax returns filed and 25% of income tax paid. *See* ATO, *Taxation Statistics 1998-99* (Canberra, AGPS, 2001), Commissioner of Taxation, *Annual Report 1999-2000* (Canberra, AGPS, 2001).

cases and the hobby loss cases – but the authorities are, to say the least, difficult.[60] Other have already remarked that it will be necessary to ponder how this jurisprudence

---

[60] In *FCT v. Faichney* (1972) 129 CLR 38, at 44, Mason J observed that examples of private or domestic expenditure "could not conceivably be incurred in gaining assessable income". Similarly, in *FCT v. Hatchett* (1971) 125 CLR 494, at 498 Menzies J said, "it must be a rare case where an outgoing incurred in gaining assessable income is also an outgoing of a private nature. In most cases the categories would seem to be exclusive …" This seemed to be orthodoxy until *Handley v. FCT* (1981) 148 CLR 182 and *FCT v. Forsyth* (1981) 148 CLR 203.

In *Handley* Stephen J said,

> "I not only conclude that the present taxpayer's apportioned outgoings are within the category of outgoings incurred in gaining his assessable income; I also regard them, in the circumstances of this case, as by their nature excluded from the category of private or domestic outgoings. Adopting the analysis which I have and discarding as insignificant matters such as the integral nature of the study and the home, nothing remains as a feature of duly apportioned parts of these outgoings which would at all answer the description of expenditure of a private or domestic nature.
>
> If this conclusion would seem substantially to deprive of effective operation the sub-class of private or domestic expenditure as an exception to the general class of deductible expenditure, this may not be as surprising as it seems at first sight. Another sub-class mentioned in s. 51(1), that related to expenditure incurred in gaining exempt income, has plainly enough no effective operation as an exception to the general class. In *Ronpibon* the court pointed out that 'exempt income can never be assessable income. They are mutually exclusive categories.' The explanation there given by the court for this specific exclusion was the legislation's 'desire to declare expressly that so much of the losses and outgoings as might be referable to exempt income should not be deductible from the assessable income.' While admittedly illogical to express such a declaration in the form of an exemption, it was said to serve "the not unimportant purpose of making an express contrast.' The same explanation may apply to the presence in s. 51(1) of the exclusion of expenditure of a private or domestic nature."

Aickin J agreed: "where decisions of this court have denied deductibility in the case of outgoings of a private or domestic nature it has been on the basis that they were not incurred in gaining or producing assessable income or in carrying on a business for the purpose of gaining or producing assessable income, rather than that they were to be excluded as deductions because, although of that character, they were also of a private or domestic nature… Logic would seem to suggest that expenditure incurred on private or domestic matters could not be incurred in gaining or producing assessable income …"

Mason J disagreed. He said, "outgoings incurred in gaining or producing assessable income and outgoings of a capital or domestic nature are not mutually exclusive. Whether the same is true of outgoings of a private nature is a question that may be left to some future occasion."

In *FCT v. Forsyth* (1981) 148 CLR 203, Wilson J took the unusual position that while the incurred-in-earning-income test was inconsistent with an expense being "private," it was not inconsistent with an expense being "domestic"! He said, "I see no reason why it would not be a proper application of s. 51 of the Act in the present case to say that if the proper conclusion on the facts was that the rent was prima facie an outgoing incurred in

might be applied to receipts, and it will be necessary to see how it applies to assets and liabilities.[61]

The "private or domestic" test appears in Division 12 (ED). Under s. 12-10 (ED), we are told, "a receipt or payment is not taken into account under s. 5-55 to the extent that it is of a private or domestic nature" and s. 12-15 (ED) excludes from the computation of opening and closing tax values a private asset and a private liability. The EM to the Exposure Draft Bill, *A New Tax System (Income Tax Assessment) Bill* 1999 candidly admits,

> 4.5 [TVM] is not suitable for individuals without some modification. For individuals, some receipts, such as gifts, and many payments, such as expenditure on food, clearly should fall outside the tax calculation. In a similar vein some liabilities, such as certain debts to a parent, and the falling tax value of assets used up through personal enjoyment should also be excluded.
>
> 4.6 The present law makes these kinds of exclusions by applying the notions of 'income', 'capital', 'private or domestic' and 'incurred in deriving the assessable income'. Under the draft legislation all receipts, payments, assets and liabilities are included unless they are specifically excluded.
>
> 4.7 ***In making these kinds of exclusions the draft legislation will rely solely upon the idea of 'private or domestic'.*** This test will have a role to play in accounting for receipts, payments, liabilities and some assets.

So the "private or domestic" words have to work very hard in TVM. They have to:

- ***exclude*** some receipts that would otherwise be taxed (some gifts, some prizes, inheritances, treasure trove, some gambling winnings, some proceeds of crime, some damages and insurance payments, the sale proceeds of some assets, etc)
- ***not affect*** the inclusion of other receipts that should be taxed (other gifts, other prizes, other gambling winnings, other proceeds of crime, other damages and insurance payments, etc)
- ***exclude*** some payments that would otherwise be deducted (some education, child care, some travel, some clothing, some entertainment, household food and living expenses, some insurance premiums, payment of fines, etc)
- ***not affect*** the recognition of other payments that should be taxed (other education, other travel, other clothing, other entertainment, other insurance premiums, other food and living expenses, etc).

Private or domestic as an inclusionary and exclusionary term

---

gaining or producing the assessable income then the exception with respect to outgoings of a domestic nature would operate to exclude it from deductibility."

[61] See eg O'Connell, *supra* note 8, at 70; Boccabella, *supra* note 9, at 88.

The discussion of the meaning of "private or domestic" in the Explanatory Memorandum to the Exposure Draft Bill asserts that,

> 4.18 'Private' is a word that can carry a number of shades of meaning. The meaning that it carries in the context of taxation laws is one that can be contrasted with 'income earning' or 'commercial' or 'business'. A transaction of a private character and a private use of an asset or liability are typically associated with the enjoyment or sharing of wealth in contrast to its creation or growth [and the meaning of domestic is] similar to, though less general than, 'private'.[62]

This is clearly wishful thinking, and the further text and examples in the EM continue in the same vein:

> *Which kinds of receipts are private or domestic?*
>
> 4.30 Generally speaking, the kinds of receipts that are presently taxed because they constitute 'income' within the ordinary meaning of that word would not be expected to be excluded under the proposed regime on the basis that they could be considered to be private or domestic. This is because it has always been inherent in the notion of 'income' that the expression tends not to embrace non-commercial, private or domestic affairs. That is, the meaning of 'income' already tends to exclude private or domestic receipts.
>
> *Example 4.5*
>
> *A father provides $10,000 to help his daughter in carrying on her meals-on-wheels business. The decision to make the payment has little to do with the nature of the business and much to do with the family relationship. As such, the receipt would be private and would not constitute income.*
>
> *On the other hand, if the daughter was entitled to a subsidy of $10,000 because of the nature of her business, the receipt would not be private and would constitute income.*
>
> 4.31 The converse does not apply. There will be many receipts which are not income but which the new method will now bring to account – while 'income' does not include capital amounts, there is no such exclusion inherent in 'receipts'.
>
> *Example 4.6*
>
> *Phoebe decides to buy a new tractor and borrows $20,000 for that purpose. Of course the amount does not constitute income, but at the time the funds are handed to her there will arise a 'receipt' (the resulting liability to the lender ensures that Phoebe is not taxed on her receipts).*

---

[62] I am reminded here of all the feminist literature on the public / private distinction in law.

Windfalls and gifts

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

Example 4.7

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

Wages etc.

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

This analysis is possible, but not inevitable. The reason that some gifts, prizes, gambling winnings and windfalls are not income is that they do not emanate from a taxable source. The background to our analysis lies in the UK law and this bald text misunderstands that law. That law is about income as something which comes from a taxable source – ie, it is not a matter of private or domestic, but about not having a source in a relevant schedule. The one area where the analysis seems apt (though I suspect it is unwitting) is in our jurisprudence about fines and penalties. The reason they are not deductible lies in the view that these are personal to the perpetrator.[63]

Now I am not saying that, were all of these matters to be re-litigated around the words "private or domestic," the same outcomes could not be reached. It's just that I think there are some reasons to doubt it.

"Private or domestic" must also not affect the inclusive rules. The next part of the EM says,

Wages etc.

4.33 Salaries, wages and fees for services provided would rarely be private …

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

---

63 *IRC v. Warnes & Co* [1919] 2 KB 444, *IRC v. von Glehn & Co* [1920] 2 KB 553.

This might come as a surprise to the taxpayer in *Groser's* case.[64] This case is authority for the proposition that amounts can be paid by a tenant to a landlord which are more than just a contribution to shared expenses, but which will nevertheless not be ordinary income.[65] One can well imagine that in a post-TVM world we will have difficult debates about whether interest paid to a relative is assessable, whether the dividends received on inherited shares are assessable, or whether royalties on an autobiography are assessable (what could be more 'domestic' than my life story, though I concede it will not be 'private' once published?)

The treatment of scholarships and many government pensions and income transfers payments will also raise this terminological difficulty. They will clearly involve receipts but if a prize can be private, a prize in the form of a competitive scholarship could be as well. Similarly a government aged pension, disability pension, Newstart allowance or war widow's benefit could easily be labelled "private."

"Private or domestic" as a nexus test

One of the claims for TVM is that it eliminates any requirement to find a relevant nexus between a receipt or payment and an income-generating activity such as employment, a business or an investment. This clearly overstates the position for individuals because it is the "private or domestic" test which expresses a nexus test.

The functioning of "private or domestic" as *nexus* text appears from the discussions in this text of the EM extracted above, especially para. 4.32 which insists that "amounts received ***in relation to*** income earning activities, such as tips or bonuses, would not be excluded from the net income formula."

But to say that TVM eliminates nexus questions is wishful thinking – characterisation is inextricably linked with examining the connection of a receipt or payment to a particular source or activity. For individuals, we still need to be able to characterise a gift / prize / compensation receipt etc as a *mere* gift / prize / compensation receipt or as a reward for service, and we will do this by seeking a sufficient connection between a receipt and an income-generating activity. It would be possible of course to provide that any gift paid by a current employer to a current employee is to be taxed as income (or fringe benefit) but that is not our current law, nor is it proposed in TVM.

Matches and mismatches

---

64 *FCT v. Groser* (1982) 13 ATR 445.

65 See also *AAT Case 12,438* (1997) 38 ATR 1019. The main consequence in these cases was that the outgoings incurred on the property were held not to be deductible, a consequence that arose from the proposition that the property was not being used to produce assessable income. In other words, the rent was not ordinary income. The Commissioner apparently applies this idea only in the case of a payment which is characterised as a contribution to shared expenses – IT 2673 – CGT: Use of Premises to Produce Income (para 13).

The treatment of "private or domestic" so far has assumed that there is a single receipt or payment and a single asset or liability which will be included or excluded by the "private" label. But the private or domestic test will be an unruly test within TVM. It will need to be able to accommodate private (or non-private) flows emerging from non-private (or private) assets / liabilities, mixed private and non-private flows on an ongoing basis, and changes of character to and from private.

We will start with the issue of private flows emanating from non-private (or private) assets. One clear asymmetry that can arise is between cash flows from assets and the proceeds of sale of assets. The mismatch between flows and assets can be demonstrated using the family holiday home. We are told in s. 12-20(1) Item 2 (ED) that the proceeds of sale of land will never be private, presumably because it is intended to tax all gains on sales of post-CGT real estate. But the amounts spent by way of rates, interest, taxes, etc on the family holiday home will be more difficult. If there is no rental income, the expenses are presumably private, so we have an asset with private flows but non-private proceeds. So, are the current expenses to be denied because they relate to the private usage or to be allowed because they relate to the non-private sale? Sections 7A-20 and 7A-25 (P2) provide a regime for absorbing these outlays into the cost of the land so that they are recovered. This test only applies to an expense that "relates to the land" and, as buildings are to be notionally severed from the land by s. 6-18(2) (P2), repairs done to the building presumably remain private as does the proceeds of sale of the *building*, but the expenses related to the land are absorbed into its cost.) But if there is rental income the outlays are probably no longer private so we now have non-private expenses and a non-private asset.[66] So we can easily end up with a combination like private expenses for the building, non-private but absorbed expenses for the land, private proceeds for the sale of the building and non-private proceeds for the sale of the land.

This problem of mixed flows and assets will occur in other contexts as well. Consider a business taxpayer who uses a car to commute from home and to do the business deliveries. We can assume that the depreciation deduction is to be denied in part because the mixed use makes a part of the decline in value private (although I can't find a pro-rating rule to this effect), but how is the sale to be dealt with? The car might be classified as entirely private or non-private or private which would answer the question. But if the car is not to be dealt with like this, do we pro-rate the proceeds, or tax the entire proceeds but add back the undeducted depreciation into the car's unrecovered tax value?

Change of character problems will also occur. Consider an author who writes the manuscript of a travel book as a hobby and then assigns the copyright in the manuscript to a publisher. Presumably the expenses incurred during the writing phase are private or domestic. If the author assigns the copyright in the manuscript for a lump

---

66 The owner-occupied home will presumably be private for both expenses and sales, although we already have seen these problems for the family home rented out for part of the year in *Re Walter and FCT* (2000) 39 ATR 1052.

sum, is this a private or non-private transaction? If private, we need ask no further questions. But if the manuscript has become a non-private asset, then we would need to create a cost for the copyright on entry into the tax world. Section 12-30 (ED) attempts to ensure that the author receives a cost in the copyright by deeming the (private) sale of the copyright for its then market value and its repurchase for the same amount.[67] This process ensures no taxable income is generated by the transaction and works appropriately.

But what if the author licenses the publisher to use the copyright in exchange for a royalty on sale instead? One might reasonably probably suspect that the royalties would never be viewed as private receipts. Now we would have private outlays and non-private receipts. One might wonder whether the underlying asset must also become non-private if the receipts it generates are non-private, but that does not seem inevitable short of sale. If s. 12-30 (ED) were able to be triggered it would effectively deal with this by deeming a cost for the purposes of Division 40 (P2) and allow depreciation deductions to be claimed against the royalty flow. But it is a plausible outcome that the expense outflow is private, the asset remains private, but the cash inflows are non-private.

Playing with "private or domestic"

I cannot leave this area of change of character without drawing attention to the kind of problem of which *Whitfords Beach*[68] is an example – that is, the games to be played by moving assets between the private and non-private world as circumstances require. I have proceeded on the hypothesis that the exclusion for "private or domestic" transactions will be applied only to individuals, not companies, as is proposed in s. 12-5 (ED).[69] If that is so, it is reasonably clear what would happen under TVM to what was a very 'private' transaction at its conception – the purchase of a tract of land by a company which its shareholders could use for access to the beach for fishing. Land cannot be a "private" asset for TVM in anyone's hands,[70] so presumably the land becomes both a CGT asset, possibly even inventory in a TVM and post-CGT world, and would be taxed to the company when sold with the difference between the historical cost and the sale price being the income. There is no private (and increasingly less pre-CGT) gain in the company's holding that needs to be shielded from tax.

---

67 This rule, that a cost arises when a non-tax asset enters the tax world has been found in the cases. See for example, *Executor Trustee & Agency Co of SA v. FCT* (Bristowe's Case) (1962) 12 ATD 520 (for shares which become revenue assets), and *FCT v. Whitfords Beach Pty Ltd* (1982) 150 CLR 335 (non-commercial land which becomes a revenue asset).

68 *FCT v. Whitfords Beach Pty Ltd* (1982) 150 CLR 355.

69 See also s. 12-1(2) (ED) which provides that "the receipts, payments, assets and liabilities of taxpayers other than individuals are never of a private or domestic nature."

70 Section 12-20, Item 2 (ED).

But it is not clear how the shareholders would be taxed – whether their shares would always be non-private, as dividends are said to be. It is not obvious to me that shares in a company which holds exclusively family assets would not themselves be "private." If the shares can be private, even though the land could never be, this offers options to a taxpayer who wants to play games. If the land is to realise a loss, we leave the land in private hands and take the loss personally. But if the land is to realise a gain, we try to acquire the land using the company and take the gain on the shares, when the land is to be sold. Of course, if we are unsure and unwilling to take the risk on acquisition, we might try to roll the land into a corporate structure after acquisition. If we can avoid subjecting the gain to tax using an incorporation rollover, and we take cost in the land as cost in the shares, but not the ***character*** of the land as character in the shares as well, we have managed to eliminate tax on the gain.

It may be that the answer to this problem is that shares will never be allowed to be "private." But that just creates the reverse incentive. Now I have an opportunity to take private assets such as cars or principal residences and, where there is a loss, to bring this loss into the tax world by wrapping them inside a company. Admittedly the loss may be a quarantined one and worth only 50% of its face value, but in some cases this might be sufficient to warrant the effort.

So one approach would be to adopt the kind of look-through rules that we have seen elsewhere in tax law to deal with this kind of this 'one-asset-within-another' problem – in this case, the enclosure of a non-private asset within a (possibly) private asset or the enclosure of a private asset within a non-private asset. We have seen these kinds of rules already for example in s. 104-230 ITAA 97 (the former s. 160ZZT ITAA 36) for post-CGT assets wrapped within a pre-CGT shareholding, s. 115-45 ITAA 97 for short-term CGT assets wrapped within a 12 month shareholding, and s. 3A of the *International Tax Agreements Act* 1953 enacted in the response to the *Lamesa* case[71] for Australian land wrapped within foreign companies. These rules tend to be difficult.

6. What Won't Change as a Result of TVM

The second part to my argument is that TVM won't solve many of the difficult parts of tax law, though it will change they way the problems are analysed. I will take two examples and add some final comments on how some of the new problems will emerge.

A capital v. income dichotomy

It has been said that under TVM, there is no capital / income dichotomy.[72] Certainly it is true that one will not find these words used in the draft legislation. Nevertheless, this is an income tax, not a cash flow tax, and so a capital / income dichotomy exists in it, albeit in other words, because it is not intended that value of savings will be deducted

---

71 *FCT v. Lamesa Holdings BV* (1997) 36 ATR 589.

72 See eg, O'Connell, *supra* note 8.

from the tax base. New investment will still have to be made with after-tax dollars under TVM.

The way that the capital / income distinction will exist for taxpayers in the TVM is:

- for individual receipts, in the idea of a receipt that comes with a liability attached,
- for individual outlays, in the idea of a payment which gives rise to an asset with a positive tax value, and
- for gains and losses from transactions involving assets, the idea of a gain on an asset which ought to be afforded CGT treatment (as opposed to one that ought to be afforded some other kind of treatment).

One can be confident that the capital-income dichotomy will prove just as fertile territory for disputes under TVM as it is under the income tax. Hard cases will remain hard, though the way that they are "hard" will be different. To see the point, consider the treatment of payments. The tax disputes will arise in this way. The taxpayer will argue that:

- the payment gives rise to no asset as defined in s. 6-15 (P2),
- if it does give rise to an asset, it is not an asset that can be held under s. 6-20 (P2) (because it is not proprietary in nature),
- if it is an asset and it can be held, the asset is of a kind that has a zero tax value under s. 6-40 (P2),
- if it is an asset and it can be held and it has a positive tax value, it is *this* kind of asset not *that* kind of asset (say, Item 1 or Item 3, rather than Item 2 or Item 9 in the Table in s. 6-40 (P2)),

The ATO will undoubtedly argue the reverse.

Consider *Montgomery's* case[73] as a standard example of a capital / income dispute involving a simple receipt. Here we have a dispute about whether the lease incentive of $29 million paid over three tax years to the partners of Freehills was assessable as income. The amount was paid to the partnership to induce the execution of a lease by the firm's service company. (Notice that even though all the events occurred after CGT, no serious argument was considered that the receipt might give rise to a taxable capital gain.) The High Court held by 4:3 that the receipt was assessable as ordinary usage income of the partners. Under TVM how will this fight arise? The taxpayer cannot feasibly dispute the fact of a receipt (though notice the staggered cash flow), but is it a receipt which comes with a liability attached, that the taxpayer has, and which has a positive tax value? If so, the taxpayer will be able to offset the receipt with an equal liability in its closing tax account and so no income arises.

What do we know about the circumstances giving rise to the payment in *Montgomery's* case? One of the documents which record the transaction between the landlord and the

---

[73] *FCT v. Montgomery* (1999) 42 ATR 475.

firm was a Deed dated 14 August 1989 between lessor, the service company and the partners of the firm under which the partners covenanted "to meet all obligations of the Nominee pursuant to the Transactions Documents." The Deed contained a provision that:

> … [the partners] ***are liable*** pursuant to the Transaction Documents to the same extent as if they had executed the Transaction Documents in their own names in lieu of the [service company].

It also contained provisions that:

> 7.1 Subject to the provisions of Clause 7.2, any liability of a Principal shall be released upon written notification being given to the Lessor of the retirement or resignation of that Principal from the Partnership, but no such release shall release any other Principals.
>
> 7.2 No less than twenty (20) Principals shall remain liable hereunder at all times.
>
> 7.3 The Principals shall procure any new member of the Partnership to acknowledge in a form acceptable to the Lessor that he or she is bound by this Deed as a Principal as if he had executed it on the date hereof.

I suspect, though the report of the case does not make clear, there were also obligations about the state and quality of the fit-out that would be made to the floors with the money paid by the landlord.

How will the fight emerge under TVM? First, the taxpayers will argue that this money came with strings, and those strings amount to a "liability" probably more than one: to procure the signature of the lease by the service company, to meet all the obligations of the service company, and to fit-out the premises to certain standards. They will argue that the liabilities are not contingent, dependent on some event such as the occurrence of a default by the service company, or the issue of a notice from the lessor. (In fact, if they are bold, the partners may even claim that the liability exists at the moment they signed the Deed and long before the majority of the cash was received, generating a (very large?) deduction long before the receipt occurs.)[74] The taxpayers will argue that (each) liability was "a present legal or equitable obligation …" They will argue that its

---

[74] This is the difficulty with using the word "liability" and insisting that it be a "present legal or equitable obligation." I have argued elsewhere that this word raises the possibility that, say, all of the rent due on a lease is incurred once the lease is signed, or all of the interest due on a loan is incurred once the loan agreement is signed (see GS Cooper, Tax Accounting for Deductions (1988) 5 *Australian Tax Forum* 26) and it is provisions such as s. 82KZM ITAA 36 and the notion of "properly referable" in *Coles Myer Finance Limited v. FCT* (1993) 176 CLR 640 which preclude this unfortunate outcome under current law. See also RW Parsons, Deductibility of Interest Payments After *Ure* and *Ilbery*, in RW Parsons, ed, *Developments in Tax Law - Series III* (Sydney: Committee for Postgraduate Studies in the Department of Law, University of Sydney, 1982) at 25-27.

tax value is high by putting it in say, Item 9 in s. 7-75 (P2), or if there is a need to apportion between the liabilities, most cost is attached to the non-routine one.

On the other hand, the Commissioner will argue: there is no liability, just an obligation about how the taxpayer will use money that it unconditionally. If the terms of the Deed do generate liabilities, he may argue that they do not yet exist – they are not a present obligation – and he will try to put the liability into a class with a low tax value such as Item 1, arguing that the liability or most of it is "routine."

There will undoubtedly be nice fights to be had about whether the documents create "liabilities" or merely "obligations" on the parties to them.[75] The difference between a liability and an obligation will be a nice one that will prove fertile ground for lawyers. There will be fights about whether any of those liabilities are contingent or not, whether they are routine or non-routine, how much of the $29 million relates to each thing found to be a liability, and so on. I am at a loss to see why the dispute fashioned around these terms is going to be any less contentious, any less likely to occur, or any easier for a Court to resolve, than one fashioned around the current label. What I can see, is the opportunity to re-litigate *Montgomery's* case – lease incentives are back in fashion because of the glut in Melbourne CBD real estate.

A similar story could be constructed for many of the other classic income v. capital receipt cases. Just think about *Dickenson*,[76] *BP Australia*,[77] or *Strick v. Regent Oil*.[78] In all of them the taxpayer enters long term trade tie arrangements which could easily be thought of as "liabilities." We will undoubtedly have disputes about whether these trade ties are a "liability" or an "asset." Does tying oneself to Shell in return for a payment amount to the part sale of the business or the undertaking of a liability? The language of these cases invariably revolves around the "sterilising" of the business and when undertaking an obligation amounts to the equivalent of a partial sale. There is clearly an arguable position that the amount paid by Shell to Dickenson was for undertaking the obligation not to sell other products, but the taxpayer was treated by the majority of the High Court as if it had sold part of its profit yielding structure in return for the payment.

Or consider how *Hallstroms Pty Ltd v. FCT*,[79] a fairly standard income v. capital dispute about a simple payment, would be dealt with under TVM. Here the taxpayer incurred expenses to prevent a rival firm from extending the life a patent, an outcome

---

75 Consider *GP International Pipecoaters Pty Ltd v FCT* (1990) 170 CLR 124 (payment made to the company to assist it to defray the costs of constructing its plant in WA because the WA government insisted on the condition that it undertake the pipecoating in WA). Is this contractual stipulation about the place at which the work will be performed simply a condition attaching to performance, like delivering on time, or does it amount to a liability to pay amounts to the other party in the event that it is breached?

76 *Dickenson v. FCT* (1958) 98 CLR 460

77 *BP Australia Ltd v. FCT* (1965) 112 CLR 386.

78 *Strick v. Regent Oil Co Ltd* [1966] AC 295.

79 *Hallstroms Pty Ltd v. FCT* (1946) 72 CLR 634.

which would have impeded Hallstrom's market penetration. The taxpayer secured no enduring benefit from the payment although the payment went to shoring up the structure by which it derived its income. The Commissioner will presumably argue that the outlay procured a new asset. He will undoubtedly also run the fall-back argument that if it led to no new asset, it nevertheless contributed to bringing an existing asset (goodwill?) to its current state.[80] The taxpayer will argue that while it might have derived some advantage from the payment, that advantage does not amount to an asset. The Commissioner will say that the asset is one that has a high tax value and preferably one the cost of which is recovered only on sale of the asset, or better yet only on termination of the business. Again, I am at a loss to see why the dispute fashioned around these labels is going to be any less contentious, any less likely to occur or any easier for a Court to resolve.

Or consider how income v. capital disputes will emerge involving gains from the sale of assets. Consider as an example the four depreciable plant cases – *FCT v. Cyclone Scaffolding Pty Ltd*,[81] *Memorex Pty Ltd v. FCT*,[82] *FCT v. GKN Kwikform Services Pty Ltd*[83] and *FCT v. Hyteco Hiring Pty Ltd*.[84] Each of them shows the same difficult asset classification issue. In *Cyclone Scaffolding Pty* for example, the taxpayer owned scaffolding equipment which it hired to the public, although it occasionally sold scaffolding equipment to governmental and semi-governmental authorities. The taxpayer usually made special purchases of equipment for the purposes of these sales but, on occasion, it also sold some of its hiring equipment. In addition, the taxpayer also "sold" plant where hirers lost or destroyed the hired equipment, because under the terms of its hiring contracts, the hirer was required to pay the taxpayer's current list price for any equipment lost or destroyed. The Commissioner argued in the case that all the equipment should be classified as trading stock or revenue asset, while the taxpayer argued that all should be treated as depreciable. The problem is that the assets had both characters at different times. TVM can't solve this problem. We will still have disputes like *Whitfords Beach*[85] or *Westfield*[86] about whether this land should give rise to an income gain because it has become trading stock, or a capital gain enjoying the 50% discount or which would be subject to loss quarantining.[87]

---

80 This is the second element of cost which will now have to be managed in s. 7A-20(1)(b) (P2).

81 (1987) 87 ATC 5083.

82 (1987) 87 ATC 5034.

83 (1991) 91 ATC 4336.

84 (1992) 92 ATC 4585.

85 (1982) 150 CLR 355.

86 *Westfield Ltd v FCT* (1991) 21 ATR 1398

87 Interestingly, though, if shares are only ever to be treated as CGT-only assets, we will not have disputes like *London Australia Investment Co Ltd v. FCT* (1977) 138 CLR 106 nor the banking and insurance cases, though this has nothing to do with TVM per se. I wonder just how much political difficulty the banks and insurance companies will make

The asset notion and asset-related ideas have already given rise to problems in our tax system – is there one asset or are there many; what is the asset; is it what it seems or is it a proxy for some other kind of asset? We have seen courts having problems identifying what asset is the relevant asset to be considering. In *Cliffs International Inc v. FCT*[88] the High Court was divided on whether the periodic payments being made were for the acquisition of the shares, as the Commissioner had contended, for the acquisition of the mining rights owned by the company, or for the use of the mining rights owned by the company. On other occasions, we have seen one asset masquerading as another. For example in *FCT v. McClennan*[89] a taxpayer who was paying for shares in a co-operative was allowed a deduction for his outlay on the basis that the shares were being purchased to fund an interest expense. The Court rejected the Commissioner's argument that the taxpayer was buying shares and should be treated in this way. Hill J. said,

> The Commissioner's submission represents a triumph of form over substance. To equate the present circumstances to an investment of shares in a company for the benefit of the congeries of rights which ownership of shares in a company carries with it, would be a misleading half-truth.[90]

In various contexts, the Commissioner's own views have vacillated between treating the asset as asset and treating it as a proxy for something else. For example the Commissioner has tried to explain the relationship between restrictive covenants and goodwill.[91] The Rulings try to deal with a difficult legal question – when is a covenant the mechanism by which a vendor conveys goodwill to the buyer of his business, and when is it an asset separate from the seller's goodwill? The Commissioner began with the view that the covenant would be an asset separate from the goodwill, but changed that view except where the parties separately value the goodwill. We have seen the masquerade problem similarly in the rulings on the transfer of tied hotel sites.[92] Again the Commissioner has been content with the position that in some cases what appears to be the transfer of a lease for a premium is in fact the means of assigning the underlying goodwill of the hotelier.

The best hope for minimising the number of capital / income disputes has nothing to do with TVM and its strategy of using assets rather receipts to express the capital

---

once it is realised they can no longer claim allowable deductions for losses on their trading portfolios?

88 (1979) 142 CLR 140.

89 (1989) 20 ATR 1771.

90 (1989) 20 ATR 1771, at 1776.

91 TR 95/3 – Application of subsections 160M(6) and 160M(7) to restrictive covenants and trade ties; Draft Taxation Ruling TR 98/D13 – Goodwill of a business; TR 99/16 – Goodwill of a business.

92 The first ruling was IT 2535 – Payment for goodwill or premium on grant of lease? which has since been withdrawn and replaced by TR 96/24 – Guidelines to determine whether an amount described in a sale of business agreement as consideration for goodwill is properly characterised as a lease premium.

income dichotomy. It is rather twin strategies of (a) attaching depreciation treatment to all wasting assets and (b) attaching CGT treatment to only a few kinds of residual assets. It is a nice irony that these strategies also make the big CGT announcement of Review of Business Taxation – the 50% and 33% CGT discounts – rather less headline-worthy. There will be so many fewer assets to which CGT treatment is relevant.

Nexus tests and the basis for characterisation

I suggested above that the argument that TVM eliminates all nexus questions is implausible. I agree that the nexus test in s. 8-1 ("a loss or outgoing … necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income") will be unnecessary for entities – it is intended under TVM that all outlays made by entities are treated as relevant to the tax base. But this goes only a little way to eliminating nexus notions from the tax system.

First, the private or domestic test will function as a nexus test for individuals, at least.

Secondly, there is a formal nexus requirement expressed in TVM between cost and asset, and between proceeds and liability.[93] This test asks whether and when an identified payment which has occurred can be traced to any particular asset or liability. We will not need to link payments to "carrying on a business for the purpose of gaining or producing your assessable income" as s. 8-1(1) ITAA 97 currently requires, but we will need to identify whether a payment is made in order to bring an asset to its current position.

More generally, for business taxpayers and investors, we will still strike nexus tests because we will still have to characterise. We will need to be able to say, for example, whether an asset is one the cost of which is recovered on sale (ie, inventory or a CGT asset) or over its life (a depreciable). We will make these characterisations based in part on the nature of the asset but also on its connection and place within an income-generating activity. No part of the cost of a car (which will have a limited life and will decline in value while sitting on the car yard) that is sitting on the yard on 30 June ought to be recovered under depreciation rules if it is inventory.[94] And I doubt that the definition of "use" in s. 40-30(2) (P2) is capable of making this distinction as it uses the current drafting fad of treating income from using assets and selling assets indifferently. Nor would the definition of "trading stock" if it mirrors current law in Division 70 ITAA 97 as many assets are held both for use and for sale, as *Cyclone Scaffolding*[95] attests.

Moreover, for the special regimes that will survive in a TVM world, we will inevitably still need to distinguish between nexus to a business and nexus to an investment. These

---

93 The nexus is described in Chapter 9 of the Explanatory Memorandum to the current Prototype. See Explanatory Memorandum to P2, paras 9.32, 9.66 and 9.80.

94 This demarcation between depreciables and inventory will still exist in TVM: s. 40-30(3)(a) (P2).

95 *FCT v. Cyclone Scaffolding* (1987) 19 ATR 674.

demarcations will survive because of tax policy judgments affording different treatment to businesses rather than investors, to some kinds of businesses rather than others, and to some kinds of receipts or payments rather than others. Example are the allocation of assets between inventory depreciable and CGT-only asset, the treatment of losses on investments, the STS system, pre-payments rules, CGT small business concessions, the PSI rules, capital loss quarantining rules, and so on and so on. They are not inherent in TVM, nor caused by TVM, but the claim that in a post-TVM world nexus and characterisation tests will be eliminated is implausible.

Eliminating any notion of nexus will cause its own problems, if receipt without connection is enough to make an amount taxable. Consider a case such as *FCT v. Federal Coke*.[96] In this case, a buyer had entered an agreement requiring it to buy a stated quantity of minerals each year at a fixed price. The demand for the buyer's product declined and it wanted to get out of the contract. The seller, Bellambi, agreed to the termination only if the buyer paid $1 million in compensation. But under the agreement, the money was not to be paid to Bellambi but to a related company in the same group, Federal Coke. The Commissioner issued his assessment to Federal Coke on the basis that the money it received was income to it. The Court held that the money was not assessable to Federal Coke because it was not the product of any business that Federal Coke carried on. The lesson of the story is that the Commissioner assessed the wrong person – he should have assessed Bellambi under s. 19 ITAA 36. But under TVM what happens? It would seem Federal Coke is assessable on the receipt as receipt – there is no salvation for Federal Coke in the notion that this amount is "private or domestic" to it, as that notion will apply only to individuals. Moreover, as there is a constructive receipt rule in 5-65(1) (P2), Bellambi is assessable on the amount as well. However, s. 5-65(2)(P2) then deems Federal Coke to have paid an equal amount to Bellambi.[97] The apparent result is that the income is taxed once and to Bellambi. This is an easy way to ensure that the income ends up taxed to the wrong person, and opens opportunities for the kind of income splitting transactions that the Government usually works so hard to defeat.

This example shows another interesting aspect of TVM. Eliminating the requirement to characterise a payment opens avoidance possibilities. At present, losses can only be formally transferred within 100% groups, and so taxpayers who want to shift income around within groups have to resort to other income-shifting strategies, but under TVM one apparently needs only to move cash, not income. Income equalisation now apparently becomes a much simpler pass-time.[98] It may be that the generic "value

---

96 *FCT v. Federal Coke* (1977) 7 ATR 519.

97 The rule deems a payment, but query whether it also has the effect of deeming the payment to be private or domestic (which would be the best way of stopping family income splitting) or deems the payment to procure an asset (which would be one way of stopping the deduction for inter-group transactions).

98 We are apparently to have a universal (ie, domestic) arm's length transfer pricing rule being done as part of TVM, though it seems to me an unrelated proposal. It is interesting to consider on what basis an arm's length rule works within a system where income and

shifting framework" referred to by the RBT is meant to solve this problem but it would only work between related entities. Similarly, the current stop-loss rules in Division 170-D ITAA 97 might be applied to members of a linked group. Alternatively, the desired effect of the payment might be reversed if it was carelessly done in a way which gave rise to an asset for the payer, though no doubt careful structuring could make this characterisation at least arguable. Alternatively, if the payment was viewed as giving rise to a "gift" to the recipient, it might be subject to reversal by way of adjustment, but again the payment might not be a gift technically defined.[99] So no doubt there is a solution to this possibility but it bears the potential of becoming a useful point of attack for the tax planning community.

Characterisation per se

The last issue I want to deal with is asset and liability characterisation. I want to return to the proposition that "under the tax value method, the distinction between identifiable and unidentifiable assets for income tax purposes is made definite."[100] In fact, my principal substantive concern about TVM is just this – the fear that the emphasis on assets and liabilities (rather than the more observable cash flows) will make the tax system more difficult rather than less difficult for taxpayers and administrators.[101] The reason is (in the absence of an explicit materiality exception or the abiding goodwill of the ATO) an asset or liability is more difficult to observe and quantify than a flow. We will spend a great deal of our time asking (a) is there an asset and (b) which asset is the relevant one to analyse? The discussion of *Montgomery's* case has already alluded to the kinds of disputes that will surface about is there a liability, what is it, how many are there, and so on. These debates will become central not peripheral.

It seems fitting to recall here the first discussion I attended on TVM. I posed a question to the presenter: if I pay a premium on 1 June to insure a building for 12 months, how would this be treated under TVM? Would the transaction be viewed as (a) generating a new asset being my rights under the policy, or (b) would it be absorbed into the cost of the building under the second element of cost?[102] During the course of the answer it became apparent that my imagination was too limited – there was a third alternative (c) that my payment had procured another asset, a put option over my house, in exchange for the insurance proceeds. That too was an asset (presumably of its own type and with its own tax value) and might have to be taken into account, although the presenter suggested that it would be solved by a materiality notion. In the absence of a materiality concept in TVM, my guess is that few would be aware of this other asset,

---

deductions are generated by moving cash, not by the provisions of services or sale of goods or provision of use of capital at over- or under-value.

99 Section 5-95 Item 10 (P2).

100 ATO and Treasury, *The Tax Value Method – Discussion Paper on Issues Raised in Consultation During December 1999 and January 2000*, unpublished, para. 3.24.

101 This issue is also discussed in O'Connell, *supra* note 8, at 77.

102 At this stage, there was no equivalent to s. 7A-25(1)(b) (P2) to exclude insurance premiums from the second element of cost.

but apparently it lurks there ready to consume cost that might be happily allocated elsewhere.

This problem of asset identification exists already in CGT and we agonise over it in many contexts. The Commissioner's Taxation Determination TD 93/86 adopts the somewhat despairing position that,

> 1. Whether all the rights comprise one single asset, or each right is a separate asset, will depend on the facts of each case. Generally, however, the initial approach will be to regard the totality of rights as the one asset for the purposes of Part IIIA of the Income Tax Assessment Act 1936.
>
> 2. Depending upon the circumstances of each particular case, an assignment of one of the rights contained in a contract is usually treated as a disposal of part of the asset (i.e. the contractal rights); the individual right that is severed from the contract is, if it continues to exist, regarded as a separate asset for CGT purposes.[103]

And TVM carries the danger of creating new characterisation dilemmas. Consider the transactions in *Arthur Murray (NSW) Pty Ltd v. FCT*[104] or *Country Magazine Pty Ltd v. FCT*.[105] In both cases the taxpayer received cash today for services (in the case of *Arthur Murray*) or goods (in the case of *Country Magazine*) to be provided tomorrow. Tax law currently treats these transactions as involving a simple accounting question – when is the income from the flow of funds to be recognised, when it is received or when the services or goods are provided? But TVM does not ask the same question; it asks, is this money received for undertaking a liability. These transactions are apparently to be viewed as depreciating liabilities so that the liability (to provide the services or goods) is written back over the life of the contract under the depreciating rules in Division 40 (P2).[106]

I have no doubt that a timing rule can emerge from the way this analysis is constructed. The first query must be whether a judge would agree that this transaction is the creation of a liability rather than the provision of goods or services. It does not seem implausible to fear that a judge would view this simply as the supply of services, rather than the creation of a depreciating asset. Next, I wonder has anything else about this transaction changed? Have the subject matter of the transaction changed by insisting on constructing its tax consequences in this way? For example, yesterday, I was viewed as selling services teaching dancing; today, am I viewed as receiving the money for undertaking a liability to provide those services. That is not the same thing. And is the purchaser to be viewed as paying for services or goods, or is the buyer to be viewed as buying the rights to the goods or services? That too is a different purchase.

---

103 I wonder how s. 7B-130 (P2) applies here?

104 *Arthur Murray (NSW) Pty Ltd v. FCT* (1965) 114 CLR 314.

105 *Country Magazine Pty Ltd v. FCT* (1968) 42 ALJR 42.

106 See Explanatory Memorandum to P2, para 1.24 ff.

We have seen this distinction before. This distinction is at the heart of the judgments in *FCT v. Ilbery*,[107] *FCT v. Gwynvill Properties Pty Ltd*[108] and *FCT v. Creer*.[109] In these cases, the taxpayers prepaid an expenses (interest and rent) but the payment was treated as no longer being for those outgoings, but rather to secure the enduring advantage of release from those expenses. It was not just a question of timing, character had changed as well. Why do these questions matter? The difference may mean for instance that my income is no longer PSI income – it now derives from selling rights to services, rather than the services themselves. It might mean that the source has been changed, and so on.

I hope this will not be so, but there will be a strong temptation for the ATO to find assets lurking in every corner and for taxpayers to find liabilities right beside them, just as the Courts did in *Ilbery*, *Creer* and *Gwynvill Properties*. The issue bears a strong resemblance to the 'everything-is-a-right' approach one encounters in current CGT and GST debates,[110] and one encounters it too often to be confident that it won't emerge here in its new form, 'everything is an asset' – selling services ceases to be selling services because it can viewed as selling the right to services, and so on.[111]

---

107 (1981) 12 ATR 563

108 (1986) 17 ATR 844

109 (1986) 17 ATR 548

110 In GST, the rights-as-asset dilemma emerges in several places. In part, it stems from a misrepresentation at the very core of the tax. The text of Division 7 and s. 9-5 *ANTS (GST) Act* 1999 would have the reader believe that GST is imposed on what is supplied – it is a tax on the value of the goods, services, real estate and intangibles supplied by a registered enterprise. It seems to be tax on assets going out. In fact, the tax base is the consideration received by a registered enterprise for making those supplies. It is a tax on revenue coming in.

One manifestation of this everything-is-an-asset problem has arisen in dealing with operating leases. The taxpayer might be viewed as supplying the use of goods, or the right to use goods. GST Ruling 2000/31 - Supplies Connected with Australia, has to refute the argument that the supply is a supply of the right to goods so that a bailment for reward of goods is governed by the place of supply rule for goods not the rule for intangibles:

> 110. Where tangible personal property is the subject of a lease or hire arrangement the GST Act contemplates that the supply is a supply of goods rather than the supply of use of the goods.

Another manifestation is in the third party consideration cases such as *Redrow Group* [1999] STC 161. In this case, the issue was whether a real estate agent had supplied services to the householder (who was not liable to pay for them) or had supplied to the builder (who had paid for something) the right to have the services delivered to the customer.

111 Indeed, we already have one example in the legislation of a rule to negate a manifestation of this approach. Section 104-35(5)(b) ITAA 97 is designed to ensure that when a seller signs a contract to sell an asset it is not to be treated as if selling the right

7. Concluding remarks

My main purpose in this paper has been to address a "truth-in-advertising" concern. The criticism is not really of TVM *per se*, but rather of one improbable claim made in its support, although admittedly in the paper I have ventured briefly into other arguments made in support of TVM. Indeed, this is my main criticism of the TVM process to date – that TVM is being supported on grounds that are either unverifiable, most probably wrong, or which might be correct but only subject to important but unstated qualifications.

So I have tried to show a few areas where TVM will likely change the tax base, either by changing what is included or excluded, by changing timing, by changing the taxpayer, or by changing character and thus treatment. A quick review suggests that in many of the transactions examined, TVM certainly can get or get close to the result that would occur under current law, though there are enough lingering doubts surrounding some of the transactions and there are clearly sufficient deliberate changes that I believe one can conclude TVM will cause changes to the tax base.

Is that significant? I think not, if the changes that would result are on the whole sensible changes, that will more likely than not improve the tax base, or will cure a current failing in the ordinary concepts notion. In that case, the change should occur, and if it takes TVM to accomplish it, then that would be a strong argument why TVM should proceed.

It is thus a disappointment to have to write this paper – I freely admit that it adds little to the current debate and would be completely unnecessary if a more sober, limited, realistic, and I would say, more accurate, assessment of what TVM can accomplish were advanced instead. TVM may well prove a breakthrough in creating a better income tax base, but making unverifiable, implausible or over-reaching claims in its support only hinders the case.

---

to the transfer of the asset instead, so that the CGT rules can apply to the real transaction which is the transfer of the asset.