Pro Testing, through Protesting, to "Maybe it works"?

Australia Post has participated in the Board of Taxation TVM testing project on two levels. Post agreed to: -

- recalculate its 1999/2000 taxable income utilising TVM methodology, and
- analyse a range of transactions based on the TVM model legislation.

This report relates solely to the first part of the testing project.

Objective of the Testing

Post recalculated its 1999/2000 taxable income utilising the TVM methodology. The purpose of this calculation was to demonstrate that the TVM methodology produced the same result or if this was not the case how the methodology failed to produce the correct result.

The testing was also necessary to highlight the difficulties that a taxpayer would be faced with in attempting to complete a TVM calculation.

From my perspective I was **Pro testing** for two fundamental reasons,

- with the level of tax law changes being experienced it is essential that any change be rigorously tried, and proven to deliver the benefits promised before it is thrust upon taxpayers, and
- the Australia Post tax return preparation process is highly automated and to be in a position to accurately scope a TVM implementation project it would be necessary to fully understand the requirements as early as possible.

Process followed

The testing process was not prescribed and as a result it was necessary to "design" the process and the output.

Several alternatives were considered:

- Commencing from the current methodology we attempted to attribute Asset and Liability balances to the reconciliation items in the Income Tax Reconciliation. This method failed to achieve a result that matched the existing calculation.
- The Profit Reconciliation Method. While we accept that this method (which is virtually the same as the current calculation methodology) will achieve the correct outcome it became apparent that it was an inappropriate justification for accepting the change to the TVM methodology.
- The Balance Sheet approach. This approach relied on strictly following the processes described in the TVM legislation. This approach was found to successfully reproduce the Taxable Income (subject to a decision not to analyse Financial Transactions and therefor accept a minor variance)

Extension of existing processes

The first attempt at a TVM was to match movements in Balance Sheet to the reconciliation items identified in the 1999/2000 actual tax reconciliation.

In some cases this was quite easy to achieve. For example, trading stock and provisions are currently calculated by identifying movements in the Tax Balance Sheet. Provisions are

currently “backed out” of the profit calculation in determining the Taxable Income. The number to back out is the difference between opening and closing balances in the books.

This exercise become somewhat confusing as it was necessary to clearly identify whether the reconciliation item was the reversal of an accounting entry or the reinstatement of an amount as a tax adjustment. In some cases the book/tax distinction was not apparent or the adjustment item took into account a combination of the two. The major area in which a matching outcome was not easily achieved was fixed assets where book and tax depreciation, disposals and additions had to be brought into line – this proved to be too hard.

While it is likely that it would be possible to reconstitute the taxable income in this way it was felt that this would be achieved only as a result of a “working back” exercise. The outcome could be achieved but it would be necessary to do the reconciliation as we are used to doing it to know what the answer was meant to be.

On this basis we abandoned this calculation and moved on.

The Profit Reconciliation Method

The Profit Reconciliation Method essentially illustrated that the Taxable Income could be calculated in much the same way as we are used to notwithstanding that the applicable laws had been changed.

Under this method it is recognised that at present the tax laws define what income is assessable and what outgoings are deductible and allow the deductible outgoings to be deducted from the assessable income to produce Taxable Income. In practice tax practitioners, and indeed the tax return form itself, fails to follow the prescribed processes.

Instead of the process prescribed in the current laws the common practice is to commence the tax reconciliation with the Net Profit before tax and to excise book adjustments that are not permitted by the tax laws and to replace them with statutory tax items. For example, the current tax laws permit a deduction for Bad Debts written off. If these same bad debts were also written off in the P&L (as would be expected) there would be no need for an adjustment in the current methodology.

This argument can easily be extended into the TVM method. The law can provide the rules for calculating the taxable income but it is not necessary to strictly follow those rules to achieve the intended outcome (ie. The law need not be prescriptive).

It is clear that a taxable income equivalent to the desired TVM outcome –or the current outcome – can be achieved by not following the TVM approach. But this was not seen to be the object of the testing process. It failed in persuading me to support the switch to TVM.

In testing the TVM method it seemed to be somewhat of a “hollow victory” to prove that the law need not be followed regardless of the extent of the change. In my view for TVM to be acceptable it had to be shown that one could follow TVM – to the letter - and achieve the desired result in a simpler process or with a greater degree of certainty.

On the basis of this we abandoned the Profit Reconciliation Method and sought a better outcome.

By this stage my view of TVM had clearly moved from **Pro testing to Protesting** and we were seriously considering giving up.

The Balance Sheet method

Starting with a clean sheet, and conscious of John Ralph's assertion that Taxable Income could be calculated on one sheet of paper (in our case we aimed at the back of a postage stamp) we set about to carry out a genuine Test Drive of the legislation. We made a number of critical assumptions, most important of which was that this testing did not need to determine whether the law as drafted was a true reflection of the current laws only that the mechanics worked.

On this basis we started with our annual report and reconstructed the Balance Sheet. We then used our existing working papers files to reconstitute the movements in the Balance Sheet accounts as follows:

Opening Balance
Plus

Additions
Less

Disposals
Less

Provisions
Equals

Closing Balance.

Our initial thought was that this was vital to ascertain the cash movements to populate the Cash Receipts and Cash Payments column of the TVM calculation model.

This process proved to be difficult, probably not because the information did not exist but because we had not set about to record it. It had not previously been necessary in the same level of detail.

With most, but not all, of the reconciliations completed we turned to the TVM calculation.

Given that there was no precedent we needed to design a spreadsheet to capture the calculation. From the TVM legislation we decided that placing the 7-column TVM model beside the Balance Sheet was a good start. We then placed 3 columns between the balance sheet and the TVM reconciliation. These we headed "Asset/Liability" "Holder' and "Value" representing the series of questions prescribed by TVM.

In our calculation the first item was Cash – we determined that this was a monetary asset and should be ignored. This decision was later revisited as to ignore Monetary items (as required by the model legislation) significantly increased the effort necessary to do the TVM calculation. We later decided to ignore the Monetary Items rules and to not use the Cash Receipts/Payments columns – we are strongly of the opinion that for a major corporate taxpayer to do otherwise defeats whatever simplicity was achieved by the rest of the TVM model.

We worked through all assets and liabilities in a level of detail appropriate to the particular item. Where possible we retained the calculation at Financial Accounts level, elsewhere it was necessary to dissect the balance. In practice we concluded that it would be appropriate to start from a detailed Balance Sheet otherwise important impacts on Taxable Income could be missed but in the context of knowing the answer before we started dissecting account groups achieved the desired result.

Items where tax and accounting treatment was the same were transferred to the TVM calculation at book value (eg. Opening and Closing balance of Land at Cost). Where differences exist the tax value was substituted (eg Land – valuation increment – tax value = nil).

This was repeated for all Balance Sheet items.

Items that gave rise to permanent differences could not be dealt with in this way. As an alternate the TVM model legislation treats these as Adjustment items. Included in these are R&D, CGT Indexation, non-deductible expenses, etc.

For these items it was necessary to add a section on the bottom of the work sheet. This process worked well and the reconciliation could be completed.

Outcomes and Conclusions

The TVM Income tax reconciliation could be completed with no additional detail from that already collected. We produced the comparable Taxable Income in about one working day from the working paper file produced for the current method.

The TVM calculation consisted of 25 line items compared with 64 under the current method. This is generally because it is not necessary to "back out" the book entries – hence approximately halving the entries.

A further review of working papers also revealed that there was virtually no superfluous information. In effect TVM had not reduced the level of analysis which sits behind a tax calculation. The process of analysing the movements in Balance Sheet items does not diminish. This is essentially because there is a need to reconcile the movement in the Asset and Liability accounts.

It is true that this is not a requirement of the TVM legislation but good tax management would dictate that opening and closing balances be reconciled, that reconciliation process gives rise to the numbers we presently use to produce tax returns.

In support of TVM the Balance Sheet approach gives a more visual depiction of the outcomes of a transaction. I would support illustrating tax impacts to non-tax management in the TVM method as it is quite simple to "see" the outcome. In addition TVM calculations benefit from not requiring a full analysis of the accounting outcomes which are frequently hidden in the detail of the P & L.

If TVM was adopted all aspects of tax calculations from transaction reporting through tax rulings to the tax return could be shown in a consistent way. This would improve tax reporting.

In summary, I have concluded that TVM as a tax calculation method can simplify the calculation however the degree of simplicity in isolation from other benefits would not warrant a change in legislation.

Finally, major corporate taxpayers will continue to calculate Taxable Income in the traditional manner if software suppliers do not adopt the new method. As there has been a move to demonstrate that there is no need to change the current processes it is likely that software will not be redesigned. I believe that if TVM becomes a reality it is vital for long-term tax management and reporting that software also adopts the change. I believe that the next generation of tax accountants will have an easier time of tax reporting if TVM is adopted in software and return formats.

Concluding Comments

The exercise we carried out was mechanical. It concluded with an outcome that we expected – it works but where to from here.

TVM gives us the same outcome except to the extent that Policy decisions are made to accommodate the change. Clearly, TVM has the capacity to eliminate black holes – but TMV is the delivery mechanism only. The elimination of black holes, for example, is a policy decision. Could a similar decision be delivered in the 1997 Act? I think it could.

We should be wary of accepting TVM for the associated Policy decisions. We should also be wary of waiting until a decision is made on TVM before good Policy is agreed to.