

# TAX VALUE METHOD

## THE PROBLEM, THE PROPOSED SOLUTION AND THE OUTSTANDING ISSUES

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### PART ONE: THE PROBLEM

#### Income tax ideal

The design problems with the Australian income tax are rooted in the increasing incoherence and fragmentation of the common law distinction between capital and income.

The classic concept of income, as developed by Henry Simons, saw income as an *increase* in the taxpayer's control over scarce resources, as measured by the increments to spending power accruing to the taxpayer during the tax year. It defined income as the market value of rights consumed by the taxpayer during the tax year and the *net change* in the store of the taxpayer's economic advantages<sup>1</sup> between the beginning and end of the tax year.<sup>2</sup> To get income you simply add together consumption and the increase in *accrued* wealth.

#### It's the compromise stupid

No key Western tax system has implemented this ideal in its pure form.<sup>3</sup> The case for practical compromise, or the political clout of capital, always prevails. But, in implementing the necessary compromises, Australia lost sight of the big picture. This is the nub of the problem. Notwithstanding the best attempts of Dixon CJ to inject clarity,<sup>4</sup> the common law concept of income was taken on a frolic of its own and lost its way in a dark forest of rigid, abstracted, categories. The rules became reified<sup>5</sup>, new categories were added to deal with the problems generated and the whole unwieldy structure became a classic example of bureaucratization<sup>6</sup>. The anomalies became set in stone as strong vested interests grew round them and built large industries based on them.<sup>7</sup> Decision makers did not respond with clarity of purpose, decisiveness and timeliness to a new log of problems:

- the development of generations of legalistic techniques for circumventing the core purposes of the income concept
- the growing consciousness of the time value of money

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<sup>1</sup> Simons used the legal term "property rights" to express wealth but, had he lived in an age where ideas and organization were the key determinants of wealth, I have no doubt he would have used the more flexible concept.

<sup>2</sup> Henry Simons, *Personal Income Tax* (U Chicago, 1938), 49. Income, Simons says, is not about goods or services but about rights which command prices in the market place. The measuring of those rights in a particular of time span is "fundamental". See how often throughout this debate you can pick examples of this of misconception, based on a misunderstanding of these crucial basics. This is all covered in much more depth by Malcolm Gammie, who injects the more modern analysis about the meaning of consumption.

<sup>3</sup> Though there have been numerous proposals for implementation of accrual or mark to market regimes to deal with particular assets. In a global economy this competitive fact is an important constraint.

<sup>4</sup> In *Carden*, see later in paper.

<sup>5</sup> Developed a life of their own, in which the rule itself and definition of its terms become the primary focus rather than the functional ends it was designed to promote.

<sup>6</sup> Used in its pejorative rather than descriptive sense; remember a large part of the blame lies with the judges who had prime responsibility for the capital/income borderline for many years.

<sup>7</sup> For example, negative gearing for housing, despite its obvious distortion of the general deduction and income rules was addressed too late and, by that time, it was too politically difficult to remove.

- the flexibility of synthetic financial products to constantly disaggregate elements of property and reintegrate them in new bundles to stay one step ahead of a ponderous bureaucratic/democratic regulation mechanism.
- the engine of wealth changed from tangibles like factories and plant to services like software and innovation and R and D but that rigid “tax expenditure” implicit in the capital tax shelter did not.

The income rules in Australia became a battlefield involving manipulation of outdated categories to create tax planning opportunities. Increasingly we have accepted these manifest distortions of the ideal concept with resignation.<sup>8</sup> The infinite potential for manipulation and arbitrage is dramatized when one obvious, but neglected, fundamental is highlighted:

**Capital is nothing more posh than the *present* price the market will pay to get economic access<sup>9</sup> to *future* economic advantages.<sup>10</sup> Capital and income are merely different ways of expressing the *same* economic advantage!<sup>11</sup>**

## PART TWO: PROPOSED TVM SOLUTION

The great strength of the TVM approach is that it cuts boldly through the atrophied rules and reasserts the modern version of Henry Simon’s unifying income concept. It asks the tough questions about how we justify existing compromises in the income tax. And, it has to be said, much of the drafting is elegant.

TVM is designed to tidy up of the Act, with no significant change in outcomes.<sup>12</sup> But can the TVM proposals *avoid* fundamental changes to the income tax base, certainly in the medium to long term?<sup>13</sup> Words are, in Bill Hayden’s words, bullets. But that understates it. Tax law, in fact, is little more than the words which express its key operational concepts.

### TVM Framework

TVM relies on raw flows of cash as the primary rule for calculating taxable income. The tax base is protected with a year end balancing charge. Adjustments are made for changes in the value of the opening and closing tax value of assets. “Asset” is widely defined according to accounting principles.

**The essential core of the TVM model is a simple extension of the current tax treatment of trading stock.** How do we handle trading stock? We take cash flowing to the taxpayer for

<sup>8</sup> For example, negative gearing is a clear departure but was too hard to address politically.

<sup>9</sup> This may be a legal right to future income but not necessarily, Someone may pay for access to a future right even though it can not exclude others.

<sup>10</sup> Enjoyed in cash or in kind.

<sup>11</sup> This hints at a number of other problems in distinguishing capital and income, conveniently covered in Meade JE *The structure and reform of direct taxation* (George Allen and Unwin for IFS, 1978), 30ff. How do you distinguish between tree and fruit in the case of a christmas tree farmer who sells off part of his “capital stock” each year? How do you deal with a rich person who invests in capital appreciating stock and realizes it only in years where the capital loss exceeds his consumption. What if he lives by simply borrowing on his capital or distributing the capital (the essential problem which the Profits First rule and Slice rule in the Unified Entities regime tried to address, which was beaten back by strong lobbying).

<sup>12</sup> Indeed, there are adjustments where the outcome is different.

<sup>13</sup> The argument developed later is that, in response to lobbying from a particular group of taxpayers, the architects have accepted as the present rules certain norms which are, fact, subject to over-arching principles. For example, interest might normally be deductible on revenue account but where it is incurred to produce non-revenue benefits it should not be allowed on revenue account.

trading stock sold during the tax year. We take cash flowing away from the taxpayer for trading stock bought during the tax year. We net them out.<sup>14</sup> In the same way, TVM directly matches, literally, **in**-come against **out**-goings.<sup>15</sup>

But the main trick is the mechanism for adjustments based on the value of trading stock on hand at the end of the tax year. This is the method TVM uses to adjust net income to take account of economic advantages<sup>16</sup> which endure beyond the end of the tax year. You simply take end of tax year closing tax value and subtract opening tax value.<sup>17</sup> It is the *practical* effectiveness of this end of year adjustment mechanism, as John Ralph himself conceded, which determines the operational effectiveness of the TVM method.

### End of year adjustment: Trading stock model

The trading stock rules in the current law contain a number of practical, and essentially arbitrary, rules to value trading stock at the end of each tax year. This allows simplified valuations based on historic cost and practical, working conventions.<sup>18</sup> But, and here is the pressure point we will explore, TVM extends this trading stock analogy a great deal. The TVM mechanism applies to a *much* wider range of economic advantages and a great deal more is at stake. Let us start by spelling out two basic points.

First, trading stock *assumes* you have a circulating asset. Expenditure on trading stock is *assumed* to be in the income basket.<sup>19</sup> In the case of TVM, having removed the old capital income distinction, what principled basis is there left for this initial and crucial sort? TVM has to deal with a very wide range of economic advantages, which cover both capital and income assets.<sup>20</sup> TVM, more by neglect than active creation of new rules, extends the umbrella of capital gains treatment to postpone liability on a large range of assets, including intangible assets.

The problem is displayed in the pragmatic responses to the lobbying for immediate write off of advertising expenditure. If you treat *all* advertising expenditure as deductible up front and without adequate mechanisms to spread the “brand power” created by that expenditure over the period of future cash flow it generates, do you compromise the most fundamental principle: a fair reflex of income for the current tax year? If you abandon the old income/capital test on advertising<sup>21</sup> you need to put in place an effective alternative control device.

The second point is that TVM stretches the trading stock analogy a very great distance. Under the proposed s6-15, the assets in question are defined according to the widest accounting concepts. The preferred draft applies to anything that embodies future economic benefits. Above all, it applies to intangibles. Such intangible benefits introduce a new range of valuation and manipulation problems. In the case of trading stock, for the most part, the taxing regime deals

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<sup>14</sup> Reflected directly in Prototype 2 Draft Legislation s5-55, Steps 1 and 2 of Method Statement. Of course, there is an important attempt to flush out evasion through the use of designated bank accounts as the clearing house for, in particular, deductions.

<sup>15</sup> Perhaps the most important reform is the need for these cash flows to go through a cash account before they are recognized. This injects important constraints on tax evasion through the cash economy.

<sup>16</sup> Liabilities are simply assets of negative value and they are not separately discussed here.

<sup>17</sup> Reflected directly in Prototype 2 Draft Legislation s5-55, Steps 3 and 4 of Method Statement. Liabilities are simply negative valued assets and mirror the same rules.

<sup>18</sup> Like FIFO which, in the case of a mixed inventory of assets, arbitrarily assumes that trading stock first acquired is the trading stock first used up.

<sup>19</sup> It is deemed to be revenue by the old s51(2)

<sup>20</sup> Note this popular articulation contains a critical imprecision. It is not the “asset” which is capital or income but the characterization of the whole process by which it is used in the income earning structure. Thus to most a house or factory is part of the capital structure but to a developer it may well be trading Stock. See the seminal decision in *FCT v St Hubert's Island* (1978) 138 CLR 210

<sup>21</sup> See analysis in *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634 to see how expenditures, including advertising, to maintain or extend the business should be treated for tax purposes.

with a marginal tax deferral problem by the taxpayer. It is a variant on the theme of the grocer who buys up on cans of beans at the end of the tax year to postpone his tax liability. Under TVM this mechanism moves to centre stage in a multi-billion dollar pressure cooker in which tax effective engineering is the norm. This TVM valuation mechanism will be severely probed.

The essential job is to build a bridge between the generalizations in those core provisions at the start of the legislation and the specifics. In fundamental respects, those generalizations are radically modified when you delve into the fine print

### **End of year adjustment: The sharp end of TVM**

The rules for year end adjustments are in the detailed boxes in s6-40. If you want to penetrate to the *real* operation of TVM you need to skip lightly over the framework articulated early in the legislation and look hard at the fine print in the boxes in s6-40. The sharp end of the working compromise, much of it the outcome of fierce lobbying, is spelt out in those boxes. The formulas have changed considerably<sup>22</sup> in response to criticisms of earlier drafts. Do the practical outcomes differ significantly from the principles stated in the general provisions at the front of the legislation? Is TVM, in crucial respects, a cash flow tax? Or is it, essentially, an accruals tax based on the matching of cash **out**goings against cash **in**come with a proper adjustment to take into account of value which has not been exhausted before the end of the tax year?

Recognised categories of assets like trading stock and depreciating assets are, subject to a significant tidy up, to very wide definitions and to rationalization, are dealt with along traditional lines. Depreciating asset is defined very widely in s40-30 (1). "An asset is a depreciating asset if, and only if, the total period for which it can be used (whether by the entity that currently holds it, a future holder, or anyone else) is limited. In s40-30(2), "Use an asset means consume economic benefits from the asset, or receive economic benefits in respect of the asset." Tax value is, as you would expect in a depreciation regime, its cost less its decline in value.

But notice that a "trading stock" characterization puts you outside the definition of "depreciating asset".<sup>23</sup> So, in fact, the essential treatment of economic advantages at the end of the tax year will turn on these two definitions. Instead of the wide tests determining capital/income status, we will have tests determining whether you characterize the asset "trading stock", a circulating asset, which, as we saw in *St Huberts Island*<sup>24</sup> raises many of the same issues. In fact, *St Huberts Island* was the first in a range of crucial common law<sup>25</sup> and the Australian decision to tax gains which were not traditional common law income, so-called "capital gains" as part of taxable income. These decisions which started the long job of convergence in the treatment of traditional and Henry Simon's definitions which the Ralph has done so much to derail.

Then you have to distinguish, particularly in the case of intangibles, depreciating assets with a limited life from the very wide class of other assets or economic advantages.

So the capital/income decision is replaced, essentially, by a sequential cascade of definitions raising very similar issues. The width of the "trading stock" definition, which is not in the June Prototype, will have a crucial bearing on whether an economic advantage is taxed on the capital gains tax model on realization or on the traditional income model or on the Henry Simon's model.

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<sup>22</sup> A large improvement over the very obvious loopholes in earlier drafts which were exposed.

<sup>23</sup> s40-30(3)(a)

<sup>24</sup> *FCT v St Huberts Island Pty Ltd* 78 ATC 4104

<sup>25</sup> *FCT v Whitfords Beach Pty Ltd* 82 ATC 4031, *FCT v Myer Emporium Ltd* 78 ATC 4363

### End of year adjustment: cash deferred

The heading “Financial assets” is misleading. The provisions on financial assets have an *extremely* wide impact. They apply to any money owing or financial liability lasting beyond the end of the income year. The mirror provisions for liabilities will extend them even further.

“Financial asset” has a very wide, open ended definition in s6-40(4): “the right to receive an amount” and also the right to receive a financial asset or part of it. So if you have a right to receive an amount which is due and payable, under Item 5, the year end tax value is simply that amount. Note, there is no distinction between principal and interest. The problems with zero coupon securities, for example, are washed out. Significantly Item 6 extends the definition to amounts paid for a “non-cash benefit”.

Where the right is not due and payable in less than 12 months you go to the table in s45-15. Under s45-1 Item 1, if *all* the amounts payable under the financial asset are certain, the tax value is the cost of the asset. Of course, you subtract amounts received earlier. Where the amounts payable are not certain the test under s45-1 Item 2 is the cost of the asset at that time less the total amount received earlier for the asset to the extent the amount represents repayment of that cost. In Div 45-C and 45-D there are accruals and mark to market proposals for some financial assets. These are the considerably watered down survivor of the grand vision of the early TOFA proposals to tax financial assets on an accruals basis.

### End of year adjustment: Other assets and goodwill

Other assets are valued at cost. Under s7A-20, this is the amount paid for the asset<sup>26</sup> plus expenditures “to bring the asset to its present condition and location”. In other words, the vast majority of assets, including intangibles and traditional non-depreciating capital assets, will, like trading stock,<sup>27</sup> be brought in at historic cost at the end of the financial year. There will be a balancing year end charge to reflect the cost of those assets.

Goodwill *acquired from others* is also valued at cost price. Goodwill is a nebulous intangible “asset”, a catch-all, to cover value which is not captured in specific, identified assets held by the business. Because the definition of “asset” is so wide there will be problems, particularly where it is the difference between historic cost and zero cost, in distinguishing the two. Goodwill is, for all practical purposes, the difference between the book value of the inventory of identifiable business assets and the value of the business itself.

In contrast, goodwill created by the taxpayer is valued at zero at the end of the tax year. In other words the costs of creating this wide “blue sky” residue of value, goodwill is fully deducted in the current year. This will cover advertising, R and D, education, money spent in setting up systems etc etc. For this category and here is the crucial point there is no, repeat no, year end balancing entry for the residual value lasting well beyond the current tax year. If, as just argued, goodwill covers accrued capital gains to the other assets of the taxpayer, in cases where no goodwill was purchased, the constantly growing accrued capital gain would be valued at zero each year.

To pull it together, for all the value created by the business on the back of assets acquired which is not represented by the forthcoming definition of “trading stock” or other specified assets covered in the boxes, TVM imposes tax, in much the same way as Capital Gains Tax in the current law, only on *realized* gains. Expenditures are fully deductible upfront and they are adjusted at year end at historic cost. But there is no adjustment for the increase, over the years,

<sup>26</sup> We are told the formula in s7A-20 “each amount you have paid in order to start holding the asset” also extends to amounts paid to create it an incidental costs of acquisition, though the formulation is problematic.

<sup>27</sup> See discussion in *Australasian Jam Co Pty Ltd v FCT* (1953) 88 CLR 3 in which it was held that cost did not mean some arbitrary figure bearing no relation to actual cost but an honest estimate of actual cost.

in the value of those assets. The difference is, of course, that this capital gains treatment is now extended to a much wider range of business assets than it is under the present rules, thus undermining the thrust of the crucial wide definition of income in the High Court decision in *FCT v Myer Emporium Ltd*.<sup>28</sup> For all practical purposes, all business assets outside the specific boxes become “honorary capital assets”. If this argument is correct, the TVM represents a quiet but very considerable roll back of the income tax and the termination of a rolling move to a Henry Simons concept of income. This is precisely the opposite promised by the rhetoric and generalities in the TVM.

But, most important, to the extent that expenditures by the taxpayer itself create a nebulous advantage to the business, labeled “goodwill”, there will be an immediate deduction and zero year end adjustment. These expenditures receive immediate write off. Tax can be postponed, possibly indefinitely, because no year end balancing charge is brought into play. If this reading is correct, this introduces a solid element of cash flow tax to income tax, a sort of negative resource rent tax to encourage super profits over and above the return on assets.

The integrity of our tax base in the main areas where it has always been under pressure turns on the ability of these boxes to with-stand the probing of tax planners. The essential issue is the prediction whether these radical new frameworks are more robust than the existing tools in s8-1 and the capital income authorities? Can they with-stand the new generation of *Myer* and *Fletcher* schemes or numerous other schemes in the current multi-billion “hard basket” of the ATO, which are covered by the secrecy provisions?

#### **End of year adjustment: The nub of it**

So what is the essential bottom line? These year end adjustment provisions will probably roll back the operation of the traditional concept of income as it applies to business. It will give “honorary” Capital gains treatment to a much wider range of assets. TVM will remove or marginalise the control devices for businesses who wish to defer gains, on the capital gains tax model.

The operational tests are moved from, an admittedly badly flawed, income principle to a characterization exercise of wide and untried definitions of key terms like “trading stock” and “depreciating asset” and “asset” itself which are likely to raise very similar issues.

The centre of gravity of the new tax base becomes a system of balance sheets covering an extremely wide range of assets, including intangible assets, and the problem of managing allocation of gains to the correct tax year turns on the manipulation of a wide inventory of economic advantages and their allocation to the correct category. This is the asset betterment system we have for default assessments. It is used, typically, for tax evaders. On a practical level it is very hard to operate and depends largely on the ability to shift the onus on the taxpayer to prove the asset betterment statement wrong.

The tax base, and TVM is no exception, is only as strong as its weakest link. We need to focus on the potential of the operational rules, through suitable engineering, to allow business immediate write off of a much wider range of expenditures and for tax on profits to be postponed. Notwithstanding the trading stock model which is the core conceptual construct in the TVM, the sharp end of the year end valuation, as it appears in s6-40 after the lobbying process, though still incomplete, appears to move the center of gravity towards a capital gains, realization, tax treatment of a much larger range of business assets. There is even more concern in the open ended deferral for that nebulous category for goodwill created by the taxpayer, which brings zero balancing charge in at the end of each and every tax year.

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<sup>28</sup> *FCT v Myer Emporium Ltd* 78 ATC 4363

## PART THREE: OUTSTANDING TECHNICAL ISSUES

The essential litmus is whether the final product of TVM reform, not to be confused with the idealistic blueprint proposed in the early literature,<sup>29</sup> injects clarity and horizontal equity where the existing capital/income rules are muddled or the subject of anomalies. And, if so, do they are a sufficient advance to justify the enormous transition costs?

Does an objective risk assessment support the sweeping approach adopted? Or would a more incremental and carefully targeted strategy based on similar constructs better quarantine the downsides? Would incremental changes move us towards better outcomes without the potential for very large revenue hemorrhage, a retreat on important issues of principle and the log jam of practical problems which threaten the public acceptance of the necessary changes in direction which are the aspirations (if not necessarily the outcome) of this package? Is the public, not to mention the suburban accountant, now suffering chronic fatigue with big bang tax reform?

The rest of this paper is essentially a selective analysis of key pressure points in TVM to assist in answering these questions. Latter papers in the workshop will take up many of these themes in more detail.

### Issue 1 Causal test in s8-1 marginalized

TVM removes, or at best marginalizes,<sup>30</sup> the causal test in the general deduction provision in s8-1.<sup>31</sup> It is easy to lose sight of the critical role of this fundamental concept in the Australian income tax. This provision requiring matching of an outgoing to the income it is spent to generate, is the most important provision in the Act. It is the key control test which inhibits tax benefit shifting and a range of timing and other means of finessing the core control device in our income tax. Income, as Henry Simons noted, at its very core, is the arithmetic result of matching income against outgoings during a particular tax year. A private or personal expenditure exception does not start to replace this important engine of the income tax, with all the R and D and road testing which has gone into it. Last minute changes inserted in response to criticisms of earlier drafts, while an improvement, do not address the issue adequately. Much of the problem is Treasury which drives the agenda is insulated from the problems, split loans and corporate tax benefit shifting schemes and the like, which must drive the practical design of operational rules in this area. They rely on abstracted concepts which gloss over the pressure points of tax planning which have raised the real challenges in the past.

### Issue 2 Temporal matching protections insufficient

Correlatively, TVM has removed any formal temporal matching test which was a by-product of the causal test of s8-1. The heroic *assumption* is that matching, using an economic paradigm to value changes in economic advantages, will be carried out adequately with the end of year asset valuation. To the extent that expenditures, not exhausted in the current year, are not brought back adequately through that adjustment, that assumption is brought into question and, more important, there is no over-riding

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<sup>29</sup> The wide gulf between original blueprint and the final product is now obvious in GST. Many of the criticisms of WST rely on similar political realities. Incidentally, I do not make these observations wholly with the wisdom of hindsight.

<sup>30</sup> The “upward adjustment” provisions Item 10 in the s5-95 table deal with payments “by way of gift or contribution” otherwise than for the purpose of [the taxpayer] gaining an economic benefit for yourself”. But it speaks of “gifts” and this key concept should be at the centre of the test. Why would you relegate a provision which has been road tested over decades and is now working tolerably well to the archives and reinvent this particular wheel? The definition of cost of an asset in s7A-20 contains a requirement that the cost of the asset at year end valuation is the amount paid “to the extent that the amount relates to that asset”. So the adjustment is based on a causal test but the deduction of the original outgoing is not.

<sup>31</sup> s8-1, formerly s51.

test such as that which was mobilized in *Fletcher*<sup>32</sup> or in *Coles Myer*<sup>33</sup> to prevent full deduction of the expenditure in the current year. If we were serious about a clear and fair income concept, this matching test would be moved to center stage rather than depending on the hope that the adjustment mechanism in the detailed boxes will operate effectively. Or is the prospect of a cash flow modality on the agenda?<sup>34</sup>

### **Issue 3 No principled substitute for capital income rules**

TVM does not propose a principled basis for the core job of sorting and valuing various non-traditional assets, particularly intangible assets. It has substituted pragmatic rules based on a cascade of defined categories. The concepts in them are essentially children of the old capital income distinction. As yet, there is no definition of the crucial “trading stock” definition. There seems to be an implicit assumption that if you avoid generalizations and instead particularize, on the model of the CGT events which drive the 1997 Act, you can keep the “shyster lawyers” in the black forest. Pragmatic accountants are the white knights who will rescue us from the legalistic jungle.<sup>35</sup>

### **Issue 4 TVM inconsistent with capital gains discount**

TVM, as I have argued, is based on a concerted refutation of an incoherent capital/income distinction in the existing law. Its rhetoric is largely about a principled, coherent and consistent tax treatment of all economic advantages. Yet TVM perpetuates and, indeed, with the, now enacted, 50% discount for capital gains, Ralph has considerably reinforced, the capital/income distinction whose incoherence is the key driver of the TVM proposals.

### **Issue 5 Zero Tax Value opens opportunities for manipulation**

The provision in s6-40(3), giving zero tax value to assets is hopelessly generous. This concession goes well beyond de minimus and allows large scope for timing manipulation.<sup>36</sup> This all looks too cosy. Tax breaks are recommended by committees of business and professionals for business and professionals. We need some proper costings and to explain the deferral advantages properly to ordinary PAYE taxpayers. This needs to be addressed in the political arena.

### **Issue 6 Routine rights an escape clause?**

The routine asset test in s6-45 is designed to wash out situations where an economic right under a contract is balanced by a matching liability. The essential object is to cut through unnecessary complexity and to give these rights a zero value at the end of the tax year. This will operate if no economic benefit is provided under the contract except the right itself. It is easy to see how intangible benefits might be created for “friendly”

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<sup>32</sup> *Fletcher v FCT* 91 ATC 4150

<sup>33</sup> *Coles Myer Finance Ltd v FCT* 93 ATC 4214

<sup>34</sup> Do not imagine for a moment that the general anti-avoidance provisions in Part IVA can deal with these problems. Tax shelters got away despite this and s51! But the real problem is the smarter taxpayers who are not too greedy but use these schemes to gain considerable timing advantages.

<sup>35</sup> Of course, there is a larger political issue just below the surface which is routinely papered over. In a capital regime, where accruals to wealth are not taxed, what basis is there, on any reasonable matching principle, for allowing a deduction for depreciation of capital assets? To argue that the depreciating cost of an asset used in the income producing process should be deducted is a convenient half truth which ignores the important asymmetry involved. Capital allowances are a manifest tax expenditure which sacrifices a coherence in the income base and horizontal equity to economic imperatives, the encouragement of investment in plant (and now to intangible “assets”). The issue is not whether we have such a tax expenditure, we have lots of these in tax legislation. The issue is whether the poorly quarantined and outdated capital/income rules are the best way to target such a large tax expenditure. The tax forgone needs to be justified in the budget just like write-offs for R and D and Films.

<sup>36</sup> Wide definition of “Listed zero value asset” in s6-40 (3). Particularly timber, “results of mining”, the intellectual property in advertising material and spare parts. How wide is non-billable work in progress? What of a solicitor who cannot bill but gets initial large payments for “security against costs”? The essential problem, as with trading stock, is that these are opportunities for manipulating the timing of tax liability, with very substantial and indefinite deferral of tax by the fortunate businesses who are beneficiaries.



parties in back to back transactions which might be used to manipulate the taxpayer's year end balancing adjustment. This provision needs to be thoroughly assessed to ensure its integrity.

#### **Issue 7 Is an accounting concept of income such a good idea?**

It is explicitly stated that a central objective of TVM was to bring tax value and commercial value, closer together.<sup>37</sup> The TVM proposals are still a moving feast. It is not easy to finger the precise outcomes. To what extent does TVM replace, admittedly, unsatisfactory legal rules with rubbery accounting rules, with all the lack of coherence, subjectivity and manipulability that implies to the core of the income tax? Is this merely a less exposed version of the view that deductions should be "determined by the custom of accountants" which was roundly pilloried by Ferguson Royal Commission on the 1936 Act as "impractical" and not a reasonable view.<sup>38</sup> These same criticisms, extensively documented, have been made over many years. This strays into areas which are the subject of other papers. But I must say one thing. Whatever the simplification outcomes, I cannot see that a solution which delegates power to determine the tax base to accountants paid by the taxpayer would be acceptable. This manifest conflict of interest has not created happy outcomes in the auditing area.

### **PART FOUR: OPERATIONAL ASSUMPTIONS**

Before we move into detailed analysis of the practical issues we should articulate and then discuss some of the operational assumptions implicit in the TVM approach. These are critical to the strategy adopted.

#### **Assumption 1 Beware transition costs**

The essential problem with a radical rewrite of tax law, backed up by long experience, is that while you may address notorious problems with the existing system, you invariably open up Pandora's box to new and unforeseen bases for challenging the integrity of the tax base. Think of the great escapes from prisoner of war camps or attempts to stop Alfie Langer from breaching a rugby league defensive line. Those who construct the defences learn only from experience and are always one step behind the probing, innovative attacker. And, believe me, there are many more innovative and motivated tax planners who will probe the many weaknesses in the TVM legislation than there are footballers of Alfie Langer's class.

A good example, is the problems generated by our shift from the Classical system of company tax to the Imputation system. Remember how the classical system was painted as the root of all evil? The very large revenue cost of the shift was soon forgotten by its beneficiaries who soon pressed for more company rate cuts. The new system opened up a hornet's nest of new problems, including dividend streaming and perceived discrimination against off-shore investors. With major change, it takes a good decade or two till the worst of the revenue hemorrhage is reigned in. Some now suggest the US was more sensible in retaining the classical system and making well targeted interventions to improve its performance rather than staggering from one company tax reform model to another as the Europeans have done. If classical company taxation does so much damage to business why does America, weighed down with this large deadweight of it, continue to outperform the rest of us?

<sup>37</sup> [Ralph Business Tax] *A platform for consultation* (AGPS, 1999) at 6

<sup>38</sup> *Third report of Royal Commission on Taxation* (Australian Parliament, 1934), para 551

And we haven't even mentioned GST or the decades and very large revenue cost it took to get the general deduction provision in s51 (now s8-1) operating half decently! Nor have we mentioned the very large compliance costs or the devaluation of a very large capital investment by professionals in familiarity with, for all its faults, the existing system.

### **Assumption 2    Manage second best imperatives**

The TVM draft legislation manifestly accepts the premise that a pure accretions concept of income is not a serious candidate for an operational tax regime. It gives up on a universal principle of accruals taxation from the start. **We are not here comparing the vile compromises in the current law with a shining TVM ideal.** The essential focus is when, for a number of very practical administrative and political reasons, an ideal is not capable of practical implementation, how we translate the unattainable ideal into practical working rules. We are in a second best environment here. It is not just that TVM has compromised with the existing income tax treatment of various transactions to forestall radical change. It is that the compromises, many of them only implicit, are at the core of the TVM design itself.

The essential question is whether those claims made for TVM that it is simpler and more robust and a better foundation for future evolution of the law are sustainable when based on compromises which may well be a permanent feature of the TVM.

It is a basic principle of second best theory<sup>39</sup> that if your ideal is not attainable you do not *necessarily* achieve the optimum outcomes by implementing those parts of the ideal that you *can* implement. If major elements of the ideal are not realizable for practical or political reasons, you will not necessarily achieve optimum outcomes by satisfying those elements of the ideal which can be satisfied. You may well achieve optimum outcomes by recasting your entire strategy.

This workshop concentrates on the practicalities of implementing the draft legislation. Analysis of these practicalities inevitably raises the question whether TVM makes the right compromises and whether TVM produces better outcomes than the vile compromises we have already.

### **Assumption 3    Getting very specific creates its own problems**

An important word of caution should inform the TVM strategy. It is that the reduction of rules to bright lines can create its own problems. The analogy of is Heisenberg's measurement of sub-atomic particles. You cannot measure them without altering the very thing you are measuring. For example, before Capital Gains Tax, it would have been fair enough to indicate informally that profits on assets sold within a year of purchase would *normally* income in nature. It is quite another thing to enact a rigid one year rule, as in the old s26AAA.<sup>40</sup> If you have such a rule, unsupported by a much more general statement about the purpose of purchase and sale, it is a very short jump to the conclusion that assets sold after the vulnerable year are capital and tax free. Who but a fool would not take advantage of such a bright line? The bright line creates it own, new, dynamic. So it is when you reduce broad principles to simple rules of thumb which are not disciplined by over-arching principles. In the longer term, it is very difficult to prevent those rules meandering into the same dark forest which has dulled our over-arching vision of the current income tax.

### **Assumption 4    A big bang strategy?**

The critical assumption is that our problem can be solved by replacing the rotting

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<sup>39</sup> See RG Lipsey and K Lancaster, "The general theory of second best" ((1956) 24 *Review of economic studies* 11

<sup>40</sup> See the detailed analysis of the Final report of the [UK] Royal Commission on the taxation of income and profits (1955, Cmnd 9474), para 114

foundations of the existing income tax and that we need radical new legislative regimes. Is this the way to go? Or are we addressing the problem in the wrong way? We have had a constant stream of radical innovations over the last two decades, all of which we were promised would bring nirvana. Perhaps the real solution lies in sharpening the focus and competence and tax technical decision making of day to day decision making in the bureaucracy and, an area much neglected, in the courts. Do we simply need to do the knitting a lot better? Have we learned from all the promise of the shining new regulatory regimes proposed by Wallis after the HIH debacle? It is a neglected truism, endorsed by the new owners of Franklins and Ansett and GIO that things can get a lot worse. We have an enormous capital investment in the knowledge base of the professionals who run the existing tax system. The job of retooling, particularly after the traumas of GST, should not be underestimated. We are talking here about getting decision makers to think and act in an economic paradigm which is foreign to most of them.

### **Assumption 5 Exactly what is TVM trying to do?**

We are assured that TVM purports to be an attempt to tidy up the Act and cut down compliance costs. This claim has been greeted with some scepticism among my constituency. Because political posturing has, on all sides, increasingly replaced hard technical analysis in most tax discourse, it is very hard to find objective evaluation of what is really happening and because it is such a root and branch change of the Act most people have a great deal of trouble in wrapping their mind round what TVM is really about. Every lobby group can find a basis for paranoia in the various unresolved tensions in the draft proposals.

On the one hand, the basic material at the front end of the TVM legislation makes TVM look like an attempt to introduce a comprehensive accruals tax regime by stealth. On the other hand, when you look at the fine print, there are a number of measures, which encourage the inference, however unjustified such an inference might be, that there is a shift in the direction of a cash flow basis of tax for business. Expenditures are deductible up front but the balancing charge is, in the case of the problem areas like intangibles and goodwill, much more problematic.

The reality is that, like all tax, TVM legislation is a child of political pressures not the pure logic of the economic theorist. The architects are responding to pressures as they kick in. But the question must be asked with all the more rigour whether the final package is reform or just change, whether the very large transition costs will produce decisively superior outcomes?

## **PART FIVE: ANALYSIS OF TECHNICAL ISSUES**

### **Issue 1 Causal test in s8-1 marginalized**

TVM removes, or at best marginalizes, the causal test in the general deduction provision in s8-1. It is easy to lose sight of the critical role of this fundamental concept in the Australian income tax. This provision requiring matching of an outgoing to the income it is spent to generate, is the most important provision in the Act. It is the key control test which inhibits tax benefit shifting and a range of timing and other means of finessing the core control device in our income tax. Income, as Henry Simons noted, at its very core, is the arithmetic result of matching income against outgoings during a particular tax year. A private or personal expenditure exception does not start to replace this important engine of the income tax, with all the R and D and road testing which has gone into it. Last minute changes inserted in response to criticisms of earlier drafts, while an improvement, do not address the issue adequately. Much of the problem is Treasury which drives the agenda is insulated from the problems, split loans and

corporate tax benefit shifting schemes and the like, which must drive the practical design of operational rules in this area. They rely on abstracted concepts which gloss over the pressure points of tax planning which have raised the real challenges in the past.

The core control test in s8-1 is not included in the Prototype TVM legislation. In its place, there are provisions, which look like an afterthought, which are shifted down to the fine print and which use a cumbersome machinery. The legislation abandons a formula we have spent many hundreds of millions in administrative and compliance costs in clarifying and road testing.

Section 5-90, Item 10 creates an *upward* taxable income adjustment where “during the income year you pay an amount by way of gift or contribution, otherwise than for the purpose of gaining an income benefit for yourself”. If you the payment doesn’t produce the income benefit, the benefit can still be claimed but adjusted in the final calculations.

Section 5-90, Item 15 creates a mirror *downward* taxable income adjustment for a gift or contribution which is not taken into account in calculating net income under the core net income calculations in s5-55. While it mentions only private or domestic payments, presumably this item in the fine print in box 15 is designed to cover pretty much the same area as s8-1. All this pussy footing to fit this new rule into the TVM template risks a whole new round of probing and schemes which exploit the uncertainties while the issues are definitively resolved. If these provisions go ahead, there will be a new industry analysing the meaning of the rather ethereal formula “ an amount by way of contribution ... which is not taken into account ... in working out your net income”. Barristers will have a field day (or field years)! It will make the current acrimony over Friday – Monday “contractors” look like a quiet 15 minutes at the beach! There seems to be a mistaken assumption that if we keep the language low key and “accountant like” that we will avoid the legalistic gymnastics and strong challenges of the past. This assumption needs revisiting and this provision needs work! I do not intend to go into a detailed analysis of the language at this draft stage.

This critical change is not necessary to the TVM system itself but perhaps was first injected as part of a log of wishes on the shelf of Treasury.

If there is a serious attempt to water down the general deduction provision in s8-1 it would be serious. It would fly directly in the face of the rest of the Ralph Business Tax Reforms. It is assumed by Ralph, accepted by Government in the tax changes following Ralph, that if we give a 50% discount to capital gains we can quarantine other income. It is assumed when we introduced a 30% company tax rate while retaining tax near 50%<sup>41</sup> tax for individuals, that we could quarantine the downsides. The Act is, in very substantial part, made up of attempts to manage just such contradictions. Of course, the current Friday-Monday Contractor debate exciting the usual superficial rubbish by the media about the taxation of PAYE taxpayers who use the usual arsenal of tax planning devices to bring themselves under the umbrella of the more generous corporate treatment is precisely about attempts to manage this “no economic rational” borderline.

Treasury has for some years attacked the use of the causal test in s8-1. The argument is set out in a 1986 Treasury Economic Paper<sup>42</sup> arguing for the full deductibility of interest on amounts spent to finance company takeovers. Treasury concludes that "strong arguments would be needed to justify action to restrict high gearing [sc to partially disallow deductions for high gearing]" for company takeovers. In the process, Treasury argues a that an attempt to trace various forms of interest expenditure can not be supported "because, in principle, attributing interest expenses to particular revenue items has no economic rationale. It is simply not possible, on economic grounds, to say that a particular interest expense relates to a particular

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<sup>41</sup> Including medicare levy

<sup>42</sup> Treasury economic paper No 12, “Some economic aspects of takeovers” (1986), 8ff

item of income. Measures to restrict deductibility of interest on money borrowed to fund takeovers, Treasury argues, is unlikely to be made to work effectively.<sup>43</sup> This argument is presumably part of the basis for the proposals in the Prototype legislation to not take interest outgoings into account in the cost base of assets in year end balancing charges.<sup>44</sup>

The plain and obvious observation is that in tax, as in many other areas of the law, we are forced, at the borderline, to maintain such distinctions. They are subject to manipulation by taxpayers who recast transactions in a different form to get in the most favourable basket. Judges are used to managing such contradictions. The essential issue is not whether such distinctions have “economic rationale” but whether they are managed badly or well. The essential question is about the quality, depth and sophistication of our decision makers in doing the hard jobs.<sup>45</sup>

This Treasury argument, based on the fungibility of borrowed money, is intertwined with the economist's idea that since macro economic theory, a theory pitched at a very high level of generality, does not distinguish such sums, that no distinction exists. The same sorts of arguments can be made for refusing to pursue insider trading vigorously. The reply is obvious. If an even playing field and an effective corporate sector is important, such problems simply must be addressed properly and if present concepts and enforcement is inadequate it must be improved. It should be noted that, however difficult they are, such issues cannot be avoided because it is still necessary, when ascribing interest to the various profit centres of a transnational transaction. Contrary to popular rhetoric, the problems also surface in GST, the neutral darling of economists, whose problems at key points have a striking resemblance to income tax.

Treasury's argument elevates the fungibility argument from a practical constraint into a theoretical imperative. Causal constructs are never completely adequate. But they thread through every part of income tax law and indeed through every other part of civil and criminal law. This form of argument, typical of much economic argument in the media and public decision-making, demonstrates the danger of a discipline which over-reaches its bounds. Application of the same argument in the general context of deductions would undermine any sustainable position and that alone is sufficient to discredit the argument. But the mere fact that arguments are nonsense has never been sufficient in Australia, given enough self interest to support them, to prevent their constant reassertion as if they were received truth.

To sum up, the Central Gateway test in s8-1, which requires a causal link between an expenditure and the production of taxable income is abandoned by Treasury in the context of the deductibility of interest for company takeovers, essentially, because it is just too hard to apply. This is taken on board by TVM. It is a fundamental flaw.

## Issue 2 Temporal matching protections insufficient

Correlatively, TVM has removed any formal temporal matching test which was a by-product of the causal test of s8-1. The heroic *assumption* is that matching, using an economic paradigm to value changes in economic advantages, will be carried out adequately with the end of year asset valuation. To the extent that expenditures, not exhausted in the current year, are not brought back adequately through that adjustment, that assumption is brought into question and, more important, there is no over-riding test such as that which was mobilized in *Fletcher*<sup>46</sup> or in *Coles Myer*<sup>47</sup> to prevent full deduction of the expenditure in the current year. If we were serious about a clear and fair income concept, this matching test would be moved to center stage rather than

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<sup>43</sup> Ibid

<sup>44</sup> s7A-25(1)(a) “cost of asset does not include ... interest on money borrowed”.

<sup>45</sup> I include the quality of the universities which train them here and it introduces issues like the stupidity of the Labor Government in diluting the quality of the top universities in the name of access and the stupidity of the conservatives in imagining that top level education and research can be maintained in a market paradigm.

<sup>46</sup> *Fletcher v FCT* 91 ATC 4150

<sup>47</sup> *Coles Myer Finance Ltd v FCT* 93 ATC 4214

depending on the hope that the adjustment mechanism in the detailed boxes will operate effectively. Or is the prospect of a cash flow modality on the agenda?

End of year balancing charges are a central pillar of the new tax system proposed by TVM. The essential job in Chief Justice Dixon's seminal language in *Carden's case*<sup>48</sup> is to "reduce the annual result of [economic] ... activity to a fair money approximation...". "[T]he inquiry should be whether in the [practical] circumstances of the case [the relevant test] is calculated to give a substantially correct reflex of the taxpayer's true income....". This is the benchmark against which we measure the effectiveness of a practical income tax base. We must be crystal clear about the principle to which they give practical expression.<sup>49</sup> The core principle driving the new regime should be the fair allocation of outgoings to the tax year in which the relevant income cash flow comes in. The essential job is to get a correct reflex of net income for relevant tax years.

While cash outgoings are included in the prima facie calculations of net income in the year cash flows out, the unexpired portion of the outgoing must *always*<sup>50</sup> be brought back into balancing charge at year end. The critical mistake in the earlier exposure draft of the legislation was the nil box for "any other asset" in s6-40. This has now been rectified. But identified problems still remain as the earlier analysis has shown. The real issue goes to problems not identified at this time.

Under the present law matching is managed, albeit crudely, by the capital exception and because outgoings must be incurred to produce assessable income. TVM has watered down this protections. The link between an outgoing and the production of assessable income in the old s51 having been abandoned,<sup>51</sup> there will be a correct reflex of income only if and to the extent that the outgoing is fully reflected in the value of an "asset" at year end.

In the simple case, outgoings will be matched by income flowing in the current tax year.<sup>52</sup> But what happens to outgoings creating advantages lasting beyond the current tax year? While the definition of "asset" is very wide, in practice, a serious balancing charge is created only where, and to the extent that, the rights are ascribed sufficient value by one of the specific boxes in s6-40 to fully reflected benefits deferred to later years. This will occur, for example, where they add dollar value to trading stock or depreciable plant or rights to receive cash.

Can tax planners organise deals so a present outgoing in the current tax year is matched by neither income in that tax year nor an asset reflecting an appropriate balancing charge? The legislation poses a new challenge for creative planners to engineer a black hole by purchase of a nebulous, intangible bundle of rights. They get instant recognition of the full outgoing but a much lower or zero balancing charge. The practical mischief is that the architects of schemes claim deductions at the front end on the ostensible basis that they will generate the matching assessable income in a never-never land at some long distant time in the future.

My preferred solution is to inject a formal matching principle into the TVM. If the taxpayer cannot demonstrate that a business outgoing is exhausted in the current tax year to earn cash flows of income *for that taxpayer in that year*, the outgoing should be recognised *only* to the extent of the income flows it generates for that current year. The excess is reflected in a balancing charge brought into account at the end of the tax year.

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<sup>48</sup> *Executor Trustee & Agency Co (SA) v C of T (SA)* (1938) 63 CLR 108.

<sup>49</sup> Ironically, this is the key role of Ralph.

<sup>50</sup> Subject only to genuine de minimus exceptions where compliance costs manifestly exceed the distortions in the current case or likely to be generated.

<sup>51</sup> Exception for private expenditures does not control outgoings between corporates. They are "business" outgoings.

<sup>52</sup> Or, of course, where there is a bona fide commercial investment which goes wrong, by a loss in that current year to be carried forward.

The legislation should articulate the over-arching principle that outgoings are amortised over the economic life of the rights created by the outgoing. The object is to give a correct reflex of net income for each of the relevant tax years. The outgoing is brought back fully in a balancing charge at the end of each tax year unless the taxpayer can demonstrate (1) the outgoing (or the residue brought in at the start of the year) is exhausted in generating flows of cash income (or equivalent consumption) received in the current tax year or, to the extent it is not, (2) its residual value is reasonably reflected in the year end value of assets in the specific boxes in s6-40.

It must be emphasised that the asymmetries I have been describing, along with timing mismatches, are the key drivers of the current crop of large corporate aggressive tax planning schemes. But a history of old schemes based on old law gives only selective insights. The essential point is that, while such structural weaknesses exist, as night follows day, innovative products will be developed to exploit them. This fundamental structural weakness will invite new millennium versions of the costly negative gearing fiasco.<sup>53</sup>

It is naïve to assume the general anti-avoidance provisions in Part IVA can do the job. Apart from a log of other issues, Part IVA requires a clear benchmark and the absence of a matching benchmark is the very issue raised here.

Our recent experience, from *Coles Myer*<sup>54</sup> to *Fletcher*<sup>55</sup> to the shonky Yak semen tax shelter schemes so popular in our own Australian Wild West, has shown that you must have a robust mechanism to match<sup>56</sup> outgoings against the assessable income they were spent (not necessarily successfully) to generate. The idea is to get a reasonable reflex of income across the relevant tax years. The \$64 billion issue is whether the TVM constructs in this area are designed adequately and sufficiently robust, in a practical sense, to maintain the coherence of this critical matching mechanism as new devices are developed and we get into the heat of the inevitable mismatching battles.

If TVM is about to be enacted, what is required is on-going research on whether TVM will tax the key schemes which worked in the past. But a history of old schemes on old law gives only distorted insights. The essential point is that, while such structural weaknesses exist, as night follows day, innovative products *will* be developed to exploit them. This fundamental structural weakness will invite new millennium versions of the negative gearing fiasco.<sup>57</sup>

We are talking about changes which, if they do not meet these benchmark standards, will introduce systemic distortions and undermine the operation of free market in allocating resources efficiently. It will be the search for tax breaks rather than economic output and pre-tax profits which will drive Australian business.

By Dixon's benchmark<sup>58</sup>, the existing law has not performed. Exploitation of mismatches is, in my experience, the key driver or a critical component in half of the current, more aggressive tax minimization schemes in Australia. It is a key feature in a great many more soft core planning schemes. The cost to revenue is very high and, if Ralph is implemented, it is likely to blow out.

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<sup>53</sup> A fundamental distortion of income tax which got through because of a lack of vigilance and attention to fundamentals; when it was properly understood, it was built into the market and it was too late to stop it.

<sup>54</sup> *Coles Myer Finance Ltd v FCT* (1993) 176 CLR 640

<sup>55</sup> *Fletcher v FCT* 91 ATC 4150

<sup>56</sup> The more accurate term is "temporal apportionment" because it is not the same as accounting matching but this headnote term will do for the headline debate. There are measure (see part two) but they are very specific and seemingly an afterthought. This issue underlines the concerns about the approach of Ralph to temporal apportionment.

<sup>57</sup> A fundamental distortion of income tax which got through because of a lack of vigilance and attention to fundamentals; when it was properly understood, it was built into the market and it was too late to stop it.

<sup>58</sup> Putting aside some important, if overdue, remedial work in *Coles Myer Finance Ltd v FCT* (1993) 176 CLR 640 which is already the subject of systematic white anting.

The practical mischief is that the architects of schemes claim deductions at the front end on the ostensible basis that they will generate the matching assessable income in a never-never land at some long distant time in the future. In practice, the lion's share of the profit from the business never arises as fully taxable income. Profits are taken in tax sheltered form or geared out forever or simply moved off-shore. Taxable income is postponed so that it is taken in heavily discounted dollars.<sup>59</sup> Or, much more serious in some of the shonky venture capital tax shelters, the scheme is organised by operators who intend to use the legal documentation as a mere front for blatant skimming. This is the "Bottom of the Harbour" of the 1990s.<sup>60</sup>

To really understand the dynamics, you need to trace current common law approaches to timing issues back to their origins to show how the judges made the wrong call back in 1937. Ironically, it was the great Dixon J, author of long roll of ground breaking dissents and brilliant judgments, who, on this occasion, got it wrong. His deduction rule was too tough! In this case the unsung Latham CJ and his majority colleagues, the nerds<sup>61</sup>, saw the looming problem of systematic mismatch with crystal clarity. They got it right. Later courts have failed to learn the important lessons of this history and TVM ignores it at its peril.

What is the bottom line? That we need is to move principles of temporal apportionment to centre stage as the benchmark test. We must, as Ralph argues, allow the most general deduction of *genuine* business outgoings<sup>62</sup>, subject to the central gateway test (that expenditure was in fact incurred to generate taxable income). But, and here is the essence of it, **we ensure actual recognition of deductions, where practicable, is spread over the economic life of the economic advantage they are spent to generate.**

**With an explicit capital/income distinction removed by TVM, the temporal matching of derivation and deduction becomes the polar star, the central organising principle, which gives coherence to the income tax.** But TVM is about to marginalize the causal test in s8-1 which is the source of such a principle, albeit not rigorously applied by the judges in recent cases, and, notwithstanding the year end net adjustment mechanism, to put something much less coherent in its place.

### Issue 3 No principled substitute for capital income rules

TVM does not propose a principled basis for the core job of sorting and valuing various non-traditional assets, particularly intangible assets. It has substituted pragmatic rules based on a cascade of defined categories. The concepts in them are essentially children of the old capital income distinction. As yet, the crucial "trading stock" definition is not in place. There seems to be an implicit assumption that if you avoid generalizations and instead particularize, on the model of the CGT events which drive the 1997 Act, you can keep the "shyster lawyers" out of the way. Pragmatic accountants are the white knights who will rescue us from the legalistic jungle.

The existing dichotomy between capital and income is not so much a logically attractive line as a memorial to past political, administrative and economic compromises. But, as we saw, TVM relies instead on rule making by reference to the defined terms "trading" stock", depreciable asset" and "asset". It will be necessary to construct criteria for the operation of these terms based on articulated criteria. The current capital/income test is as follows:

<sup>59</sup> I am not unaware of the argument that this "tax expenditure" encourages investment and wealth creation. The problem is that it is so undisciplined and badly targeted and so open-ended that it cannot seriously be defended on this basis.

<sup>60</sup> It will be recalled that Bottom of the Harbour started with judges taking a formalist approach and turning a blind eye to the bending of rules to allow dividend strips. After all, it was most unfair and economically short sighted to force closely held private companies to distribute all their profits when the same rules did not apply to public companies. Can you pick the obvious fallacy?

<sup>61</sup> If I may use the vernacular respectfully of the learned judges, this term is used here as a term of endearment.

<sup>62</sup> With this important caveat that even business deductions can be used for tax benefit shifting. So it has to be a genuine business advantage for *that* taxpayer.



- 1 The process of deciding whether an expenditure is capital or income is a broad characterization process based on all the circumstances.
- 2 The basic criterion is whether the expenditure can be more appropriately characterized as made *predominantly* to bolster fixed capital (the tree, the permanent income earning structure, perpetual advantage) or *predominantly* as part of circulating capital to show a return directly in the form of income (the fruit).<sup>63</sup> After the inconclusive decision in *Cliffs International Inc v FCT*<sup>64</sup>, this primary test must be juxtaposed with a test which looks primarily at the causal connection to the advantage produced.
- 3 In making this characterization the following factors must be considered. No single factor can be relied on exclusively.
  - 3.1 The "lumpiness" of the payment (how often did it recur? Over what period? Did it extend over the life of the advantage?)
  - 3.2 Is it likely, as a practical prediction, to recur in the future? As a broad approximation is it less misleading to say it was made "once and for all" or as a recurrent obligation?<sup>65</sup>
  - 3.3 How substantial was the payment when compared to the entire capital structure of the taxpayer?
  - 3.4 Did the advantage produced have a comparatively short life or was it, relatively speaking and for practical purposes, for the enduring benefit of the income earning structure (say more than 5 years)? If the expenditure was incurred to gain or create a fixed asset did it rapidly depreciate or waste? If the expenditure was spent to produce a thing in action did it have a solid proprietary nature to it?<sup>66</sup>
  - 3.5 How closely was the payment tied, on a plane of time, to the assessable income coming in dollar by dollar?
  - 3.6 Did the return from the expenditure vary with the profits produced by the advantage purchased? If it does this points strongly towards the income end of the spectrum
  - 3.7 Did the expenditure produce a new income earning potential or was it related more closely to the protection or enhancement of existing income earning potential?
  - 3.8 Under the contractual arrangements, did the payment purport to pay for an item which was treated as a capital item of the business? Note the absence of such an item is by no means conclusive, but it can certainly act against the taxpayer.
  - 3.9 Is the expenditure likely to be deductible in later years (eg as depreciation) and, if so, which point of time is the deduction more likely to produce a fair reflex of income

While adopting an accruals, trading stock model of income at its core, TVM perpetuates and, indeed, with the 50% discount for capital gains, Ralph has considerably reinforced, the capital - income distinction. Capital allowances continue to be based on a depreciation capital model and

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<sup>63</sup> Though of course, to a Christmas tree farmer, the tree is both the tree and the "fruit".

<sup>64</sup> (1979) 9 ATR 507

<sup>65</sup> *Vallambrosa Rubber Co Ltd v Farmer* 1910 SC 519, 525 (HL)

<sup>66</sup> *British Insulated & Helsby Cables Ltd v Atherton* [1926] AC 205, 213)

the TVM provisions still use the essential framework for distinguishing the treatment of various assets at year end.

For all its faults, the capital characterization is a test for deciding which outgoings on assets should be amortized over the current tax year and which should be subject to the generous concession of accrual treatment. What has TVM put in its place?

Shrewd advisers have been able to convert non-deductible capital expenditures into deductible revenue expenditures. To take one example from a great many, by borrowing a high percentage of the capital value of an asset the taxpayer incurs high interest charges (frequently exceeding the return on an asset). The interest charges (ostensibly spent to earn an income return on the asset) are thus deductible at the front end and the “capital” profit on the asset is deferred indefinitely and taken in sheltered or tax free form. Far from interest charges always being a revenue expense, the real and very significant issue is the appropriate basket in which such outgoings should be claimed. If the entrepreneur makes a large part of the profits from realization of assets lasting well beyond the current tax year the deduction of outgoing, and particularly interest, should be matched against the appropriate basket of profits. To allow a loss to be set against other income is an invitation to arbitrage schemes to, in effect, be converted income into capital. The case for an open ended mismatch of this type is based on politics, not any sensible cost-benefit economics.

Incidentally, this example shows the folly of a rigid rule, such as that in the Prototype s7A-25(1),<sup>67</sup> that interest should be on revenue account. Even an academic in the Ivory Tower can work out a number of schemes to exploit that. Yes, I know the High Court made the same mistake in obiter dicta in *Steele*, but the High Court, as we saw with the abandonment of the Barwick line on tax avoidance, can extricate itself from ill advised reasoning. It is much harder once you lock it into legislation. Someone needs to go back to the American literature and see the hash the American’s made when they removed the all restraints on interest deductibility<sup>68</sup> Do we really need to revisit their mistakes?

You can see the mistake in negative gearing schemes and more exotic variants. The rationale is to get the interest offset against the income basket when the outgoing is incurred, in part, to create assets in the capital basket. This is a clumsy way of handling the problem and invites tax driven schemes.

To return to the main argument, TVM is essentially a refutation of the existing income tax based, as it is, on the fragmented and outdated capital/income distinction. But when it comes to the business end, TVM adapts itself to the existing distinction between capital and income. It mobilizes the existing concept of capital, using “trading stock” as the discrimen, to allow write off of capital expenditures of depreciable assets over their economic life.

So TVM still makes the essential pragmatic compromises to the politics, administrative and liquidity arguments which spawned the capital/income distinction. Like the Grand Old Duke of York, is it caught half way up the hill between a pure accretions concept of income which is adopted in its central provisions and pragmatic compromises in the boxes in s6-40 which define various categories of asset and their end of year valuation treatment? The main danger is that, in the process, it abandons the control mechanism by which we can discipline the second best compromise. Above all it weakens the tests by which control can be exercised over the means of exploiting the borderline.

### **Issue 7 Is an accounting concept of income such a good idea?**

It is explicitly stated that a central objective of TVM was to bring tax value and

<sup>67</sup> Excludes “interest on money borrowed” from the cost of an asset and therefore leads to the result that all interest is deductible in the current year.

<sup>68</sup> See Grbich, “Interest on debt financing” in Krever, Grbich and Gallagher, *Taxation of corporate debt finance* (Longman Professional, 1991), at 278.

commercial value, closer together.<sup>69</sup> The TVM proposals are still a moving feast. It is not easy to finger the precise outcomes. To what extent does TVM replace, admittedly, unsatisfactory legal rules with rubbery accounting rules, with all the lack of coherence, subjectivity and manipulability that implies to the core of the income tax? Is this merely a less exposed version of the view that deductions should be “determined by the custom of accountants” which was roundly pilloried by Ferguson Royal Commission on the 1936 Act as “impractical” and not a reasonable view.<sup>70</sup> These same criticisms, extensively documented, have been made over many years.

The purposes of commercial accounting and tax law are fundamentally different. In commercial accounting the firm arrives at a balanced appreciation of its current business position by, among other things, making an *estimate* of potential profits from its assets and liabilities, fully discounted to net present value. There may be all sorts of conventions but such guesstimates will always have a large element of subjectivity. For commercial purposes such guesstimates, based on pretty rubbery assumptions and accounting conventions may be useful in giving a working idea of how a business is progressing.

But tax law has a very different purpose. A large amount of tax turns on these rubbery assumptions. Should a taxpayer receive a balancing charge because provision is made for future contingent liabilities? The taxpayer continues to enjoy the benefit of the cash in the meantime and the crucial benefits of this liquidity need to be reflected in the amount of relief the taxpayer gets against the cash flow into her hands in the current tax year. This tension between income tax recognition of a reasonable estimate of future liabilities and the availability of cash is a central theme in the tax accounting cases.

In Australian **tax** law, we have pointedly eschewed the UK use of accounting profits for our tax base. The Australian legislation matches assessable income and the statutory concept of allowable deductions. It arrives at deductions on the basis of objective criteria. There is some ambiguity about just what it takes to get over the ‘**outgoing**’ or ‘**outgoing incurred**’ threshold. But, even within the wide range of outcomes within the scope of these ambiguities, the law is a country mile from allowing deduction for mere accounting provision. Accounting provision is far too easy to manipulate in the hands of creative accountants Accounting provision, being so subjective, may very well give more ammunition to resourceful tax planners. While the provisions in this legislation do not delegate the calculation of the tax base to accountants, the package explicitly moves closer to an accounting treatment of income. This is one of the many issues which must be probed fully before we accept such radical changes.

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<sup>69</sup> [Ralph Business Tax] *A platform for consultation* (AGPS, 1999) at 6

<sup>70</sup> *Third report of Royal Commission on Taxation* (Australian Parliament, 1934), para 551