Tax Value Method

Information Paper

March 2002

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Information

This book is part of package of material released by the Board of Taxation to inform further consultation on the tax value method (TVM). Available printed material includes:

- *Tax value method: an overview*;
- *Tax value method: information paper*;
- *Tax value method: demonstration legislation (prototype 4)*; and
- *Tax value method: explanatory material (prototype 4).*

These publications and other material are available on the Board website:
http://www.taxboard.gov.au

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Disclaimer

This book provides a brief introduction to the TVM — accordingly it is not a definitive guide to this proposal, which will depend on the law, should it be enacted by Parliament.

While all care has been taken to ensure the highest possible standards and accuracy of the contents of this publication, no person is entitled to place legal reliance on it. Any specific or other tax advice required should be obtained from a qualified professional person.

Submissions

The Board of Taxation is seeking written submissions to assist it in evaluating the feasibility of introducing the TVM.

Issues on which the Board welcomes comment include those outlined in the Chairman's introduction on page 4.

Submissions should be received by 30 April 2002. Send your submission to:

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PARKES ACT 2600

Or e-mail: taxvaluemethod@taxboard.gov.au

All submissions will be treated as public unless the author indicates to the contrary. Public submissions lodged electronically will be published on the Board of Taxation's website at www.taxboard.gov.au

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CHAIRMAN'S INTRODUCTION

Background — Review of Business Taxation

The tax value method (TVM) and the Board of Taxation both have their origins in the 1999 Review of Business Taxation. The Review's scope was broad, covering the fundamental design of the income tax system, the process of ongoing tax policy making, the drafting of legislation and the administration of business taxation. This comprehensive evaluation provided an opportunity for Australia to develop and implement a more certain, equitable and durable taxation system.

The Review also sought to move the taxation system towards a greater commercial reality. Its stated aim was to accomplish a robust structure based on explicit principles so that the architecture of business tax legislation would be durable and capable of future modification without doing damage to the framework on which it is based.

The Review discussed two options for determining taxable income under the framework of incorporating changing tax values of assets and liabilities. The choice was between maintaining the existing assessable income and allowable deductions dichotomy or adopting an approach based on cash flows and changing tax value of assets and liabilities.

The Review noted that both options would produce the same outcome as existing methods of calculation. However, it recommended the second in the belief that this would provide the greater structural integrity. It considered that the TVM could replace the disparate rules of the current law with new core rules that would provide greater uniformity and a superior framework for further developments in the law.

In response, amongst other things, to concerns that the views of the community were not being effectively heard in the development of taxation laws, the Review also recommended the establishment of a Board of Taxation. The Board has now been in operation for over 18 months. As an advisory body to the Treasurer, its focus to date has been on three main areas:

- progressing the development of the TVM;
- developing effective consultative processes that can deliver better tax law; and
- identifying issues of community concern relating to the Government's tax reform agenda.

Board's role in developing the tax value method

The Government has noted that the TVM, if implemented properly, has the potential to underwrite the development of a stable, less ambiguous and more understandable income tax

system, and in particular, a system more readily conducive to manageable, ongoing development into the future.[1]

The Government also noted that many detailed issues would need to be resolved for the TVM to be developed and that this would require ongoing consultation with all sectors of the community as well as a major education campaign for practitioners. To that end, it requested the Board to evaluate and make recommendations regarding the feasibility of introducing the TVM.

In order to set up an open development process, the Board established a Legislative Group[2] and a Working Group, comprising representatives from industry, academic and professional associations, to assist it in developing the TVM material being released for this consultation. The Board has also sought to engage more generally with the community by publishing on its website, and inviting comment on, all material developed; by holding a TVM consultative conference in July 2001; and by other meetings with key stakeholders.

Over the last twelve months, prototypes of the TVM legislation and explanatory material have been progressively developed and released onto the Board's website. These drafts have not been endorsed by the Government. They have served primarily as a means of generating debate and feedback from the community on the TVM concept and the practical realities that would need to be addressed for the TVM legislation to meet its stated objectives. The TVM development process has been unique in providing those opportunities.

The prototype TVM legislation has been amended at regular intervals in response to matters raised during the consultative process. With business and wider community input received through the Board's Legislative Group and Working Group and directly from the public, a reasonably complete legislative product covering the core rules and certain key peripheral rules has now been developed to enable public evaluation of the TVM concept.

The Board has also been overseeing testing of the core TVM provisions in some real life situations and has separately commissioned work around evaluating compliance issues. The results from the testing and other evaluation activities will assist the Board in its evaluation of the TVM.

The only benchmark currently available to the TVM is the 1936 and 1997 income tax Acts. While it is logical to benchmark the TVM against these Acts, there is a large measure of agreement among tax professionals and the business community, in particular, that the existing law is seriously flawed and outmoded, and therefore must be significantly changed or completely revamped. With almost anything being better, the current income tax law becomes a poor benchmark. Accordingly, to provide another benchmark for thorough evaluation of the TVM, the Board is also sponsoring work by some members of its Working Group on alternative theories to the TVM proposal. This work will continue to be considered by the Board's Working Group.

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1 Treasurer's press release dated 7 August 2000, No. 081 of 2000.

2 Comprising officers from the ATO and Treasury, and external consultants.

Materials being released for this consultation

This publication forms part of a consolidated package being released for further consultation, comprising:

- prototype legislation covering the TVM core and key peripheral rules;
- explanatory material for that prototype legislation;
- an overview of the TVM; and
- this information paper.

All this material remains provisional in status and, as with the prototype legislation, has not been endorsed by the Government. It will form the basis of further TVM consultation with stakeholders. Submissions are invited, by end April 2002, from individuals and industry representatives and there are some key issues on which the Board would particularly welcome comment (discussed below).

The present version of the prototype TVM legislation incorporates a range of other Review of Business Taxation recommendations, including the rights reforms and accrual rules for the taxation of financial arrangements. These recommendations have been endorsed in principle by the Government but are at varying stages of policy development. The rights reforms, which are designed to give a comprehensive treatment for intangible assets and rights, are important to the underlying structure of the TVM and are being considered with the TVM. The taxation of financial arrangements and other initiatives, including the treatment of leases, would be subject to ongoing development processes.

The TVM itself is intended to be revenue neutral overall, except to the extent that other policy initiatives propose variations to the existing law. A status summary of these is provided in Chapter 5.

What the Board seeks from submissions

With such an open process of design and development, the emphasis going forward needs to be on informed comment. Incorporation of public comment into earlier legislative and explanatory drafts means that some initial criticisms and conceptions of the TVM may no longer be relevant and it is important that submissions be based on the materials released for this consultation.

Submissions would be enhanced by an indication of:

- what practical contact the contributor has with the current tax law in the course of their business, practice or tax affairs;
- the materials and information sources, if any, on which they currently rely (such as legislation, case law, rulings, return forms or professional tax advice); and

- what involvement, if any, the contributor has had in the TVM development process to date (such as workshops, seminars, correspondence).

The Board is particularly interested in submissions that address one or more of the following questions:

1. Do you consider there is a need to address the complexity, inconsistencies and volume of Australia's current income tax legislation and related materials (such as explanatory material and rulings)?

[See Chapters 1-2; Attachment A]

2. Does the TVM concept have the potential to deliver the improvements needed in Australia's present income tax system (please provide reasons)?

[See Chapters 1-2; Attachments A, C and D]

3. What specific benefits or costs, including transitional costs, might the TVM have on taxpayers or tax practitioners, or both?

For submissions regarding **taxpayers**, comments are sought regarding specific anticipated effects on business, tax reporting and tax compliance. Submissions that focus on a specific taxpayer group (for example, individuals, small businesses, medium to large businesses) should refer to the case studies and worksheets prepared for that group.

For submissions regarding **tax practitioners**, comments are sought regarding specific anticipated effects on business systems, tax reporting, tax advice and tax compliance. Submissions should refer to the case studies and worksheets prepared for various taxpayer groups.

[See Chapters 2-3; Attachments B, C and D]

4. Are there areas in the prototype legislation that would require adjustment to ensure consistent outcomes with the current law (apart from those areas where other policy initiatives propose variations to the existing law)?

[See Chapter 5]

5. What would be the most efficient method and most appropriate timeline, if the TVM were to be implemented?

Comments regarding implementation could also address anticipated educational and skilling issues and any proposed alternatives to the structure used in the prototype legislation.

[See Chapter 4]

On the last point, the Board considers that it would not be realistic for the TVM to be implemented from 1 July 2003. However, I stress that the focus of the Board's consideration remains evaluation of the TVM proposal, with considerations as to potential timing only one factor in that evaluation.

Conclusion

On behalf of the Board I would like to thank those who have participated in the development and evaluation of the TVM material to date, especially members of the TVM Working Group who have given a great deal of their time to this endeavour. I would also particularly like to thank Mr Paul Abbey of Shaddick & Spence, Mr Tom Reid, Consultant Drafter, as well as Mr Andrew England and Mr Michael Smith and their teams from the Australian Taxation Office for their sterling efforts in developing and shaping the material being released for this consultation.

The Board's evaluation of the TVM over the coming months will take into account the perceived benefits of any change versus the associated compliance costs, including the cost of transition. Your submissions and other input in the consultation process will be very important to the Board's evaluation process.

This has been, is and will be the most open and inclusive consultative process in the development of proposed tax law reform in Australia. Your objective participation will further enhance that process. I therefore encourage all taxpayers and tax professionals to be involved in this further consultation and contribute their knowledge and expertise to the task of creating the best possible tax law for Australia.

Richard FE Warburton
Chairman
Board of Taxation

1 WHY CONSIDER THE TAX VALUE METHOD?

The TVM was developed with a great deal of specialist input, especially from a legal perspective. The main outcome of that work can be seen in the prototype legislation and explanatory material. However, were the reform to proceed, it would impact **all** users of the income tax system, and the Board is seeking consultation on this issue from a wide cross-section of the taxpaying community. Chapters 1 and 2 aim to give a more informal introduction to the proposed reform for a broad, non-specialist audience. They describe how the TVM relates to the current system and what potential benefits it may bring.

The need for reform — the current income tax system

Today's income tax system was originally designed early last century (based on State legislation of the previous century) and has now been amended many times. The business transactions of today were not envisaged when the earlier laws were drafted, and the system has had to adapt ever since.

It is like a house we have lived in for generations, gradually adding rooms and extensions as our needs grew, but with no architect's plan or building program to guide our work. Thus we have created a vast building which shelters us on the whole, but is at the same time a maze of old, rarely used rooms, blind corridors and parts which no longer provide protection from the weather. We rely on experts even to guide us from one area to another, and it is nigh on impossible to get a mental picture of the whole building.

Here and there, however, we find well-designed spaces. They hint at what the house might have been were it constructed with a clear plan and the benefit of today's perspective.

This may seem somewhat poetic language with which to describe the income tax system, but it aims to give a more palpable sense of where the community stands at the beginning of a new century, operating under an income tax system with a foundation grounded firmly in the realities of 1936.

How did the tax system get so complex?

Not all complexity in the tax system can realistically be removed. The world of financial activity is extremely complex in itself, so a degree of complexity in the system designed to assess income tax might be expected. But not all complexity in the tax system reflects the complexity in the world of financial transactions. Much of it is simply the result of an accretion of tax regimes over

the past century, with no guiding principle for the evolution of the body of law on which the system is based.

By looking at the way in which the law has evolved, it is possible to distinguish between these kinds of complexity. Moreover, the implicit principles that structure (albeit poorly) our current income tax law become clearer.

Australia inherited its law from English models of income tax. These were first expressed federally in 1915 and stated more fully in the *Income Tax Assessment Act 1936* (ITAA 1936). Many of the basic elements of that law form the foundations for the current income tax law, and would continue to apply under the TVM. Examples include rules on who pays income tax, how that tax is collected and annual periods for assessment.

But also in the ITAA 1936 are some elements that have become a source of complexity today.

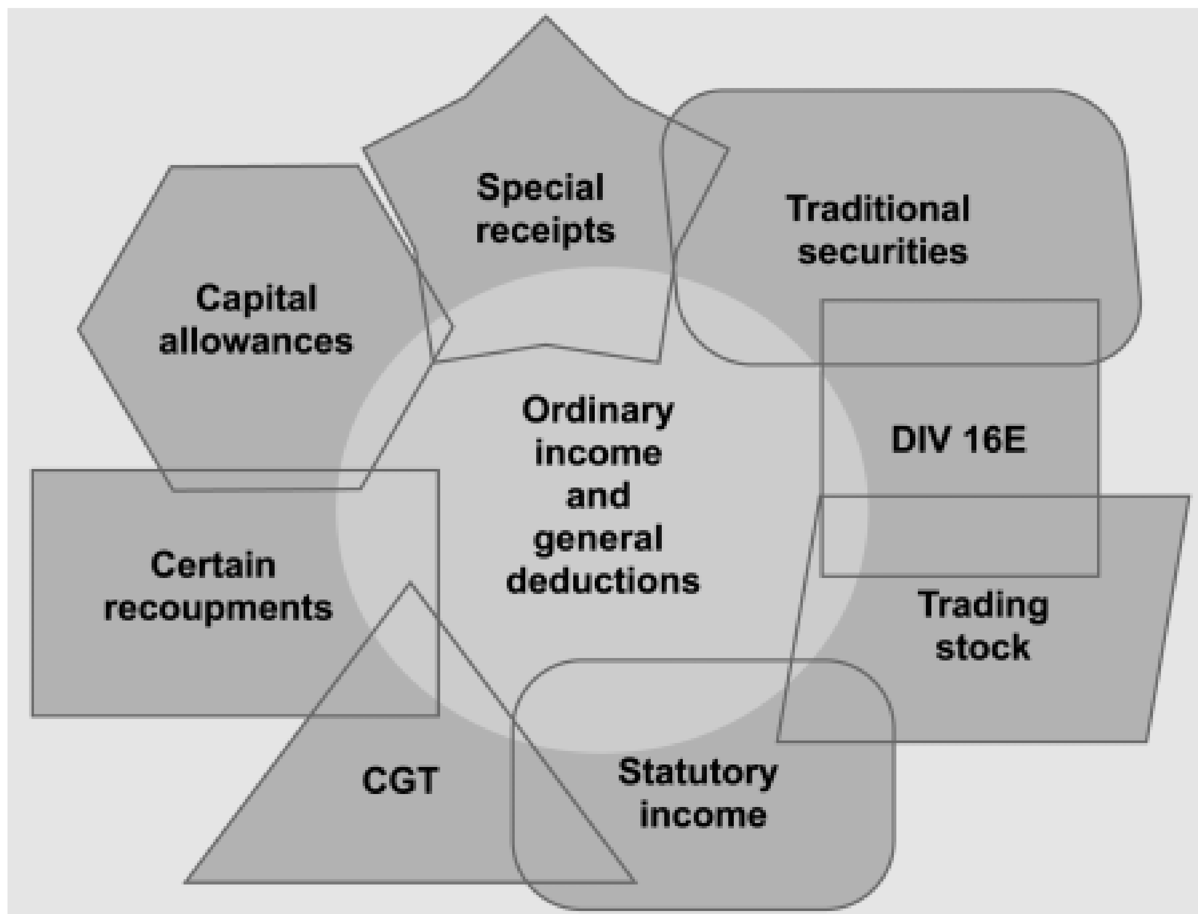
The current revenue/capital dichotomy

The 1936 and earlier income tax law aimed to subject only some kinds of gain to taxation — 'ordinary income' and some limited 'statutory income'. There are other kinds of income, notably income from many kinds of capital gain. However as a general rule, the law sought to subject revenue income to taxation, but not capital gains. The revenue/capital dichotomy, based on judicial interpretation, has lasted ever since, and is now a major source of contention and cost for the community, for example, through the need to seek rulings and to contest tax treatments imposed by the Commissioner.

While this revenue/capital dichotomy has persisted in the law, over almost a century the income tax base has been extended by a series of new tax regimes and amendments to existing law. New kinds of gain have been made subject to taxation — gains that the parliaments of the early twentieth century had no intention to tax.

Australia's intended tax base has reached a point where it is almost universal — that is, virtually all gains (from both revenue and capital) are intended to be part of taxable income. But the legislation covers this tax base through a series of regimes, akin to a patchwork quilt: new patches are incorporated to cover new kinds of income, and extra patches repair conflict and uncertainty between regimes. This complex patchwork might be reasonable if the final result was a clear and unambiguous coverage of all income. But it is not. Ambiguity still remains, so that the tax treatment of some financial transactions is unclear and subject to dispute. Further, the patchwork quilt can never cover all gains in a certain way, because it is always possible that new forms of income making activity will emerge.

Diagram 1-1: The current system as a patchwork quilt



This diagram shows in a simple way how the current law is a series of separate regimes. Each of these regimes has its own pattern and set of rules. Together they form a complex web.

A tax language of 'assessable income' and 'allowable deductions' — creating distance between tax calculation and normal accounting

The original range of assessable income was relatively limited, and the ITAA 1936 included the concept of 'allowable deductions' as part of the equation to calculate taxable income. But these deductions were not simply 'expenses': for the most part, only those expenses that could be directly related to making revenue income were counted as deductible. As new regimes were introduced, they brought with them new rules for deductions, rules which did not fit easily with the earlier framework and which became more and more complex.

In the current system, most gains are taxable, and most business expenses are deductible, but the two sides of the equation are treated quite differently by the law, despite their economic similarity. This is a source of complexity for members of the community, who have to translate all their economic dealings into a special tax language, distinct from economic and accounting concepts, to calculate their taxable income.

Little guidance on timing has led to the need for many complex details

Early income tax law had little to say about when gains and losses should be brought to account, apart from the general principle of annual calculation of tax liabilities. Yet the timing of taxation can be an important point of leverage for business. Facilitated by innovations in financial markets, among other things, increasing effort (legitimate and otherwise) has gone into seeking the best tax treatment for many business activities. If the results of the current legislation were a clear treatment of timing for all kinds of business activity, its complexity would pose no great problem. However, this is not the case, and questions about classification of gains and losses continue to burden business, tax practitioners, tax administrators, legislators and policy makers.

The result is a large body of law that lacks cohesion

This historical overview highlights the relatively limited scope of early tax law, and it shows how difficult it was to build later expansions of the tax base into the earlier framework. Tax designers over the past 60 years have not intentionally aimed to be difficult and obscure. The scope and structure of the earliest income tax law, while appropriate for the time, did not prove an easy foundation on which to build. Thus the Australian community now inherits an income tax system structured by a large body of law that does not form a coherent whole, and which imposes great complexity and cost.

This explains much of the complexity of tax law today, but it also shows the opportunity for reform. Before recent changes (especially the capital gains regimes of the 1980s and the tax base reforms in the Review of Business Taxation) comprehensive reform of the income tax law would have been extremely difficult given the gaps in the tax base. Now, however, with an income tax base that is virtually universal, it is possible to consider overall reform to the way the law covers that tax base. It may be an opportune time to seek a way to achieve this kind of reform.

The nub of the problem: putting a microscope to the law

The cost of complexity, ambiguity in tax treatment and many litigated cases can be attributed to a few features of the body of legislation that makes up our income tax law. For a reform to be effective, it must squarely address these issues.

Many ways of doing things

The current income tax law uses many different sets of rules to describe the tax base. Basically, the income tax law is a series of regimes with different rules — regimes that overlap with each other. Each of these regimes has its own pattern and set of rules; together they form a complex web. The overlapping in itself is a technical problem that could be overcome with a technical solution. (Indeed, that is what happens at the moment — little pieces of law deal specifically with overlaps between regimes.) But more important than the overlaps, the fundamental problem

is that there are many regimes trying to do essentially the same thing — to assess gains and recognise losses.

For example, when you get income or incur an expense at the moment, the first thing you have to work out is which of the many regimes apply, and in what priority. That can be a laborious process.

The TVM provides the opportunity to replace these disparate rules with new core rules that provide greater uniformity and lay a strong foundation for further developments in the law.

An improved structure of the law based on the TVM could make income tax law easier to learn, understand and apply, thereby reducing tax administration and compliance costs.

Inadequate default treatment

The intended tax base (after the adoption of reforms proposed in the Review of Business Taxation) has reached the point where it is true to say that virtually all business gains are intended to be taxed and virtually all business expenditure is intended to be recognised by the tax system. It would be relatively easy to specify the few exclusions.

However, the current income tax law works the other way around: regime by regime, it specifies what income and expenses are to be **included** in the tax system. That means that any income or expenses that do not fall within the regimes are excluded by default. This gives rise to so called 'black hole expenses'[3] — legitimate business expenses that cannot be claimed as tax deductions because they do not fall within the boundaries of current regimes.

It is of course much harder to define **what more** should be covered (especially by piecemeal extension) than it is to define what should be covered as a whole concept.

Large volume of legislation

The income tax law in Australia has grown massively since it was first enacted in 1915. The 1915 Act comprised only 22 pages of legislation. The law has been growing continually since then, but the growth accelerated dramatically after 1985. Starting with the tax reforms of that year, nearly 3,000 pages of legislation, and a significant amount of explanatory material and rulings, have been added in the last 16 years.

The law has expanded for a number of reasons but a key one has been the desire to develop the tax base. This has happened in a series of unrelated amendments to place this receipt or that expense either within or outside the tax net.

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3 Refer to the Review of Business Taxation recommendation 4.14, *A tax system redesigned*, July 1999; see also Treasurer's press release dated 22 March 2001, No. 16 of 2001.

In this way the law has developed as the original core rules and a large body of extensions. By adding extensions in this way, the law has become more voluminous than it would have been were it based on an overall plan. For instance, instead of stating a concept once, the law has many variations on each concept. So, for example, there is more than one rule for the 'cost' of things; there is one rule for the cost of depreciating assets, one for capital gains tax (CGT) assets, one for trading stock, one for traditional securities and so on.

Lengthy law is not inherently problematic. If there is much to say, then it is quite reasonable for the law to take a lot of pages to say it. But, as a general rule, the longer the law is, the harder and more costly it is to learn and the more difficult it is to find all the rules applicable to any given case. So, when a law is identifiably longer than it needs to be, it is important to consider solutions that will reduce its length.

Inappropriate characterisation of transactions

The current law tends to characterise a transaction as being one thing or another, even though the transaction has several components, each of which has its own character. This means that gains or losses that will never exist economically are recognised by the tax system.

For instance, at its core, the income tax law currently seeks to characterise a payment as revenue or capital. If it is characterised as revenue, it is normally deductible immediately. If it is capital, it normally is not (but is in most cases eventually recognised at a later time). In making that characterisation, the law almost always looks to the legal form in which the transaction is cast. It ignores whether the payment actually leads to an economic loss or not.

Suppose, for example, that money is borrowed. Repayment of the principal sum will be characterised as capital and consequently is not deductible. Any payments of interest on the principal will be characterised as revenue and therefore deductible. However, if the transaction can be arranged so that the legal form of the principal and interest payments are together taken to be, say, rent, they will be characterised as all revenue and therefore fully deductible. This means that a deduction would be given for a repayment of principal even though that repayment does not represent an economic loss to the taxpayer.

Asymmetric treatment

There are usually two sides to a transaction. In a sale, for instance, there will be a buyer and a seller. When both sides are taxpayers, it is highly desirable for their tax treatment to be symmetrical. When it is not, holes appear that can be exploited.

The most common form of asymmetry is where an amount of money associated with a transaction is recognised at different times for each party to the transaction. For instance, a lump sum payment for granting, say, a restrictive covenant is taxed as a capital gain when the grantor receives it but tax relief is only given to the grantee through a capital loss when the right

terminates. Where this happens, the parties to the transaction can find opportunities to gain a tax advantage.

Some amendments to the law target specific timing problems. However, they are not a systemic solution that prevents the problems arising in the first place. The problem of asymmetric treatment indicates that the current law has a serious durability problem in this area.

The impact of current income tax laws on the community

Business decisions are made more difficult because of tax considerations

Getting clarity about tax implications for some business transactions is a time-consuming, costly process. Rather than being able to make decisions on business criteria, businesses have to spend valuable time comprehending the tax consequences. Or, having made decisions, they may find themselves in long and costly legal disputes over taxation.

It is unlikely that the tax system would ever do away with the need for tax planning or disputation, but much of the present uncertainty arises because of a lack of transparency in the law, a complex range of regimes which apply and the failure of the current law to accommodate the economic realities of transactions.

Even for tax specialists, the law is difficult to understand and learn, and the community pays the price

Business owners and individuals may not encounter the volume and complexity of the income tax law as a direct problem, but they certainly pay for it through the tax specialists they hire. Such specialists will always provide an integral service to most businesses and many individuals, but currently their work is hampered by the volume and complexity of income tax law. One consequence, arguably, is that the cost of taxation advice is higher than it might otherwise be. In fact, the tax profession has been one of the driving forces for reform — it was early to recognise the poor state of the current system, and has been a strong voices for change.

Tax reform is made doubly difficult, and business suffers as a result

Bringing in tax reform that promotes Australia's economic growth while enhancing fairness and equity among taxpayers is a difficult enough task. The magnitude of the problem increases considerably when the attempt is made to graft such reforms onto the existing income tax law in a simple and clear way. Business suffers because reform is delayed, or unintended consequences are introduced to the growing raft of legislation and to plug the holes created by ill-matched regimes.

The options for reform

This chapter has looked at the problems with the current income tax law and some of the basic causes. Also it has considered some of the features of the body of income tax law that create particular difficulties. This provides a basis for considering possibilities and options for reform. The available options are fairly simple:

- do nothing;
- make relatively minor adjustments to the existing law;
- retain the existing law, but update it by amending older law with new concepts;
- revisit the main principles of calculating assessable income and allowable deductions; or
- radically revise income tax, changing its basic foundations.

The options to be recommended to the Government will lie somewhere within this spectrum. Few would argue for those at either extreme. The 'do nothing' option retains the complexity and inequity that currently exist. The main argument in favour of this position is that the system has not reached a point of unmanageable crisis (yet), so 'if it ain't broke, why fix it?'. However, there are many in business and the tax profession suggesting that change is urgently needed.

At the other extreme, a 'radical revision' of our income tax law and system would go well beyond the recommendations of the Review of Business Taxation. Examples might include the adoption of a cashflow or expenditure-based taxation, or changing fundamentals such as who is liable to pay income tax, or when the tax is collected. Such revisions might be conceivable, but would carry costs that the community would be unable and unwilling to bear at this time.

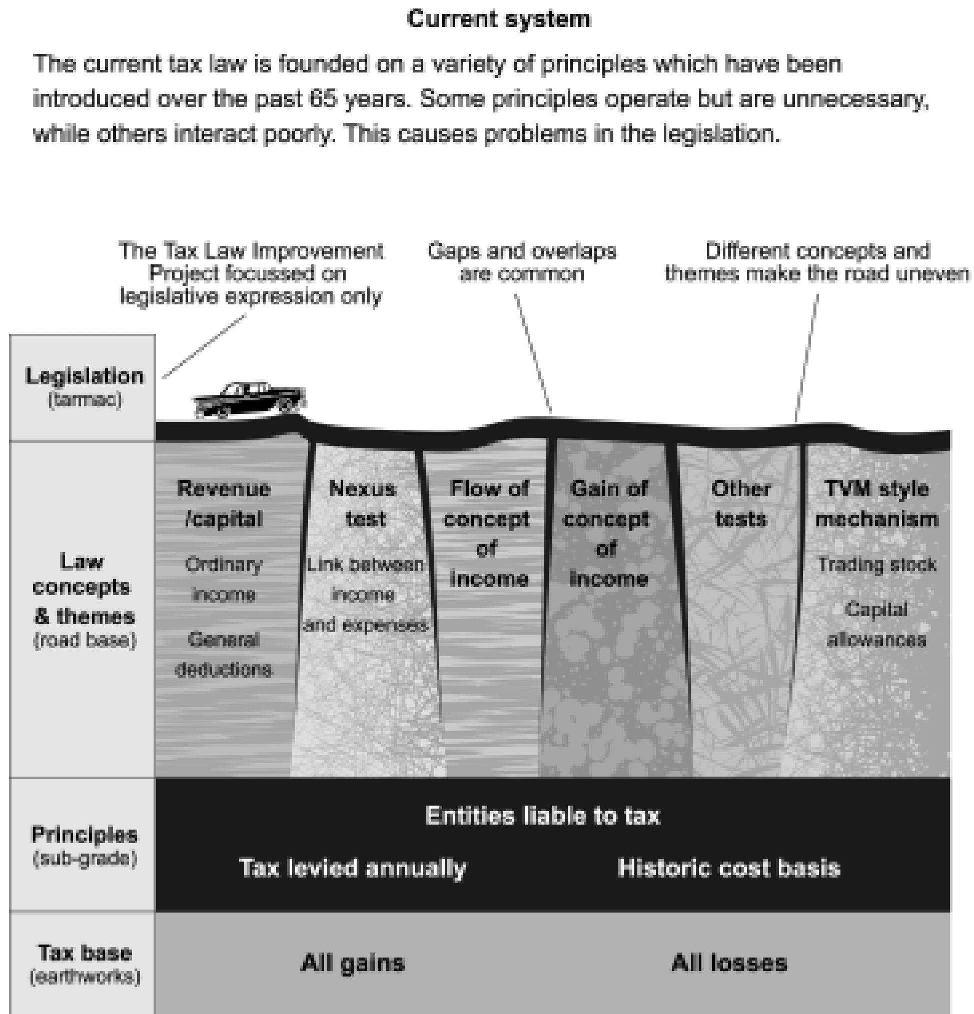
The real possibilities lie in between the two extremes. That was the conclusion of Review of Business Taxation, which eventually considered two such approaches. The 'tax value method' was the preferred options for reform. It revisits the main principles of calculating income tax, but does so in a way that does not change the income tax fundamentals, and does not impact greatly on taxpayers' activity.

How does it do this? Another analogy helps to explain: compare the income tax system with a road.

The driver travelling along the road suffers the effects of potholes, cracks and bumps in the road and believes they are problems with the tarmac. However, the problems are often caused by the road's poor foundations, which create the weakness in its surface.

In the same way, the user of the tax law sees problems with that law and thinks those problems come from the way the law is expressed. However, like the road, the underlying problem is often not the law's expression, but its foundations.

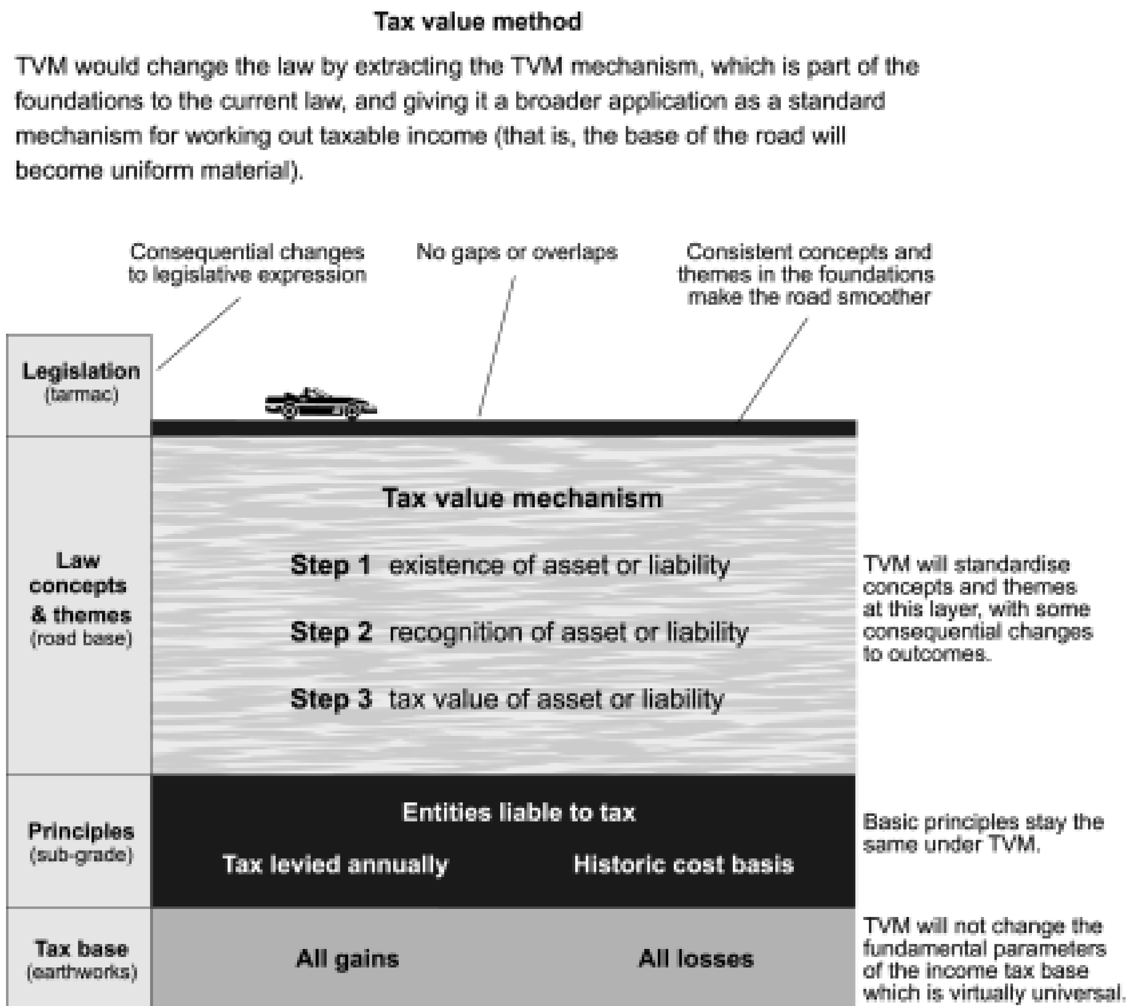
Diagram 1-2: The current tax system as a road



Rather than constantly repair the tarmac, a better plan is to fix that part of the road's structure that causes the problems. Better foundations to the road will improve the surface: it will crack less often, contain fewer bumps and require less repair. The driver will have a better journey but will still only experience how the road is to travel upon, not what is under the surface.

Many of the problems with the income tax law are due to the law's different concepts and themes. This is the level that determines the way taxable income is expressed in the law. The approach taken by the TVM is that it is best to fix the law by fixing this foundation.

Diagram 1-3: The tax value method as a road



Key reform principles

When looking at the possibilities for reforming the income tax system, some limits must be kept in mind from the outset. The consultation and evaluation of the TVM is about testing the idea against these (among other) criteria.

The reform should be 'revenue neutral'

This kind of reform, aimed at simplifying the law, is not an exercise in collecting more (or less) money for the Government. Therefore the amount of tax paid by taxpayers should change very little as a result of the reform in itself. Taxable income may change for some taxpayers, but only in line with explicit policy initiatives.

The reform should not significantly alter the tax base

As well as being revenue neutral, the reform should not broaden the tax base beyond the specific recommendations of the Review of Business Taxation. This reform would therefore be different from, for example, the GST, which did aim to change what was indirectly taxed, and by how much.

Underlying principles of the income tax system should not be touched

Some basic elements of the income tax system were established early, and continue to serve the community well. They include the description of who is liable to pay income tax, how that tax is collected and the fact that income tax liability is generally calculated annually. They also cover principles like the assessment of income tax on a realisation basis, and the use of tax values based on the cost of assets. An income tax reform should not change basic features like these.

Compliance costs should not increase

Working out the tax implications of a transaction, especially for complex business transactions, will always carry a cost. But a reform which aims to reduce complexity in the income tax system should also bring a reduction in compliance costs.

The cost of transition should be considered

It is also important to consider the transitional cost of adopting any new basis for calculating taxable income, including costs of adapting business and financial systems. Even when moving to a simpler, more efficient system (like the change from typewriter to word processor) it takes some time and cost to make the shift. The cost of change (which should be relatively short term) must be judged against the potential, lasting benefit.

2 THE TAX VALUE METHOD

What is the tax value method?

The TVM is a way to work out taxable income. It does not affect the other basic elements of income tax liability, such as income years, tax rates, tax offsets, exempt entities and residency.

The TVM is not a new tax and would not mean an overall increase in tax revenue. It does not tax unrealised gains and is not expected to create new information or reporting requirements. Rather, it applies one set of uniform rules to the calculation of all forms of taxable income and losses.

The TVM concept views taxable income as the annual change in the tax value of a taxpayer's assets (including cash) and liabilities:

Change in tax value of assets − Change in tax value of liabilities

This expression closely resembles the current law's calculation for taxable income:

Assessable income − Allowable deductions

Under the TVM, the tax value of an asset or liability (as recognised in our current law) is its value for tax purposes under that law. As a general rule, an asset's tax value usually equals its cost, not its market value. One important exception is a depreciating asset, whose tax value declines over time. Assets whose tax value corresponds to cost will only be taxed when they are sold or otherwise realised, as under the current law.

To this basic concept, adjustments are then made where necessary for such things as exemptions, concessions and unused tax losses.

The prototype TVM legislation uses a broad definition of assets and liabilities that includes cash, while excluding intangible benefits or costs not recognised in our current law.[4] The result is that the TVM concept describes all items currently brought to taxation.

4 For example, less obvious advantages such as market recognition from an advertising campaign, are not brought to account. As a result, tax relief is afforded immediately for expenditure on those advantages because the expenditure is not matched by a corresponding increase in assets that are held: explanatory material paragraph 4.17.

Although the TVM recognises cash as one type of asset, it does not impose a tax on cashflow. Businesses generally can use opening and closing cash to calculate their net cash movements (receipts less payments) for an income year. Only individuals need to consider cashflow, as they do currently, and then only for such things as salary, interest or dividend income and any other non-private receipts or payments. Partnerships that include an individual also need to consider cashflow in a similar way under the TVM.

How does the tax value method work?

The TVM focuses on taxable income as a function of the annual change in the tax value of all assets (including cash) and liabilities. The annual change in the tax value of an asset or liability means its closing tax value (at the end of the income year) less its opening tax value (at the start of that income year).

The TVM does not adopt the current law's judicial test for distinguishing between revenue and capital. As a result, all receipts and payments (other than those that are private or domestic) are automatically included in taxable income, except where an adjustment applies to exclude them.

Applying this to income from shares, you may receive income from dividends each year you hold the shares and, in the year you come to sell them, you may receive income from the increase in the share price. Under the TVM, your taxable income increases each year by any dividends you receive. In the year you sell the shares, your taxable income may also increase to reflect any increase in the share price since purchase.

The TVM concept can logically explain all aspects of taxable income and is already the basis of some parts of the current tax law, such as trading stock and depreciating assets. However, the TVM is currently only reflected within each self-contained regime, rather than as an integrating principle that streamlines the overall tax law.

Adjustments to the taxable income

The purpose of the adjustment mechanism is to incorporate such things as concessions and exemptions. Using the basic TVM concept plus relevant adjustments to work out taxable income ensures that current and future Government policy is easily incorporated and readily identifiable.

Examples of adjustments in the TVM prototype legislation include:

- partial private or domestic use of particular assets;[5]
- tax incentives for gifts to charitable causes;[6] and

5 Divisions 222 and 234.
6 This Division has not yet been drafted.

- the 50 per cent discount for individuals on sale of investment assets.[7]

For individuals, and partnerships that include an individual, the prototype legislation generally excludes receipts, payments, most liabilities and some assets from taxable income if they are private or domestic.[8] For receipts or payments that are only partly private or domestic in use, this proportion is excluded from taxable income. Special adjustment rules apply for depreciating assets and liabilities that have some private or domestic use component.

How tax values affect taxable income

As stated earlier, the tax value of an asset or liability is simply the value it has for tax purposes under our current law and the tax value of most assets is cost, rather than market value.

Under the TVM's simplified cost rules, an asset's cost equals all amounts paid to hold it (such as purchase price, stamp duty, or registration fees) plus any amount paid to bring the asset to its present condition and location (such as an improvement). Similarly, the proceeds of incurring a liability are made up of the amounts received for incurring it, together with any amounts received for an increase in the liability.

Taxable income **is not affected** in an income year by:

- the change in market value of assets held during the year — there is no change in the tax value of these assets for the income year because the increase (or decrease) in market value is not realised by selling or otherwise disposing of them;[9] and

- the acquisition of assets (other than depreciating assets) that you still hold at the end of that year — this is because the tax value of most assets is matched and cancelled out by the amount paid for them.[10]

However, taxable income **is affected** in an income year by:

- assets that you sell or otherwise realise at a profit (or loss) — this increases (or decreases) taxable income by the difference between the asset's current tax value (for example, its cost) and the value realised upon disposal (for example, the sale price);[11]

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7 Division 100.

8 Division 222. Payments of this kind include, as under the current law, those for most clothing, childcare and travel between home and work. Some land and collectables that have a private or domestic character will be included in taxable income so that gains in respect of them can be included in taxable income. This is consistent with their treatment under the current law: explanatory material Chapter 17.

9 The treatment of trading stock, and the mark-to-market treatment under the taxation of financial arrangements (as recommended by the Review of Business Taxation), are exceptions to this (Divisions 70 (still to be drafted), 74 (still to be drafted) and 76).

10 Or in the case of non-cash transactions, the value of the asset that was exchanged for them (Division 16).

11 See the core rules as outlined in Division 6. Note that adjustments may then apply to this general principle, such as the 50 per cent discount for individuals, or the small business concessions.

- the decline in value of your depreciating assets — this will reduce taxable income to the extent of the decline in tax value during that year;[12] and
- receipts and payments that are not matched by an equivalent change in the tax value of other assets or liabilities — receipts of this kind increase taxable income, while payments reduce it.[13]

  This last situation arises in the case of payments to acquire assets that have no value for tax purposes (that is, their tax value is zero). Examples include consumable stores, spare parts, office supplies other than trading stock, shareholders' rights to receive company dividends, and intellectual property in advertising material (unless that property was acquired from someone else).[14]

The prototype legislation has comparable rules for liabilities.[15]

The above principles generally reflect the same outcomes as the present law, but using simpler and fewer rules. The TVM also reflects the current law for the following specific business assets and liabilities:

- trade debtors;[16]
- trading stock;[17] and
- goodwill.[18]

Calculating taxable income under the tax value method — getting to the economic reality

How is calculating taxable income different under the TVM?

At present the starting point for calculating taxable income is asking a series of questions about your activity during the year. Did you make any lease payments? Did you make any capital

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12 The TVM's treatment of depreciating assets is simpler than the present legislation, which applies CGT rules to a gain or loss made on the sale of depreciating asset, to the extent that the asset was for private or domestic use: Division 72.
Taxable income could also be affected by an increase in the tax value of an asset subject to the taxation of financial arrangements rules, as recommended by the Review of Business Taxation.

13 Examples of such receipts and payments are receipt of money for services performed by a business and payment of salaries to staff, respectively: Division 6.

14 Division 68 explanatory material paragraph 7.115. Further work is being done on how to implement the Review of Business Taxation recommendation 4.3 as it relates to unbillable work in progress: Section 68-10.

15 Divisions 6, 68 and 72; explanatory material Chapters 8 and 13.

16 Divisions 6, 76 and 545.

17 The tax value equals the market value if the taxpayer is eligible and chooses to apply for it, for those assets with readily ascertainable market value: Division 70 (still to be drafted).

18 Section 78-50.

gains? Any pre-payments? What ordinary income did you receive? Any expenses incurred in producing income? And so on. And so on.

The starting point under the TVM is different. The fundamental question is: What have been the changes in your assets and liabilities? (If you want to separate cash from other assets you would also ask: What is the difference between receipts and payments for the year? Otherwise you would treat your cash as simply another asset.).

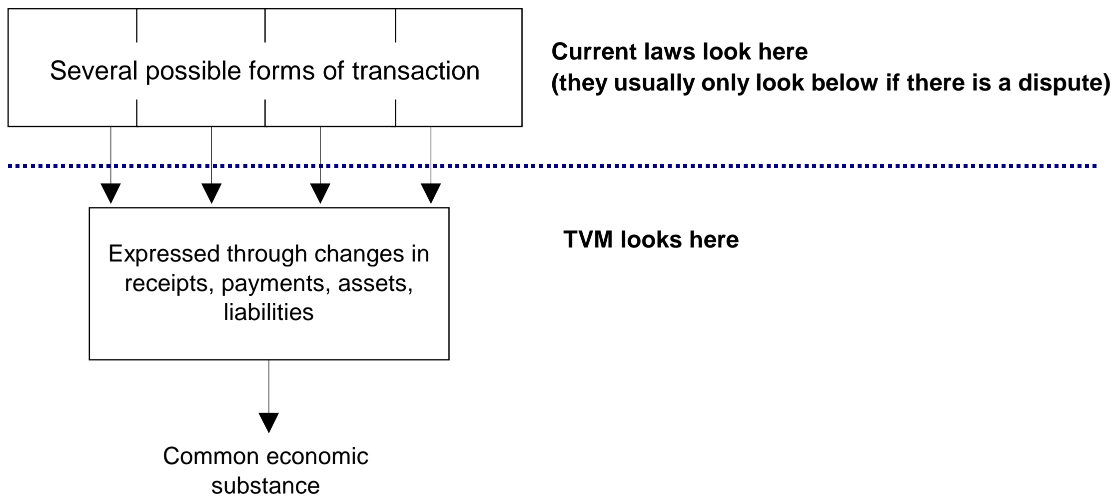
Why the different starting point? It is because the TVM aims to get closer to the economic reality of gains and losses and to get closer to the way the community of taxpayers already accounts for its finances. How so?

The form of a transaction may vary, but the economic substance will always be expressed by the overall changes in receipts and payments, assets and liabilities. So you could have transactions with identical economic effects expressed in several forms. For example a company could raise finance through a simple loan, or through a more complicated arrangement — say, selling plant to raise the money, leasing the plant back, and then repurchasing it at the end of the leasing period. Both arrangements might have exactly the same economic outcome, and there could be very good business reasons for choosing one way over the other. Tax advantage should not be one of those reasons.

If there is an economic gain or loss, there will always be actual receipts, payments, assets and liabilities that, collectively, get to that outcome. What those receipts, payments, assets and liabilities are called or how they are divided and combined will not change the final outcome unless the economic substance itself is changed.

A major problem in the tax system at present is that, when it comes to calculating taxable income for the year, the law generally looks in the first instance at the **form** of business transactions, rather than at their **economic substance**. Different forms of transaction belong to different tax regimes, with entirely different rules. That means that much business effort can be diverted from objectives like making profit into manipulating and re-characterising transactions so that they fit into the tax regime that gives the best tax outcome. Although tax can be legitimately minimised, a principle of our tax system should be that transactions with identical economic effects receive the same tax treatment. This is a foundation stone for fairness and equity.

Diagram 2-1: Viewing the form and economic substance of transactions



Looking at simple business activities

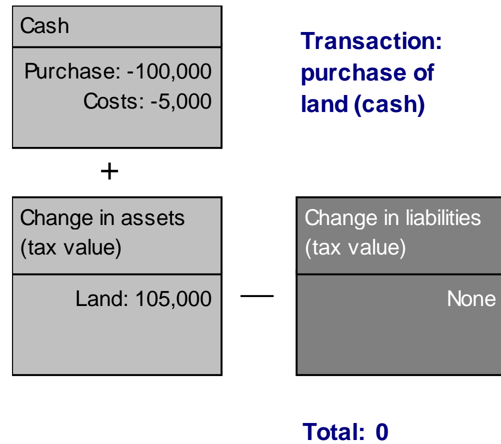
To return to calculating taxable income using the TVM, a business would look at the changes over the year in the tax value of the assets (including cash) and liabilities it holds.

The tax value depends on what kind of asset or liability it is: most assets have a tax value equal to their cost, and most liabilities have a tax value equal to the proceeds received for assuming the liability. This means their tax value does not change from year to year, so they do not have any effect on taxable income — the same as at present.

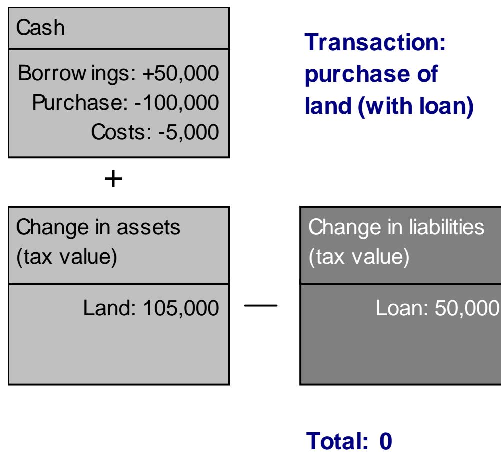
This is demonstrated in the case studies in Attachment A.

So how does it come up with results that are the same as they are now? Take an example. You buy a packet of pens for the office for $10. They are an asset, but consumables with a tax value of zero. So when it comes to looking at taxable income at year end, you will find that the value of one asset you hold — your cash — has decreased by $10 while you have acquired a new asset — the pens — which have a tax value of zero. So this purchase will decrease your taxable income by $10. The result is exactly the same as at present, where you count the purchase of pens as a deduction.

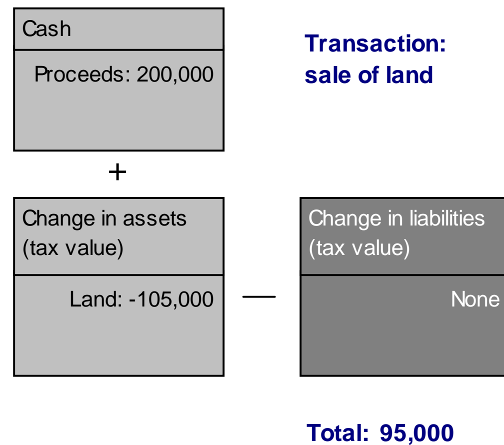
Another example. You buy a piece of land for $100,000, paying in cash. The purchase costs are $5,000. When you calculate your taxable income in the year of the purchase, your cash will have decreased by $105,000 and you will have an asset with a tax value of $105,000 — the cost of purchase. (This tax value will remain the same for the time you hold the asset, assuming you do nothing to improve the land.) The decrease in your cash matches exactly the increase in the assets you hold: the purchase would have no impact on your taxable income, the same as under current rules. However in this case there is no need to enter into the field of revenue/capital distinctions.



Say, in the same example, you paid half the price and the costs in cash, and borrowed the rest. In this case, at year end your cash will have decreased by $55,000, you will have a liability (the loan) with a tax value of $50,000 and an asset with a tax value of $105,000. Once again, the decrease in your cash, taken together with the increase in liability, exactly matches the increase in your assets — there is no tax impact.



Five years later you have paid off the loan and you sell the land for $200,000. Looking at your taxable income, your cash will have increased by $200,000 — the proceeds of the sale — and you will have lost an asset with a tax value of $105,000 (it never changed from the time you bought it). When you subtract the tax value of assets at the beginning of the year from the tax value of assets at the end, the difference is an increase of $95,000 — this will be part of your taxable income. This result is exactly the same as at present under capital gains tax laws. (Note, however, that under the TVM, investment assets will receive the same concessions as are presently available).



Looking at a year overall

It is possible to work out taxable income under the TVM in this way, transaction by transaction. But it is also possible to do it in a consolidated way. Taxable income (before applying adjustments for such things as exemptions, concessions and unused tax losses) is:

[Receipts - Payments] + [Closing tax value of assets - Opening tax value of assets] - [Closing tax value of liabilities - Opening tax value of liabilities]

This formula[19] is close to the calculations that most businesses already do year by year in finalising their accounts.

The Board has already conducted workshops with tax practitioners to see if the figures needed by the TVM can be drawn from normal financial accounts of businesses. Early results are promising, and the Board would value further input from business on this issue.

Analysing specific transactions

At present the process of analysing some business dealings to discern their tax implications is very complex. It is necessary to research which of the tax regimes apply to the transactions involved, what the rules for each are, which rules take priority in the case of overlaps and so on.

19 This is known in the prototype legislation as the 'net income formula': explanatory material Chapter 1.

In many cases the business involved would seek advice about whether it would be possible to transact the deal slightly differently to give the same effect but with a better tax treatment.

Under the TVM the analysis is much clearer. No matter what the form of the transaction, in every case the following methodology applies.

Does the activity bring a change in assets or liabilities?

Do you hold the assets or have the liabilities?

What kind of assets or liabilities are they: what is their tax value?

Are there any precedents for the tax value method?

It is also important to consider where this potential change would place our tax system in an international context. On one hand, are there other countries that use the TVM in their income tax systems? And on the other, would taking up the TVM cause problems, especially in relation to Australia's double tax treaties?

The short answer to the first question is that there is no full working model of the TVM that would serve as a case study. However, that is to be expected: income tax systems around the world are so dissimilar that it is difficult to make comparisons.

However, while no country is operating with exactly this model of calculating taxable income, the kinds of calculation involved would be familiar in most international income tax systems. Every income tax system establishes tax values for assets and liabilities, even if the term is not specifically used.

On the second question — the effect on our double tax treaties — the TVM would not cause problems for our arrangements with other countries. Australia's treaty partners and the Organisation for Economic Co-operation and Development (OECD) have been supplied with information about the TVM and none have expressed any concerns about it.

The potential benefits

These following are some of the benefits that Australia could potentially gain under a TVM approach to income tax.

Consistency in the income tax law is improved

Specific improvements that the TVM could bring to our current law include:

- adequate default treatment of business gains and expenditure, such as the elimination of 'blackhole expenses' — legitimate business expenses that cannot be claimed as tax deductions because they do not fall within the boundaries of the current system;[20]

- appropriate characterisation of transactions to ensure consistent taxation treatment, irrespective of a transaction's legal form — for example, this would overcome anomalies in the current law arising from the traditional distinction between revenue and capital;

- removal of other asymmetric treatments, such as discrepancies in the timing of deductibility for parties on each side of a transaction; and

- consequential reduction in the volume of legislation addressing specific situations, anomalies and avoidance opportunities.

These issues are dealt with in more detail in the case studies at Attachment A.

The length and complexity of the law is greatly reduced

Under the TVM the length of the law would be reduced, but more importantly, much of its complexity would be removed. This should lead to greater certainty and transparency in the law, so that business decisions could be made more reliably. It should also lead to less need for tax rulings and less litigation. See Attachment B for more detail on the possible reduction in these areas.

Examples of simpler law under the tax value method — CGT and others

Under the current income tax law, a special regime is required to include capital gains and losses in taxable income. However, the TVM automatically includes such gains and losses without the need for special rules.

This means that the prototype legislation has a much simpler tax treatment of investment assets. It dispenses with most of the extensive rules in the current law regarding CGT events, the cost base of assets, disposal proceeds, non-cash transactions and non-arm's length transactions. The only specific rules in the prototype legislation are those that:

- quarantine capital losses[21] so that they cannot be offset against other forms of income; and

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20 Review of Business Taxation recommendation 4.14 provides for deductibility for blackhole expenditures; see also Treasurer's press release dated 22 March 2001, No. 16 of 2001.

21 These are called 'investment asset losses' in the prototype TVM legislation.

- maintain concessional treatments, such as the CGT discount for individuals and superannuation funds.[22]

So far, the TVM redraft of these key CGT rules has reduced their size by more than 74 per cent (126 pages reduced to 32 pages).

Other areas of the current law that may be significantly reduced or dispensed with under the TVM include:

- recoupments of deductible expenses;[23]
- rules that treat a hire purchase arrangement as a sale and loan for tax purposes;[24] and
- rules that deny deductions under certain tax avoidance schemes.[25]

Australia has a sturdy platform for future tax changes

It will always be necessary to make changes to the income tax system. Future governments will want to give particular tax treatment to certain kinds of commercial or financial activity. Currently, there is no streamlined way to do so; it is simply a matter of *ad hoc* amendments to the existing legislation, adding further length and complexity.

With a TVM platform in place, future policy makers will have a clear framework on which to build new policy. Such policy may add detail to the law, but it will not add a greater degree of complexity, since each change would still use the same mechanism.

Effects on taxpayers

While the TVM would restructure the legal basis for determining taxable income, it is not expected to change tax outcomes, records or reporting for most taxpayers.[26]

Business records and reporting

Business taxpayers who do not currently prepare formal accounts[27] would not have to start preparing them to work out their taxable income under the TVM. Equally, business taxpayers who do currently prepare such accounts could continue to use them to work out their taxable income.

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22 This is called the 'investment asset discount' in the prototype TVM legislation.
23 Subdivision 20-A of the ITAA 1997.
24 Division 240 of the ITAA 1997.
25 Sections 82KH — 82KL of the ITAA 1936.
26 The Review of Business Taxation noted that adopting the TVM would produce the same outcome as existing methods of calculation: see *A Tax System Redesigned* at page 163.
27 That is, a Statement of Financial Position (Profit and Loss Statement) and Statement of Financial Performance (Balance Sheet).

Because the TVM is not expected to generally affect substantive outcomes of the current tax law, many areas will remain the same for the purposes of business systems and compliance, including the GST, PAYG and FBT.

Readers interested in the TVM's effect on businesses should refer to the worksheets to calculate taxable income at Attachment C and the worked examples at Attachment D.

Individual taxpayers

Individual taxpayers could still work out their taxable income under the TVM by filling in a *TaxPack* or other form, as happens now. Individuals whose main forms of income include salary or wages, interest or dividends would continue to primarily use a cash basis of accounting, as under the current income tax law.

Most private or domestic amounts continue to be excluded from the calculation of taxable income for individuals (and partnerships that include individuals). As currently occurs, individuals would need to consider cashflow for salary and any other non-private receipts and payments. Readers interested in the TVM's effect on individuals should refer to the worksheets to calculate taxable income at Attachment C and the worked examples at Attachment D.

Simplified Tax System taxpayers

The Simplified Tax System (STS) was added to the current law in 2001. It provides some measures intended to simplify the practical application of the income tax law for certain small businesses. Broadly, business taxpayers with average turnovers below $1 million may be eligible to elect into the STS.

The version of the STS included in the prototype TVM legislation largely replicates the STS. It maintains the three outcomes for taxpayers that qualify to be STS taxpayers and elect into the system. It gives them a cash accounting treatment for some transactions; it pools their tangible (and some intangible) depreciating assets and gives those pools a single, usually accelerated, rate of depreciation; and it allows them to choose not to have to bring to account small changes in trading stock values.

Readers interested in the TVM's effect on STS taxpayers should refer to the worksheets to calculate taxable income at Attachment C and the worked examples at Attachment D.

Tax practitioners

Tax practitioners, including accountants and members of the legal profession, are the main users of the income tax law. As such, they may well face significant transitional impact if the TVM were to be introduced. However, tax practitioners also stand to gain the most benefit from the TVM's long-term potential to overcome difficulties with the current law. It is primarily practitioners who face the challenge of keeping up to date with the many developments in the

present law and the difficulty of understanding rules with little interpretative guidance and unclear policy intent.

There is a need to consider the scope of re-education and skilling required if the TVM were to be implemented, and to obtain a clearer view of the likely impacts for tax practitioners. The Board has arranged for further testing to be carried out on the compliance aspects of implementing the TVM.

These issues are dealt with in more detail in Chapter 3 and Attachment B.

Superannuation and not-for profit organisations

With the focus of the present redraft being the core rules of the income tax law, many special rules and adjustments that currently apply to special categories of taxpayers have not been incorporated in full detail into the TVM prototype legislation. These categories include superannuation funds and not-for-profit organisations.

The explanatory material broadly explains how current concepts (such as, in the case of superannuation, taxable and untaxed contributions, earnings and payment of benefits) would translate into the TVM framework.[28] It is also anticipated that case studies to demonstrate how the TVM could work, similar to those for business and individual taxpayers, will be constructed in consultation with each of these sectors.

How does the tax value method fit in with the GST?

The explanatory material outlines two options for drafting the interaction between the TVM and the GST.[29] Both options would result in the same outcome as the current law, whereby GST collected and payable, together with input tax credits, does not affect the income tax base.

Options for implementing the tax value method

There are two main options for delivering a TVM-based income tax law. One is to bring all the income tax liability provisions into a single, integrated law built consistently on TVM principles and on the principles developed by the Tax Law Improvement Project that were embodied in the *Income Tax Assessment Act 1997* (ITAA 1997). Users would no longer need to consult two Acts. The main alternative option would be to deliver a TVM-based income tax law through amendments that revise and restructure the ITAA 1997. Options for implementing the TVM are outlined in more detail in Chapter 4.

28 See explanatory material Chapter 23.
29 See explanatory material Chapter 20.

Policy and costing issues

The TVM itself is intended to be revenue neutral overall, except to the extent that other policy initiatives propose variations to the existing law.[30] A status summary of these and other policy initiatives incorporated in the prototype TVM legislation is provided in Chapter 5.

30 Review of Business Taxation, recommendation 4.1(c).

3 IMPACTS OF THE TAX VALUE METHOD

Overview

This chapter discusses impacts of the current law on various segments of the community and potential impacts that may arise should a decision be made to implement the TVM from some future date.

This chapter examines:

- impacts of the current law;
- potential impacts of the TVM;
- Board's testing, evaluation and development work;
- what the findings are so far; and
- what further work needs to be done.

Impacts of the current law

In order to properly evaluate and understand the potential impacts of the TVM, the current impacts on different segments of the community (stakeholders) need to be summarised. A summary of the impacts is in Table 3-1 below.

Table 3-1: Impacts on stakeholders from processes under the current law

Stakeholders	Process	Impacts of the current law
Business generally, especially those entering complex business arrangements	Making business decisions Complying with their taxation obligations Preparing tax returns and other approved forms	Advice needed to understand complex legislation to determine and minimise tax implications. Resources being transferred from productive business processes.
Individual non business taxpayers	Completing and lodging tax returns annually	Finding the time — even for those individuals with straightforward tax affairs. The assistance of tax practitioners is often sought to: ▪ prepare and lodge returns ▪ provide advice around the treatment of CGT or negatively geared arrangements.

Stakeholders	Process	Impacts of the current law
Tax practitioners and ATO	Law interpretation Ensuring compliance with the law	Need to keep up to date with all developments. Hard to understand rules which have little interpretive guidance and unclear policy intent.
Courts, tax practitioners and ATO	Dispute resolution	Expensive litigation required because of: ▪ multiple bases for argument ▪ precedent value of decisions diminished by legislative complexity ▪ impact of judicial decisions on the whole system are hard to foresee. Court resources diverted from other issues.
Government, Parliament, Treasury, ATO and Office of Parliamentary Counsel	Policy making in response to: ▪ Government priorities ▪ business behaviour ▪ inequitable outcomes ▪ adverse court decisions.	Law making has become difficult and time consuming because of: ▪ no clear basis on which to determine policy on a whole-of-system basis. This often results in reactive responses to solutions proposed ▪ legislative complexity itself requires policy responses ▪ difficulties in explaining new law to those not well versed in tax law. There is a significant backlog of amendments which have been announced by Government as now applying but are yet to be legislated.
ATO and Office of Parliamentary Counsel	Legislating in response to policy making	Extensive, complex research is required to fit new law into existing law. This means drawn out project cycle times. No overarching principle on which to base drafting (creating heterogenous regimes), making it difficult for legislative amendments to accurately implement intended policy. Complex legislation results in technical errors which require further amendments to correct.
Software developers	Building new software and modifying existing software to reflect changes in the tax system	Software changes are required to reflect new initiatives and annual tax return changes. Adding functionality to software to improve current products and meet particular needs of individuals, businesses and tax practitioners.
ATO and business	Administering the law by: ▪ promoting and verifying compliance (for example, education) ▪ dealing with non-compliance	Complex research to match compliance activities to regimes and roles. Disparate education for the diverse range of regimes. Expanded range of information requirements. Effects from interpreting the law and resolving disputes.

Potential impacts of the tax value method

The impacts under the current law as summarised in Table 3-1 provide a good starting point from which to examine the potential impacts that may arise should the Government decide to implement TVM from some future date. These impacts are summarised in Table 3-2.

The Board's current consultation and development processes provide opportunities for these impacts to be assessed through further testing and evaluation of both the prototype legislation and related explanatory and other material.

Table 3-2: Potential impacts from the tax value method

Stakeholders	Potential impact of the tax value method
Small and medium businesses	Transition costs including: ▪ understanding and applying TVM concepts ▪ modifying existing systems, if necessary. Downstream benefits through improved compliance processes and support products (like rulings and other publications).
Large businesses	Transition costs as with small and medium businesses. Improved certainty in making business decisions and fewer disputes. Fewer resources diverted into tax planning.
Individuals not in business	Negligible transitional impact. Downstream benefits through improved compliance processes and support products (like rulings and other publications).
Tax practitioners	Significant transitional impact, particularly for those with large business clients. Need to consider scope of education and skilling involved and any potential effect on tax practitioner population. Significant medium to longer term benefits through improved processes for interpreting the law and preparing tax returns and fewer disputes.
Software developers	Expect minimal impact on business software used in the day to day business activities. This is because business transactions are expected to be recorded in the software in much the same way as now. It is anticipated that existing software used by tax practitioners to prepare tax and other returns, with suitable modifications around terminology, will enable the calculation of taxable income under the TVM. However, further analysis and evaluation is required to confirm this outcome. Major concern for software developers is that sufficient time is allowed for software changes to be implemented. They support a longer lead time for TVM development should the concept proceed and have indicated a willingness to participate in the development process.

Stakeholders	Potential impact of the tax value method
ATO	Significant transitional impact. Significant medium to longer term benefits through improved processes for interpreting the law and ensuring compliance and fewer disputes. Improved processes and shorter cycle times for legislating new policy. The degree of computer systems impacts for the ATO will mainly depend on what changes are made to tax returns. Should TVM proceed, it is important to ensure that, where possible, changes made prior to its implementation due to other tax change initiatives are consistent with and reflect TVM concepts.
Office of Parliamentary Counsel	Significant transitional impact, dependent in part on how the TVM would be implemented — see Chapter 4. Improved processes and shorter project cycle times for legislating new policy.
Treasury	Significant transitional impact. Improved processes and shorter cycle times for making and implementing new policy.
Government	Transitional political risk. Improved processes and shorter cycle times for making and implementing new policy and legislation.
Parliament	Improved processes and shorter cycle times for making and implementing new policy and legislation.

Board's testing, evaluation and development work

Formal testing and evaluation work

To better understand the likely impact of the TVM on particular taxpayers, the Board has overseen testing of the core TVM provisions in some real life situations. This testing was completed and presented at the Board's consultative conference at Coogee in July 2001.

More recently, the Board has arranged for further work to be done to:

- better understand the compliance cost implications of moving to the TVM;
- examine the claim that introducing the TVM will result in an increase in certainty from interpreting the legislation; and
- explore some alternative theories to the TVM concept.

A more detailed summary of this testing and evaluation work is provided below.

Testing the tax value method core provisions

Some initial testing of the TVM was commissioned by the Board in early 2001. This work was co-ordinated by A J Baxter & Associates, and involved the voluntary participation of Telstra Corporation Ltd, Australia Post and BHP Ltd (as it then was). The tremendous assistance given

by these companies is gratefully acknowledged. At the same time, the Board also commissioned the firm of chartered accountants, Pitcher Partners, to similarly test the TVM across a range of small and medium sized enterprises.

The key objectives of the testing were:

- to determine at an early stage whether the TVM contains any conceptual flaws so that it cannot be effectively applied;
- to identify key issues that will need to be addressed in developing the draft legislative framework; and
- to identify any early compliance issues, for example, can existing accounting and financial systems generate, or be readily adjusted to generate, the information required for TVM based taxable income calculations.

The testing involved analysing in detail more than 60 relatively complex transactions drawn from the 1999-2000 financial accounts of the three major companies, and some from small and medium enterprises (SME). Australia Post, BHP Ltd and Pitcher Partners (in relation to four SMEs) also performed recalculations of actual 1999-2000 taxable incomes based on the TVM. Taking into account the subsidiaries included in BHP's analysis, the testing embraced activities in the manufacturing, mining, petroleum, telecommunications, finance (corporate treasury) and services (postal) sectors.

Overall, the testing did not reveal any fundamental or insurmountable flaws in the TVM concept and indicated that existing accounting and financial records provided sufficient information to calculate taxable income under the TVM. While the transactional analysis did point to a range of potential issues, such as a potential for some tax timing and other differences relative to current law, the key findings of the Baxter and Pitcher analyses were that these generally could be addressed by drafting or otherwise were not fatal. Indeed, from this perspective, the analysis was extremely useful in assisting and guiding the further development of the draft legislation.

In respect of identifiable compliance issues, the essential conclusion of the testing was that '…the practical side of compliance would seem to be capable of being dealt with. Existing data will generally be sufficient but new software would be necessary for different forms of calculation.'[31] A number of potential TVM calculation methodologies were tested with varying results in terms of simplicity, but all generally confirmed that the required information was already available. This testing also showed that in some cases existing data might in fact be more easily manipulated to calculate taxable income under the TVM (eg when working from a balance sheet).

Highlighted in A J Baxter's report also was that the experience of the 20 or so people involved in the testing program '...would suggest that the basic structure of TVM is quite easy to understand

31 Yuri Grbich and Neil Warren eds, *Tax Value Method Consultative Conference* (Sydney, Australian Tax Research Foundation, 2001), p 62

and to assimilate. The calculation methodologies also were found to pose no difficulties in comprehension for a group that probably comprised a majority of accountants.'[32]

The papers presented at the July 2001 conference include more detailed reports on this testing program and are available on the Board's website at www.taxboard.gov.au.

Compliance cost implications in moving to the tax value method

The Board recently engaged Associate Professor Chris Evans and Dr Binh Tran-Nam from Australian Taxation Studies Program (ATAX) at the University of New South Wales to do further work on evaluating the compliance costs and benefits of the TVM. The objectives of this work will be to provide an independent and indicative evaluation of the potential transitional and recurrent compliance costs and benefits of the TVM for business taxpayers. Where possible, the earlier testing participants will be revisited as they already have some familiarity with the TVM concepts.

Certainty testing

The Board has commissioned the University of Melbourne (Professor Graeme Cooper) to assess whether the TVM provides more certainty. This project, which has only recently commenced and will utilise methodologies currently applied in areas of social science, is designed to elicit a quantifiable measure of the extent which the TVM enhances or detracts from the degree of certainty expressed in the current income tax law.

Alternative theories to the tax value method concept

The Board has commissioned preliminary work on a possible alternative to the TVM, referred to as 'Option 3', as part of the overall approach to evaluating the relative merits of the TVM. Under the sponsorship of the Board, the Option 3 approach is being advanced by a subgroup of the Board's TVM Working Group. The concept is only partially developed at this stage. Its proponents consider that it may offer many of the benefits of the TVM while representing a less 'radical' change to the income tax system. As with the TVM, the Board will be releasing publicly the results of work undertaken on Option 3 as it becomes available. In addition to any more general views, the Board will be formally seeking the advice of its TVM working group on the Option 3 concept as part of its overall evaluation of the TVM.

Products developed to explore tax value method impacts

Various products have been developed to examine whether the TVM would have a positive effect on the impacts outlined in Table 3-1 and meet the expectations summarised in Table 3-2. These products are summarised below.

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32 Ibid, p58.

The TVM policy intent documents

A series of high level documents (5 pages) were prepared early in the TVM development process to outline the underlying intent and key objectives of the TVM. In addition, the documents explain what the TVM is about, how it works and why it is being considered. These intent documents can be found on the Board's website at www.taxboard.gov.au.

Prototype legislation and explanatory material

The prototype legislation, as formally released by the Board on 6 March 2002, provides the legal platform as drafted to that time and from which other information products are developed to allow different segments of the community to interact with the tax system. For most taxpayers, the legislation would not be directly referred to. Instead it would be a source for the development of other products used by different segments of the community to interact with the tax system in order to meet their statutory obligations.

Examples of products which facilitate this transition include the explanatory material which accompanies the legislation, *TaxPack*, fact sheets, income tax rulings, various worksheets and instruction guides like those to calculate net capital gains, advice provided via telephone and e-mail and other similar material.

Tax practitioners, including accountants and members of the legal profession, who are in the business of ensuring their clients comply with their taxation obligations, are the main users of the taxation law and the explanatory material. The courts and judiciary also become users when disputes arise between the Commissioner and a taxpayer as to a particular interpretation. Depending on the outcome of those disputes, the Parliament and other stakeholders involved in making and amending laws could also be impacted.

Business taxpayers — worksheets to calculate taxable income under the tax value method

Worksheets for business taxpayers to calculate taxable income were developed to assist the Board in better understanding what impacts there would be on business taxpayers in calculating their taxable income under TVM. A particular concern was whether existing records and computer systems can produce the information required to calculate taxable income under TVM.

At this early stage in the TVM development process, the focus has been to better understand what would be the underlying change in methodology involved in calculating taxable income under TVM rather than what a tax return form would look like in some future year if a decision was made to implement TVM.

This approach has been taken for business taxpayers as it starts with the basic TVM concepts rather then just manipulating existing products for business taxpayers to interact with the TVM. It has provided the opportunity to examine whether the structure and concepts underlying the

TVM provide a superior platform from which to build products to support its introduction and administration.

The three worksheets, which are described more fully in Attachment C, are the:

- direct preparation approach worksheet;
- reconciling from profit and loss approach worksheet; and
- TVM formula approach worksheet (Versions 1 and 2).

Attachment D contains examples of the calculation of taxable income under the TVM for business (non STS), an STS taxpayers. The business examples demonstrate how each worksheet can be completed under the TVM using varying levels of information. Also provided for comparison is the outcome under the current law.

Individual taxpayers — changes to tax returns and related material

Work has been undertaken to examine the impacts of TVM on individual taxpayers by examining the changes required to the existing individual return form and *TaxPack* to enable these taxpayers to work out their taxable income under the TVM. An individual return form under the TVM could look very similar to the current return form as the same general categories of receipts and payments (after excluding those which are private or domestic) will be reflected in an individual's taxable income. At this stage of the development process, a complete individual return form has not been developed.

For example, concepts like assessable income and allowable deductions are not being transported into the TVM which, through its structure, will require information about amounts which increase and decrease an individual's taxable income. Salary or wages income will continue to increase taxable income under the TVM in the same way as it does now.

Attachment D contains two examples of individual taxpayers to show how they could calculate taxable income under the TVM and some of the changes to terminology that would be required to the existing individual return form and *TaxPack*. Under the TVM, it is still envisaged that *TaxPack* (or a similar publication) would provide detailed instructions to assist individual taxpayers to work out taxable income.

User design and testing workshops

The Board arranged for workshops to be conducted with business taxpayers, tax practitioners and individual taxpayer representatives. Workshops have also been conducted with representatives of the software industry. The Board views these workshops as crucial to the development and evaluation of the TVM. The workshops were intended to:

- involve users in the development of the worksheets for business taxpayers and the material developed for individual taxpayers discussed above;
- better understand the likely impacts that calculating taxable income under the TVM would have on existing systems and record keeping arrangements; and
- provide a platform whereby potential users could test the worksheets by using transactions for a recent income year.

Ten workshops were conducted for business taxpayers and their representatives and attended by about 50 participants. Several workshops have been conducted with representatives of individual taxpayers (for example, retirees) and representatives of the software industry.

Litigation case studies

Attachment A contains an analysis of both the *Metal Manufactures* and *Myer* cases. This work was done to examine the claims that the TVM would be more robust and durable than the current law. Each case analysis compares the application of the current law and the prototype legislation to the different factual situations.

Metal Manufactures case

This case[33] shows how the current law treats many transactions according to their legal form rather than their economic substance. For instance, the current law does not recognise sale and lease-back transactions according to their economic effect, which is that of finance. This example is illustrative of a wider systemic problem that has meant that, in a number of cases, the current law:

- recognises losses that will never occur; and
- has been amended in an *ad hoc* fashion to remedy these defects.

In contrast, it can be seen from the case study that the TVM platform for the rules for the taxation of financial arrangements better accords the tax treatment of transactions with their economic substance. This means that the TVM:

- is more **robust** — as only actual gains and losses are recognised; and
- is more **durable** — as fewer amendments should be required.

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33 *Commissioner of Taxation v Metal Manufacturers Ltd* (2001) 184 ALR 98; (2001) 108 FCR 150; 2001 ATC 4152.

Myer case

This case[34] analysis shows how the many, often overlapping and inconsistent, mechanisms that can apply to a single transaction under the current law would be replaced by a single mechanism under the TVM. The analysis further demonstrates how the TVM would have avoided the need to unnecessarily amend the taxation law in response to an adverse court decision. The case also shows how the single, integral approach to treating transactions under the TVM may well reduce the effort devoted to tax minimisation under the current law.

Identifying benefits for the community and the ATO

Attachment B outlines the potential benefits of the TVM on the day-to-day interactions between taxpayers and the ATO, with specific focus on the area of CGT. The analysis in the Attachment has been based on an examination of taxation rulings, taxation determinations, income tax rulings and recent cases. The results of this analysis have then been extrapolated out to ascertain potential benefits in the number of direct interactions between taxpayers and the ATO in the areas of telephone enquires, general correspondence, disputes and requests for private rulings.

Preliminary indications from the analysis are that the TVM may result in a reduction in CGT related taxation rulings and taxation determinations of up to 28 per cent and a reduction in CGT related litigation of around 60 per cent. The potential need for taxpayers to deal with the ATO on CGT matters, annually, could be reduced by the TVM as follows:

- the number of calls to the ATO by around 166,000;
- the number of requests for amendment by around 17,000;
- general correspondence by around 14,000;
- the number of objections by around 700; and
- private rulings by around 730.

While it is unlikely that the potential benefits of the TVM in other areas would be as high as for CGT, the preliminary results indicate that the TVM has the potential to result in significant savings to the community, both in terms of time and money.

What are the findings so far?

By way of general comment, workshop participants and others who have engaged with the consultation process have had difficulties in finding the time to test the various worksheets using

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34 *Commissioner of Taxation v Myer Emporium Ltd* (1987) 163 CLR 199; 87 ATC 4363.

transactions from previous years. Further testing of the worksheets will be undertaken as part of the compliance analysis being undertaken by the Board.

Business taxpayers

Following the Board's 2001 July conference, some segments of the community suggested that the TVM will require taxpayers to undertake new processes that would add to compliance costs. Examples of the processes referred to were the need to prepare and keep a Statement of Financial Position (balance sheet) and carry out annual valuations of all assets and liabilities.

The worksheets and examples in Attachments C and D clearly demonstrate that business taxpayers who do not currently prepare formal accounts would not have to start preparing them to work out taxable income under the TVM. Equally, business taxpayers who currently prepare formal statements could continue to use them to work out their taxable income under the TVM.

This conclusion is supported by the examples in Attachment D and the formal testing conducted by the Board prior to its July 2001 conference.

Tax practitioners

Feedback so far suggests that taxable income could be calculated under the TVM using the worksheets from existing systems and records.

Issues also arose around the costs (for example, education, training and skilling) of transition, compliance and the need to understand a 'new' system involving different core concepts like assets and liabilities compared to the current assessable income and deductions terminology.

There is a concern that inadequate work has been done to quantify the likely impacts for tax practitioners and the small and medium size businesses they advise. As explained above, the Board has arranged for further testing to be carried out on the compliance impacts from the TVM.

The few tax practitioners that have attended the workshops, while accepting there may be no insurmountable problems with the TVM methodology, have queried — **Is TVM better than the current system?** and **Where are the benefits from the new approach?** These are two of the key questions which need to be addressed during the current consultation process.

Individual taxpayers

The impacts on individual taxpayers from introducing the TVM is expected to be minimal. Examples of how individuals would work out their taxable income are provided in Attachment D.

Software developers

The analysis and workshops have indicated that the TVM will not have a significant impact on the accounting software used by business taxpayers.

This is not to say that there would not be changes required to accounting software as there no doubt would be. However, the impact is expected to be on the software used by accountants to meet tax obligations (for example, to prepare tax returns) rather than on the software used by business taxpayers in the day to day running of their businesses.

While the TVM changes the legislative mechanism behind transactions, it does not change the transactions themselves. For example, when a business taxpayer acquires an asset, whether for cash, credit or under a lease or hire purchase arrangement, the transaction would need to be recorded in the taxpayer's accounting software much the same as it is now. What may change is the way the accountant uses this information when calculating taxable income.

The degree of the impact on accounting software used by accountants is expected to depend on the existing structure and functionality of the software and how it is currently used. If the software is electronically linked to the taxpayer's software (for example, data from the taxpayer's business software is electronically loaded into the accountant's software and visa versa) the software changes required are expected to be greater. Whereas, if the taxpayer's software produces paper reports that are reviewed by the accountant before information is manually keyed into the accountant's software, then the impact is likely to be less.

Impacts on accounting software used by accountants

Likely changes to the accounting software used by accountants are expected to relate to: be concerned with:

- terminology (depending on whether accountants will require the new TVM terms to be reflected in their accounting software);
- classification of transactions (some changes to the chart of accounts are anticipated as, for example, accountants may wish to keep separate general ledger accounts for the book and tax value of **all** assets and liabilities); and
- report layouts (this will depend on the approach used to calculate taxable income).

For business taxpayers to calculate taxable income, initial feedback from accounting software developers is that the methodologies behind the worksheets could be accommodated in existing accounting software products.

Software developers have indicated that they want to ensure that enough time is given to implement the change requirements and that they are given the opportunity to participate in the development process.

An important issue for accounting software developers is that often the existing functionality in their systems is not used correctly. In particular, existing transactions are not always correctly classified in the taxpayer's business accounting software. While this may not present a significant problem at present, the view of some software developers is that moving to a TVM environment may mean that users of their accounting software products may need to be re-educated on how to correctly enter transactions into their system, and in particular how to correctly classify assets and liabilities.

Impacts on accounting software used by business taxpayers

Likely changes to accounting software used by business taxpayers are expected to be mainly concerned with terminology, as it may be desirable to use some of the new terms being introduced with the TVM into software products.

The analysis conducted to date indicates that the TVM is expected to have a minimal impact on accounting software products used by business taxpayers who do not currently contain a distinction between book values and tax values (that is, those who only record one value is recorded in the software).

This means that many business taxpayers would continue to use their existing record keeping approaches in maintaining a record of the tax values of assets and liabilities (whether this be via manual asset registers, spreadsheets containing depreciation worksheets or other).

Impacts on accounting software used by non business taxpayers

Although no analysis has yet been undertaken on the impact of the TVM on the software products used by non business taxpayers (for example, individual taxpayers with salary and wage, investment and rental income) it is also expected that the impact on this group would be minimal.

What further work needs to be done?

It is clearly evident that only a minor part of the taxpayer community currently has a base or working knowledge of the TVM. Accordingly, it is reasonable to say that very few people have so far been sufficiently informed to reach a considered view on the TVM potential significance and the accuracy of the various claims that have been made. What is now required is the involvement by many more people from each segment of the taxpayer community to undertake a thorough evaluation of material being released and work currently in progress.

Further consultation, simulation and discussion are important for the Board to be fully informed as to the merits or otherwise of the TVM. True engagement by the different segments of the community during the consultation period to 30 April 2002 is very important to enable the Board to properly evaluate the merits or otherwise of the TVM.

4 IMPLEMENTATION OF THE TAX VALUE METHOD

A single Act with a 'big bang' commencement

The main option for delivering a new income tax law based on the TVM is to deliver it in a single Act, at a single time. Some commentators have called this the 'big bang' option. This Act would commence on 1 July[35] of some future year. Given the size of the task involved in converting the entire existing income tax law before delivery, that future year is likely to be several years into the future.

The new Act would replace the content of both the ITAA 1997 and the ITAA 1936. Some of the content of those Acts will be transferred to a restructured *Taxation Administration Act 1953* in accordance with the plan for developing the Australian Tax Code.

Before its introduction, this new Act would continue to be developed in an integrated and consultative manner, involving interested parties from the tax practitioner, accounting, corporate finance, legal and academic spheres.

An indicative structure and arrangement of the new income tax law is set out in Chapter 24 of the explanatory material.

Supporting legislation

Application provisions to explain which transactions are covered by the new income tax law, and transitional provisions to convert from the existing law to the new income tax law, would be included in a separate Act. A further Act would amend other Commonwealth legislation (including other legislation within the Australian Tax Code) to the extent made necessary by enacting a new income tax law. These amendments would be needed as other legislation currently refers to key concepts (for example, assessable income) used in the ITAA 1936 and ITAA 1997.

Earlier spin-offs from the work of the tax value method project

There may well be some rules or features developed during the TVM's development that the Government may wish to implement in advance of the commencement of the new TVM law. These could be enacted within the framework of the old law. Some examples of such rules already identified are:

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35 Or possibly on the first day of a given income year, to accommodate taxpayers with substituted accounting periods.

- uniform cost rules;
- taxation of financial arrangements; and
- a reformed treatment of leases and other rights.

Variant: single commencement but staged enactment

A variant of the big bang option might be to enact the new income tax law in stages as tranches of the legislation are developed, but to postpone their operation until the entire conversion was complete. This retains the single commencement of the big bang option but would involve a staged enactment of law. Although the Act would have a single commencement, it would be enacted by instalments: a principal Act progressively built up by further amending Acts.

There would be some benefit in having the law enacted piece by piece like this because it would be easier for the ATO, practitioners and the public to digest and consider than a lump of legislation delivered in one go.

It would also permit Parliamentarians to focus on the legislation in stages rather than being asked to accept an extensive package at one time, which would inevitably dilute the attention they could give it.

The idea of an Act existing but not operating until some future time is not new but is fairly uncommon.

This variant, however, has disadvantages. From a design perspective, once a component of the new TVM law was approved by the Parliament any further design alterations would need to be dealt with by the Parliament. A further disadvantage is that changes to the current income tax law enacted during the development of the TVM law would require the enacted TVM rules to be continually re-visited by the Parliament to keep them up to date.

Alternative option

The main alternative to the big bang option would be to deliver a TVM-based income tax law through amendments revising and restructuring the ITAA 1997. This would involve a staged enactment of law with a staged commencement. That approach was first thought of as a way to deliver the reforms recommended by the Review of Business Taxation. The first tranche might include the core rules that are the conceptual heart of the TVM, and a set of 'conversion' provisions designed to enable the bulk of the existing law to operate in a TVM context.

At no stage has it been considered appropriate to have a new Income Tax Assessment Act operating alongside the existing two Acts. That option is explicitly rejected now.

Considerations

Advantages of the big bang option

The big bang option would bring all the income tax liability provisions into a single, integrated law built consistently on TVM principles and on the new drafting style embodied in the ITAA 1997.

The Board intends that the TVM law would continue to be developed in an open consultative way. Accordingly, as the TVM law was developed, revised versions would be available for consideration and comment. Taxpayers would be better able to identify any problem areas in a complete package than in a series of isolated pieces of legislation that only revealed their full implications when viewed against further pieces of legislation not yet drafted. In addition, when the current law is amended during the development process, the TVM rules would be updated to ensure that they reflect the current law outcomes. As a consequence there is a greater chance than under the alternative option that the new income tax law would fit together properly.

To ensure a smooth transition to the TVM, an appropriate period would be needed between the time draft legislation is introduced into Parliament and the commencement of the TVM.

Law benefits

Users would not need to consult two Acts. Under the alternative option, the interactions between the ITAA 1997 and ITAA 1936 would constantly change as parts of those Acts were converted to comply with the TVM core rules and moved to a new place.

Education benefits

Open development of the TVM will allow the community to become more aware of the TVM during its development, making the transition to the new rules easier. It might be reasonable to expect training institutions to start including the TVM in their courses on income tax as the draft law is developed.

ATO and practitioners

The big bang option will make transition to the TVM easier through a growing understanding of the principles underlying the new rules. There will be less confusion over transitional issues than would be the case under the alternative option, as new rulings and educational information will generally apply from one time — the commencement of the TVM.

Disadvantages of the big bang option

The principal benefits of the TVM would be delayed for a number of years. This might be ameliorated by the interim adoption of some of the features developed for the new income tax

law, but the main benefits would have to wait for final commencement because they flow from the effect of the TVM on the whole income tax law.

Problems with the legislation or its implementation will mostly be discovered only after it begins to apply in its entirety. Such problems may be less serious under the alternative option. There might also be lessons learnt from implementing early stages that would prevent similar problems arising in later stages. An open consultation process would minimise this problem.

Changes will be required to update ATO and taxpayer systems (for example, computer programs, methodologies, information resources) should TVM be implemented. Some preliminary work has been done in this area, but initial indications are that changes will be manageable although much more work needs to be done to evaluate the likely impacts properly. In addition to systems changes, the tax professions have expressed the need to re-educate and re-skill their members. The Board is specifically requesting submissions on costs or benefits, including transitional and compliance costs, that TVM could have on the community and, in particular, tax practitioners.[36]

There would undoubtedly be some need to amend the existing law during the development process. In some cases, this may necessitate producing two versions of amendments — one to fit into the existing law and one to update the developing TVM draft.

Advantages of the alternative option

There would probably be more thorough consultation during legislative development because taxpayers would be aware that each tranche would be likely to be enacted in a shorter timeframe. That may focus more attention than a single package which might not be enacted for many years.

The workload necessary to come to grips with the new income tax law, and particularly in changing systems, updating information and obtaining advice, would be spread over a longer period, limiting the possibly stunning effects of significant change happening at a single point.

Disadvantages of the alternative option

The timing and transitional arrangements necessary to support a staged introduction of the TVM would be complex and there is a risk that they would fail at some points. The law might produce results not intended by Parliament, or even produce no result at all in some cases. Such problems could be solved by retrospective amendment but that is undesirable. Until the work was fully completed, there would probably be a longish period of uncertainty, or even confusion, in some situations.

It may be found that provisions enacted earlier in the process could have been done better, either conceptually or textually, in the light of later work. There would be an issue about whether those earlier provisions should be amended or remain as originally enacted.

36 See Chapter 2, Attachment B and Chapter 3.

There could be a constant stream of dislocating amendments over many years, rather than a single delivery that might be absorbed in a year or two.

Preferred approach

On balance, the currently preferred approach is the big bang option. Although it has the potential to be disruptive for a time, that period is likely to be much shorter than under the alternative option, especially if the ATO, advisers, publishers and information technology suppliers prepare in good time. That consideration is highly persuasive.

However, the Board has yet to finalise its opinion and is eager for the views of others during the current consultation phase about these, or any other delivery options.

How to deliver the single Act

The rest of this chapter examines what would be required to deliver the big bang option.

Components of the legislative task

Preparing a new Income Tax Assessment Act for a single enactment is a significant legislative task. It would involve at least these elements:

- completing the 'product platform' development: the TVM core rules and other key building blocks of the new income tax law;
- completing a structure and arrangement for the new income tax law;
- developing the policy, and drafting legislation, for the Business Tax Reform measures that would be implemented through the TVM (for example, taxing of financial arrangements and reforming the treatment of leasing and rights);
- reviewing the whole of the existing income tax law,[37] deciding what needs to be retained and how it needs to be changed to operate within a TVM framework;
- preparing legislation to convert the existing income law into a TVM approach (including the transitional provisions necessary to bridge the gap between the existing law and the new); and
- maintaining an effective and open consultation process for the development of the TVM law.

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37 Including new legislation enacted during the development process.

Rulings

To minimise compliance costs for taxpayers during the transition to the TVM, there may need to be special procedures to deal with its impact on public and private rulings.

Currently, taxpayers can obtain certainty about the application of the income tax laws to their taxation arrangements by relying on public rulings or by seeking a private ruling. If the TVM proceeds, taxpayers may find that an arrangement previously covered by a public or private ruling is no longer covered by that ruling. That would occur because the law on which the ruling is based will not apply once the new income tax law takes effect.

The following suggested approach would seem appropriate but should be further developed by the ATO in consultation with taxpayers.

Public rulings

In consultation with taxpayers, the ATO would identify and prioritise issues that will require a public ruling (including product and class rulings) under the TVM with a view to issuing major rulings in draft form before the new income tax law began to apply. This would mean examining the current public rulings to identify those that need to be retained or modified, as well as identifying new public rulings that may be required.

Private rulings

Private ruling requests made before the introduction of the new income tax law into Parliament could be addressed in accordance with normal practice. The ATO could advise the taxpayer, however, that when the TVM legislation commences, the taxpayer should check their affairs and, if necessary, seek a new private ruling.

In the transition to the TVM, it is expected that the ATO could apply administrative solutions similar to those adopted in relation to Business Tax Reform — as set out in Practice Statement PS 2001/4. This would ensure minimal disruption and uncertainty flowing from the change.

Under this approach taxpayers could expect the ATO to administer the new income tax law consistently with advice given before enactment even though, strictly speaking, advice about proposed laws could only be given on an indicative, non-binding, basis. That approach would be subject to:

- the advice being given **after** the relevant new legislation was introduced into the Parliament;
- the legislation that receives Royal Assent not being materially different from the introduced legislation on which the advice was based; and
- nothing being said in the Parliament during the passage of the Bill that would alter the basis of the advice.

In the case of ATO advice which would ordinarily be in the form of a private ruling (rather than a public ruling):

- the written advice given by the ATO expressly provides that the ATO would stand by the advice if the relevant conditions are satisfied; and
- the advice is given in respect of a specific request from a taxpayer, or the taxpayer's professional adviser, and the request meets the requirements of a private binding ruling request.

If a request for a private ruling is made after the introduction of the TVM legislation into the Parliament but before Royal Assent, the advice provided by the Commissioner would probably be limited to the first year of income to which the TVM law applies.

Resources and planning

The work to convert the existing law to a TVM platform would need to be managed and balanced with the 'business as usual' work needed to meet the existing legislative priorities until the new income tax law commences.

To ensure a smooth transition to the new income tax law, tax legislation in the interim period will need to be developed in a way that will enable it to be integrated into the new income tax law.

This work would primarily involve the resources of the ATO, the Office of Parliamentary Counsel and the Treasury, and would need to involve the community as represented by taxpayers, tax professionals and their representative bodies.

The Board has already shown a strong commitment to full consultation in the development of the prototype TVM legislation. This transparency would need to continue as a feature of the development work required to implement the new tax system.

A project plan for the legislation would need to be developed through an open process and made public, so that the extent and timing of public consultation is known generally and well in advance. The re-enactment of the entire income tax law means that all substantive and textual changes would need to be clearly documented and open to scrutiny, even in those areas of the law not significantly changed by the TVM. Carrying out this scrutiny will involve a commitment of resources by independent bodies, such as those representing taxpayers or tax professionals.

5 POLICY AND REVENUE CONSEQUENCES

Overview

This chapter explains the policy and revenue issues associated with the TVM and the incorporation of TVM-related Review of Business Taxation recommendations into the prototype legislation. It also discusses the potential revenue impact of these recommendations.

Introduction

The TVM core rules, and certain key peripheral rules, are drafted such that they generally replicate the current outcomes relating to the calculation of taxable income. For instance, the calculation of taxable income would continue to be determined on an annual basis, would typically use historic cost, and would tax most gains and losses on a realisation basis.

However, it is not possible, nor would it be desirable, to apply exactly the current set of core and key peripheral rules of the ITAA 1936 and 1997 to the detailed rules of the TVM, since many of the TVM benefits derive from bringing together disparate regimes across two Acts into one unified framework. Moreover, the streamlined design of the TVM framework, with features such as uniform rules on the treatment of assets and liabilities, precludes this from occurring. Examples of standardised rules that apply to all assets and liabilities include uniform cost rules, and recognition rules regarding when assets are held or when a taxpayer has a liability.

When the TVM concept was considered as part of the Review of Business Taxation, it was intended that the TVM would not result in a broadening of the tax base and that any variation to the tax base should only occur by express intention. This is reflected in the Review of Business Taxation recommendation that the 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.[38]

In his press release of 7 August 2000, the Treasurer noted that no additional revenue is budgeted to be raised from the TVM.

38 No. 081 of 2000; see also Review of Business Taxation recommendation 4.1(c).

Review of Business Taxation recommendation for the tax value method

Table 5-1 contains a list of identified changes to current tax outcomes that would occur under the TVM and would be subject to the revenue neutrality constraint (referred to in, recommendation 4.1 of the Review of Business Taxation). It also gives an indication of the potential revenue implications. This table has been prepared through a sampling process, rather than a comprehensive assessment of the law, due to the limited timeframe available. Nevertheless, it provides an indication of the potential changes to current tax outcomes.

The changes to current tax outcomes listed in Table 5-1 have been described according to the type of impact the TVM would have, such as changing the timing of deduction or assessment. Many individual changes to outcomes within these classes result in offsetting revenue effects. For example, in the area of timing effects, the negative revenue impact of an early deduction for some transactions would be partly offset by bringing certain taxing points forward. When all changes to outcomes are brought together, preliminary costing estimates suggest that implementation of the TVM would have only a small impact on revenue.

Review of Business Taxation recommendations related to the tax value method

There are also a range of Review of Business Taxation recommendations that are closely related to the TVM and that have been incorporated into the prototype TVM legislation (see Table 5-2). These changes are important to the underlying structure of the TVM but are generally not subject to the TVM revenue constraint. Early indications are that many of these will have negative revenue implications.

These recommendations are at varying stages of policy development. Examples include the recommendations relating to the exemption principles for tax values, specific exemptions producing zero tax values, rights reforms, write-off for blackhole expenditures and uniform cost rules. Many of the changes to current tax outcomes that arise under the prototype legislation result from the rights and taxation of financial arrangements recommendations and largely affect timing nature.

Finally, not all differences to outcomes that arise in comparing the prototype TVM legislation with the current law will necessarily remain. This is because the draft legislation does not yet include many of the detailed rules for particular transactions that exist in the current law. These additional rules would be included in subsequent amendments to the draft legislation to replicate current tax outcomes.

Table 5-1: TVM prototype legislation: changes to current tax outcomes that are subject to the revenue neutrality constraint

Possible change to current tax outcome	Qualitative assessment of revenue impact
Timing differences for investment asset treatment (currently CGT treatment)	
The TVM would recognise the disposal of an asset when taxpayers' legal or equitable rights to the asset cease. For example, this would result in:	Minor overall revenue loss, with impact on revenue occurring only when the transactions straddle two financial years.
▪ delaying the taxing point from the time a contract is entered into to the time the contract is settled	Revenue negative.
▪ bringing the recognition of expenses of granting options forward from the time the options end to the time the options are created. This reflects that there is no matching asset for such expenses and therefore they are immediately written off. Currently these expenses form part of the cost bast of the options	Revenue negative.
▪ bringing the taxing point of compensation for loss or destruction forward from the time the compensation is received to the time when the right to receive the compensation arises	Revenue positive.
▪ bringing the recognition of loss or destruction of assets forward to the time the loss or destruction is discovered:	
– if there is compensation for the loss or destruction	Revenue negative.
– if there is no compensation.	Nil (current practice).
Differences in treatment of expenditure to acquire assets	
Certain expenditures incurred to acquire an asset would no longer be part of the cost of the acquired asset and therefore written down over the effective life of the asset. Instead, they could be deductible immediately. Examples for such expenditures include:	Small revenue loss.
▪ costs incurred to secure a contract for acquiring an asset	Revenue negative.
▪ expenditure used to generate knowledge internally that may eventually be protected by an intellectual property right.	Revenue negative.
Treatment of revenue assets	
The gain from selling an asset that is currently a revenue asset (that is, assets acquired for resale purpose or ventured into a business arrangement) would be subject to the TVM investment asset treatment. Entities affected by the change are individuals, insurance companies and superannuation funds.	Revenue impact depends on the relative size of gain from loss quarantine and loss from discount treatment.
Changes of tax accounting method	
Taxpayers who change from an accrual to a cash basis accounting and vice versa would be treated in a consistent manner. In particular, taxpayers would no longer be:	Small revenue change.

Possible change to current tax outcome	Qualitative assessment of revenue impact
▪ taxed twice upon the same amount when changing from an accrual to a cash basis of tax accounting	Revenue negative.
▪ excluded from tax completely on accrued amounts when changing from a cash to an accrual basis of tax accounting.	Revenue positive.

Table 5-2: TVM prototype legislation: changes to current tax outcomes arising from other recommendations[39] that are NOT subject to the revenue neutrality constraint

Change to current tax outcome	Qualitative assessment of revenue impact
Exemption principles for tax values	
Certain classes of assets and liabilities would be given a zero tax value.	To the extent that this varies from existing law, revenue impact depends on the types of assets and liabilities receiving exemption.
Determining tax values for individual taxpayers	
Individual taxpayers would not be required to determine tax values for many assets and liabilities.	Revenue impact depends on specific treatments of assets and liabilities.
Investment asset treatment (currently CGT treatment)	
Narrower definition of assets subject to investment asset treatment. Increase the tax-free threshold for private collectables from $500 to $10,000.	Revenue negative as loss of revenue from fewer loss quarantining items would more than offset gain due to fewer discount treatments.
Private use of assets	
Taxable income derived from the disposal of privately used assets, other than land, would not include any non-monetary income, receipts that reflect private use of the asset, and the corresponding proportion of expenses incurred in relation to the private use of the asset.	Revenue positive as the cost base of privately used assets is reduced.
Deductibility of blackhole expenditures	
Blackhole expenditures may become deductible.	Revenue negative; included in the Treasurer's press release of 21 September 1999.
General deductibility of interest	
Typically interest expenditure will be deductible in calculating taxable income in the year incurred.	Revenue negative; included in the Treasurer's press release of 21 September 1999.
A single meaning of 'cost'	
In determining the tax values of assets, cost has been defined to have a consistent meaning including all expenditures in bringing an asset to its present condition and location.	Minimal revenue impact as the new definition mainly simplifies application of existing law.
Rights	
Rights over non-depreciable assets will be taxed under a general framework that more closely reflects the economic substance of the arrangements.	Revenue negative; included in the Treasurer's press release of 21 September 1999.
Financial arrangements and leases	
Taxation of financial arrangements and treatment of leases are subject to ongoing development processes.	Revenue impact would depend on the nature of specific treatments.

39 There are other recommendations that are already part of the existing law.

CASE LAW UNDER THE CURRENT SYSTEM AND UNDER THE TAX VALUE METHOD

This attachment summarises the *Myer Emporium*[1] case and the *Metal Manufactures*[2] case. Each case analysis compares the current law and the prototype legislation to the different factual situations.

Myer Emporium case

What this tells us about the tax value method

- The many, often overlapping and inconsistent, mechanisms that can apply to a single transaction under the current law would be replaced by a single mechanism under the TVM.
- The time and money spent in understanding, explaining and disputing the current law will be less under the TVM.
- The single, integral approach to treating transactions under the TVM may well reduce the effort devoted to tax minimisation under the current law.

Facts

Myer Emporium entered into two transactions in March 1981. The point to the arrangement was to borrow $45 million to finance a group reorganisation but to do so in the most tax effective way.

6 March 1981

Myer Emporium lent $80 million to its subsidiary, Myer Finance, repayable on 30 June 1988, at an interest rate of 12.5 per cent per annum.

On the same day, Myer Finance paid $82,192 to Myer Emporium as interest for the first three days of the loan.

9 March 1981

Myer Emporium assigned its right to interest under the loan to Citicorp Canberra for $45.37 million payable immediately. It notified Myer Finance of the assignment and all future interest was paid directly to Citicorp.

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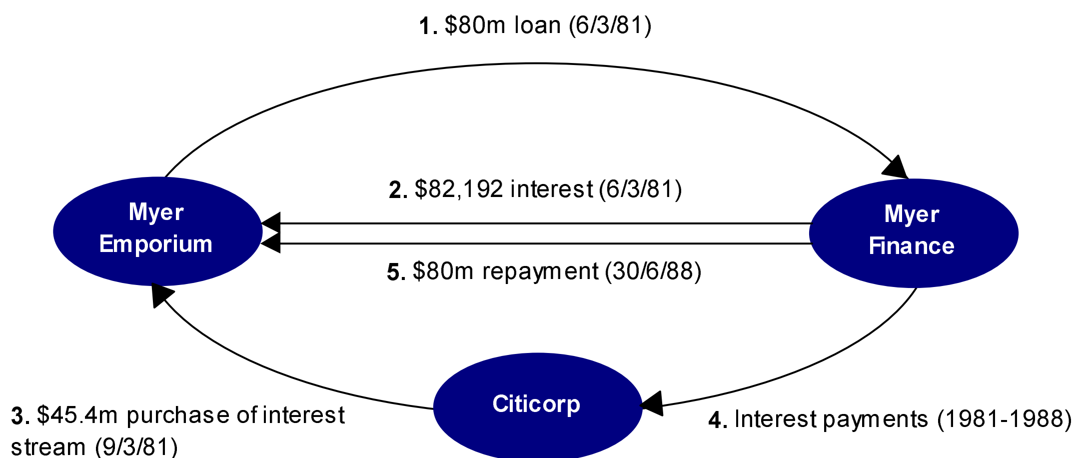
1 *FC of T v Myer Emporium Ltd* 87 ATC 4363.

2 *FC of T v Metal Manufactures Ltd* 2001 ATC 4152.

Diagram A-1: A map of the *Myer Emporium* transactions



Outcome under current law

Myer hoped to benefit from this arrangement by converting the interest stream that it would receive over the term of the loan into an immediate capital receipt (this was pre-CGT). The tax-free capital receipt would have been more than the total after tax interest receipts and would be immediate rather than spread over time.

Myer won at first instance and on appeal to the Full Federal Court. The High Court, however, upheld the Commissioner's appeal, rejecting the claim that the $45 million lump sum was capital. In its view, the receipt was income; a revenue profit made on the transaction.

Outcome under the tax value method

When Myer Emporium entered into the loan with Myer Finance, Myer Emporium would begin holding a financial asset, consisting of a right to repayment of the $80 million principal in 1988 and a right to interest over the course of the loan. When it entered into the agreement to assign the right to interest to Citicorp, the TVM would split the financial asset into the right to the principal that Myer Emporium retained and the right to interest that it transferred. The split would be done by apportioning the tax value of the original financial asset between the two new assets in accordance with their relative market values.

The TVM would bring to account the lump sum Myer Emporium received for the transfer but over the period of the loan rather than immediately. It does that by balancing the receipt with a decline in the value of the assets it holds. In accordance with the Review of Business Taxation recommendations on financial arrangements, the tax value of the remaining right to repayment of the principal would rise gradually towards the face value of the principal sum, effectively bringing the gain to account over that time.[3]

3 This proposal implements an economic point that the High Court noted in the *Myer* judgment 87 ATC 4363 at page 4371:
'If economic equivalence were the appropriate accounting basis, the debt would be brought to account at the beginning of the period in an amount less than the amount of the money lent and would increase day by day until it equalled the amount of the money lent when the period expired.'

Diagram A-2: The *Myer Emporium* transactions under the tax value method

	Receipts — Payments	+	Closing tax value of assets - Opening tax value of assets	-	Closing tax value of liabilities - Opening tax value of liabilities	=	
6/3/81	0.1m[4]-80.0m[5]	+	79.9m[7]-0	-	0-0	=	0
9/3/81	45.4m[6]-0		31.3m[8]-79.9m		0-0		-3.2m
30/6/81	0-0		32.6m[9]-31.3m		0-0		1.3m
	45.5m-80.0m		32.6m-0		0-0		-2.0m
1981-82	0-0	+	37.0m-32.6m	-	0-0	=	4.5m
1982-83	0-0	+	42.1m-37.0m	-	0-0	=	5.1m
1983-84	0-0	+	47.9m-42.1m	-	0-0	=	5.8m
1984-85	0-0	+	54.4m-47.9m	-	0-0	=	6.6m
1985-86	0-0	+	61.9m-54.4m	-	0-0	=	7.4m
1986-87	0-0	+	70.3m-61.9m	-	0-0	=	8.5m
1987-88	80.0m[10]-0	+	0[11]-70.3m	-	0-0	=	9.7m

The key observation here is that the $45.4 million gain is brought to account, not on receipt, but over the period of the loan to which it relates.[12] In conjunction with the Review of Business Taxation recommendations on financial arrangements, the TVM makes it possible to recognise financial gains on an appropriate economic basis.

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4 This is the $82,192 interest received on that day.

5 This is the $80million lent to Myer Finance.

6 This is the amount received from Citicorp for transferring the right to interest on the loan.

7 This is the tax value on 6 March 1981 of the rights to principal and the remaining interest.

8 This is the tax value on 9 March 1981 of the right to repayment of the principal. It is a proportionate share of the original financial asset's tax value at the date of transfer. The rest of the original financial asset's tax value is attributed to the right transferred. It is no longer an asset held by Myer Emporium.

9 This is the tax value on 30 June 1981 of the right to repayment of the principal. It has increased since the transfer on 9 March and will continue to increase as the time for repayment gets closer.

10 This is the $80million received when Myer Finance repays the loan.

11 There is no longer any right to either principal or interest.

12 Over that same period, Myer Finance would have been paying about $72.6 million in interest to Citicorp so that, overall, the Myer group would record a tax loss on the transaction.

Alternative treatments of Myer arrangement under the current law

The $45.4 million would be brought to account under the current law as ordinary income in accordance with the High Court's decision in the *Myer Emporium* case. However, there are also a significant number of other provisions in the law that could also apply to the Myer arrangement. This part of the attachment examines some of them.

Profit-making plans

The first of these is section 15-15 of the ITAA 1997. This provision assesses profits made from the carrying out of profit-making undertakings or plans. We know this applies to Myer arrangements because the High Court held in the *Myer* case that its predecessor (paragraph 26(a) of the ITAA 1936) applied as an alternative to the ordinary income provisions. However, the scope of the provision was limited by the Tax Law Improvement Project rewrite. Today it would only apply to any part of the profit that was not ordinary income and, even then, only if the right to the income was acquired by the transferor before 20 September 1985 (the operative date for CGT purposes).

Capital gains

And that brings us to the next provision — the capital gains regime. The original financial asset is probably a 'CGT asset' (within section 108-5 of the ITAA 1997) that was split into 2 assets — the right to repayment of the principal and the right to interest — on 9 March 1981. An alternative possibility is that it was always two CGT assets. The difference between the two possibilities is probably minimal. One caveat is that, if there were always two assets, it is possible to argue that the cost base of the right to interest was nil because the $80 million Myer Emporium lent to Myer Finance was fully devoted to the right to have that money repaid.

If it was a single CGT asset split into two, its cost base must be divided between the two new assets in a reasonable way (subsection 112-25(3) of the ITAA 1997). The most reasonable way is probably in accordance with their relative market values in this case. The cost base of the right to repayment of the principal would become $31.3 million and that of the right to interest would be $48.6 million.

When the right to interest was assigned to Citicorp, the capital gain or loss would be worked out:

- If the right to interest had no cost base, the capital gain would equal the full $45.4 million received. That amount would be included in the net capital gain that forms part of assessable income (section 102-5 of the ITAA 1997) as an instance of CGT event A1 (section 104-10 of the ITAA 1997).[13]

- However, if the cost base was $48.6 million, there would instead be a capital loss of $3.2 million. This would be counter balanced by the later gain on the discharge of the right to repayment of the principal as an instance of CGT event C2 (section 104-25 of the ITAA 1997). That later gain would be $48.7 million.

The double counting rule in section 118-20 of the ITAA 1997 could apply when a CGT gain was made. That rule is designed to prevent an amount being included in a net capital gain to the

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13 Even if Myer Emporium had been an individual or a superannuation trust, there would not be a CGT discount because the right had not been held for at least 12 months.

extent that it was elsewhere included in assessable income. Whether it applies in this case is not obvious. The amount included in assessable income under the *Myer* decision was a different amount than that received for discharging the right to repayment of the principal. Since the CGT gain is worked out on a different event, it is likely that the double counting rule is not applicable. The Commissioner tends to take a tolerant view in these cases but, technically, that means that the gain could be assessed twice.

Alienation rules

The income tax law has had an anti-alienation rule in section 102B of the ITAA 1936 for almost 40 years. That rule applies the income tax law as if a short-term transfer of income rights had not occurred. In essence, it works to assess the transferor on the income that flows from those rights. Arguably, this provision could apply to Myer-type arrangements but there are two reasons why it would not have applied to Myer itself.

First, 'short-term' means less than 7 years (subsection 102A(1) of the ITAA 1936, definition of 'prescribed date') and the Myer loan was for over 7 years. The rule in 102B extends to cases where the term 'may' be less than 7 years but there is nothing in the facts of Myer to indicate the possibility of a truncated loan term (indeed, the contract expressed the opposite intention).

Second, section 102B does not apply if the transfer was for an at least arm's length consideration (paragraph 102B(2)(c) of the ITAA 1936). No doubt we could debate whether or not the $45.4 million was an arm's length consideration but it seems likely that it was, more or less.

On the day after the Commissioner's loss in the Federal Court (his appeal from which was ultimately successful), the Government announced remedial legislation backdated to that day. That legislation was section 102CA of the ITAA 1936. In essence, it applies where 102B does not. When it applies, it includes the consideration for the transfer of a right to income in the transferor's assessable income. This provision would operate to include the $45.4 million in Myer's assessable income when the transfer occurred.

There are some issues that can complicate the operation of section 102CA. For instance, it will not always be clear:

- what was the consideration for the transfer (for example if the transfer was in satisfaction of an option it is not clear if the price paid for the option is counted in the consideration); or
- when the transfer occurred.

Stripped securities

Section 159GZ of the ITAA 1936 operates to treat a security as always having been multiple securities for the purposes of Division 16E when some of the rights under the original security are transferred. A loan is a 'security' (see subsection 159GP(1) of the ITAA 1936), so it seems clear that Division 16E could apply to a *Myer* arrangement.

Section 159GZ would divide the $80 million that Myer Emporium paid for the original security between the two securities that section 159GZ deems to have been issued, in proportion to their original market values. The issue price for the right to repayment of the $80 million ('the principal security') would become $31.3 million and the issue price for the interest stream ('the interest security') would be $48.7 million.

Division 16E would then assess the $48.7 million 'gain' on the principal security on an accruals basis over the term of the loan.

There is a doubt about how the law would treat the interest security. Because the amounts due under it seem to be periodic interest, the interest security may not be a 'qualifying security' (see subsections 159GP(1), (3) and (6) of the ITAA 1936) and therefore, may not come within the double counting rule in section 159GR of the ITAA 1936.

If that is correct, the $45.4 million lump sum received for assigning the interest security might still be assessable as ordinary income under the *Myer* decision even though $48.7 million was assessed under Division 16E as a gain under the principal security.

There is a possibility that the interest security is a 'traditional security' so that any loss on its assignment would give rise to a deduction under section 70B of the ITAA 1936. It would first have to be a 'security', of course. The term has the same meaning in section 70B as it has in Division 16E. Although it does not seem to meet the Division 16E definition (see subsection 159GP(1) of the ITAA 1936), it is arguable that, when section 159GZ deems the interest security to be a security 'for the purposes of the application of Division 16E', it also does so for the purposes of section 70B.

Even if it is therefore a traditional security, there still needs to be a loss to deduct. Unlike section 159GZ, section 70B contains no rules for working out the cost of this security, so any loss must be discernible on ordinary principles. There is an argument that the cost of the interest security is the same $48.7 million under ordinary principles that section 159GZ would produce. If that is correct, section 70B would allow a deduction for a $3.2 million loss.

Anti-avoidance measures

Finally, given that there were some scheme elements in the *Myer* circumstances, the possibility of the general anti-avoidance provision applying cannot be ruled out. The Commissioner had argued unsuccessfully that section 260 of the ITAA 1936 applied but did not take that issue to the High Court so we cannot know whether the argument might have succeeded.

It seems clearer that Part IVA of the ITAA 1936 could apply today. Had Myer been successful in its primary arguments, there would have been a 'scheme' (section 177A of the ITAA 1936) and a 'tax benefit'; viz. the exclusion of an amount of interest that would have been assessable income but for the scheme (subsection 177C(1) of the ITAA 1936). The issue would be whether Myer entered into the scheme for a purpose of obtaining that tax benefit (section 177D of the ITAA 1936). Taking into account the factors listed in that section, there is a respectable argument that Part IVA would apply.

If Part IVA did apply, the Commissioner could determine that the amount that was not included in assessable income because of the scheme should be included (subsection 177F(1) of the ITAA 1936). Presumably, the effect of that determination would be to include the amounts of interest due over the course of the loan in Myer's assessable income of the relevant years. The amount assessed ($72.6 million) would have been greater than the $45.4 million lump sum but spread over the 8 income years of the loan.

The tax value method effect on legislative treatments

Because the TVM brings all receipts to account, special regimes are not necessary to do the job:

- There is no 'ordinary income', so the point of the Myer Emporium case would be irrelevant. Is there a receipt? If yes, bring it to account.
- The profit-making plans provision is only residual in the current law and would also have no place in the TVM system. The point of that provision was to assess receipts that were not ordinary income and, as already noted, that distinction is not relevant under the TVM.
- Under the TVM, the investment asset regime serves only to provide a concessional treatment in the hands of individuals and superannuation funds for some types of gain and to quarantine some types of loss. There is no need for it to perform the role of a backup in case the main assessing provisions do not apply. The TVM draws into the tax net everything that CGT would.
- The alienation rules in section 102CA of the ITAA 1936 will not be needed. The consideration would be brought to account like any other receipt. Arguably, the short-term alienation rules in section 102B might still be necessary to prevent high taxed entities gifting income earning property to low taxed ones. Its scope might be more limited because of the rules about contributions of capital and arm's length dealings.
- The accruals regime, and the special stripped securities rules, in Division 16E of the ITAA 1936 would no longer be necessary, nor would the rules for losses on traditional securities in section 70B. The TVM rules about the tax value of financial assets would ensure that there was an economically acceptable treatment without need for special rules.
- The general anti-avoidance rule would still exist to counter tax avoidance arrangements. However, it would have no role in the Myer arrangement because the $45.4 million would have been brought to account as a receipt.

Replacing all of these regimes with one standard treatment of gains and losses means that the tax effect of this (or any other) transaction would be much easier to work out. There are no overlaps and therefore no need for rules to cope with them. There are no differences in what triggers assessment. There are no differences in when an amount is assessed. There are no differences in what amount is assessed.

What would have happened under the tax value method?

The *Myer* litigation involved the considerable, and considerably expensive, time of three different courts and 9 different judges on what was essentially a trivial matter. Had Myer entered into its arrangement under the TVM, there would have been no litigation. As now, Myer would know that the interest it received on its loan to Myer Finance would have to be brought to account. But, unlike now, it would also know that the $45.4 million it got for selling its right to that interest would have to be brought to account as well because it would know that the TVM brings **all** receipts to account. There would have been no argument about whether the receipt was income or capital in nature — the distinction would be irrelevant. It would also know that, just like the interest it replaced, the $45.4 million would be brought to account over the period of the loan. The $45.4 million receipt would be matched initially by a decline in the tax value of its

rights under the loan but, over time, the tax value of the remaining right to repayment of the principal would increase towards the full $80 million value. Those increases, representing the gain, would be accounted for as they arose.

Perhaps the most important consequence had the TVM been in place is that Myer Emporium would never have entered into the transaction in the first place. The point to the arrangement was to borrow $45 million to finance a group reorganisation but to do so in the most tax effective way. The arrangement was sold to the Myer group on this basis.[14] If the law had clearly treated economically identical arrangements in identical ways, there would have been no incentive for the group to choose a more complicated form over the simpler straight loan. One of the more obscure, but nonetheless important, benefits of the TVM may well be that less effort will be put into tax minimisation.

Metal Manufactures case — sale and lease-back

What this tells us about the tax value method

The current law treats many transactions according to their legal form rather than their economic substance. For instance, the current law does not recognise sale and lease-back transactions according to their economic effect, which is that of finance. This example is illustrative of a wider systemic problem that has meant that, in a number of cases, the current law:

- recognises losses that will never occur; and
- has been amended in an *ad hoc* fashion to remedy these defects.

In contrast, it can be seen from the following example that the TVM platform for the taxation of financial arrangements rules better aligns the tax treatment of transactions with their economic substance. This means that the TVM:

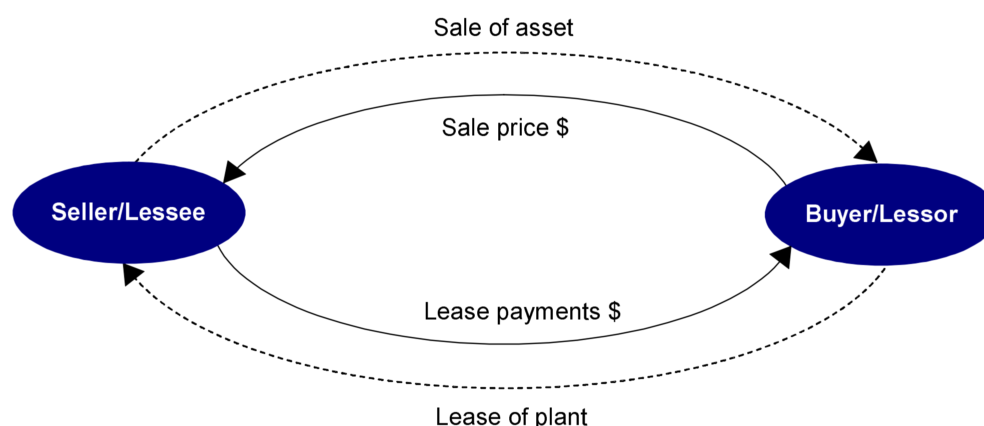
- is more **robust** — as only actual gains and losses are recognised; and
- is more **durable** — as it will not be in need of correction.

What is a 'sale and lease-back'?

A 'sale and lease-back' occurs when an asset owned and used by one entity is sold but the asset continues to be used by that entity as lessee. Sometimes, at the end of the lease the asset is sold back to the original owner.

14 See 87 ATC 4363 at page 4365.

Diagram A-3: Map of the *Metal Manufactures* transactions



What is the economic substance of a sale and lease-back?

Sale and lease-back arrangements have the economic effect of providing finance to the original owner of the asset (who becomes the lessee). For this reason these transactions fall into a wider class of arrangements known commercially as 'asset-based finance'.

In a sale and lease-back the lessee receives a sum, and in return has an obligation to make regular lease payments to the lessor. For the term of the arrangement the lessee retains the use and enjoyment of the asset and commonly has either the right, or the practical opportunity, to repurchase the asset at the end of the lease.

In other words, the lessee receives the benefit of a lump sum that they will effectively repay (with interest) over a period of time. There is no change in the underlying beneficial user of the asset as the original owner continues to use the asset and is reasonably sure to become the owner again at the end of the lease.

In these transactions, an important tax issue is what part of the lessee's payments is deductible? The entire amount or only the notional interest component?

How does the current law treat the *Metal Manufactures* case[15]

In April 1988, Metal Manufactures Ltd entered into arrangements with the State Bank of New South Wales to sell plant and equipment to them and lease it back.[16]

The initial agreement was for Metal Manufactures to receive a total of $50 million for the sale and lease the plant back for 5 years, making half-yearly lease payments of $5.265 million. Although Metal Manufactures had no **right** to reacquire the asset the effect of the agreement was to reasonably assure them that they would repurchase it at the agreed residual value of $18.75 million at the expiry of the lease. The agreement was subsequently re-financed twice.[17]

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15 *FC of T v Metal Manufactures Ltd* 2001 ATC 4152.

16 The arrangement was substantially the same in *Eastern Nitrogen v FC of T* 2001 ATC 4164, which was heard on appeal in conjunction with *Metal Manufactures*.

17 At the end of that initial period, the lease was renewed for a further 5 years, with half yearly lease payments of $1.667 million and a residual value at the end being $7.03 million. At the end of that period, the lease was again renewed with the new half-yearly lease payments of $599,117 and a residual value being $2.64 million.

For the years of income ending 31 December 1988 to 31 December 1995 inclusive[18], Metal Manufactures claimed deductions for the lease payments under subsection 51(1) of the ITAA 1936. The Commissioner did not accept that there was a valid sale of plant and disallowed all amounts, but before the Court at first instance the Commissioner conceded that the interest component would be allowable subject to evidence.

The availability of balancing charge rollovers meant that there was no significant tax effect for Metal Manufactures as a result of the sale of the plant and equipment.

What amount is deductible to the lessee?

The Commissioner submitted that the arrangement should be characterised as a loan. His argument was that the payments were in substance the making of a loan to the taxpayer of $50 million and the repayments of that loan together with interest and a balloon payment at the termination of that period. The payments were therefore to be deductible only to the extent that they represented interest.

The Court at first instance rejected the Commissioner's submission that the arrangement had all the characteristics of a loan and that the lease payments were partly capital.[19] The lease payments made by the taxpayer were, therefore, fully deductible.

The Commissioner appealed to the Full Federal Court, contending that the lease payments to the bank were (at least partly) of a capital nature.

The Full Federal Court dismissed the appeal. Although it acknowledged that the arrangement was of the nature of finance, it followed the reasoning of the Court at first instance in not accepting that the transaction should be characterised as a loan. Therefore, the lease payments made by the taxpayer were fully deductible.

That is, despite reasoning along the above lines, the Court found no basis for characterising the payments as other than to secure the right to use the plant under the lease.

How does the current law treat a sale and lease-back with a right to reacquire?

Sale and lease-back arrangements that include an option or other right for the lessee to acquire the asset will be treated as hire purchase arrangements. This is in contrast with the situation in *Metal Manufactures*, where the agreement gave the lessee no such right or option. That case demonstrates that the operation of the law distorted commercial decisions. In that case Metal Manufactures sought finance and the sale and lease-back was presented as a means to provide such finance. The choice of the sale and lease-back rather than a simple loan was coloured by the tax advantages afforded by that arrangement. In particular, the agreement did not give any right to the lessee to reacquire the asset, since that would mean the agreement would receive the less favourable tax treatment of a hire purchase.

Division 240 of the ITAA 1997 was recently legislated to give effect to the administrative practice of treating hire purchase transactions as a means of finance. Under Division 240, hire purchase transactions are treated as a 'sale and loan'. That is, the arrangements are recast as a sale of

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18 In lieu of 30 June 1989 to 30 June 1996.

19 *Metal Manufactures Ltd v FC of T* 99 ATC 5229 at 5273.

property by a financier to a buyer, financed by a loan. The purchaser is then deemed to be the owner of the asset and to make instalment payments that notionally have components of:

- non-deductible principal; and
- deductible interest.

This change has brought the treatment of hire purchase agreements in line with their economic substance, as finance. However, the decision in *Metal Manufactures* demonstrates the incongruity this creates between hire purchase agreements and the economically equivalent sale and lease-back.

The tax value method treatment of sale and lease-back transactions

In contrast to the current law, which treats sale and lease-back and hire purchase agreements differently, the TVM treats **all** asset-based finance according to the **economic effect** of the transaction, that is, as a loan. The TVM applies to the actual receipts, payments, assets and liabilities that are involved regardless of the legal form and characterisation of the overall arrangement. The result is a principled treatment that accords with the economic substance of the agreement.

The 'sale and loan' paradigm is not used under the TVM. Instead, the Division 45 tax value rules apply to give the same effect. This means that the rules in Division 240 of the ITAA 1997 would probably not be required under the TVM. As a corollary, this should mean that under the TVM, further amendments would not be required to appropriately treat the various types of asset-based finance.

What amount is 'deductible' to the lessee?

According to the *Metal Manufactures* case, the lessee would continue to hold the plant and equipment.[20] However, the tax value of the plant and equipment would be zero, since they had been fully depreciated prior to the arrangement.[21] The lessee's **right to use the asset** under the lease is ignored since they hold the asset itself.[22] Therefore, the opening and closing tax values of the lessee's assets are zero throughout the agreement.

The lessee has a liability, being the present legal obligation to make the future lease payments.[23] Initially the tax value of the liability is the proceeds of incurring it, which is what the lessee receives in return for taking on the obligation, the right to use the plant.[24] When the parties are dealing at arm's-length the lessee's liability has a market value equal to the present value of the future lease payments and the present value of the residual value at which it will repurchase the asset.[25]

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20 Section 10-20, item 1 of the table, TVM prototype legislation. Note, however thatin a conventional sale and lease-back the plant would be held under section 24-10; in the *Metal Manufactures* case the taxpayer was not successful in conveying legal title to the bank..

21 *Metal Manufactures Ltd v FC of T* 99 ATC 5229 at 5246.

22 Subsection 24-10(3), TVM prototype legislation.

23 Section 12-15, TVM prototype legislation.

24 Sections 12-40, item 4 of the table, section 76-115, item 4 of the table, and Subdivision 76-D, TVM prototype legislation.

25 The net present value is calculated by using the interest rate that is implicit in the overall agreement, that is, 13.79 per cent. This is approximately the same as the prevailing market interest rate at the time of the agreement.

The tax value at a later time is that amount inflated by the rate of return, less any payments that have been made under the liability.[26] This means that the lease payments will be partially matched by the decrease in the financial liability. The extent to which they are not matched, and so reduce net income, is the interest component on the outstanding liability.

That is, the repayments of principal will not reduce net income but payments of interest will. This means that the TVM achieves the bifurcation of the notional interest and principal repayments that aligns the tax treatment of the arrangement with its economic substance. Importantly, the TVM does so without relying on a characterisation of the transaction as a loan, but instead by analysing the transaction according to the receipts, payments, assets and liabilities involved.

For instance, assume that the initial agreement in the *Metal Manufactures* case was completed (5-year lease with resale for agreed residual). Metal Manufactures would have a $50 million receipt (on the sale), and annual payments of $10.53 million (lease payments) with a final payment of $18.75 million (the residual value for buying the plant back). For the term of the lease the lessee would also have a financial liability, being the present legal obligation to make the lease payments over the term of the lease.

26 Section 76-310, TVM prototype legislation.

Diagram A-4: The effect on Metal Manufactures' net income[27]

	[Receipts — Payments]	+	[Closing tax value of assets - Opening tax value of assets]	-	[Closing tax value of liabilities - Opening tax value of liabilities]	=	
1988-89	[90.05m[28] — 50.58m[29]]	+	[0–0[30]]	-	[32.68m[31] — 0]	=	$6.79m[32]
1989-90	[0 — 10.53m]	+	[0–0]	-	[26.02m — 32.68m]	=	-$3.87m
1990-91	[0 — 10.53m]	+	[0–0]	-	[18.44m — 26.02m]	=	-$2.95m
1991-92	[0 — 10.53m]	+	[0–0]	-	[9.81m — 18.44m]	=	-$1.91m
1992-93	[0 — 10.53m]	+	[0–0]	-	[0 — 9.81m]	=	-$0.72m
1993-94	[0 — 18.75m]	+	[0–0]	-	[0 — 0]	=	-$18.75m

Taken together, these amounts of net income are the notional interest paid on the loan of $50 million (that is, the 13.79 per cent internal rate of return).

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27 Based on an internal rate of return of 13.79 per cent on the stream of lease payments and the final sale.

28 Receipt of $50million on sale of plant and equipment plus deemed receipt of $40.05million (market value of the right to use the asset, which is equal to the market value of the future lease payments) under section 16-25, TVM prototype legislation.

29 Lease payments of $10.53million and deemed payment of $40.05million (equal to the deemed receipt).

30 The asset had a written down value of zero at the time the arrangement was entered into.

31 Initial tax value of the liability is the proceeds of assuming it, which is the $40.05million deemed receipt referred to in footnote 25. The tax value of the liability at a later time is worked out according to the formula in section 76-310 TVM prototype legislation:

[Last tax value x (1+rate) — *Reset Amounts*]

32 This recognises the gain that Metal Manufactures makes on the 'sale' of the plant and equipment. They receive $50million from the sale, of which they pay $10.53 as lease payments. At the end of the year they have a liability with a tax value of $32.68million. The difference between the net cash flows and the change in the tax value of their liabilities is the gain of $6.79million.

SOME POTENTIAL BENEFITS OF THE TAX VALUE METHOD FOR THE COMMUNITY AND THE ATO

Overview

This attachment gives a general overview of the potential benefits of the TVM by trying to put those benefits into perspective and by giving a general overview of what the potential impact of the TVM could be on rulings, cases and taxpayer interactions with the ATO.

The analysis identifies some of the benefits of the TVM by way of a potential reduction in the number and complexity of rulings, cases, telephone calls and correspondence coming into the ATO on technical issues. The main focus is on CGT, as it represents an important subject area of taxpayer interaction with the ATO.

For the purposes of this analysis, it is assumed that the explanatory memorandum that would accompany the TVM legislation will include illustrative examples of the operation of the TVM in a wide range of scenarios. The appendix to Chapter 17 of *Tax value method: explanatory material (prototype 4)*, which deals with private or domestic issues, illustrates the way this would be dealt with. It is anticipated that many issues that would otherwise have required taxation rulings or taxation determinations to explain the application of the law will not be required as the final explanatory memorandum itself will robustly deal with a wide range of issues and transactions.

The analysis is based on an examination of:

- income tax rulings and taxation rulings (both called taxation rulings for the purposes of this paper) and taxation determinations[1];
- High Court, Federal Court and AAT cases over the period 1996 to 2001; and
- private rulings and details of other taxpayer contact with the ATO.

The analysis points to the TVM providing potential benefits by way of a reduction in the need for:

- taxation rulings and taxation determinations;
- private rulings;
- litigation; and
- taxpayer contact with the ATO.

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1 The taxation rulings and determinations that are used in this attachment are those dealing with income tax assessments and that are in force at 31 January 2002. Procedural issues, archived and withdrawn rulings are excluded.

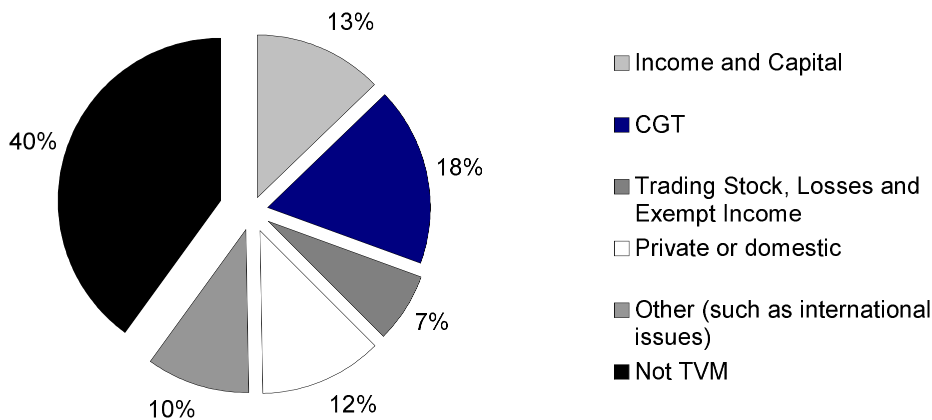
The big picture — what are the areas of confusion and dispute in the current law?

Indicators of uncertain and inconsistent law are that the Commissioner is required to:

- publicly state the ATO position in relation to an issue or issues by way of a taxation ruling or taxation determination;
- pursue litigation concerning an issue or issues; and
- provide advice on issues to taxpayers on request.

What does the ATO rule on?

Chart B-1: Rulings issues



The subject classifications in this chart are indicative only. They have been selected to give an idea of the broad subject areas on which the ATO provides taxation rulings or taxation determinations.

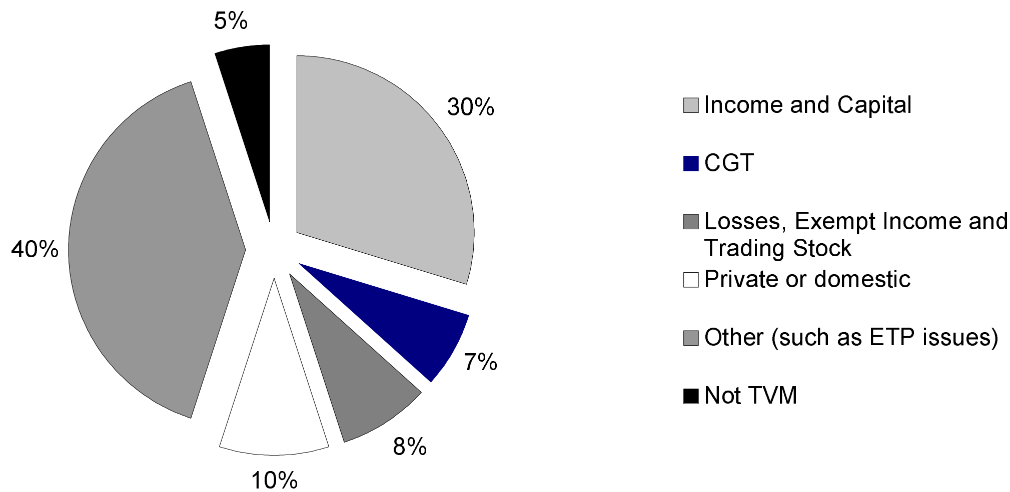
As at 31 January 2002, there were approximately 1,460 taxation rulings and taxation determinations that apply to income tax matters. Of these, approximately 40 per cent are not likely to be directly affected by the TVM as they deal with issues not involved in working out taxable income (for example, penalties or administrative issues).

Of the 1460 taxation rulings and taxation determinations, 258 (or 18 per cent) deal with CGT issues. A further 185 (or 13 per cent) deal with the distinction between income and capital. That is, they deal with the classification of income into 'taxable' revenue or 'non-taxable' capital.

This analysis has only considered current taxation rulings and taxation determinations. It has not attempted to estimate to what extent new or additional rulings might be needed under the TVM.

What does the ATO litigate?

Chart B-2: Litigated issues



The subject classifications in this chart are indicative only. They have been selected to give an idea of the broad subject areas of litigation the ATO has been involved in.

In the case of litigation, there were about 350 reported cases litigated in the High Court, Federal Court and Administrative Tribunals on income tax related matters over the period 1996 to 2001. Approximately 19 (or 5 per cent) of these cases deal with issues that are not likely to be affected by the TVM. These cases deal with issues such as penalties, onus of proof and general administrative issues.

About 25 (or 7 per cent) of the cases deal with CGT issues while a further 105 (or 30 per cent) deal with the distinction between capital and income (including deductions). That is, they deal with the classification of income into 'taxable' revenue or 'non-taxable' capital.

What is the potential impact of the tax value method using CGT as an example?

CGT represents an important area of taxpayer contact with the ATO. An analysis of the currently drafted TVM investment asset rules, which would replace the current CGT regime, indicates that there may be a reduced need for rulings and litigation.

There are 258 taxation rulings and taxation determinations on CGT issues currently in force. In addition, there have been around 25 reported cases on CGT in various venues in the last 5 years.

For the purposes of this analysis, the terms 'not affected', 'explained in the TVM legislation or explanatory material', 'not relevant' and 'yet to be drafted' are used to indicate the status of the issue under the TVM. They mean:

- **not affected** — the issue exists under the current law and would still exist under the TVM. That is, there will be a negligible impact on taxation rulings and taxation determinations and cases on the issue;
- **explained in the TVM legislation or explanatory material –** the issue under the current law will be clearly explained in the TVM legislation or explanatory material;
- **not relevant** — the issue under the current law will not exist under the TVM (such as CGT timing issues that would no longer occur under the TVM). There will be no need to rule or litigate on the issue; and
- **yet to be drafted** — the issue under the current law has yet to addressed by the TVM drafting process (for example, the main residence and rollover provisions).

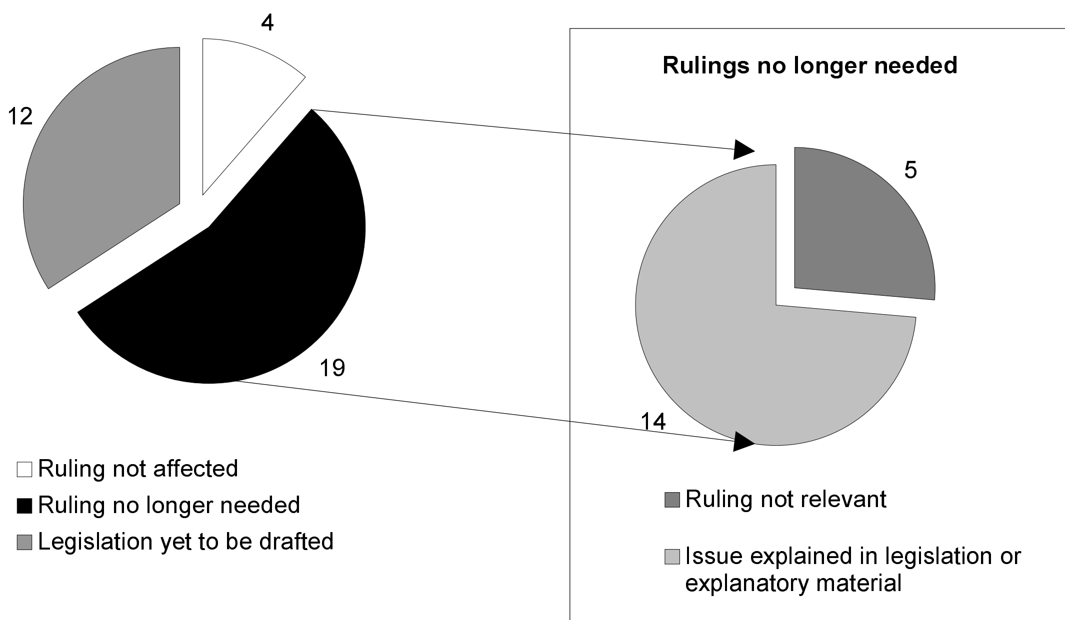
Potential impact of the tax value method on CGT taxation rulings

There are 35 taxation rulings that deal with CGT issues. Under the TVM, 19 (or 54 per cent) of these may no longer be needed, 12 (or 34 per cent) deal with issues for which the TVM legislation has yet to be drafted and 4 (or 11 per cent) are not affected by the TVM.

Of the 19 taxation rulings that may no longer be needed:

- 5 deal with issues that are not relevant under the TVM; and
- 14 deal with issues that will be explained in the TVM legislation or explanatory material.

Chart B-3: Impact of the TVM on CGT taxation rulings



Potential impact of the tax value method on CGT taxation determinations

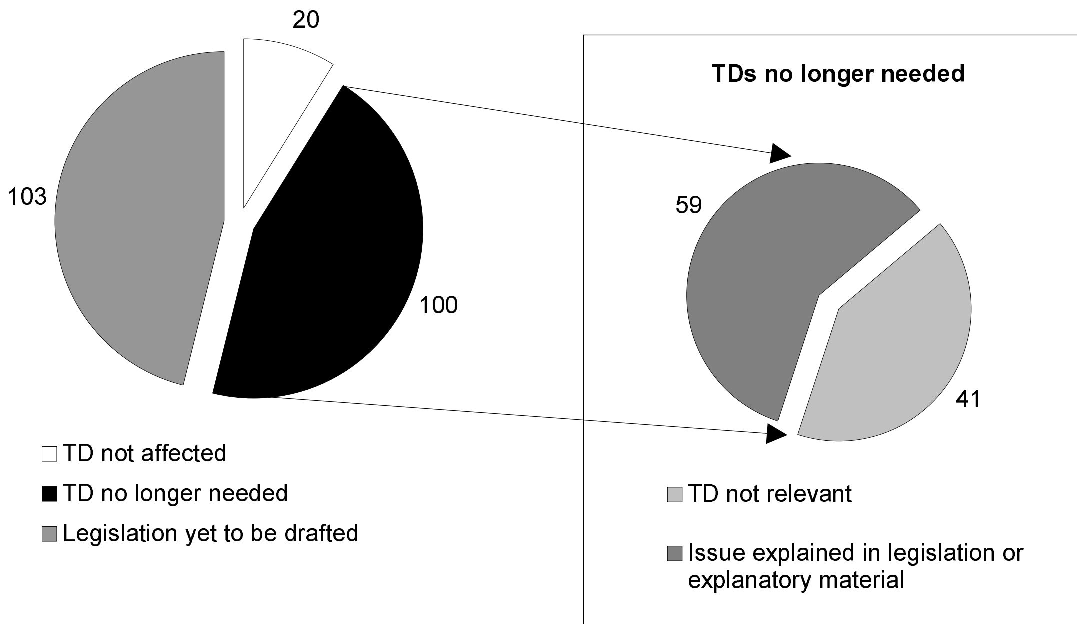
There are 223 taxation determinations that deal with CGT issues. Under the TVM, 100 (or 45 per cent) of these may no longer be needed, 103 (or 46 per cent) deal with issues for which the TVM legislation has yet to be drafted and 20 (or 9 per cent) are not affected by the TVM.

Of the 100 taxation determinations that may no longer be needed:

- 41 deal with issues that are not relevant under the TVM; and
- 59 deal with issues that will be explained in the TVM legislation or explanatory material.

Included in the 103 taxation determinations that deal with the TVM legislation that has yet to be drafted are 30 that deal with the main residence provisions and 42 that deal with the rollover provisions.

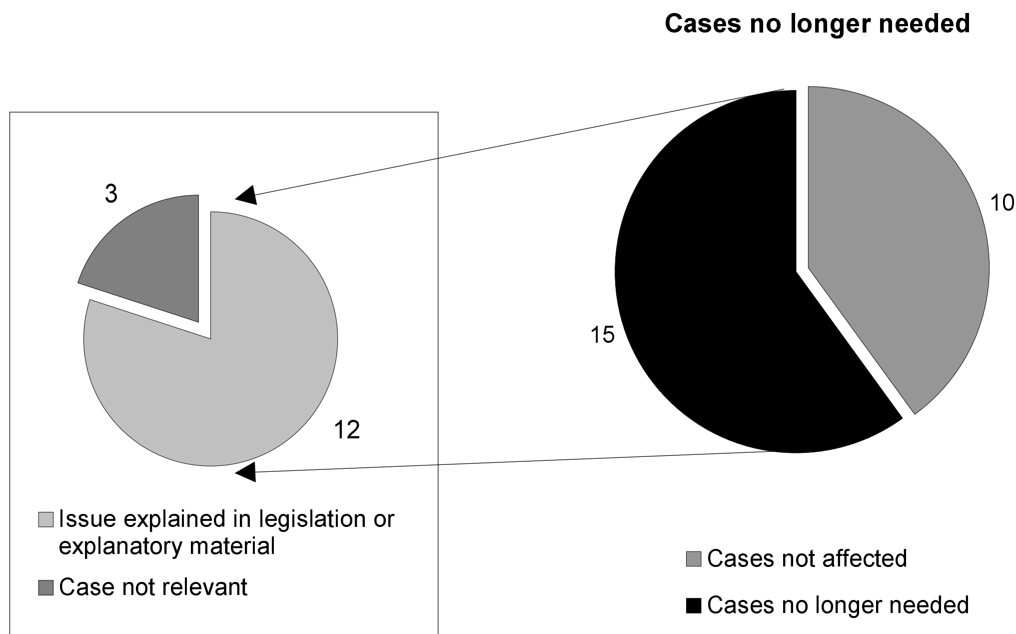
Chart B-4: Impact of the TVM on CGT taxation determinations (TDs)



Potential impact of the tax value method on CGT litigation

Out of all of the cases dealing with income tax issues, about 25 cases deal with CGT. Ten of these cases are likely to still have been litigated under the TVM, 12 would probably not have been litigated and in 3 cases the issues in dispute would not be relevant under the TVM. This represents a potential reduction of 60 per cent in the cases that are currently in force.

Chart B-5: Impact of the TVM on CGT case law



Potential impact of the tax value method on CGT correspondence, private ruling requests and telephone calls

There is a potential reduction in the need for CGT related taxation rulings and taxation determinations of, on average, around 28 per cent. This reduction is represented by those CGT issues that are not relevant under the TVM. That is, the reduction applies only to those taxation rulings and taxation determinations that will disappear under the TVM as the issue will no longer exist. In determining this figure, the numbers of taxation rulings and taxation determinations where the issues have yet to be addressed by the TVM drafting process have been excluded.

This potential reduction in the number of CGT taxation rulings and taxation determinations reflects the elimination by the TVM of a range of CGT issues that exist under the current law. For the purposes of this analysis it has been assumed that, in broad terms, this reduction would flow through to phone calls, written advice, disputes and requests for private rulings.

This assumption is based on the likelihood that where a taxation ruling or taxation determination deals with an issue that is no longer relevant under the TVM, there will be a flow through effect of a reduction in the need for phone calls, written advice, disputes and requests for private rulings on that issue. Issues that have been explained in the TVM legislation or explanatory material have been ignored. This is because the issues will still exist under the TVM and it can be expected that there will still be a level of taxpayer interaction with the ATO on those issues.

While there may be a reduction in the number of instances of taxpayer interaction with the ATO on the issues, the extent of the reduction is less clear.

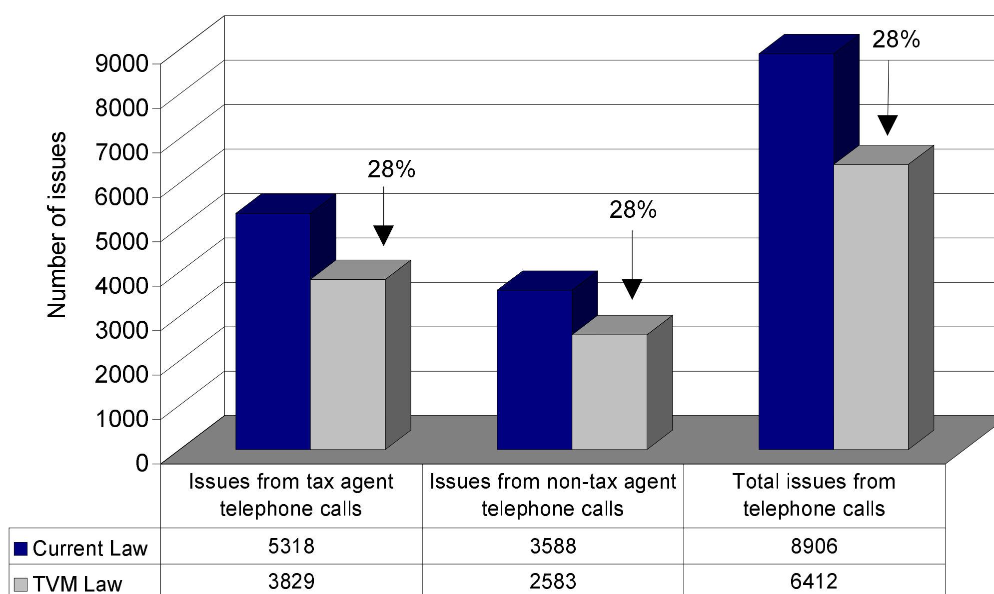
The results of the analysis of the impact of the TVM on CGT taxation rulings and taxation determinations has been applied to phone calls, written advice, disputes and requests for private rulings to give an indication of how the TVM might impact on the direct interactions between the community and the ATO on a day to day basis.

The benefits of the TVM, through the simplification of the CGT regime and the general simplification of the income tax law, have the potential to result in substantial reductions in the need for taxpayers to contact or seek advice from the ATO.

Telephone calls

In the 2000-01 financial year the ATO CGT Centre of Expertise (CoE) received phone calls on some 8,900 CGT issues. These calls came from both tax agents and non-tax agents alike. The TVM has the potential to reduce the number of phone calls by around 2,500.

Chart B-6: Impact of the TVM on issues from CGT CoE telephone calls



	Issues from tax agent telephone calls	Issues from non-tax agent telephone calls	Total issues from telephone calls
Current Law	5318	3588	8906
TVM Law	3829	2583	6412

Private rulings

In the 2000-01 financial year the ATO CGT CoE received 113 requests for private rulings on CGT issues. The TVM has the potential to reduce the number of requests for private rulings by around 32.

General correspondence

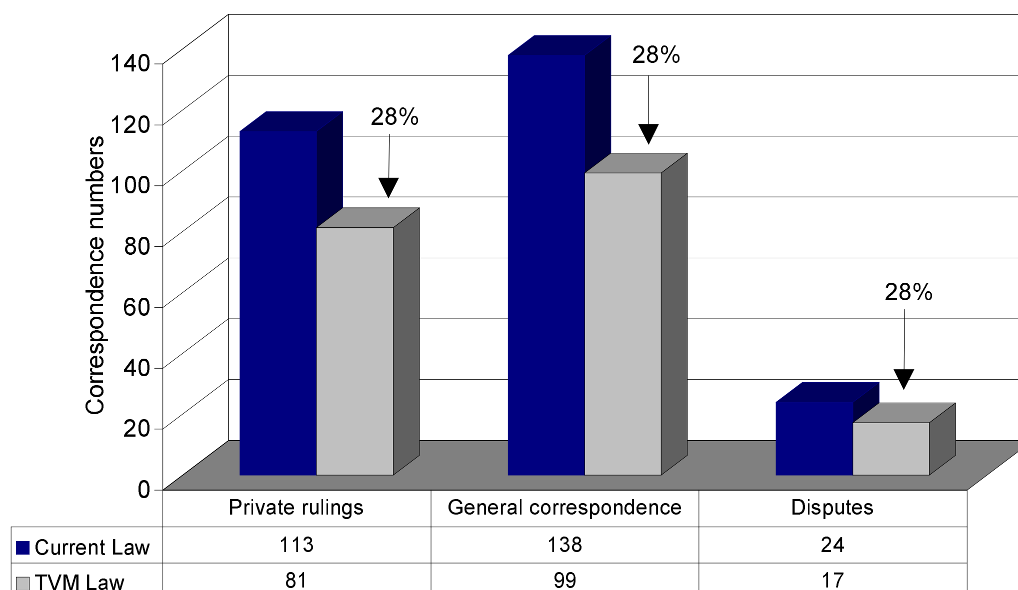
In the 2000-01 financial year the ATO CGT CoE received 138 requests for general advice on CGT issues. The TVM has the potential to reduce the number of requests for general advice by around 39.

Disputes

In the 2000-01 financial year the ATO CGT CoE received 24 disputes (or objections to assessments) on CGT issues. The TVM has the potential to reduce the number of disputes by around 7.

The chart below shows the potential impact of TVM on correspondence, requests for private rulings and disputes.

Chart B-7: Impact of the TVM on CGT CoE correspondence



Less need for ATO contact

The above analysis shows that under the TVM as currently drafted there will be less need for taxpayers to contact the ATO for advice. This reduction could be made greater by developing more informative ATO products, such as *TaxPack*, fact sheets, information guides and other educational products, to clearly set out and explain the operation of the TVM.

If an analysis of the impact of the TVM on CGT issues indicates a potential reduction of an average of 28 per cent in instances where taxpayers need to contact the ATO, then the potential benefits of the TVM, to both the community and the ATO, could be substantial.

How can the tax value method impact on the practical administration of the law?

The analysis of CGT rulings and cases indicates that there are potential benefits that can flow to the community if the TVM were adopted. Assuming that the general reduction in the need for taxation rulings and taxation determinations (from the CGT analysis) flows through to the areas of general advice (both by telephone and mail) as well as private ruling requests, there are significant potential benefits to both the ATO and the community.

For all income tax matters it deals with each year the ATO generally handles:

- over 10 million income tax returns;
- over 480,000 items of general correspondence;
- over 13,000 requests for private rulings;
- almost 6 million phone enquiries;
- over 24,000 objections; and
- over 600,000 amendments.

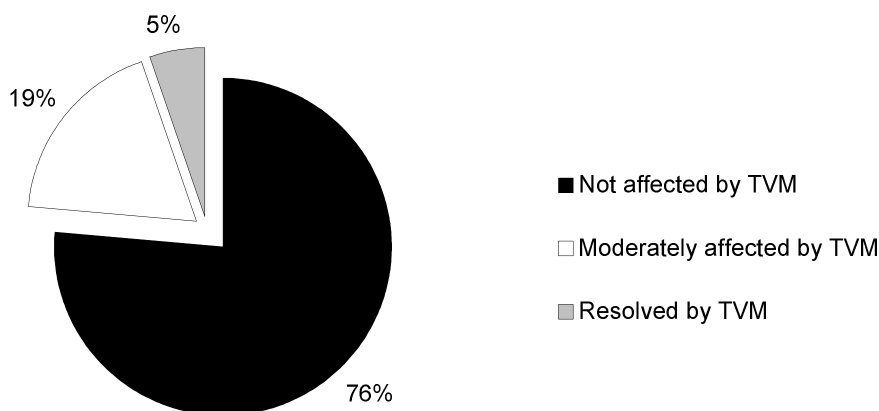
Adoption of the TVM could deliver a potential reduction in private ruling requests, disputes and telephone and written correspondence on CGT issues of, on average, about 28 per cent.

This figure is promising, but is unlikely to be reflected in the number of contacts needed with the ATO generally.

A sample of written correspondence (including requests for advice, disputes and requests for private rulings) dealt with by the ATO last year indicates that the TVM would have a small impact on ATO correspondence. There is only likely to be a reduction of between 5 to 24 per cent in the level of correspondence to the ATO. This is represented by about 5 per cent of correspondence being unlikely to be needed and up to 19 per cent of correspondence being at least moderately impacted (that is, the issue raised in the correspondence would be dealt with to some degree) by the TVM.

Even if only a 10 percent reduction is achieved, that still represents a significant reduction in the need for taxpayers to contact the ATO. For example, there could be 1,300 less requests for private rulings and up to 600,000 fewer phone calls.

Chart B-8: Impact of the TVM on ATO general correspondence



Conclusion

The differing outcomes between the analysis of the TVM's impact on CGT and general correspondence could possibly be explained by the nature of the issues raised. In the CGT context, there appears to be a higher number of specific issues raised dealing with the actual application of the tax law to work out taxable income. The proportion of issues dealing with working out taxable income is much lower in the general correspondence received by the ATO, which includes a large number of requests for various kinds of advice dealing with issues such as penalties and other administrative issues.

The analysis in this paper is preliminary only as it is based on the TVM prototype legislation as it is drafted to March 2002. More work needs to be done if the TVM law is to be further developed.

WORKSHEETS TO CALCULATE TAXABLE INCOME

Overview

This attachment contains the three worksheets which have been developed for business taxpayers to calculate taxable income under the TVM. The worksheets were developed then discussed at the user design and testing workshops referred to in Chapter 3.

The workshops were intended to inform potential users about the TVM concepts and, more importantly, to have users test those concepts by using the worksheets to calculate taxable income from actual transactions and to compare the results with outcomes obtained under the current law.

The worksheets represent the next step from the work done during the Review of Business Taxation to demonstrate how taxable income could be calculated under the TVM[1] from existing records and statements currently prepared by business.

Limited testing of the worksheets and further developments in the TVM prototype legislation have resulted in some modifications to the worksheets used in the workshops.

At the conclusion of this attachment is a guide in relation to some items referred to in the reconciling from profit and loss and the TVM formula approach worksheets.

The worksheets

The three worksheets provided below are the:

- direct preparation approach worksheet;
- reconciling from profit and loss approach worksheet; and
- TVM formula approach worksheet (versions 1 and 2).

1 See pages 206 to 213 of *A tax system redesigned.*

Direct preparation approach worksheet

This worksheet separately records items that increase and decrease taxable income under the TVM. The items reflected in the worksheet are generally those found on the current company tax return form.

Unlike the other two worksheets which specifically cater for upward and downward taxable income adjustments to reflect policy decisions, this worksheet records amounts inclusive of those adjustments rather than actual accounting figures. For example, research and development would include, in addition to the actual money spent, the current 25 per cent concession.

The main features and assumptions underlying this worksheet are:

- taxpayers do not need a Statement of Financial Performance (Profit and Loss Statement) or a Statement of Financial Position (Balance Sheet); and
- it can be prepared with the records taxpayers currently use.

Reconciling from profit and loss approach worksheet

This worksheet commences with a taxpayer's net accounting profit or loss before income tax. This worksheet reconciles the difference between profit and loss and taxable income by adjusting for the difference between book values and tax values of assets and liabilities.

The main features and assumptions underlying this worksheet are:

- taxpayers must have a Statement of Financial Performance (Profit and Loss Statement) and a Statement of Financial Position (Balance Sheet) or be able to make similar calculations;
- it is similar to the current approach used by business taxpayers, particularly companies when calculating their taxable income;
- it can be prepared from the records taxpayers currently use; and
- when the book value of assets and liabilities equals their tax value only adjustments for tax policy reasons are required to calculate taxable income.

TVM formula approach worksheet

This worksheet reflects the taxable income formula contained in the TVM prototype legislation.

Version 2 of the worksheet has been developed to reflect the legislation which provides that a taxpayer who is not an individual or a partnership with private or domestic receipts or payments can work out the receipts minus payments component of the formula by subtracting their

opening money (that is, cash including cash at bank) from their closing money[2]. This is the only difference between the two versions.

The main features and assumptions underlying these worksheets are:

- taxpayers do not need a Statement of Financial Performance (Profit and Loss Statement) or a Statement of Financial Position (Balance Sheet);
- they are more streamlined than the current methodology used by business taxpayers, particularly companies, to calculate taxable income; and
- they can be prepared with the records taxpayers currently use.

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2 See Division 6 – Taxable income, in particular, sections 6-55 and 6-60 of the prototype legislation.

TVM Taxable Income or Loss Calculator
Direct Preparation Approach

Items that increase taxable income

Item	Amount
Sales of goods and services	$
Distributions of partnership taxable income	$
Distributions from trust estates	$
Interest	$
Lease income	$
Rent	$
Dividends	$
Royalties	$
Fringe benefit employee contibutions	$
Government industry payments	$
Net investment asset gains	$
Other	$

Total **A** $

Items that decrease taxable income

Transfer the amount from B on page 2 and write it here **B** $

Unused tax losses

Item	Amount
Tax losses applied	$
Tax losses transferred in	$

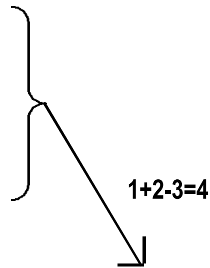
Total of unused tax losses applied this year **C** $

Taxable income or loss

Taxable income or loss (A - B - C) $

Items that decrease taxable income

Tax value of opening stock	1	$
Purchases and other costs	2	$
Tax value of closing stock	3	$



Cost of sales (opening stock + purchases and other costs - closing stock)	4	$
Distributions of partnership tax losses		$
Contractor, subcontractor and commission expenses		$
Salaries		$
Employee superannuation		$
Bad debts		$
Lease expenses within Australia		$
Lease expenses overseas		$
Rent expenses		$
Interest expenses within Australia		$
Interest expenses overseas		$
Royalty expenses within Australia		$
Royalty expenses overseas		$
Depreciation expenses		$
Motor vehicle expenses		$
Repairs and maintenance		$
Research and development		$
Other		$

Total (transfer this amount to B on page 1) **B** $

TVM Taxable Income or Loss Calculator
Reconciling from Profit & Loss Approach

Total profit or loss	A	$

Assets

	Change in book value (Closing - Opening Balance)	Change in tax value (Closing - Opening Balance)
Listed zero tax value assets	$	$ 0
Trading stock	$	$
Depreciating assets — Intangible	$	$
Tangible and IRU	$	$
Market value assets	$	$
Financial assets	$	$
Investment assets (any other asset that you hold)	$	$
Total	B1 $	B2 $

Asset change variation (B2- B1)	B	$

Liabilities

	Change in book value (Closing - Opening Balance)	Change in tax value (Closing - Opening Balance)
Listed zero tax value liabilities	$	$ 0
Depreciating liabilities	$	$
Market value liabilities	$	$
Financial liabilities	$	$
Paid up share capital	$	$
Any other liabilities	$	$
Total	C1 $	C2 $

Liability change variation (C2- C1)	C	$
(A + B - C)	D	$

From previous page **D** $

Upward adjustments

Net exempt income $

Investment assets $

Other $

Total of upward adjustments **E** $

Downward adjustments

Research and development $

Net exempt income $

Investment assets $

Other $

Total of downward adjustments **F** $

Unused tax losses

Tax losses applied $

Tax losses transferred in $

Total of unused tax losses applied this year **G** $

Taxable income or loss $
(D + E - F - G)

TVM Taxable Income or Loss Calculator
TVM Formula Approach Version 1

Receipts	$
Payments	$

Receipts minus Payments	A	$

Assets

		Closing tax value	Opening tax value
Listed zero tax value assets		$ 0	$ 0
Trading stock		$	$
Depreciating assets	Intangible	$	$
	Tangible and IRU	$	$
Market value assets		$	$
Financial assets		$	$
Investment assets (any other asset that you hold)		$	$
	Total	B1 $	B2 $

Change in tax value of assets (B1 - B2)	B	$

Liabilities

	Closing tax value	Opening tax value
Listed zero tax value liabilities	$ 0	$ 0
Depreciating liabilities	$	$
Market value liabilities	$	$
Financial liabilities	$	$
Paid up share capital	$	$
Any other liabilities	$	$
Total	C1 $	C2 $

Change in tax value of liabilities (C1 - C2)	C	$
Net income (A + B - C)	D	$

(Net income from previous page) **D** $

Upward adjustments

Income tax paid	$
Net exempt income	$
Investment assets	$
Other	$

Total of upward adjustments **E** $

Downward adjustments

Research and development	$
Net exempt income	$
Investment assets	$
Other	$

Total of downward adjustments **F** $

Unused tax losses

Tax losses applied	$
Tax losses transferred in	$

Total of unused tax losses applied this year **G** $

Taxable income or loss
(D + E - F - G) $

TVM Taxable Income or Loss Calculator
TVM Formula Approach Version 2

Money at end of year	$
Money at start of year	$
Change in money (end - start)	**A** $

Assets

		Closing tax value	Opening tax value
Listed zero tax value assets		$ 0	$ 0
Trading stock		$	$
Depreciating assets	Intangible	$	$
	Tangible and IRU	$	$
Market value assets		$	$
Financial assets		$	$
Investment assets (any other asset that you hold)		$	$
	Total	**B1** $	**B2** $

Change in tax value of assets (B1 - B2) **B** $

Liabilities

	Closing tax value	Opening tax value
Listed zero tax value liabilities	$ 0	$ 0
Depreciating liabilities	$	$
Market value liabilities	$	$
Financial liabilities	$	$
Paid up share capital	$	$
Any other liabilities	$	$
Total	**C1** $	**C2** $

Change in tax value of liabilities (C1 - C2) **C** $

Net income (A + B - C) **D** $

(Net income from previous page) | D | $

Upward adjustments

Income tax paid	$
Net exempt income	$
Investment assets	$
Other	$

Total of upward adjustments | E | $

Downward adjustments

Research and development	$
Net exempt income	$
Investment assets	$
Other	$

Total of downward adjustments | F | $

Unused tax losses

Tax losses applied	$
Tax losses transferred in	$

Total of unused tax losses applied this year | G | $

Taxable income or loss
(D + E - F - G) | $

Guide to items in the worksheets

The following tables contain information about the tax value of assets and liabilities and taxable income adjustments which are used in the worksheets.

Table C-1: Location of asset classifications in explanatory material or legislation

Asset classification	Example	Location in explanatory material or legislation
Listed zero tax value asset		
A listed zero tax value asset is an asset that is given a nil tax value. Expenditure on some of these assets (such as spare parts) will get immediate tax relief. Alternatively, where a taxpayer receives a right to a payment, treating it as a listed zero tax value asset generally defers the taxing point until the time of the payment.	Consumable stores, spare parts and office supplies that are not trading stock. A right to receive a dividend from a company.	Explanatory material paragraphs 7.115 to 7.130 Division 68 Item 1 of the table in subsection 10-40(1)
Trading stock		
Trading stock will retain a similar definition to the current law – that is, anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of business; and livestock	Newspapers and magazines purchased and held by a newsagency for sale	Explanatory material paragraphs 7.131 to 7.132 Division 70 (not yet drafted) Item 2 of the table in subsection 10-40(1)
Depreciating assets		
A depreciating asset is an asset that can be used for only a limited period However, an asset cannot be a depreciating asset if it is trading stock, a financial asset, a market value asset, a collectable or a share in a company or interest in a trust. Different rates for writing off such assets apply For tangible depreciating assets[3] the write off is based on the entity's choice between the straight-line method and the diminishing value method. For other depreciating assets the write off is broadly based on the way in which economic benefits are to be received	Physical assets of a wasting nature that decline in value because of deterioration or obsolescence Copyrights and rights to get goods or services through prepayments that have a limited lifetime due to statutory or contractual limitations	Explanatory material paragraphs 7.133 to 7.135, Chapter 12 Divisions 72 and 545-C Item 3 of the table in subsection 10-40(1)

3 Including co-ownership interests in tangible asset and IRUs (indefeasible right to use an international telecommunications submarine cable).

Asset classification	Example	Location in explanatory material or legislation
Market value assets		
A market value asset is an asset that has a tax value equal to its market value. Gains and losses from changes in the market value of these assets are included in net income each year However, this method will not apply automatically to any asset. It will only apply when a taxpayer chooses to apply it to the asset and only for certain assets whose market value is readily ascertainable	The right of a bank to receive a payment under a debt arrangement	Explanatory material paragraphs 7.136 to 7.137 Division 74 (not yet drafted) Item 4 of the table in subsection 10-40(1)
Financial assets		
A financial asset is money or a right to be paid money. It is also a right to get another financial asset[4]	Term deposit Debt due Bond	Explanatory material paragraphs 7.138 to 7.139, Chapter 14 Division 76 Items 5 of the table in subsection 10-40(1)
Investment assets		
An investment asset is an asset that does not fit into any of the other asset categories Gains and losses from investment assets are taxed when the asset is realised	Goodwill, shares in companies and units in unit trusts, land, perpetual options, and high-cost private-use collectables	Explanatory material paragraphs 7.140 to 7.149; Chapter 15 Divisions 78 and 100 Item 6 of the table in subsection 10-40(1)

4 Financial assets exclude amounts (cash and cash at bank – see section 6-55 of the prototype TVM legislation) to the extent that they have been included in the opening money or closing money figure in the Version 2 of the *TVM formula approach* worksheet.

Table C-2: Location of liability classifications in explanatory material or legislation

Liability classification	Example	Location in explanatory material or legislation
Listed zero tax value liability		
A listed zero tax value liability is a liability that is given a nil tax value. The effect on net income from incurring such a liability is deferred indefinitely or until the liability is satisfied (for example, by paying money or providing goods)	The obligation of a company to pay a dividend to its shareholders	Explanatory material paragraphs 8.68 to 8.71 Division 68 Item 1 of the table subsection 12-40(1)
Depreciating liabilities		
A depreciating liability is a liability under which economic benefits will be provided for only a limited period However, a liability cannot be a depreciating liability if it is a financial liability or the paid up capital of a company or the capital contributed to a trust. Different rates for measuring the tax value of such liabilities apply The write-off is broadly based on the way in which economic benefits are to be provided	The obligation of a dancing school to provide 10 dancing lessons to a student	Explanatory material paragraphs 8.72 to 8.73,Chapter 13 Division 72 Item 2 of the table in subsection 12-40(1)
Market value liabilities		
A market value liability is a liability that has a tax value equal to its market value. Gains and losses from changes in the market value of these liabilities are included in net income each year However, this method will not apply automatically to any liability. It will only apply when a taxpayer chooses to apply it to the liability and only for certain liabilities whose market value is readily ascertainable	The obligation of a bank to make a payment under a derivative contract	Explanatory material paragraphs 8.74 to 8.76 Division 74 (not yet drafted) Item 3 of the table in subsection 12-40(1)
Financial liabilities		
A financial liability is an obligation to pay money. It is also an obligation to provide another financial asset[5]	The obligation of a borrower to pay principal and interest under a loan contract	Explanatory material paragraphs 8.77 to 8.78, Chapter 14 Division 76 Item 4 of the table in subsection 12-40(1)

5 Financial liabilities exclude amounts (such as an overdraft see section 6-55 of the prototype legislation) to the extent that they have been included in the opening money or closing money figure in version 2 of the *TVM formula approach* worksheet.

Liability classification	Example	Location in explanatory material or legislation
Paid-up share capital		
The amount of a company's paid-up share capital is treated as a liability. A similar rule will apply for capital contributed to trusts	The amount actually paid by a shareholder to a company which is credited to its share capital account The amount of capital contributed by a unit holder in a unit trust	Explanatory material paragraphs 8.79 to 8.81 Items 5 and 6 of the table in subsection 12-40(1)
Other liabilities		
Any other liability has a tax value equal to the proceeds of incurring it	A perpetual obligation	Explanatory material paragraph 8.82 Item 7 of the table in subsection 12-40(1)

Table C-3: Location of taxable income adjustments in explanatory material or legislation

Taxable income adjustments	Example	Location in explanatory material or legislation
Taxable income adjustments will adjust net income to arrive at a taxpayer's taxable income. It can be a positive or a negative amount	See below for examples of upward and downward adjustments	Explanatory material 6.48 — 6.51 Division 95
Upward adjustments		
An upward adjustment adds to taxable income There are upward adjustments: ▪ to deal with negative net exempt income ▪ to quarantine investment asset losses ▪ for income tax paid	A taxpayer's investment asset losses exceed their investment asset gains for the year. There is an upward adjustment equal to the excess to quarantine the loss	Explanatory material table 6.3
Downward adjustments		
A downward adjustment reduces taxable income There are downward adjustments: ▪ to deal with positive net exempt income ▪ to apply carry forward investment asset losses ▪ for policy concessions such as incentives for research and development ▪ for income tax refunds	A taxpayer's investment asset gains for the income year exceed the investment asset losses for the year, and they have unapplied carry forward investment asset losses. There is a downward adjustment equal to the total of the carry forward losses applied	Explanatory material table 6.4

WORKED EXAMPLES

Overview

This attachment provides examples of how taxpayers could calculate taxable income under the TVM. The examples use the worksheets that were developed for the TVM user design and testing workshops.

The three worksheets which are described in Attachment C are the:

- direct preparation approach;
- reconciling from profit and loss approach; and
- TVM formula approach (versions 1 and 2).

The worksheets are merely illustrative and demonstrate how taxable income can be calculated under the TVM from different source documents.

The examples show that business taxpayers who do not currently prepare formal accounts would not have to start preparing them to work out their taxable income under the TVM. Equally, business taxpayers who currently prepare formal statements could continue to use them to work out their taxable income under the TVM.

This attachment is divided into three categories of examples:

- business taxpayers (non STS);
- business taxpayers (STS); and
- individual taxpayers (non-business).
- For superannuation funds, in the absence of draft legislation, Chapter 23 of the explanatory material outlines the proposed treatment. A case study is being developed from this material for further discussion with the superannuation industry.

Business taxpayers (non STS)

Each of the examples is in the form of a case study based on the Crowbar Pty Ltd (Crowbar) example in the Review of Business Taxation report July 1999 — *A Tax System Redesigned* — explanatory notes at pages 103 to 116.

Some additional transactions have been included to further explain the operation of the TVM. These transactions are:

- a CGT event — the sale of some freehold;
- a difference in valuation of trading stock for accounting and tax purposes (this is only relevant for the *Reconciling from profit and loss approach*);
- advertising asset;
- consumable stores asset; and
- superannuation payments in excess of the (current) aged based limits.

The treatment of GST has not been included in this initial phase of testing.

The detail in the *Reconciling from profit and loss approach* case study is the most comprehensive of the three case studies and most closely resembles the case study detail in the above mentioned explanatory notes. In addition to completing the *Reconciling from profit and loss approach* worksheet, the *Reconciling from profit and loss approach* case study could also be used to complete the *TVM formula approach* worksheet and the *Direct preparation approach* worksheet.

It was also recognised that not all business taxpayers maintain a full set of accounting records or prepare a *Cash flow statement*, *Statement of financial performance* and *Statement of financial position* that are included in the *Reconciling from profit and loss approach* case study. This case study was therefore modified to exclude this accounting data to show that those business taxpayers who do not maintain a full set of accounting records could also calculate their taxable income under the TVM using the *TVM formula approach* worksheet or the *Direct preparation approach* worksheet.

For comparison purposes, following these examples are calculations of taxable income for the Crowbar case study under both the current law and the methodology contained on page 211 of *A Tax System Redesigned*.

Business taxpayers (STS)

An STS business taxpayer example is also provided showing how taxable income can be calculated under the TVM using the three worksheets.

Individual taxpayers (non-business)

As discussed in Chapter 3, the impact of the TVM on individual taxpayers is expected to be minimal.

Two case studies have been developed for individuals showing how taxable income could be worked out under the TVM based on the current *TaxPack* for individuals (and *TaxPack* supplement) with some minor changes in terminology. For example, in the case studies reduction (label R) rather than deduction (label D) is used.

TaxPack could continue to provide detailed instructions for calculating the amount to show at each item of the tax return. In most cases, the calculations will be the same as under the current law. There will be the same general categories of amounts that increase taxable income (income) and amounts that decrease taxable income (deductions).

Like the current law, under the TVM, an individual's taxable income calculation will exclude receipts and payments that are private or domestic. Similar to the apportionment that happens under the current law, the return form would only show the portion of the receipts or payments that are not private or domestic.

Where payments are made that result in the acquisition of an asset, these amounts are not included in the tax return. This is because these payments have no effect on taxable income at that time, as they are matched to the increase in the tax values of assets. Such payments are described as capital payments under the current law.

The information needed by individuals to complete the tax return is not anticipated to change.

Claims for tax offsets will be unchanged by the TVM and will be made in the same way as under the current system. The TVM is only concerned with calculation of taxable income and does not affect other parts of the individual tax return such as offsets, Medicare levy surcharge or family tax benefit.

While not showing a complete return, the case studies for individuals show sections of the current return form with modifications to the terminology to illustrate how a taxpayer could go about calculating taxable income under the TVM using a return form similar to the current return form for individuals.

Business taxpayers (non STS)

Case study — Direct preparation approach

Crowbar Pty Ltd (Crowbar) is a family owned company carrying on a hardware retail business, trading as The Paint Tin. The company started in the mid-1990s with one retail outlet. Through innovative marketing and competitive pricing it has expanded to run four outlets across the metropolitan area. Crowbar owns the freehold for two of its outlets, and leases the others.

During the current financial year (Year 2) Crowbar trades profitably. The following transactions and events are relevant to the preparation of Crowbar's accounts and calculation of taxable income under this approach:

- Crowbar's accounting period and income year both run from 1 July to 30 June;
- Crowbar uses the accrual system of accounting but does not prepare financial statements;
- in Year 2 Crowbar received prepayments from customers for the highly sought after 'Nomadic Toolman' range with delivery due early in Year 3. As at the end of Year 2, $125,900 had been received;
- Crowbar sells part of its freehold for $5 million. This freehold sold cost $3 million. The indexed cost base of this freehold at the time of sale was $3.5 million (see note 3);
- the remaining freehold has a market value of $4.8 million as at the end of Year 2;
- on the last day of Year 2 Crowbar sold two trucks for $137,840. These vehicles had an adjustable value of $80,000 for tax purposes (see note 2);
- in Year 2, Crowbar paid $400,000 for new equipment (see note 2);
- Crowbar makes a $11,000 donation to a registered charity (see note 1);
- $9,000 is spent on entertaining clients (see note 1) which is not deductible under the current law;
- Crowbar had acquired 'Who Cares Hardware?', a boutique hardware business for the Z-generation of hardware enthusiasts, in a previous year. The excess of the consideration over the fair value of net assets (goodwill) was $780,000;
- Crowbar paid income tax of $765,056 and paid dividends to its shareholders of $2 million;
- Crowbar spent $24,000 on research and development (see note 1) which is eligible for an extra 25 per cent concession ($6,000) under the current law;
- Crowbar prepaid $73,448 of general operating expenses as at the end of Year 2 (see note 1);
- the inventory on hand as at the end of Year 2 has a tax value of $6,027,467. Crowbar also has stores and other consumables on hand at a cost of $10,000;

- Crowbar paid $200,000 for employee superannuation (see note 1) to the *Crowbar staff superannuation fund* (a complying fund) of which an amount of $160,000 was for two company directors ($80,000 each) who were each aged 40. The balance of $40,000 was for the other employees. The total amount eligible for deduction under the current law is $106,174;

- Crowbar has a number of loans each requiring regular repayments of principal and interest; and

- Crowbar does not have any unused tax losses.

Note: The circled numbers on the following pages cross-reference to the worksheet at the end of the case study.

Taxation records for Year 2

Receipts		Amount $
Customers — sales	2	53,630,000
Customers — prepayments		125,900
Sale of freehold		5,000,000
Interest	3	8,200
Proceeds from sale of trucks	4	137,840
Loans		2,694,000
Dividends	5	16,000
Total		**61,611,940**

Payments		Amount $
Suppliers	6	34,285,490
Other payments (note 1)		8,098,277
Income tax		765,056
Loan repayments		3,318,860
Dividends paid		2,000,000
Purchase of equipment		400,000
Total		**48,867,683**

Notes

These items are readily identifiable from Crowbar's cash book or bank statement.
The following explain how the *sales of goods and services* and *purchases and other costs* figures in the worksheet are calculated.

(2) Sales of goods and services

Customer Sales Receipts	53,630,000	
Plus: closing tax value of receivables	6,961,586	
	60,591,586	
Less: opening tax value of receivables	4,362,478	
	56,229,108	(figure in worksheet)

(6) Purchases and other costs

Supplier Payments	34,285,490	
Plus: closing tax value of trade creditors	4,101,480	
	38,386,970	
Less: opening tax value of trade creditors	5,357,656	
	33,029,314	(figure in worksheet)

Assets	Closing tax value $	Opening tax value $
Receivables(a)	(2) 6,961,586	(2) 4,362,478
Consumable stores	Nil	Nil
Inventory(b)	(7) 6,027,467	(8) 4,674,896
Prepayments(c)	73,448	Nil
Freehold(d)	1,765,769	4,765,769
Buildings, plant and equipment(e)	1,434,635	1,458,256
Goodwill(d)	780,000	780,000
Advertising	Nil	Nil
Investments (shares)(d)	243,500	243,500
Total	**17,286,405**	**16,284,899**

Notes

The tax value of the assets (a) to (e) above could come from the following records:

(a) invoices, card system, computer listing, and so on;

(b) stocktake — stock cards — computerised stock control system;

(c) record of expenses paid in advance at year end — general operating — see note 1;

(d) asset register records; and

(e) depreciation worksheet — see note 2.

Liabilities	Closing tax value $	Opening tax value $
Customer prepayments(a)	125,900	Nil
Trade creditors(b)	(6) 4,101,480	(6) 5,357,656
Accruals(c)	10,155	1,902
Loans(d)	3,745,840	4,370,700
Provision for employee entitlements(e)	130,278	98,374
Paid up capital	4,000,000	4,000,000
Total	**12,113,653**	**13,828,632**

Notes

The tax value of the liabilities (a) to (e) above could come from the following records:

(a) prepayments on the Normadic Toolman range — receipt book, card, computer listing;

(b) amounts owing to suppliers — invoices, cards, computer listing;

(c) expenses not paid at year end — advertising, electricity, postage and telephone — see note 1;

(d) loan account details; and

(e) salary accrued at year end — wages book — see note 1.

Taxable income adjustments — upward adjustments		Amount $
Superannuation	[13]	93,826
Entertainment	[10]	9,000

Taxable income adjustments — downward adjustment		Amount $
Research and development (extra 25%)	[9]	6,000

Note 1: Other payments, prepayments and accruals

Payments	Cash	Prepaid (Year 1)	Prepaid (Year 2)	Accrued (Year 1)	Accrued (Year 2)	Expense (Year 2)
Research and Development	24,000					[9] 24,000
Advertising	75,000				5,000	80,000
Electricity	48,256				2,677	50,933
Donations	11,000					11,000
Entertainment	9,000				[10]	9,000
Postage and telephone	60,373			1,902	2,478	60,949
General operating	1,867,049		73,448			1,793,601
Rent	3,750,600					[11] 3,750,600
Interest	649,320					[12] 649,320
Sub-total	**6,494,598**		**73,448**	**1,902**	**10,155**	**6,429,403**
Superannuation	200,000					[13] 200,000
Salaries	1403,679			98,374	130,278	[14] 1,435,583
Total	**8,098,277**		**73,448**	**100,276**	**140,433**	**8,064,986**

Note 2: Tax depreciation worksheet

Description of each unit	Cost	Additions Year 2	Opening adjustable value	Adjustable value on disposal	Rate %	Year 2 decline in value	Closing adjustable value
Buildings	600,000		600,000		N/A	0	600,000
Trucks	560,000		308,000	80,000	15	84,000	144,000
Computers	358,590		68,133		27	68,133	0
Equipment	876,588	400,000	482,123		15	191,488	690,635
Total	**2,395,178**	**400,000**	**1,458,256**	[4] **80,000**	[15]	**343,621**	**1,434,635**

Note 3: Investment asset worksheet

Sale of freehold — Year 2	Amount $
Cost	3,000,000
Indexed cost base	3,500,000
Sale proceeds	5,000,000
Indexed gain on sale (that is, $5,000,000 — $3,500,000) [16]	1,500,000

Crowbar Pty Ltd
TVM Taxable Income or Loss Calculator
Direct Preparation Approach

Items that increase taxable income

Item	Amount
Sales of goods and services	$ (2) *56,229,108*
Distributions of partnership taxable income	$
Distributions from trust estates	$
Interest	$ (3) *8,200*
Lease income	$
Rent	$
Dividends	$ (5) *16,000*
Royalties	$
Fringe benefit employee contibutions	$
Government industry payments	$
Net investment asset gains	$ (16) *1,500,000*
Other	$ (4) *57,840*

Total **A** $ *57,811,148*

Items that decrease taxable income

Transfer the amount from B on page 2 and write it here **B** $ *39,988,524*

Unused tax losses

Item	Amount
Tax losses applied	$
Tax losses transferred in	$

Total of unused tax losses applied this year **C** $

Taxable income or loss

Taxable income or loss (A - B - C) $ *17,822,624*

Items that decrease taxable income

Item		Amount
Tax value of opening stock	1	$ (8) 4,674,896
Purchases and other costs	2	$ (6) 33,029,314
Tax value of closing stock	3	$ (7) 6,027,467

1+2-3=4

Item		Amount
Cost of sales (opening stock + purchases and other costs - closing stock)	4	$ 31,676,743
Distributions of partnership tax losses		$
Contractor, subcontractor and commission expenses		$
Salaries		$ (14) 1,435,583
Employee superannuation		$ (13) 106,174
Bad debts		$
Lease expenses within Australia		$
Lease expenses overseas		$
Rent expenses		$ (11) 3,750,600
Interest expenses within Australia		$ (12) 649,320
Interest expenses overseas		$
Royalty expenses within Australia		$
Royalty expenses overseas		$
Depreciation expenses		$ (15) 343,621
Motor vehicle expenses		$
Repairs and maintenance		$
Research and development		$ (9) 30,000
Other		$ (10) 1,996,483
Total (transfer this amount to B on page 1)	B	$ 39,988,524

Business taxpayers (non STS)

Case study — Reconciling from profit and loss approach

Crowbar Pty Ltd (Crowbar) is a family owned company carrying on a hardware retail business, trading as The Paint Tin. The company started in the mid-1990s with one retail outlet. Through innovative marketing and competitive pricing it has expanded to run four outlets across the metropolitan area. Crowbar owns the freehold for two of its outlets, and leases the others.

During the current financial year (Year 2) Crowbar trades profitably. The following transactions and events are relevant to the preparation of Crowbar's accounts and calculation of taxable income under this approach:

- Crowbar's accounting period and income year both run from 1 July to 30 June;
- Crowbar uses the accrual system of accounting;
- Smokescreen Pty Ltd — one of Crowbar's best customers — was wound up with no possibility of making payment. Accordingly $50,000 was written off as a bad debt during Year 2;
- in Year 2 Crowbar received prepayments from customers for the highly sought after 'Nomadic Toolman' range with delivery due early in Year 3. As at the end of Year 2, $125,900 had been received ;
- Crowbar makes provisions for employee entitlements, including accrued salaries, annual leave and long service leave (see note 1 for salary details). Only the accrued salaries are allowable deductions under the current law;
- Crowbar makes provisions for future warranty claims. The provisions are not deductible under the current law;
- Crowbar sells part of its freehold for $5 million. This freehold sold cost $3 million. The indexed cost base of the freehold at the time of sale was $3.5 million (see note 4);
- the remaining freehold has a market value of $4.8 million as at the end of Year 2;
- on the last day of Year 2 Crowbar sold 2 trucks for $137,840. These vehicles had adjustable values of $100,000 and $80,000 for accounting and tax purposes respectively (see notes 2 and 3);
- in Year 2, Crowbar paid $400,000 for new equipment (see notes 2 and 3);
- the decline in value of depreciating assets is different for accounting and tax purposes (see notes 2 and 3);
- Crowbar makes a $11,000 donation to a registered charity (see note 1);
- $9,000 is spent on entertaining clients (see note 1) which is not deductible under the current law (see note 5);

- Crowbar had acquired 'Who Cares Hardware?', a boutique hardware business for the Z-generation of hardware enthusiasts, in a previous year. The excess of the consideration over the fair value of net assets (goodwill) was $780,000. This is written off for accounting purposes over 20 years, or 5 per cent per annum (see note 2);
- Crowbar paid income tax of $765,056 and paid dividends to its shareholders of $2 million;
- Crowbar spent $24,000 on research and development (see note 1) which is eligible for an extra 25 per cent concession ($6,000) under the current law (see note 5);
- Crowbar prepaid $73,448 of general operating expenses as at the end of Year 2 (see note 1);
- for Year 2 Crowbar has adopted a different valuation method for closing inventory for accounting and tax purposes. In addition, for Year 2 accounting purposes Crowbar has capitalised expenditure on stores and other consumables at cost of $10,000. For accounting purposes the inventory of $6,237,467 includes the $10,000 consumable stores (at cost). The inventory has a tax value of $6,027,467;
- for accounting purposes Crowbar has capitalised $20,000 of its $80,000 expenditure on advertising contained in note 1;
- Crowbar paid $200,000 for employee superannuation (see note 1) to the *Crowbar staff superannuation fund* (a complying fund) of which an amount of $160,000 was for two company directors ($80,000 each) who were each aged 40. The balance of $40,000 was for the other employees. The total amount eligible for deduction under the current law is $106,174 (see note 5);
- Crowbar has a number of loans each requiring regular repayments of principal and interest; and
- Crowbar does not have any unused tax losses.

Note: The circled numbers on the following pages cross-reference to the worksheet at the end of the case study.

Financial statements

Crowbar prepares the following:

- cash flow statement (Figure 1);
- statement of financial performance (profit and loss statement) (Figure 2); and
- statement of financial position (balance sheet) (Figure 3).

Figure 1: Crowbar Pty Ltd (trading as The Paint Tin)

Cash flow statement for year ended 30 June Year 2

	$	$
Cash inflows		
Receipts from customers	53,630,000	
Prepayments from customers	125,900	
Interest received	8,200	
Consideration for sale of trucks	137,840	
Sale of freehold	5,000,000	
Dividends received	16,000	
Loans received	2,694,000	61,611,940
Less cash outflows		
Payments to stock suppliers	34,285,490	
Total of other payments (see note 1)	8,098,277	
Loans repaid	3,318,860	
Purchase of new equipment	400,000	
Payment of income tax	765,056	
Payment of dividends	2,000,000	48,867,683
Net increase in cash held		**12,744,257**
Add opening cash brought forward		183,736
Closing cash carried forward		**12,927,993**

Figure 2: Crowbar Pty Ltd (trading as The Paint Tin)

Statement of Financial Performance for year ended 30 June Year 2

	$	$
Revenue		
Sales revenue	56,279,108	
Interest received	8,200	
Dividends received	16,000	
Profit on sale of trucks (see note 2)	37,840	
Total operating revenue		**56,341,148**
Less expenses		
Cost of goods sold	31,466,743	
Bad debts expense	114,117	
Advertising (see note 1)	60,000	
Electricity (see note 1)	50,933	
Rent (see note 1)	3,750,600	
Donations (see note 1)	11,000	
Entertainment (see note 1)	9,000	
Research and development (see note 1)	24,000	
Postage and telephone (see note 1)	60,949	
General operating (see note 1)	1,793,601	
Interest on loans (see note 1)	649,320	
Employee superannuation (see note 1)	200,000	
Salaries (see note 1)	1,435,583	
Amortisation expense (see note 2)	39,000	
Depreciation expense (see note 2)	293,377	
Other employment expenses	214,291	
Warranty expense	20,000	40,192,514
Net operating profit before extraordinary revenue and income tax		**16,148,634**
Add extraordinary revenue Gain on sale of freehold		2,000,000
Net profit before income tax		**18,148,634**
Less income tax expense		5,845,967
Net profit after income tax		**12,302,667**

Figure 3: Crowbar Pty Ltd (trading as The Paint Tin)

Statement of Financial Position as at 30 June Year 2

	Year 2 $		Year 1 $		Difference (Year 2 — Year 1)
Assets					
Consumable stores		10,000		0	(1) 30,000
Other intangible asset(advertising)		20,000		0	
Inventory		6,227,467		4,674,896	(3) 1,552,571
Prepayments		73,448		0	(5) 73,448
Building, plant and equipment	2,595,178		2,395,178		
Less provision for depreciation	953,507	1,641,671	760,130	1,635,048	(7) 6,623
Cash		12,927,993		183,736	
Receivables	6,961,586		4,362,478		(9) 15,279,248
Less provision for doubtful debts	158,797	6,802,789	94,680	4,267,798	
Freehold		1,765,769		4,765,769	
Goodwill	780,000		780,000		
Less accumulated amortisation	117,000	663,000	78,000	702,000	(11) -3,039,000
Investments (shares)		243,500		243,500	
Total assets		**30,375,637**		**16,472,747**	
Liabilities					
Customer prepayments		125,900		0	(15) 125,900
Trade creditors		4,101,480		5,357,656	
Accruals		10,155		1,902	(17) -1,872,783
Loans		3,745,840		4,370,700	
Provision for employee entitlements		577,241		331,046	
Provision for warranties		150,000		130,000	(21) 266,195
Provision for income tax		5,845,967		765,056	
Total liabilities		**14,556,583**		**10,956,360**	
Net assets		**15,819,054**		**5,516,387**	
Shareholder's funds					
Paid up capital		4,000,000		4,000,000	(19) 0
Retained profits		11,819,054		1,516,387,	
Total shareholder's funds		**15,819,054**		**5,516,387**	

Notes
The statement of financial position covers the year 2 and year 1 columns only.
The difference column has been added merely to assist navigation to the worksheet.
This statement has been re-ordered to assist navigation to the worksheet and accordingly, the ordering is not meant to imply that the TVM would require this format.

Note 1: Other payments, prepayments and accruals

Payments	Cash	Prepaid (Year 1)	Prepaid (Year 2)	Accrued (Year 1)	Accrued (Year 2)	Expense (Year 2)
Advertising	75,000				5,000	80,000
Electricity	48,256				2,677	50,933
Rent	3,750,600					3,750,600
Donations	11,000					11,000
Entertainment	9,000					9,000
Research and development	24,000					24,000
Postage and telephone	60,373			1,902	2,478	60,949
General operating	1,867,049		73,448			1,793,601
Interest	649,320					649,320
Sub-total	**6,494,598**	**0**	**73,448**	**1,902**	**10,155**	**6,429,403**
Superannuation	200,000					200,000
Salaries	1,403,679			98,374	130,278	1,435,583
Total	**8,098,277**	**0**	**73,448**	**100,276**	**140,433**	**8,064,986**

Note 2: Accounting amortisation and depreciation schedules

Goodwill amortisation	Year 2	Year 1
Cost	780,000	780,000
Less accumulated amortisation	117,000	78,000
	663,000	**702,000**

Buildings, plant and equipment	Cost	Additions Year 2	WDV disposals Year 2	Effective life	Year 2 depreciation	Year 1 depreciation
Buildings	600,000			25	24,000	24,000
Trucks	560,000		100,000	8	70,000	70,000
Computers	358,590			5	71,718	71,718
Equipment	876,588	400,000		10	127,659	87,659
Total	**2,395,178**	**400,000**	**100,000**		**293,377**	**253,377**

Buildings	**Year 2**	**Year 1**
Cost	600,000	600,000
Less provision for depreciation	96,000	72,000
	504,000	**528,000**

Computers	**Year 2**	**Year 1**
Cost	358,590	358,590
Less provision for depreciation	286,872	215,154
	71,718	**143,436**

Trucks	**Year 2**	**Year 1**
Cost	*360,000	560,000
Less provision for depreciation	180,000	210,000
	180,000	**350,000**

Equipment	**Year 2**	**Year 1**
Cost	1,276,588	876,588
Less provision for depreciation	390,635	262,976
	885,953	**613,612**

* Sold 2 trucks at end of Year 2 with cost of $200,000 for $137,840.

Sale of trucks	**$**
Consideration	137,840
Less WDV	100,000
	37,840

Buildings, plant and equipment	**Year 2**	**Year 1**
Cost	2,595,178	2,395,178
Less provision for depreciation	953,507	760,130
	1,641,671	1,635,048

Taxation records for Year 2

Tax value of assets and liabilities

In addition to its accounting records Crowbar also maintains details of the tax value of its assets and liabilities. Some assets will be valued differently for accounting and tax purposes (for example, trading stock). The following are details of the tax values of Crowbar's assets and liabilities for Year 2:

Assets	Closing tax value $	Opening tax value $		Difference $
Advertising	Nil	Nil	2	
Consumable stores	Nil	Nil		
Inventory	6,027,467	4,674,896	4	1,352,571
Prepayments	73,448	Nil	6	73,448
Buildings, plant and equipment (see note 3)	1,434,635	1,458,256	8	-23,621
Receivables	6,961,586	4,362,478	10	15,343,365
Cash	12,927,993	183,736		
Goodwill	780,000	780,000		
Investments (shares)	243,500	243,500	12	-3,000,000
Freehold	1,765,769	4,765,769		
Total	**30,214,398**	**16,468,635**		

Liabilities	Closing tax value $	Opening tax value $		Difference $
Customer prepayments	125,900	Nil	16	125,900
Trade creditors	4,101,480	5,357,656		
Accruals	10,155	1,902	18	-1,872,783
Loans	3,745,840	4,370,700		
Paid up capital	4,000,000	4,000,000	20	0
Provision for employee entitlements	130,278	98,374	22	31,904
Total	**12,113,653**	**13,828,632**		

Note 3: Tax depreciation worksheet

Description of each unit	Cost	Additions Year 2	Opening adjustable value	Adjustable value on disposal	Rate %	Year 2 decline in value	Closing adjustable value
Buildings	600,000		600,000		N/A	0	600,000
Trucks	560,000		308,000	80,000	15	84,000	144,000
Computers	358,590		68,133		27	68,133	0
Equipment	876,588	400,000	482,123		15	191,488	690,635
Total	**2,395,178**	**400,000**	**1,458,256**	**80,000**		**343,621**	**1,434,635**

Note 4: Investment asset worksheet

Sale of freehold — Year 2	Amount $
Cost	3,000,000
Indexed cost base	3,500,000
Sale proceeds	5,000,000
Indexed gain on sale (that is, $5,000,000 — $3,500,000)	1,500,000

Note 5: Taxable income adjustments

Upward adjustments	Amount $
Superannuation	93,826
Entertainment	9,000
Total (23)	**102,826**

Downward adjustments	Amount $
Research and development (extra 25%) (24)	6,000
Investment assets (CGT indexation — see note 4) (25)	500,000
Total	**506,000**

Crowbar Pty Ltd
TVM Taxable Income or Loss Calculator
Reconciling from Profit & Loss Approach

Total profit or loss	A	$ *18,148,634*

Assets

	Change in book value (Closing - Opening Balance)	Change in tax value (Closing - Opening Balance)
Listed zero tax value assets	$ ① *30,000*	$ ② *0*
Trading stock	$ ③ *1,552,571*	$ ④ *1,352,571*
Depreciating assets — Intangible	$ ⑤ *73,448*	$ ⑥ *73,448*
Depreciating assets — Tangible and IRU	$ ⑦ *6,623*	$ ⑧ *-23,621*
Market value assets	$	$
Financial assets	$ ⑨ *15,279,248*	$ ⑩ *15,343,365*
Investment assets (any other asset that you hold)	$ ⑪ *-3,039,000*	$ ⑫ *-3,000,000*
Total	B1 $ *13,902,890*	B2 $ *13,745,763*

Asset change variation (B2- B1)	B	$ *-157,127*

Liabilities

	Change in book value (Closing - Opening Balance)	Change in tax value (Closing - Opening Balance)
Listed zero tax value liabilities	$	$ *0*
Depreciating liabilities	$ ⑮ *125,900*	$ ⑯ *125,900*
Market value liabilities	$	$
Financial liabilities	$ ⑰ *-1,872,783*	$ ⑱ *-1,872,783*
Paid up share capital	$ ⑲ *0*	$ ⑳ *0*
Any other liabilities	$ ㉑ *266,195*	$ ㉒ *31,904*
Total	C1 $ *-1,480,688*	C2 $ *-1,714,979*

Liability change variation (C2- C1)	C	$ *-234,291*
(A + B - C)	D	$ *18,225,798*

From previous page	D	$ 18,225,798

Upward adjustments

Net exempt income	$
Investment assets	$
Other	$ (23) 102,826

Total of upward adjustments	E	$ 102,826

Downward adjustments

Research and development	$ (24) 6,000
Net exempt income	$
Investment assets	$ (25) 500,000
Other	$

Total of downward adjustments	F	$ 506,000

Unused tax losses

Tax losses applied	$
Tax losses transferred in	$

Total of unused tax losses applied this year	G	$

Taxable income or loss (D + E - F - G)	$ 17,822,624

Business taxpayers (non STS)

Case study — TVM formula approach

Crowbar Pty Ltd (Crowbar) is a family owned company carrying on a hardware retail business, trading as The Paint Tin. The company started in the mid-1990s with one retail outlet. Through innovative marketing and competitive pricing it has expanded to run four outlets across the metropolitan area. Crowbar owns the freehold for two of its outlets, and leases the others.

During the current financial year (Year 2) Crowbar trades profitably. The following transactions and events are relevant to the preparation of Crowbar's accounts and calculation of taxable income under this approach:

- Crowbar's accounting period and income year both run from 1 July to 30 June;
- Crowbar uses the accrual system of accounting but does not prepare financial statements;
- in Year 2 Crowbar received prepayments from customers for the highly sought after 'Nomadic Toolman' range with delivery due early in Year 3. As at the end of Year 2, $125,900 had been received;
- Crowbar sells part of its freehold for $5 million. This freehold sold cost $3 million. The indexed cost base of this freehold at the time of sale was $3.5 million (see note 3);
- the remaining freehold has a market value of $4.8 million as at the end of Year 2;
- on the last day of Year 2 Crowbar sold 2 trucks for $137,840. These vehicles had an adjustable value of $80,000 for tax purposes (see note 2);
- in Year 2, Crowbar paid $400,000 for new equipment (see note 2);
- Crowbar makes a $11,000 donation to a registered charity (see note 1);
- $9,000 is spent on entertaining clients (see note 1) which is not deductible under the current law;
- Crowbar had acquired 'Who Cares Hardware?', a boutique hardware business for the Z-generation of hardware enthusiasts, in a previous year. The excess of the consideration over the fair value of net assets (goodwill) was $780,000;
- Crowbar paid income tax of $765,056 and paid dividends to its shareholders of $2 million;
- Crowbar spent $24,000 on research and development (see note 1) which is eligible for an extra 25 per cent concession ($6,000) under the current law;
- Crowbar prepaid $73,448 of general operating expenses as at the end of Year 2 (see note 1);
- the inventory on hand as at the end of Year 2 has a tax value of $6,027,467. Crowbar also has stores and other consumables on hand at a cost of $10,000;
- Crowbar paid $200,000 for employee superannuation (see note 1) to the *Crowbar staff superannuation fund* (a complying fund) of which an amount of $160,000 was for two company

directors ($80,000 each) who were each aged 40. The balance of $40,000 was for the other employees. The total amount eligible for deduction under the current law is $106,174;

- Crowbar has a number of loans each requiring regular repayments of principal and interest; and
- Crowbar does not have any unused tax losses.

Notes:

The circled numbers on the following pages cross-reference to the worksheet at the end of the case study.

The TVM formula excludes money in hand from the calculation of opening and closing tax values of assets. This is because receipts and payments capture this change in value. The TVM formula approach (version 1) is consistent with this methodology (see section 6-55 of the TVM prototype legislation).

However, the TVM formula approach (version 2) has been designed to allow a taxpayer, who is not an individual or a partnership (with one or more individuals as partners) to use an alternative calculation in place of receipts minus payments. This alternative calculation is worked out by subtracting from money held at the end of year the money held at the start of the year (see section 6-60 of the TVM prototype legislation).

Taxation records for Year 2

Receipts	Amount $
Customers — sales	53,630,000
Customers — prepayments	125,900
Sale of freehold	5,000,000
Interest	8,200
Proceeds from sale of trucks	137,840
Loans	2,694,000
Dividends	16,000
Total	**61,611,940**

Payments	Amount $
Suppliers	34,285,490
Other payments (note 1)	8,098,277
Income tax	765,056
Loan repayments	3,318,860
Dividends paid	2,000,000
Purchase of equipment	400,000
Total	**48,867,683**

Note: These items are readily identifiable from Crowbar's cash book or bank statement.

Cash at bank		Amount $
Opening cash	1a	183,736
Receipts	1	61,611,940
Sub-total		**61,795,676**
Payments	2	48,867,683
Closing cash	2a	**12,927,993**

Notes: The amounts at (1) and (2) are used in the TVM formula approach version 1 worksheet.
The amounts at (1a) and (2a) are used in the TVM formula approach version 2 worksheet.

Assets	Closing tax value $	Opening tax value $
Consumable stores	(3) Nil	Nil
Advertising	Nil	Nil
Inventory(b)	(4) 6,027,467	(5) 4,674,896
Prepayments(c)	(6) 73,448	Nil
Buildings, plant & equipment(e)	(7) 1,434,635	(8) 1,458,256
Receivables(a)	(9) 6,961,586	(10) 4,362,478
Freehold(d)	1,765,769	4,765,769
Goodwill(d)	(11) 780,000	(12) 780,000
Investments (shares)(d)	243,500	243,500
Total	**17,286,405**	**16,284,899**

Notes

The tax value of the assets (a) to (e) above could come from the following records:

(a) invoices, card system, computer listing, and so on;

(b) stocktake — stock cards — computerised stock control system;

(c) record of expenses paid in advance at year end — general operating — see note 1;

(d) asset register records; and

(e) depreciation worksheet — see note 2.

Liabilities	Closing tax value $	Opening tax value $
Customer prepayments(a)	(13) 125,900	Nil
Trade creditors(b)	4,101,480	5,357,656
Accruals(c)	(14) 10,155	(15) 1,902
Loans(d)	3,745,840	4,370,700
Paid up capital	(16) 4,000,000	(17) 4,000,000
Provision for employee entitlements(e)	(18) 130,278	(19) 98,374
Total	**12,113,653**	**13,828,632**

Notes

The tax value of the liabilities (a) to (e) above could come from the following records:

(a) prepayments on the Normadic Toolman range — receipt book, card, computer listing;

(b) amounts owing to suppliers — invoices, cards, computer listing;

(c) expenses not paid at year end — advertising, electricity, postage and telephone — see note 1;

(d) loan account details; and

(e) salary accrued at year end — wages book — see note 1.

Taxable income upward adjustments		Amount $
Income tax paid	20	765,056
Dividends paid		2,000,000
Superannuation	21	93,826
Entertainment		9,000
Total		**2,867,882**

Taxable income downward adjustments		Amount $
Research and development (extra 25%)	22	6,000
Investment assets (CGT indexation)	23	500,000
Total		**506,000**

Note 1: Other payments, prepayments and accruals

Payments	Cash	Prepaid (Year 1)	Prepaid (Year 2)	Accrued (Year 1)	Accrued (Year 2)	Expense (Year 2)
Advertising	75,000				5,000	80,000
Electricity	48,256				2,677	50,933
Rent	3,750,600					3,750,600
Donations	11,000					11,000
Entertainment	9,000					9,000
Research and Development	24,000					24,000
Postage and telephone	60,373			1,902	2,478	60,949
General operating	1,867,049		73,448			1,793,601
Interest	649,320					649,320
Sub-total	**6,494,598**	**0**	**73,448**	**1,902**	**10,155**	**6,429,403**
Superannuation	200,000					200,000
Salaries	1,403,679			98,374	130,278	1,435,583
Total	**8,098,277**	**0**	**73,448**	**100,276**	**140,433**	**8,064,986**

Note 2: Tax depreciation worksheet

Description of each unit	Cost	Additions Year 2	Opening adjustable value	Adjustable value on disposal	Rate %	Year 2 decline in value	Closing adjustable value
Buildings	600,000		600,000		N/A	0	600,000
Trucks	560,000		308,000	80,000	15	84,000	144,000
Computers	358,590		68,133		27	68,133	0
Equipment	876,588	400,000	482,123		15	191,488	690,635
Total	**2,395,178**	**400,000**	**1,458,256**	**80,000**		**343,621**	**1,434,635**

Note 3: Investment asset worksheet

Sale of freehold —Year 2	Amount $
Cost	3,000,000
Indexed cost base	3,500,000
Sale proceeds	5,000,000
Indexed gain on sale (that is, $5,000,000 — $3,500,000)	1,500,000

Crowbar Pty Ltd
TVM Taxable Income or Loss Calculator
TVM Formula Approach Version 1

Receipts	$ (1)	*61,611,940*
Payments	$ (2)	*48,867,683*
Receipts minus Payments	A $	*12,744,257*

Assets

	Closing tax value	Opening tax value
Listed zero tax value assets	$ (3) *0*	$ *0*
Trading stock	$ (4) *6,027,467*	$ (5) *4,674,896*
Depreciating assets — Intangible	$ (6) *73,448*	$
Tangible and IRU	$ (7) *1,434,635*	$ (8) *1,458,256*
Market values assets	$	$
Financial assets	$ (9) *6,961,586*	$ (10) *4,362,478*
Investment assets (any other asset that you hold)	$ (11) *2,789,269*	$ (12) *5,789,269*
Total	B1 $ *17,286,405*	B2 $ *16,284,899*

Change in tax value of assets (B1 - B2) B $ *1,001,506*

Liabilities

	Closing tax value	Opening tax value
Listed zero tax value liabilities	$ *0*	$ *0*
Depreciating liabilities	$ (13) *125,900*	$
Market value liabilities	$	$
Financial liabilities	$ (14) *7,857,475*	$ (15) *9,730,258*
Paid up share capital	$ (16) *4,000,000*	$ (17) *4,000,000*
Any other liabilities	$ (18) *130,278*	$ (19) *98,374*
Total	C1 $ *12,113,653*	C2 $ *13,828,632*

Change in tax value of liabilities (C1 - C2) C $ *-1,714,979*

Net income (A + B - C) D $ *15,460,742*

(Net income from previous page)	D	$ 15,460,742

Upward adjustments

Income tax paid	$ (20) 765,056
Net exempt income	$
Investment assets	$
Other	$ (21) 2,102,826

Total of upward adjustments	E	$ 2,867,882

Downward adjustments

Research and development	$ (22) 6,000
Net exempt income	$
Investment assets	$ (23) 500,000
Other	$

Total of downward adjustments	F	$ 506,000

Unused tax losses

Tax losses applied	$
Tax losses transferred in	$

Total of unused tax losses applied this year	G	$

Taxable income or loss (D + E - F - G)	$ 17,822,624

Crowbar Pty Ltd
TVM Taxable Income or Loss Calculator
TVM Formula Approach Version 2

Money at end of year	(2a)	$ 12,927,993
Money at start of year	(1a)	$ 183,736
Change in money (end - start)	A	$ 12,744,257

Assets

	Closing tax value	Opening tax value
Listed zero tax value assets	(3) $ 0	$ 0
Trading stock	(4) $ 6,027,467	(5) $ 4,674,896
Depreciating assets — Intangible	(6) $ 73,448	$
Depreciating assets — Tangible and IRU	(7) $ 1,434,635	(8) $ 1,458,256
Market value assets	$	$
Financial assets	(9) $ 6,961,586	(10) $ 4,362,478
Investment assets (any other asset that you hold)	(11) $ 2,789,269	(12) $ 5,789,269
Total	B1 $ 17,286,405	B2 $ 16,284,899

Change in tax value of assets (B1 - B2)	B	$ 1,001,506

Liabilities

	Closing tax value	Opening tax value
Listed zero tax value liabilities	$ 0	$ 0
Depreciating liabilities	(13) $ 125,900	$
Market value liabilities	$	$
Financial liabilities	(14) $ 7,857,475	(15) $ 9,730,258
Paid up share capital	(16) $ 4,000,000	(17) $ 4,000,000
Any other liabilities	(18) $ 130,278	(19) $ 98,374
Total	C1 $ 12,113,653	C2 $ 13,828,632

Change in tax value of liabilities (C1 - C2)	C	$ -1,714,979
Net income (B - C)	D	$ 15,460,742

(Net income from previous page)	D	$ 15,460,742

Upward adjustments

Income tax paid	$ (20) 765,056		
Net exempt income	$		
Investment assets	$		
Other	$ (21) 2,102,826		
	Total of upward adjustments	E	$ 2,867,882

Downward adjustments

Research and development	$ (22) 6,000		
Net exempt income	$		
Investment assets	$ (23) 500,000		
Other	$		
	Total of downward adjustments	F	$ 506,000

Unused tax losses

Tax losses applied	$		
Tax losses transferred in	$		
	Total of unused tax losses applied this year	G	$

Taxable income or loss (D + E - F - G)	$ 17,822,624

Business taxpayers (non STS)

Taxable income under the current system

Under the current system Crowbar would prepare a statement of income tax reconciliation showing the adjustments required to accounting profit to reveal taxable income.

Statement of income tax reconciliation for Year 2

	$	$	$
Accounting profit before income tax			**18,148,634**
Add back items			
Accounting decline in value of depreciating assets	293,377		
Accounting superannuation	200,000		
Balancing adjustment event - sale of trucks	57,840		
Goodwill amortisation	39,000	590,217	
Movements in non-allowable provisions			
Doubtful debts	64,117		
Employee entitlements	214,291		
Warranty	20,000	298,408	
Non-deductible expenditure			
Entertainment		9,000	897,625
Other assessable amounts			
Net capital gains			1,500,000
			20,546,259
Less			
Tax decline in value of depreciating assets		343,621	
Additional deduction — R & D		6,000	
Profit on sale of trucks (accounting)		37,840	
Extraordinary profit (accounting)		2,000,000	
Increase in consumable stores		10,000	
Decrease in trading stock		200,000	
Advertising		20,000	
Superannuation		106,174	2,723,635
Taxable income			**17,822,624**

Business taxpayers (non STS)

Statement of taxable income — Review of Business Taxation methodology

Set out below is the Crowbar case study example used in this attachment displayed in the same format as that shown on page 211 of *A tax system redesigned*.

Statement of Taxable Income (working from tax values of assets and liabilities)		Book Values Y2	Book Values Y1	Tax Values Y2	Tax Values Y1	Net Change in Tax Value	Tax Adjust-ments	Taxable Income Calculation
Shareholders Funds								
Contributed Capital		4,000,000	4,000,000	4,000,000	4,000,000	0		0
Retained Profits	1	11,819,054	1,516,387					
Total Shareholders' Funds		**15,819,054**	**5,516,387**					
Liabilities								
Customer deposits		125,900	0	125,900	0	-125,900		-125,900
Trade Creditors		4,101,480	5,357,656	4,101,480	5,357,656	1,256,176		1,256,176
Accruals		10,155	1,902	10,155	1,902	-8,253		-8,253
Borrowings		3,745,840	4,370,700	3,745,840	4,370,700	624,860		624,860
Provisions								
Employee	5	577,241	331,046	130,278	98,374	-31,904		-31,904
Warranties	2	150,000	130,000	0	0			
Tax	2	5,845,967	765,056	0	0			
Total Liabilities		**14,556,583**	**10,956,360**					
Total Liabilities & Equity		**30,375,637**	**16,472,747**					
Assets								
Cash	3	12,927,993	183,736					
Receivables		6,961,586	4,362,478	6,961,586	4,362,478	2,599,108		2,599,108
Less provision for doubtful debts	2	-158,797	-94,680					
Inventory		6,227,467	4,674,896	6,027,467	4,674,896	1,352,571		1,352,571
Consumable Stores		10,000		0				
Prepayments		73,448	0	73,448	0	73,448		73,448
Freehold		1,765,769	4,765,769	1,765,769	4,765,769	-3,000,000		-3,000,000
Plant & Equipment		2,595,178	2,395,178	1,434,635	1,458,256	-23,621		-23,621
less provision for Depreciation		-953,507	-760,130					
Goodwill		663,000	702,000	780,000	780,000	0		
Investements		243,500	243,500	243,500	243,500	0		
Other intangible assets		20,000		0				
Total Assets		**30,375,637**	**16,472,747**					
Receipts				61,611,940				
Payments				48,867,683				12,744,257
Upward Adjustments								
- Income Tax Paid							765,056	765,056
- Dividends Paid							2,000,000	2,000,000
- Entertainment	4						9,000	
- Superannuation	4						93,826	102,826
Downward Adjustments								
Research and Development	4						6,000	-6,000
Investment Assets	4						500,000	-500,000
Less Losses								
Taxable Income								17,822,624

Notes

1 Retained earnings and non-cash additions to reserve accounts have no tax value.

2 Provisions balances have no tax value.

3 Cash balances (positive and negative) have no tax value.

4 The amounts in the box in 'Taxable Income' column are the same adjustments as appear in the current conventional calculation of taxable income.

5 Adjusted for non-deductible amounts.

Business taxpayers (STS)

Case study

Maureen operates a retail business in partnership with her sister. The partnership decides to become an STS taxpayer for the current year (Year 2). This means that in Year 2 the partnership will cease to account on an accruals basis and will move to the STS cash accounting method. To ensure this transition does not lead to the double counting or omission of any income or deductions, the partnership would currently need to apply the STS accounting entry rules in section 328-110 of the ITAA 1997.

The following transactions and events are relevant to preparing the partnership's accounts and working out its taxable income for Year 2:

- the partnership's receipts from customers for Year 2 total $239,600. This includes a $2,000 receipt from its only Year 1 debtor. At the end of Year 2 the partnership has no debtors;
- the partnership receives $400 interest on its bank account during Year 2;
- the partnership's opening stock value for Year 2 is $50,000 and its reasonably estimated closing stock value for the year is $53,000. This estimated closing stock value is based on the closing stock figure produced by the partnership's computerised stock control system. (Note: As an STS taxpayer, the partnership will not need to do a stocktake or account for the variation in the value of trading stock in Year 2 because the difference between its opening stock value and its reasonably estimated closing stock value is less than $5,000.);
- the partnership's total stock purchases for Year 2 are $93,000. At the end of Year 2 the partnership is still to pay $2,500 of that amount;
- during Year 2 it also pays $8,000 to creditors from Year 1. This was mainly for stock bought towards the end of Year 1;
- total drawings by the partners for Year 2 were $31,200;
- on 1 February in Year 2, the partnership buys a new van for $30,000. It sold its previous van the day before for $8,000. Both the previous and new vans have a private percentage of 30 per cent. The partnership borrowed $22,000 to fund the purchase of the new van. The loan for the new van requires regular repayment of principal and interest. To 30 June in Year 2 total loan repayments were $1,900 made up of principal $1,000 and interest $900;
- the partnership also buys a new fax machine for $800 on 25 June in Year 2. The fax machine has no private percentage;
- the Year 2 opening tax value of the partnership's depreciating assets is $29,500 (old van $15,000, other plant and equipment $14,500). These assets all have an effective life of less than 25 years. Because the partnership is now an STS taxpayer all of these assets are allocated to its general STS pool. The closing tax value of the partnership's general STS pool will be:

STS Pool		
Opening tax value	29,500	
Less private % — old van	4,500	25,000
New assets — new van	30,000	
Less private %	9,000	21,000
Base value		**46,000**
Less decline in tax value (30%)		13,800
		32,200
Add back for new van ($21,000 x 15%)		3,150
		35,350
Less sale proceeds of pooled asset	8,000	
Less private %	2,400	5,600
Closing tax value of STS pool		**29,750**

Note: Under the TVM formula there will be upward adjustments of $4,500 and $9,000 to prevent a tax benefit for the private percentages of the assets that went into the pool. There will also be a downward adjustment of $2,400 to prevent the private percentage of the old van sold during the year being taxed.)

- the partnership's other expenses totalled $94,500 as follows:

Expense	Amount $
On 1 January in Year 2 it pays its general business insurance premium for the next 24 months	2 000
Rent	40 000
Interest on loan for van	900
Van running expenses	2 500
Postage and telephone	1 000
Employee superannuation	3 600
Other employee costs	500
Electricity	2 000
General operating expenses	2 000
Total	**94 500**

Note: The $2,000 paid for insurance is a prepayment for future benefits (insurance protection). This will give rise to a depreciating asset (the right to get those benefits) whose tax value will have declined to $1,504 by the end of Year 2. If the insured period was no more than 12 months, or if the amount paid was less than $1,000, the right to the future benefits would have a zero tax value instead.

- based on the figures above, the partnership would have a taxable income for Year 2 under the STS of $44,074.

Note: The STS has 3 main elements:

(a) cash accounting method that recognises most business income and expenses only when they are received and paid;

(b) simplified trading stock rules where businesses only need to conduct stocktakes and account for changes in the value of trading stock in limited circumstances; and

(c) simplified depreciation rules where depreciating assets costing less than $1,000 each are written off immediately. Most other depreciating assets are pooled and deducted at a rate of 30 per cent.

Taxation records

Receipts	Amount $
Customers — sales	239,600
Interest	400
Van sale	8,000
Van loan	22,000
Total	**270,000**

Payments	Amount $
New van	30,000
New fax machine	800
Purchases	90,500
Creditors	8,000
Expenses (1)	93,480
Van loan repayments	1,000
Total	**223,780**

Notes: Total expenses of $94,500 less the private percentage of interest on loan for van ($270) and van running expenses ($750) — section 12-10 of the prototype TVM legislation.
Receipt and payment detail is readily identifiable from the partnership's cash book or bank statements.

Assets	Closing tax value $	Opening tax value $
Debtors	0	2,000
Stock	50,000	50,000
Prepaid insurance	1,504	0
Plant and van	29,750	29,500
Total	**81,254**	**81,500**

Liabilities	Closing tax value $	Opening tax value $
Trade creditors	0	8,000
Van loan	21,000	0
Total	**21,000**	**8,000**

TVM taxable income calculator worksheets

The information above will enable the partnership to calculate its taxable income using either the TVM formula approach worksheet or the direct preparation approach worksheet. If the partnership prepares a statement of financial performance (profit and loss) and a statement of financial position (balance sheet) it could also calculate its taxable income using the reconciling from profit and loss approach worksheet. Completed worksheets for each approach are included at the end of this case study.

Financial statements

Maureen partnership prepares the following:

- STS and accounting statements of financial performance (profit and loss statements) (Figure 1); and
- STS and accounting statements of financial position (balance sheets) (Figure 2).

Figure 1: Maureen partnership

Statements of financial performance for year ended 30 June Year 2 (profit and loss statements)

	STS		Accounting	
Sales		237,600		237,600
Interest		400		400
		238,000		238,000
Opening stock	50,000		50,000	
Purchases	90,500		93,000	
	140,500		143,000	
Less closing stock	50,000	90,500	53,000	90,000
Gross profit		**147,500**		**148,000**
Less expenses				
Insurance	496		496	
Rent	40,000		40,000	
Interest	630		630	
Electricity	2,000		2,000	
Salary	40,000		40,000	
Employee superannuation	3,600		3,600	
Other employee costs	500		500	
General operating costs	2,000		2,000	
Postage and telephone	1,000		1,000	
Van running expenses	1,750		1,750	
Depreciation	11,450	103,426	11,450	103,426
Net profit		**44,074**		**44,574**

Note: The depreciation amount above has been calculated as follows:

General STS pool		
$25 000 @ 30%	7,500	
New van purchased on 1 February	3,150	
		10,650
Low cost asset — fax machine		800
Total		11,450

Figure 2: Maureen partnership

Statements of financial position as at 30 June Year 2 (balance sheets)

	STS	Accounting	
	Year 2	Year 2	Year 1
Assets			
Cash on hand	500	500	500
Cash at bank	34,000	34,000	20,000
Debtors	0	0	2,000
Stock	50,000	53,000	50,000
Prepaid insurance	1,504	1,504	0
Plant and van	29,750	29,750	29,500
Total assets	**115,754**	**118,754**	**102,000**
Liabilities			
Trade creditors	0	2,500	8,000
Van loan	21,000	21,000	0
Partner’s equity	94,754	95,254	94,000
Total liabilities and partner’s equity	**115,754**	**118,754**	**102,000**

Maureen Partnership
TVM Taxable Income or Loss Calculator
Direct Preparation Approach

Items that increase taxable income

Item	Amount
Sales of goods and services	$ *237,600*
Distributions of partnership taxable income	$
Distributions from trust estates	$
Interest	$ *400*
Lease income	$
Rent	$
Dividends	$
Royalties	$
Fringe benefit employee contibutions	$
Government industry payments	$
Net investment asset gains	$
Other	$

Total **A** $ *238,000*

Items that decrease taxable income

Transfer the amount from B on page 2 and write it here **B** $ *193,926*

Unused tax losses

Item	Amount
Tax losses applied	$
Tax losses transferred in	$

Total of unused tax losses applied this year **C** $ *0*

Taxable income or loss

Taxable income or loss (A - B - C) $ *44,074*

Items that decrease taxable income

Item		
Tax value of opening stock	1	$ *50,000*
Purchases and other costs	2	$ *90,500*
Tax value of closing stock	3	$ *50,000*

1+2-3=4

Item		
Cost of sales (opening stock + purchases and other costs - closing stock)	4	$ *90,500*
Distributions of partnership tax losses		$
Contractor, subcontractor and commission expenses		$
Salaries		$ *40,000*
Employee superannuation		$ *3,600*
Bad debts		$
Lease expenses within Australia		$
Lease expenses overseas		$
Rent expenses		$ *40,000*
Interest expenses within Australia		$ *630*
Interest expenses overseas		$
Royalty expenses within Australia		$
Royalty expenses overseas		$
Depreciation expenses		$ *11,450*
Motor vehicle expenses		$ *1,750*
Repairs and maintenance		$
Research and development		$
Other		$ *5,996*
Total (transfer this amount to B on page 1)	B	$ *193,926*

Maureen Partnership
TVM Taxable Income or Loss Calculator
Reconciling from Profit & Loss Approach

(STS a/cs also prepared)
(Accounting P&L)

Total profit or loss	**A**	$ 44,574

Assets

	Change in book value (Closing - Opening Balance)	Change in tax value (Closing - Opening Balance)
Listed zero tax value assets	$	$ 0
Trading stock	$ 3,000	$
Depreciating assets **Intangible**	$ 1,504	$ 1,504
Tangible and IRU	$ 250	$ 250
Market value assets	$	$
Financial assets	$ 12,000	$ 12,000
Investment assets (any other asset that you hold)	$	$
Total	**B1** $ 16,754	**B2** $ 13,754

Asset change variation (B2- B1)	**B**	$ -3,000

Liabilities

	Change in book value (Closing - Opening Balance)	Change in tax value (Closing - Opening Balance)
Listed zero tax value liabilities	$	$ 0
Depreciating liabilities	$	$
Market value liabilities	$	$
Financial liabilities	$ 15,500	$ 13,000
Paid up share capital	$	$
Any other liabilities	$	$
Total	**C1** $ 15,500	**C2** $ 13,000

Liability change variation (C2- C1)	**C**	$ -2,500
(A + B - C)	**D**	$ 44,074

From previous page **D** $ 44,074

Upward adjustments

Net exempt income	$
Investment assets	$
Other	$

Total of upward adjustments **E** $

Downward adjustments

Research and development	$
Net exempt income	$
Investment assets	$
Other	$

Total of downward adjustments **F** $

Unused tax losses

Tax losses applied	$
Tax losses transferred in	$

Total of unused tax losses applied this year **G** $

Taxable income or loss $ 44,074
(D + E - F - G)

Maureen Partnership
TVM Taxable Income or Loss Calculator
Reconciling from Profit & Loss Approach

(STS a/cs only prepared)
(Book value = Tax value)

Total profit or loss **A** $ *44,074*

Assets

	Change in book value (Closing - Opening Balance)	Change in tax value (Closing - Opening Balance)
Listed zero tax value assets	$	$ *0*
Trading stock	$	$
Depreciating assets — **Intangible**	$ *1,504*	$ *1,504*
Tangible and IRU	$ *250*	$ *250*
Market value assets	$	$
Financial assets	$ *12,000*	$ *12,000*
Investment assets(any other asset that you hold)	$	$
Total	**B1** $ *13,754*	**B2** $ *13,754*

Asset change variation (B2- B1) **B** $

Liabilities

	Change in book value (Closing - Opening Balance)	Change in tax value (Closing - Opening Balance)
Listed zero tax value liabilities	$	$ *0*
Depreciating liabilities	$	$
Market value liabilities	$	$
Financial liabilities	$ *13,000*	$ *13,000*
Paid up share capital	$	$
Any other liabilities	$	$
Total	**C1** $ *13,000*	**C2** $ *13,000*

Liability change variation (C2- C1) **C** $

(A + B - C) **D** $ *44,074*

From previous page	D	$ *44,074*

Upward adjustments

Net exempt income	$
Investment assets	$
Other	$
Total of upward adjustments	E $

Downward adjustments

Research and development	$
Net exempt income	$
Investment assets	$
Other	$
Total of downward adjustments	F $

Unused tax losses

Tax losses applied	$
Tax losses transferred in	$
Total of unused tax losses applied this year	G $

Taxable income or loss (D + E - F - G) $ *44,074*

Maureen Partnership
TVM Taxable Income or Loss Calculator
TVM Formula Approach Version 1

Receipts	$ 270,000
Payments	$ 223,780

Receipts minus Payments	A	$ 46,220

Assets

		Closing tax value	Opening tax value
Listed zero tax value assets		$ 0	$ 0
Trading stock		$ 50,000	$ 50,000
Depreciating assets	Intangible	$ 1,504	$
	Tangible and IRU	$ 29,750	$ 29,500
Market value assets		$	$
Financial assets		$	$ 2,000
Investment assets (any other asset that you hold)		$	$
	Total	B1 $ 81,254	B2 $ 81,500

Change in tax value of assets (B1 - B2)	B	$ -246

Liabilities

	Closing tax value	Opening tax value
Listed zero tax value liabilities	$ 0	$ 0
Depreciating liabilities	$	$
Market value liabilities	$	$
Financial liabilities	$ 21,000	$ 8,000
Paid up share capital	$	$
Any other liabilities	$	$
Total	C1 $ 21,000	C2 $ 8,000

Change in tax value of liabilities (C1 - C2)	C	$ 13,000
Net income (A + B - C)	D	$ 32,974

(Net income from previous page) **D** $ *32,974*

Upward adjustments

Income tax paid	$
Net exempt income	$
Investment assets	$
Other	$ *13,500*

Total of upward adjustments **E** $ *13,500*

Downward adjustments

Research and development	$
Net exempt income	$
Investment assets	$
Other	$ *2,400*

Total of downward adjustments **F** $ *2,400*

Unused tax losses

Tax losses applied	$
Tax losses transferred in	$

Total of unused tax losses applied this year **G** $

Taxable income or loss
(D + E - F - G) $ *44,074*

Individual taxpayers (non business)

Individual taxpayer case study 1 — Tom

Tom is a junior architect employed by a small firm. His salary for the income year was $40,000. In addition, he received $225 in interest and $450 in unfranked dividends from shares he bought in 1998.

Tom has made the following payments during the year:

- telephone call charges $600 (Tom has worked out that 50 per cent of these calls were work related);
- training course (work-related self education) $550 — As Tom paid $270 for child care while attending the work related training course he is not required to reduce the $550 claim as explained in *TaxPack*; and
- trade journal subscriptions (work-related) $250.

Tom jointly owns a rental property with his ex-wife, Pauline. His share of the rent for the year was $5,200. During the year, Tom and Pauline spent $4,000 on landscaping and improving the garden[1].

In May, Tom decided to sell his shares. He had paid $5,000 for the shares. He sold them for $7,800.

Tom's tax return for the income year would include the following items:

Amounts that increase taxable income

Items	Amount $	2001 *TaxPack* question reference
Salary or wages	40,000	1
Gross interest	225	10
Dividends	450	11
Rent	5,200	20 (supplement)
Net investment asset gain	1,400	17 (supplement)
Total	**47,275**	

The following paragraphs briefly outline the sort of instructions that would be provided to assist in completing each label of the tax return, and what amount Tom would include.

1 Tom's share of the $4,000 is an improvement to the rental property and has no effect on Tom's taxable income because it is matched by an increase (of the same amount) in the cost of the asset.

Salary or wages

Include any amounts of salary, wages, commissions, bonuses and so on received, including income from part-time and casual jobs from which tax was withheld.

Tom would have received a Payment Summary from his employer showing he earned $40,000 this year. Tom would include the $40,000 at this item.

1 Salary or wages — Description: Your main salary and wage occupation
Payer's Australian Business Number — Tax withheld .00 — C Amount received—do not show cents .00

Gross interest

Include any interest received, or credited, from any source within Australia. This includes any interest received from financial institution accounts and term deposits as well as interest received, or credited, from the Australian Taxation Office.

Tom would include the $225 at this item.

10 Gross interest — If you are a non-resident make sure you have printed your country of residence on page 1. — Gross interest L .00
Tax file number amounts M

Dividends

Include any dividends received, or credited, from an Australian company, corporate unit trust, public trading trust or corporate limited partnership. This includes all franked and unfranked dividends.

Tom would include the $450 at this item.

11 Dividends — If you are a non-resident make sure you have printed your country of residence on page 1.
Unfranked amount S .00
Franked amount T .00
Tax file number amounts V — Imputation credit U .00

Rent

Include the net amount of any rent received. The net amount is the amount of rent received less any payments you made that reduce your taxable income and relate to rent received.

Tom would include the $5,200 at this item.

20 Rent

Gross rent P

Interest expenses Q

Capital works reduction F

Other rental expenses U

P less (Q+F+U)

Net rent

LOSS

Net investment asset gains

Include any net investment asset gains from investment assets[2] after subtracting:

- investment asset losses for the current and prior years (note special rules apply to collectables);
- investment asset discount; and
- exemptions and rollovers.

Tom would include the $1,400 at this item.[3]

17 Investment asset gain

Did you have a investment asset event during the year? G NO YES

You must also print X in the YES box at G if you received a distribution of a investment asset gain from a trust.

Net investment asset gain A

Total current year investment asset gains H

Carried forward investment asset losses to later income years V

2 The TVM's core rules and investment asset regime replaces the current CGT regime. Some assets that were formerly CGT assets will not be investment assets. Refer to Chapter 15 of the explanatory material for more information.

3 When Tom disposes of his shares, an investment asset, he must calculate an investment asset gain or loss. The process he follows to calculate the gain or loss is essentially the same as it would be if he were calculating a capital gain under the current law. Tom would calculate a gain of $2,800, which is the difference between the receipt of $7,800 (representing the proceeds of realising the shares) and the tax value of the shares (being the cost of $5,000). The amount of this gain is then reduced by the 50 per cent discount available to individuals for investment assets. The net effect on his taxable income is $1,400 — this is the figure Tom would include in his return.

Amounts that reduce taxable income

Items	Amount $	2001 *TaxPack* question reference
Work-related self-education expenses	550	D4 (reduction)
Other work-related expenses	550	D5 (reduction)
Total	**1,100**	

Note: Under the TVM Label D (deduction) could become Label R (reduction).

Expenses related to your employment

Include any amounts that reduce taxable income and that relate to your employment. Do not include amounts to the extent that they are private or domestic. There are also special rules for calculating how much can be included for certain things (such as car expenses and laundry expenses) — more information about these items will be included in *TaxPack*.

Tom would include the $550 for self-education expenses and the $250 subscription here. The payment of $600 for telephone calls partly relates to his work and is partly of a private or domestic nature. Tom would need to work out how much relates to his employment and include only that amount. In this case 50 per cent of the calls were work related so Tom would include $300 of this amount at this item.

R4 Work related self-education expenses D CLAIM TYPE

R5 Other work related expenses E

Under the TVM, Tom's taxable income would be $46,175 (that is, $47,275 less $1,100). This is the same figure he would have calculated under the current system.

Individual taxpayer case study 2 — Judy

Judy worked as a public servant until the end of January. Her salary for those seven months was $28,000. During those seven months, Judy made work related calls on her mobile phone totalling $130. She left the public service at the end of January to study full-time but continued to do some casual work in a local shop for which she received $3,000 between February and June. She is studying law full-time and paid $2,000 in fees for this course — this payment is of a private or domestic nature and, as such, cannot be used to reduce her taxable income.

During the year, Judy also received $400 in interest from her investment in a term deposit and paid $75 in account keeping fees related to that investment.

Judy had private hospital cover for the whole year and did not claim the 30 per cent private health insurance offset as a premium reduction. Her total premium for the year was $500.

Judy's tax return for the income year would include the following items:

Amounts that increase taxable income

Items	Amount $	2001 *TaxPack* question reference
Salary or wages	31,000	1
Interest	400	10
Total	**31,400**	

Salary or wages

Include any amounts of salary, wages, commissions, bonuses and so on received, including income from part-time and casual jobs from which tax was withheld.

Judy would have received a Payment Summary from each of her employers showing she earned $31,000 this year ($28,000 + $3,000). Judy would include these amounts at this item.

1 Salary or wages Description Your main salary and wage occupation

Payer's Australian Business Number Tax withheld .00 C Amount received—do not show cents

.00 D

Gross interest

Include any interest received, or credited, from any source within Australia. This includes any interest earned from financial institution accounts and term deposits as well as interest received, or credited, from the ATO.

Judy would include the $400 at this item.

10 Gross interest — If you are a non-resident make sure you have printed your country of residence on page 1. — Gross interest L [ ][ ][ ],[ ][ ][ ] .00

Tax file number amounts M [ ][ ][ ],[ ][ ][ ].[ ][ ]

Amounts that reduce taxable income

Items	Amount $	2001 *TaxPack* question reference
Other work-related expenses	130	D5 (reduction)
Interest and dividend expenses	75	D6 (reduction)
Total	**205**	

Note: Under the TVM Label D (deduction) could become Label R (reduction).

Expenses related to your employment

Include any amounts that reduce taxable income and that relate to your employment. Do not include amounts to the extent that are private or domestic. There are also special rules for calculating how much can be included for certain things (such as car expenses and laundry expenses) — more information about these items will be included in *TaxPack*.

Judy would include the $130 here.

R5 Other work related expenses E [ ][ ][ ],[ ][ ][ ] .00

Interest and dividend expenses

Include any amounts paid by you that reduce your taxable income that relate to your interest and dividend income such as:

- government taxes;
- account keeping fees or management fees; and
- interest charges on money borrowed to buy shares.

Judy would include the $75 here.

R6 Interest and dividend expenses I [ ][ ][ ],[ ][ ][ ] .00

Under the TVM, Judy's taxable income would be $31,195 ($31,400 less $205). This is the same figure he would have calculated under the current system.

In addition, Judy will claim $150 for the 30 per cent private health insurance offset as she could under the current system. Just like the current law, this will continue to reduce the amount of her basic income tax liability.

GLOSSARY

A tax system redesigned	The report released by the Review of Business Taxation, July 1999, AGPS, sometimes referred to as the **Ralph report**. (Available at: http://www.rbt.treasury.gov.au/publications/paper4/index.htm).
AAT	**Administrative Appeals Tribunal**.
accruals taxation	The spreading of gains and losses for tax purposes over the period to which they relate.
Administrative Appeals Tribunal (AAT)	The Administrative Appeals Tribunal (AAT) may review certain decisions of the **Commissioner of Taxation** or the Registrar of the Australian Business Register.
ATO	Australian Taxation Office.
binding	Generally used to mean that the Commissioner is bound to apply the law in a stated way. The Commissioner can be legally bound or administratively bound. For example, for private rulings, section 170BB of the *Income Tax Assessment Act 1936* states that the effect of a **private ruling** on tax (other than withholding tax) is such that the amount of tax payable will not be more than it would have been had the law applied in the way described in the ruling. The Commissioner is thereby legally bound to apply the law in that way.
blackhole expenditure	Business expenditure which currently does not qualify for deduction over an appropriate period of time.
Board of Taxation	A statutory board with majority membership external to the public sector and accountable to the Treasurer. Its focus has been on: • progressing the development of the tax value method; • developing effective consultative processes that can deliver better tax law; and • identifying issues of community concern relating to the Government's tax reform agenda.
BTR	**Business Tax Reform.**
business	Includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee.
Business Tax Reform (BTR)	Business Tax Reform (BTR). Implementation of those recommendations in **A tax system redesigned** accepted by the Government.
capital gain	Increased value of an asset over its purchase price or tax value. Gains arising under the capital gains tax rules can be offset by both realised income and capital losses. In TVM terms, an **investment asset gain**.
CGT	Capital gains tax.
Chairman	Mr Richard FE Warburton, Chairman of the **Board of Taxation**.
CoE	Australian Taxation Office Centre of Expertise.
Commissioner	The Commissioner of Taxation.

company	An incorporated body registered with the Australian Securities and Investments Commission. Company is defined to include: • a body corporate; and • any other unincorporated association or body of persons; but does not include a **partnership** or a non-entity joint venture.
compliance costs	Generally, the costs of complying with the tax laws.
consultative conference	The TVM Consultative Conference at Coogee in July 2001.
cost base	The cost base of an asset is its acquisition cost plus any other capital costs expended on the asset.
double tax agreement (DTA)	A treaty between 2 countries outlining each country's taxing rights over certain forms of income flowing between the 2 countries. Broadly such agreements are designed to prevent **double taxation** between the relevant countries and ensure that one of the countries has a taxing right over income.
double taxation	Where economic income is taxed more than once. This can occur inadvertently under Australian law or from a combination of Australian and foreign laws where the double taxation of taxable income is not corrected by relief available under the foreign tax credit system or under a double tax agreement (DTA).
entity	Under general income tax law — any taxpayer including an individual, company, partnership or trust. Generally a specific type of structure through which business activities are conducted, for example, sole trader, **company**, trust, partnership, superannuation fund, joint venture club or association. Entity can also generally mean all companies (including co-operatives and life insurance companies) and limited partnerships and trusts subject to the entity tax regime.
exempt entities	Entities which are exempt from income tax. Examples include government entities, public benevolent institutions, public hospitals and non-resident entities.
explanatory material	Tax value method: explanatory material (prototype 4).
FBT	**Fringe benefits tax**.
fringe benefits tax (FBT)	The tax payable by employers under the Fringe Benefits Tax Assessment Act 1986 on certain fringe benefits paid in respect of employees and their associates.
goods and services tax (GST)	GST is a broad-based tax of 10 percent on most goods, services or anything else for consumption in Australia.
grantee	A person who is granted rights over an asset by another person who owns those rights (for example, the lessee under a lease).
grantor	A person who grants rights over assets they own to others (for example, the lessor under a lease).
GST	**Goods and services tax**.
individual	A taxpayer who is a natural person (that is, a human being).
input tax credit	An **entity** can generally claim a tax credit for the **good and services tax** (GST) component of the purchase price of a creditable acquisition. This credit is called an input tax credit and can be offset against the amount of GST an entity may need to pay in the relevant tax period.
integrity	Relates to the design of tax law to curtail scope for tax planning and minimisation.

investment asset gain	Increased value of an asset over its purchase price or tax value. Gains arising under the investment asset rules can be offset by both realised income and capital losses. In current terms, a **capital gain**.
ITAA 1936	*Income Tax Assessment Act 1936.*
ITAA 1997	Income Tax Assessment Act 1997.
partner	A partner is a person who has entered into a partnership with others.
partnership	Two or more people or entities carrying on a business or in receipt of income jointly. Generally characterised by joint assets and income. **Family partnership** A partnership where 2 or more members are related to each other. **Limited partnership** A partnership where the liability of at least one of the partners is limited. **Other partnership** A partnership which consists of 2 or more people or entities carrying on a business or in receipt of income jointly. All other partnerships that are not limited partnerships or family partnerships.
Pay As You Go (PAYG)	Pay As You Go (PAYG) is a single integrated system for the for reporting and paying: • tax on business and investment income (PAYG instalments); and • amounts withheld from payments to employees and others (PAYG withholding).
private ruling	A written expression of the Commissioner of Taxation's opinion as to the way in which a tax law or tax laws would apply to a person in relation to an arrangement in respect of a specified year of income. Private rulings are provided to a particular taxpayer in respect of their particular circumstances.
prototype legislation	Tax value method demonstration legislation (prototype 4).
public ruling	A public ruling is a written expression of the Commissioner of Taxation's opinion on the way in which a tax law applies to persons or classes of persons in relation to arrangements or classes of arrangements. It includes a ruling on the way in which a discretion of the Commissioner under that law would be exercised.
Ralph report, Ralph review	The final report released by the **Review of Business Taxation**, chaired by Mr John T Ralph AO, **A tax system redesigned**, July 1999, AGPS. (Available at: http://www.rbt.treasury.gov.au/publications/paper4/index.htm).
RBT	**Review of Business Taxation**.
Review of Business Taxation (RBT)	The Review of Business Taxation (RBT) chaired by Mr John T Ralph AO.
rights reforms	Recommendations from A tax system redesigned designed to provide a comprehensive treatment for intangible assets and rights. These are important to the underlying structure of the TVM and are being considered with the TVM.
rollover, rollover relief	Allows assets to be transferred between related entities without triggering capital gains tax (CGT) or other tax consequences. Also refers to the option for taxpayers to defer CGT on gains under special provisions of the law, such as those applying for small business or from involuntary disposals of assets.

sale and leaseback	Refers to the sale and subsequent leasing back of an asset. The asset continues to be used by the original owner. However, the new owner is entitled to the depreciation deductions.
simplified tax system (STS)	Package of measures to assist small business through reduced compliance costs — consisting of a cash accounting regime, a simplified depreciation regime and a simplified trading stock regime.
tax avoidance	Exploitation of structural loopholes in the tax law to obtain a tax benefit not intended by Parliament.
tax value	The valuation for tax purposes for each asset or liability in a class of assets or liabilities. For example, an asset whose gains are taxed at realisation has a tax value equal to its relevant cost base.
taxation of financial arrangements	A recommendation from A tax system redesigned for the closer alignment of tax accounting and commercial accounting of financial assets and liabilities, to provide greater consistency and clarity, and recognise commercial valuation methods in the tax treatment of financial arrangements. The measures will affect all financial arrangements including debt and derivatives, whether denominated in local or foreign currency.
unrealised gains	The increase in value of an asset over its purchase price which has not been received through disposal.