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Dataset: Table II.1. Statutory corporate income tax rate

Year		2017				
Corporate income tax rate		Central government			Sub-central government corporate income tax rate	Combined corporate income tax rate
		Corporate income tax rate	Corporate income tax rate exclusive of surtax	Corporate income tax rate less deductions for sub-national taxes		
Country						
Australia		30.00	..	30.00	..	30.00
Austria		25.00	..	25.00	..	25.00
Belgium	i	33.00	33.00	33.99	..	33.99
Canada		15.00	..	15.00	11.70	26.70
Chile	i	25.00	..	25.00	..	25.00
Czech Republic		19.00	..	19.00	..	19.00
Denmark		22.00	..	22.00	..	22.00
Estonia		20.00	..	20.00	..	20.00
Finland		20.00	..	20.00	..	20.00
France		34.43	33.33	34.43	..	34.43
Germany		15.83	15.00	15.83	14.35	30.18
Greece		29.00	..	29.00	..	29.00
Hungary	i	9.00	..	9.00	..	9.00
Iceland	i	20.00	..	20.00	..	20.00
Ireland		12.50	..	12.50	..	12.50
Israel		24.00	..	24.00	0.00	24.00
Italy		24.00	..	23.91	3.90	27.81
Japan	i	23.40	..	22.59	7.38	29.97
Korea		22.00	..	22.00	2.20	24.20
Latvia		15.00	..	15.00	..	15.00
Luxembourg	i	20.33	19.00	20.33	6.75	27.08
Mexico		30.00	..	30.00	..	30.00
Netherlands	i	25.00	..	25.00	..	25.00
New Zealand		28.00	..	28.00	..	28.00
Norway		24.00	..	24.00	..	24.00
Poland	i	19.00	..	19.00	..	19.00
Portugal		28.00	21.00	28.00	1.50	29.50
Slovak Republic		21.00	..	21.00	..	21.00
Slovenia		19.00	..	19.00	..	19.00
Spain		25.00	..	25.00	..	25.00
Sweden		22.00	..	22.00	..	22.00
Switzerland	i	8.50	..	6.70	14.45	21.15
Turkey	i	20.00	..	20.00	..	20.00
United Kingdom		19.00	..	19.00	..	19.00
United States		35.00	..	32.90	6.01	38.91

Data extracted on 17 Apr 2018 06:35 UTC (GMT) from OECD.Stat

FOI 2556
Document 11

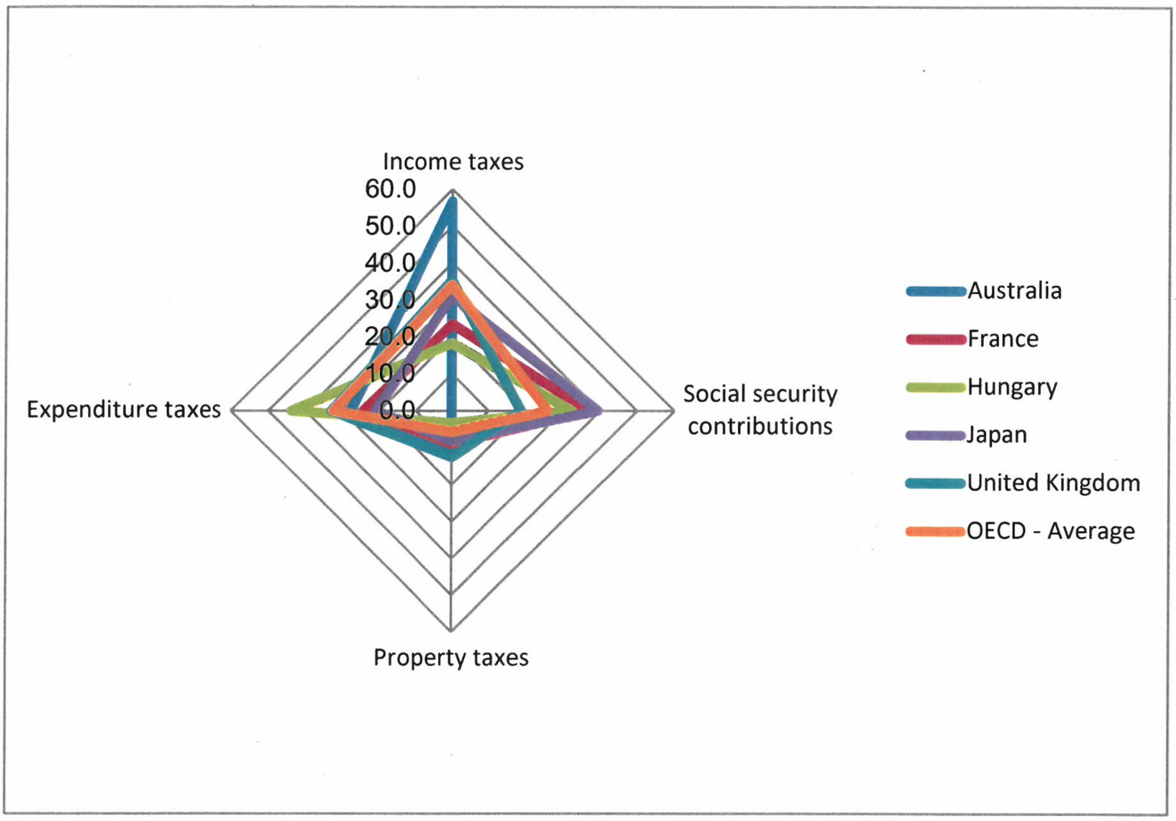

Chart X: Revenue share of major tax bases

Source: OECD

FOI 2556
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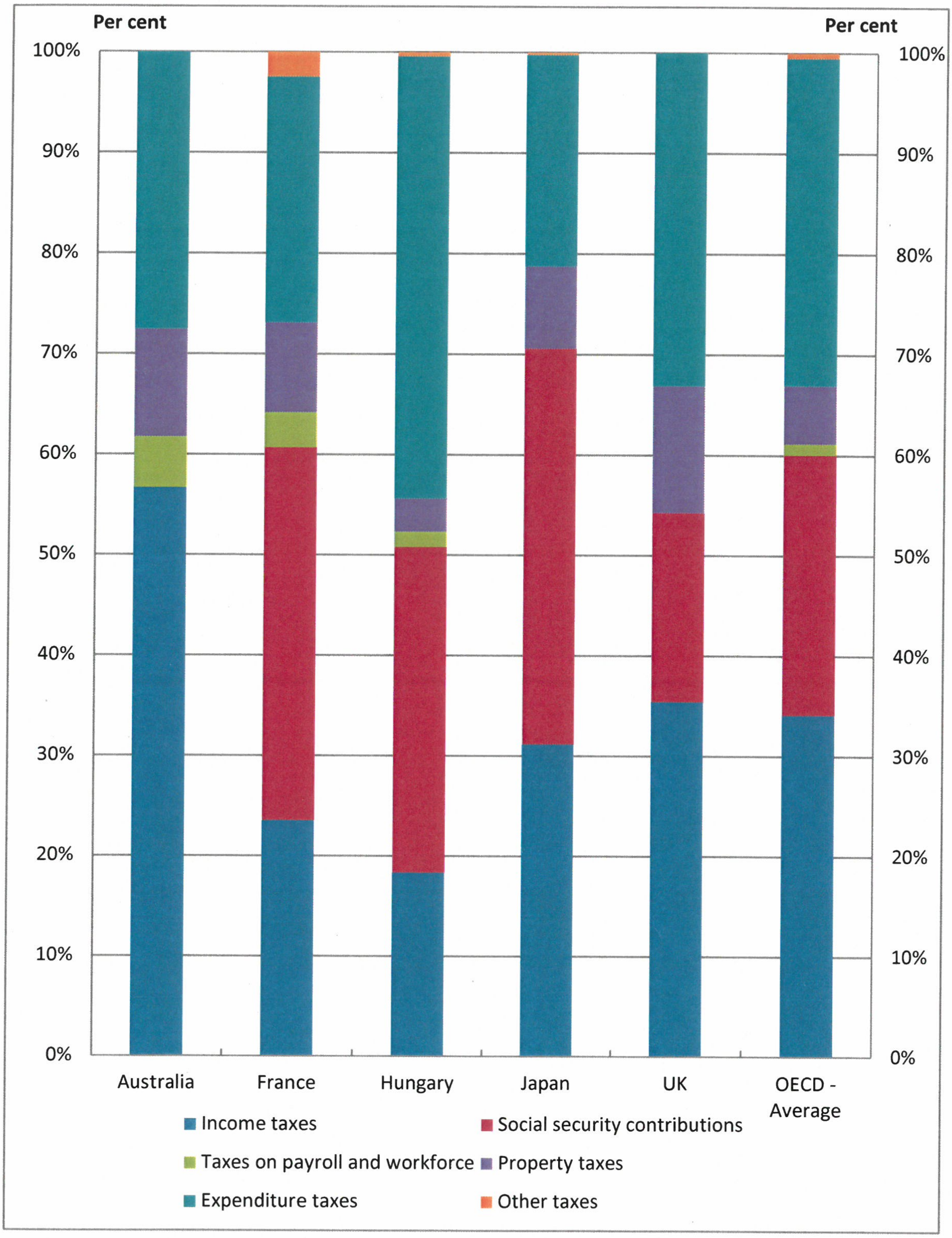
Dataset: Revenue Statistics - OECD countries: Comparative tables

Level of government	Total				
Indicator	Tax revenue as % of total taxation				
Year	2015				
Tax revenue	Total tax revenue	Total tax revenue			
		Income taxes	Social security contributions	Taxes on payroll and workforce	Property taxes
Country					
Australia	100.0	56.7	0.0	5.0	10.7
Austria	100.0	30.2	33.6	6.8	1.3
Belgium	100.0	35.7	31.9	0.0	7.8
Canada	100.0	47.9	15.1	2.0	11.8
Chile	100.0	36.4	6.9	0.0	4.4
Czech Republic	100.0	21.5	43.1	0.0	1.4
Denmark	100.0	63.1	0.1	0.6	4.1
Estonia	100.0	23.4	33.4	0.0	0.8
Finland	100.0	35.2	28.9	0.0	3.3
France	100.0	23.5	37.1	3.5	9.0
Germany	100.0	31.2	37.6	0.0	2.9
Greece	100.0	22.5	29.4	0.0	8.5
Hungary	100.0	18.3	32.4	1.5	3.3
Iceland	100.0	46.9	9.8	0.8	5.4
Ireland	100.0	43.0	16.8	0.6	6.4
Israel	100.0	31.2	16.4	3.8	10.6
Italy	100.0	31.8	30.1	0.0	6.5
Japan	100.0	31.2	39.4	0.0	8.2
Korea	100.0	30.3	26.6	0.3	12.4
Latvia	100.0	25.9	28.7	0.0	3.4
Luxembourg	100.0	36.4	29.0	0.0	8.9
Mexico	100.0	41.7	13.9	2.4	2.0
Netherlands	100.0	27.7	37.8	0.0	3.8
New Zealand	100.0	55.5	0.0	0.0	6.1
Norway	100.0	39.4	27.3	0.0	2.9
Poland	100.0	20.1	38.5	0.7	4.2
Portugal	100.0	30.2	26.1	0.0	3.7
Slovak Republic	100.0	21.8	42.7	0.0	1.3
Slovenia	100.0	18.1	39.7	0.1	1.7
Spain	100.0	28.3	33.8	0.0	7.7
Sweden	100.0	35.9	22.4	10.7	2.4
Switzerland	100.0	46.5	24.6	0.0	6.7
Turkey	100.0	20.3	29.0	0.0	4.9
UK	100.0	35.3	18.7	0.0	12.6
United States	100.0	49.1	23.7	0.0	10.3
OECD - Average	100.0	34.1	25.8	1.1	5.8

Data extracted on 20 Apr 2018 11:02 UTC (GMT) from OECD.Stat

Expenditure taxes	Other taxes
27.5	0.0
27.3	0.5
23.8	0.0
23.1	0.1
54.1	-1.8
33.5	0.0
31.6	0.0
41.8	0.0
32.4	0.1
24.3	2.5
27.8	0.0
39.4	0.0
43.8	0.4
32.4	4.7
32.6	0.0
38.0	0.0
27.3	3.9
21.0	0.3
28.0	2.5
41.3	0.0
25.5	0.1
38.6	1.5
29.6	0.2
38.4	0.0
30.4	0.0
35.9	0.1
38.4	1.3
33.7	0.0
40.0	0.0
29.7	0.0
28.1	0.1
21.8	0.4
44.3	1.5
32.9	0.0
17.0	0.0
32.4	0.5



Revenue share of major tax bases

Source: OECD

PBO REPORT 02/2018: TRENDS AFFECTING THE SUSTAINABILITY OF COMMONWEALTH TAXES

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Document 13

TOP LINES:

- HEADLINE
-
- Projections in the report are based on current policy and recent trends, implicitly assuming no future changes to current tax settings. However, the report also notes that a sustainable tax base requires a robust tax system which constantly evolves to meet structural changes in the economy.
  - The Government has taken a number of measures to deal with structural pressures including action on BEPS, introduction of the MAAL and measures aimed at the black economy.

KEY FACTS AND FIGURES:

- asd

BACKGROUND:

- The report examines historical trends in tax receipts across Commonwealth tax bases since 2001-02 in an effort to identify risks to the sustainability of these bases into the future.
- The report notes that 'based on recent trends and current policy' changes to tax receipts over the coming decade will include:
  - a decrease in company tax receipts (noting that this may be offset as losses being carried forward in the resources industry are exhausted);
  - an increase in personal income tax receipts due to bracket creep (notwithstanding the tax plan outlined in 2018-19 Budget); and
  - ongoing decreases in various consumption tax receipts driven by consumer behaviour and technological change.
- It also notes that risks arising from uncertainty in international tax settings and changes to the structure of the labour market may impact tax receipts.
- The report concludes that in the absence of taxation reform – if the risks it identifies do eventuate – there will be a need to increase reliance on labour income taxes to maintain the current level of taxation revenue as a proportion of GDP.

QTB Number:	QB18-000XXX	QTB Category:	Taxation
Contact Officer:	[Name]	Date and time:	18/07/2018 2:08 PM
Contact Number:	(02) 6263 XXXX	Next update:	
Office Responsible	TSR	Office Adviser Initial and Date Cleared	

FOI 2556
Document 14

Dataset: Revenue Statistics - OECD countries: Comparative tables

VAT/GST revenue as a prope

	Year	2000	2001	2002	2003
Tax revenue	Australia	3.4	3.6	3.9	4.0
5111 Value added taxes	Austria	7.9	7.8	7.9	7.8
	Belgium	7.0	6.7	6.8	6.6
	Canada	3.2	3.2	3.2	3.3
	Chile	7.9	7.8	8.0	8.0
	Czech Republic	5.9	5.8	5.8	5.8
	Denmark	9.2	9.2	9.2	9.2
	Estonia	8.4	8.1	8.4	8.2
	Finland	8.0	7.7	7.9	8.2
	France	7.2	7.0	6.9	7.0
	Germany	6.7	6.4	6.2	6.2
	Greece	6.9	7.2	7.3	6.7
	Hungary	8.7	8.1	7.7	8.1
	Iceland	10.3	9.1	9.1	9.4
	Ireland	7.1	6.6	6.7	6.7
	Israel	7.4	7.5	8.0	7.9
	Italy	6.3	6.0	6.0	5.7
	Japan	2.3	2.4	2.4	2.3
	Korea	3.7	3.8	4.1	4.1
	Latvia	7.0	6.7	6.5	6.9
	Luxembourg	4.9	5.2	5.3	5.4
	Mexico	3.1	3.2	3.1	3.3
	Netherlands	6.4	6.8	6.8	6.9
	New Zealand	8.1	8.2	8.4	8.7
	Norway	8.2	8.2	8.3	8.1
	Poland	6.9	6.8	7.2	7.1
	Portugal	7.6	7.4	7.5	7.6
	Slovak Republic	6.9	7.2	6.9	7.3
	Slovenia	8.5	8.2	8.4	8.4
	Spain	5.9	5.7	5.5	5.7
	Sweden	8.3	8.3	8.4	8.4
	Switzerland	3.6	3.6	3.6	3.6
	Turkey	5.7	5.9	6.3	6.3
	United Kingdom	5.9	6.0	6.1	6.2
	United States	0.0	0.0	0.0	0.0
	OECD - Average	6.4	6.3	6.4	6.4

Data extracted on 20 Apr 2018 03:32 UTC (GMT) from OECD.Stat

2000-01 2001-02 2002-03 2003-04

ertion of GDP (OECD countries)

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
3.9	3.9	3.8	3.8	3.4	3.6	3.4	3.3	3.3	3.5
7.7	7.7	7.4	7.4	7.5	7.8	7.7	7.6	7.7	7.7
6.7	6.9	6.9	6.9	6.8	6.8	6.9	6.9	6.9	7.0
3.2	3.2	3.0	2.9	3.9	4.0	4.2	4.2	4.2	4.1
8.0	7.8	7.0	7.5	8.4	7.3	7.5	7.8	8.0	8.1
6.7	6.6	6.1	6.0	6.5	6.6	6.6	6.9	7.0	7.4
9.3	9.7	9.9	10.0	9.6	9.7	9.4	9.5	9.5	9.2
8.3	8.1	9.0	8.8	7.8	8.7	8.5	8.2	8.4	8.2
8.2	8.4	8.4	8.2	8.1	8.4	8.3	8.8	9.0	9.3
7.0	7.2	7.1	7.0	6.9	6.7	6.8	6.8	6.8	6.8
6.1	6.1	6.2	6.8	6.9	7.2	7.0	7.0	7.0	7.0
6.5	6.7	6.8	7.1	7.0	6.3	7.1	7.3	7.2	7.0
8.7	8.3	7.5	7.9	7.6	8.3	8.6	8.4	9.2	8.9
10.1	10.8	11.0	10.1	8.7	7.5	7.6	7.7	8.0	7.9
7.0	7.3	7.4	7.3	7.0	6.1	6.0	5.7	5.8	5.8
7.6	7.5	7.3	7.4	7.3	7.3	7.5	7.5	7.3	7.7
5.6	5.7	6.0	5.9	5.7	5.5	6.1	6.0	6.0	5.9
2.4	2.5	2.5	2.4	2.4	2.5	2.5	2.6	2.6	2.7
3.9	3.9	3.9	3.9	4.0	4.1	4.1	4.1	4.3	4.1
6.7	7.4	8.0	7.6	6.3	5.9	6.7	6.8	7.2	7.4
5.8	6.1	5.5	5.9	6.1	6.5	6.4	6.6	7.1	7.3
3.3	3.4	3.6	3.6	3.7	3.4	3.8	3.7	3.7	3.5
6.8	6.8	6.9	7.0	6.8	6.5	6.8	6.5	6.5	6.5
8.6	8.6	8.6	8.0	8.3	8.4	9.3	9.4	9.6	9.3
7.9	7.7	7.8	8.0	7.1	7.7	7.8	7.6	7.5	7.7
7.1	7.7	8.1	8.2	7.9	7.3	7.6	7.8	7.1	7.0
7.6	8.2	8.3	8.2	8.1	6.8	7.5	8.1	8.3	8.1
7.6	7.7	7.3	6.6	6.7	6.6	6.2	6.7	6.0	6.3
8.4	8.4	8.4	8.3	8.3	7.9	8.1	8.1	8.0	8.5
6.0	6.2	6.2	5.8	4.9	3.8	5.3	5.2	5.4	5.9
8.3	8.5	8.5	8.6	8.8	9.1	9.2	9.0	8.9	9.0
3.6	3.6	3.5	3.4	3.4	3.3	3.4	3.5	3.5	3.5
5.3	5.1	5.2	4.9	4.7	4.7	5.4	5.6	5.2	5.6
6.2	6.0	6.0	6.0	5.9	5.3	6.1	6.8	6.8	6.8
0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6.5	6.6	6.5	6.5	6.4	6.2	6.4	6.5	6.6	6.6

2004-05 2005-06 2006-07 2007-08 2008-09 2009-10 2010-11 2011-12 2012-13 2013-14

2014	2015	2016
3.5	3.7	..
7.7	7.7	7.8
6.9	6.7	6.8
4.1	4.2	4.3
8.2	8.4	8.4
7.4	7.3	7.4
9.2	9.2	9.5
8.7	9.2	9.4
9.2	9.1	9.1
6.9	6.9	6.9
6.9	7.0	7.0
7.1	7.3	..
9.3	9.7	9.4
8.0	8.3	8.5
5.9	4.6	4.7
7.9	7.8	7.5
6.0	6.1	6.2
3.7	4.2	4.0
4.2	3.8	4.2
7.6	7.7	8.1
7.4	6.5	6.3
3.9	3.9	4.1
6.4	6.6	6.9
9.7	9.8	9.6
7.8	8.2	8.6
7.1	7.0	7.1
8.5	8.6	8.5
6.6	6.9	6.7
8.5	8.4	8.3
6.2	6.4	6.4
9.0	9.1	9.3
3.5	3.4	3.4
5.0	5.2	5.0
6.8	6.9	6.9
0.0	0.0	0.0
6.7	6.7	..

2014-15   2015-16

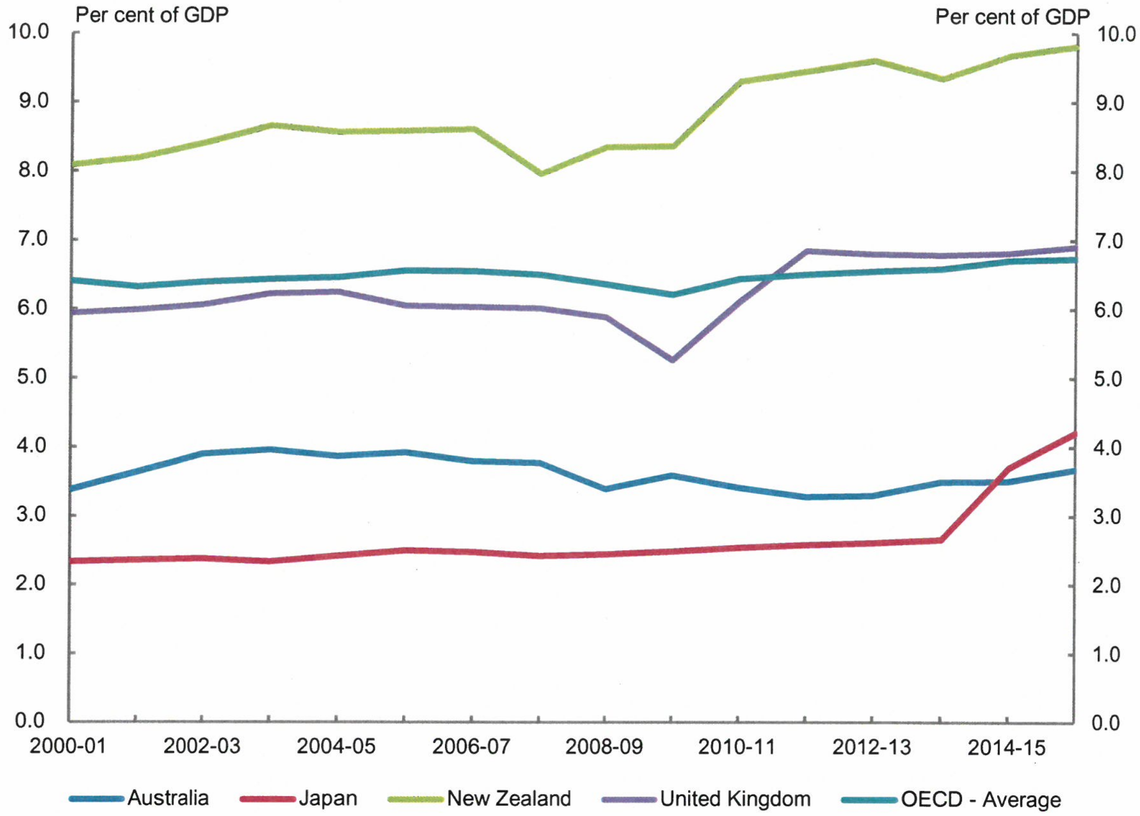


Chart X: VAT/GST revenue as a percentage of GDP

Source: OECD

October 2001

The Tax Value Method (TVM)

Why make the change?

Purpose

This document is intended to expand upon the TVM overview documents 'Overview of objectives', 'The essential thesis', 'Existing problems and outcomes sought' and 'The mechanism'. It is very much a work-in-progress at this time.

It articulates the benefits sought from TVM and explores the extent to which those benefits can be shown to exist now and what still needs to be done to establish their existence.

It commences by examining TVM's role in the broader tax reform context, and then goes on to suggest what is wrong with the current system, how TVM might address those deficiencies and how the benefits of TVM might be demonstrated and measured. It briefly examines alternatives to TVM and suggests a way forward for the TVM project.

This paper has been prepared by the TVM Legislation Group and the ATO TVM project team. The paper reflects development of TVM to September 2001. It has not been endorsed by the Government, Board of Taxation, Treasury or ATO.

Table of contents

1. The Reform Context

TVM's context within tax reform

1.1 The following analysis explains how TVM fits within the broader tax reform context.

TVM as one part of the reform agenda

The ANTS reforms present an overall package.

The initial Review of Business Taxation (RBT) documents[1] identified a broad range of possible reforms for Australia's taxation system. The highest level aims of reform have been to promote Australia's economic growth, to strive for equity between taxpayers and to promote simplicity and certainty within the taxation system.

Within the reform agenda, TVM addresses a specific part – income tax legislation.

The scope of reform covered by the broad heading of 'Tax Value Method' is essentially the legislation governing income tax, and the systems and processes that are built on that legislation. Thus the reform covers the treatment of a major part of the tax base (income, as distinct from expenditure), currently treated under many taxation regimes, expressed in several thousand pages of legislation.

The proposed reform…

Some basic parameters help to define the scope of this area of reform:

…should not alter the tax base…

➲ the reform should not substantially change the income tax base itself; that is, new legislation in this area should extend to the same range of income, expenditure, gains and losses as are currently covered by income tax legislation;

…should not alter basic tax principles…

➲ the reform should not touch the basic principles on which the whole of the tax system is based – for example, it should work within given structures such as annual taxation periods, and within the existing concepts of taxable entities (other reform measures were designed to

[1] *A Strong Foundation* (November 1998) and *A Platform for Consultation* (February 1999).

address these basic principles);

...should be revenue neutral...

- ➲ the reform should provide a result that overall is revenue neutral – that is, while there may be changes up or down in liability for some taxpayers, the reform should create tax outcomes which are by and large the same as the present system;

...should not increase compliance costs...

- ➲ ultimately, the reform should not increase the compliance burden on taxpayers – on the contrary, a measure of success for the reform would be a decrease in compliance costs (and a decrease in the cost of many business processes which involve income tax considerations);

...should consider transitional costs.

- ➲ the cost of transition to a reformed system should be included as part of the analysis – this cost will be considered against the projected benefits of the reform.

The goal of reform in income tax legislation

The reform agenda has aims that are sometimes in tension with one another.

The RBT document *A Strong Foundation*[2] went to some length to describe the sometimes contradictory nature of its 3 overall aims – economic growth, equity between taxpayers and simplicity and certainty within the system. Within this framework, the potential impact of a reform to the structure of income tax legislation is significant.

TVM's surface aim is to increase simplicity and certainty...

At a surface level, the potential impact of a reform like TVM would be on the goal of 'simplicity and certainty': if it were possible to reform the notoriously complex and lengthy volumes of income tax legislation, the benefits in this area would be obvious. A positive outcome in 'equity' could also be achieved when TVM is taken together with other RBT policy recommendations. A positive outcome in 'economic growth' would possibly follow, but would be 'collateral' – for example, clearer law should decrease compliance costs and thus contribute to economic growth.

---

[2] Pages 59-93.
[3] *Tax Reform: Not a New Tax, A New Tax System* (August 1998)

…but its greatest impact is in combination with other reforms.

The greater potential of a reform of this kind is truly seen only in the context of the whole reform agenda. A government of any persuasion will identify opportunities to promote economic growth by changing the tax treatment of certain kinds of business activities. (Several such reforms are included in ANTS.[3]) However, within the current framework of income tax legislation it is extremely difficult to introduce such changes without making the system yet more complex and uncertain. Moreover, any such change to the present system tends to create loopholes exploited by tax specialists, which compromises the equity of the system on one hand, and requires further complex legislative 'patch-ups' on the other.

An effective reform to the *structure* of income tax legislation would potentially allow present *and future* tax reforms aimed at economic growth outcomes to be put in place *without greatly increasing the complexity of tax law*, and thereby with significantly less potential for loopholes and the inequities they bring.

Some fundamentals about an income tax system

1.2 All income tax systems establish the tax value of assets and liabilities. Tax value is *not* a new concept, even if it is not always specifically recognised (e.g. the tax written down value of a wasting asset equals its tax value).

1.3 Tax policy determines the incidence of taxation which, in turn, determines the tax value of each asset and liability in a business. The reconciliation of accounting profit to taxable income is the difference between the tax values of assets and liabilities and financial (balance sheet) values of those assets and liabilities.[4]

1.4 Changing tax policy brings about changes in tax outcomes (and, therefore, tax values). Adopting a principle-based approach improves the equity and efficiency of the tax system. What is a principle-based approach?

- Taxing transactions closer to their economic substance than their legal form.
- Taxing similar transactions in a similar manner, irrespective of their legal form.
- Symmetry in the tax recognition of income and expenses.
- Adopting standardised approaches.

1.5 If principle-based reforms are to be adopted, the argument for TVM is that it is the most efficient, simplest and most transparent method of implementing it. The principle-based

4 This does not imply that TVM requires a balance sheet to be kept.

approach leads to greater equity. TVM presents an opportunity for that to be achieved with greater integrity and in fewer pages of legislation.

1.6 TVM is not the only method of achieving the desired result. Policy changes could be incorporated into existing legislation, but at a substantial cost in terms of volume of legislation and complexity. At the end, the tax value of assets and liabilities would be identical with what is being proposed in TVM *provided* the more complex legislation could deliver the intent. That is, the same outcome could be achieved but at a higher ongoing cost.

2. Diagnosing problems in the current system of income tax law

Evolution of the current law - why we have the system we do

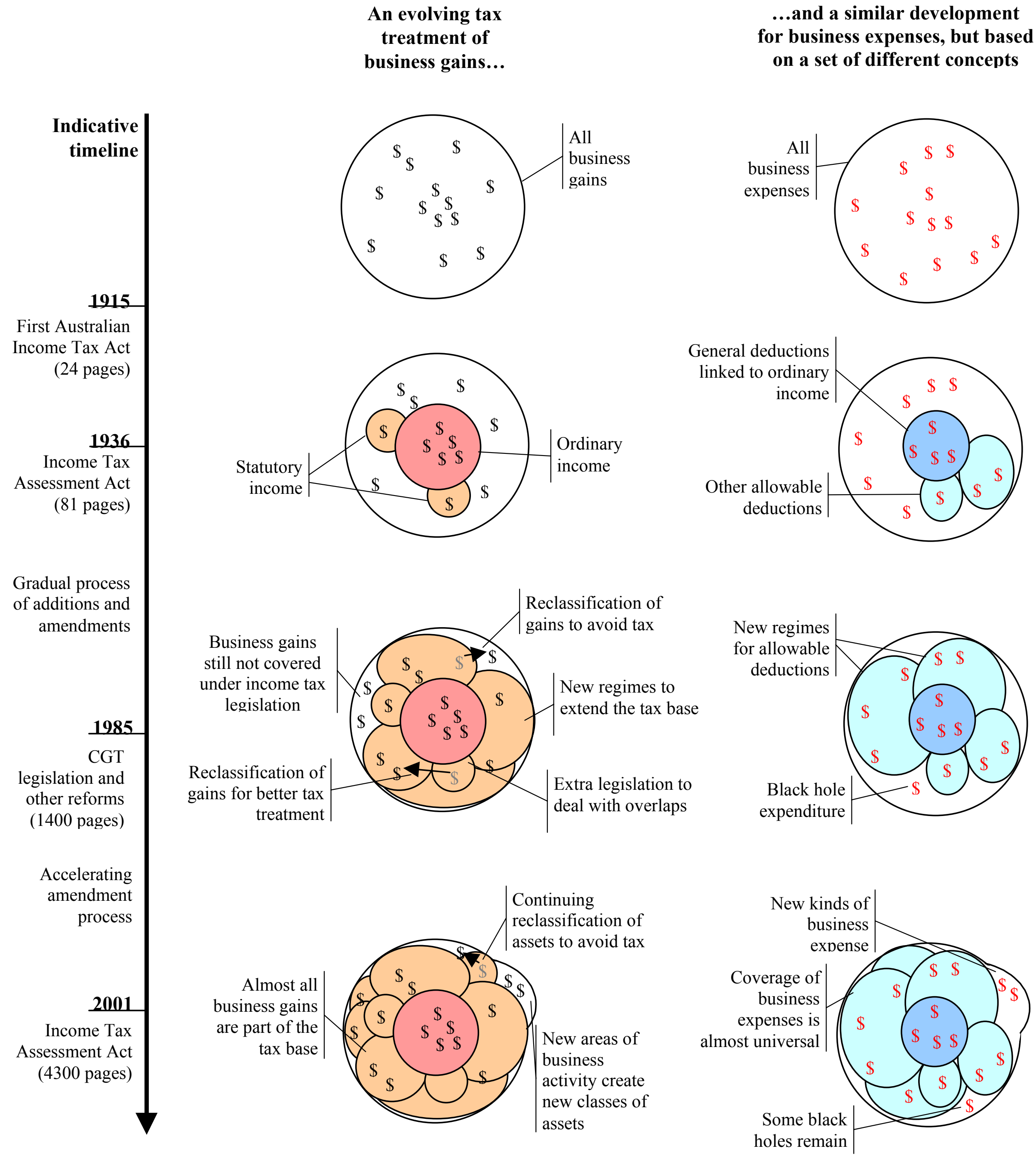
2.1 It is easy to say that Australia's income tax legislation is lengthy and complex, but it is important to strive to understand the roots of that complexity so that wise reform decisions can be made.

2.2 Not all complexity is inherently a bad thing. The world of business activity is extremely complex in itself, so we might expect to see a degree of complexity in the legislation designed to assess income tax.

2.3 On the other hand, not all complexity in the legislation reflects the complexity of the business world. 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.

2.4 By looking at the way in which the law has evolved, we can start to distinguish between these kinds of complexity. Moreover, we can begin to discern the implicit principles that structure (in a poor way) our current income tax law.

Diagram 2.1 The current system: systemic complexity caused by accretion



2.5 Two themes present in the earliest Australian income tax legislation have major implications for the complexity of legislation that we have today:

1. Income tax originally aimed to subject only some kinds of business gain to taxation – ‘ordinary income’ and some limited ‘statutory income’.
2. ‘Allowable deductions’ were limited to expenses directly related to producing income.

Both of these were basically limited to revenue items, based on the judicial distinction between revenue and capital.

2.6 To these 2 themes we could add an *absent* theme – one that is not present in the early framework, but has become a source of complexity since that time because of the extension of the tax base to recognise most gains and, post-RBT, most losses:

3. The framework for income tax legislation has little to say about the appropriate *timing* for recognition of those gains and losses.

2.7 The bulk of our present legislation has been built on a framework that included these basic features.

2.8 Under the first of these features, we have seen a gradual extension of the income tax base by a series of new tax regimes and amendments to existing law. At present, the intended tax base is almost universal – i.e. practically all business gains are intended to be assessable for income tax. But the legislation covers this tax base like a patchwork quilt: new patches cover new kinds of business gain, 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 business gains. But it is not. Ambiguity still remains, so that the tax treatment of some business activity 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 business gains will emerge that we cannot yet imagine.

2.9 From the second and third features has evolved an asymmetric treatment of gains and losses (or assets and liabilities) in business activities. In fact, within the current framework, a business must translate the normal concepts of liabilities and losses into a quite different tax concept of 'deductions'. And while the tax base has expanded to become almost universal over the past 80 years or so, an expansion of the concept of 'allowable deductions' followed hand-in-hand, but with its own series of regimes and amendments. In the current system, most assets and gains by business are taxable, and most losses and liabilities are deductible, [5] but the 2 sides of the equation usually speak, as it were, entirely different languages, despite their economic similarity.

2.10 From the third feature – the lack of a timing principle in the early legislation – has grown the need to specify timing in many of the new regimes and amendments. The timing of taxation can be an important point of leverage for business, so much effort (legitimate and otherwise) goes into seeking the best tax treatment for many business activities. As above, if the result of the current legislation was 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 continues to burden business, tax administrators, legislators and policy makers.

2.11 Taking this historical perspective of our current income tax system highlights 2 kinds of complexity, one necessary and useful, and the other simply a result of an unprincipled evolution of legislation.

2.12 The necessary complexity relates to the variety of business activities. Some categories of activity need special taxation treatment, according to government policy. This will always be the case, and therefore complex questions will always be present regarding the classification of certain actions.

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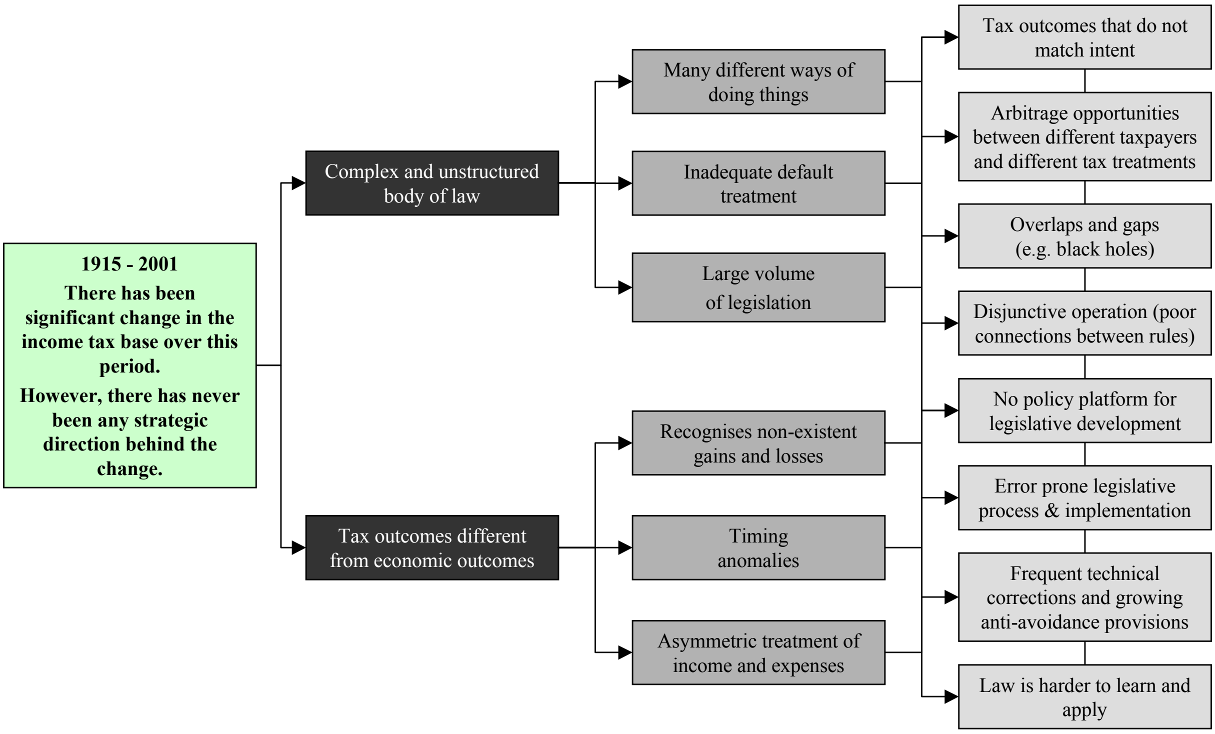
[5] Assuming an implementation of the RBT recommendation on recognising black hole expenditure.

2.13 The less useful kind of complexity results from many ways of doing similar things, asymmetric treatment of gains and losses and a variety of timing rules for tax treatment. The historical analysis here suggests that these are problems inherent in the foundations of our current law, and that it may be impossible to improve the situation without revisiting the underlying structure of our legislation.

What is wrong with the current system?

2.14 There are many problems with the current income tax system, most of which flow out of the income tax law that sits at the centre of that system. This diagram summarises those problems.

Diagram 2.2 Problems with the current law

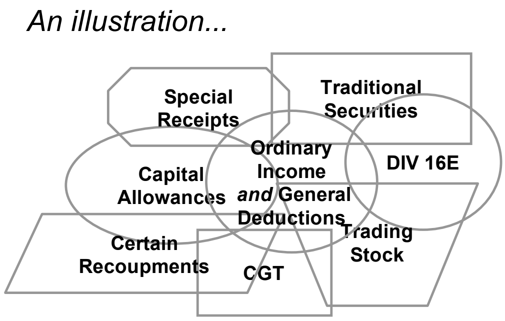


2.15 Changes in the tax base have been made by *ad hoc* additions to the law, leading to legislative volume and systemic complexity. The resulting complex interactions have led to uncertainty for taxpayers (business decisions harder to make) and make amending the law complex and difficult (leading to the need for more technical corrections with additional uncertainty for taxpayers). The deficient foundation and structure of the income tax law creates inequity and a lack of robustness. Taxpayers can have gains taxed and losses recognised at the wrong time or not at all. Other taxpayers can arbitrage the deficiencies to avoid or defer the taxation of gains or bring forward the recognition of losses

Many different ways of doing things

2.16 The current law uses many different sets of rules to describe the tax base:

Diagram 2.3 The nature of the current system



2.17 This diagram shows in a simple way how the current law is a series of separate regimes. But it is not just illustrating a technical problem with the current legislation (overlaps) that could be overcome with a technical solution. Rather it is illustrating the fundamental nature of the problem; that *there are different regimes trying to do essentially the same thing* – to assess gains and recognise losses. Each of these regimes has its own pattern and set of rules. Together they form a complex web.

Downstream effects of doing things in many ways

2.18 That complex web leads to:

- complex analytical processes to determine the income tax consequences of a transaction;
- timing anomalies (inconsistencies or inadequacies in when gains and losses are recognised) (e.g. *Myer Emporium* case[6]);
- double counting (e.g. *Country Magazine* case[7]);
- black holes;
- no cohesively defined platform for future developments; and
- an error-prone legislative development process.

2.19 How these systems and concepts apply under the current regime is *a function of historical development* rather than consistently applied underlying principles (see paragraphs 2.1 to 2.13).

6 *FCT v The Myer Emporium Ltd* 87 ATC 4263.
7 *Country Magazine v FCT* (1968) 117 CLR 162.

A case study – the Myer Emporium case

2.20 The impact of these problems is best illustrated by a case study: the celebrated *Myer Emporium* case.

The facts

2.21 Myer Emporium lent $80 million to its subsidiary, Myer Finance, at commercial rates of interest. 3 days later, it sold the right to that interest to Citicorp for a $45 million lump sum. The point to the arrangement was to borrow $45 million from Citicorp to finance a group reorganisation but to do so in the most tax effective way.

The outcome

2.22 Even though the interest, if received periodically, would have been ordinary income, Myer argued that the lump sum that replaced the interest stream was of a non-assessable capital nature. The Victorian Supreme Court and the Federal Court agreed with Myer but the High Court overturned those decisions, holding that the lump sum was assessable income.

2.23 As well as the lump sum being assessable income under ordinary principles, there are several other regimes in the law that would also assess some or all (or more) of the gain in this case. Those regimes include the capital gains provisions, the alienation provisions and the accruing securities provisions. They do not all assess the same amount as the ordinary income provisions or each other and do not always assess the amounts at the same time. There are not always rules to cope with those differences and those that are there do not always work properly.

2.24 The legislative response to the decisions in the Victorian Supreme Court and the Federal Court was to amend the alienation provisions to ensure that the transaction was dealt with. The High Court's decision perhaps made those amendments unnecessary. The point though is that there was a perceived need to 'fix the law'.

What the case shows about the current system

2.25 The case shows that the main concern for business with the current system is the uncertainty created in making commercial decisions. It is difficult and expensive to work out which rules apply. But the existence of many rules also creates an incentive to try to structure a transaction in a way that legitimately minimises the tax cost. And the taxpayer then runs the risk of their understanding of the tax consequences being found to be wrong in a subsequent dispute with the revenue authority.

2.26 It also shows that there is no cohesive treatment of gains and losses in the current law. Rather, it is a mosaic of regimes that may or may not collectively do the intended job. There is no overarching principle in the law that guides you to the right outcome; there is no such principle that tells you whether something is intended to be taxed and, if so, when and in what amount. This also means there is no cohesively defined platform for future developments. It is our contention that this problem is inherent in a patchwork approach, no matter how well conceived and drafted a particular part of the law may be.

2.27 A full analysis of the case and what it can teach us is at ***Attachment A***.

Inadequate default treatment

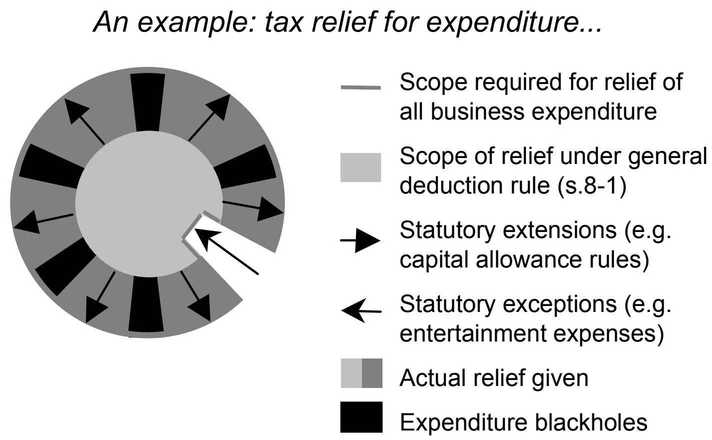
2.28 The existing legislation often departs from the intended tax base because future developments were not foreseen or because complex interactions were not understood by law makers. Gaps appear in what is intended to be covered.

2.29 The intended tax base after the RBT recommendations about the treatment of black hole expenditure 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.[8]

2.30 However, the legislation that tries to achieve that tax base is still founded on the outmoded revenue/capital concept.[9] This means that, even if the legislated extensions of the current core model were perfectly accomplished, income and expenses not falling within them would get a default treatment inconsistent with the intended scope of the post-RBT income tax base. That they are seldom perfectly accomplished merely compounds the problem.

2.31 That means that income and expenses not falling within (inadequately) specified extensions get a default treatment inconsistent with the intended scope of the post-RBT income tax base.

Diagram 2.4 Piecemeal relief for business expenditure



2.32 This diagram aims to show one of the problems that the multiple regime approach produces under the current law. Because the original 1915 law did not intend to recognise all business expenditure, many types of expenditure were not recognised. Since that time, we have moved to a position where we broadly intend to recognise all business expenditure (with some deliberate exceptions such as entertainment expenditure). Getting to that result could only be achieved if the further regimes added since 1915 have fully covered the extension. Of course, it is 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. The difficulties in that task are revealed in the presence of ‘black holes’, gaps in the recognition of business expenditure. Examples are the costs of unsuccessfully trying to sell a capital asset.

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8 See generally Abbey, P. and Keating, M. *Tax Value Method: What, Why and Why Now*; paper to the Board of Taxation/ATAX conference 23 July 2001.

9 See paragraphs 2.33 to 2.35.

Why is the current revenue/capital test outmoded?

2.33 It is now reasonably clear that the revenue/capital test that sits at the core of our current income tax law is outmoded and, therefore, is an inadequate default treatment. Why?

2.34 The revenue/capital concept is based on judicial interpretation of the meaning of the words 'income' and 'capital'. But the limitations placed on the meaning of those words are not useful in an income tax system that now wants to recognise almost all gains and losses, and wants to recognise them when the related benefits are received or provided. In particular, the revenue/capital concept:

- is not adequate to describe the *scope* of the gains and losses that should be recognised; and
- is not adequate to set the appropriate *timing* of recognition of gains and losses.

2.35 The test's obsolescence manifests itself in 2 categories of rules in the current law that seek to overcome those inadequacies:

- In terms of scope, there are many rules that seek to recognise capital gains as income (classically, the capital gains tax rules), while others seek to give tax relief for capital expenditure (e.g. various capital allowance rules);
- In terms of timing, there are also many rules that seek to alter the timing of recognition of gains and losses with a revenue character. For example, Division 16E seeks to bring forward the taxing point for revenue gains ('income') from qualifying securities. Likewise, the timing of recognition of prepayments of revenue expenditure is delayed under the prepayment rules[10] until related benefits are received.

Downstream effects of an inadequate default treatment

2.36 The main problem caused by this approach to law development is a ***constant need to amend the law*** to fill the gaps or to deal with other problems the approach creates. These include:

- expenditure 'black holes';
- income 'white holes';
- double counting when an amount falls into several regimes; and
- timing differences between regimes (leading to inequity and tax avoidance).

[10] Section 82KZM et al of the *Income Tax Assessment Act 1936* (1936 Act).

A case study – tax relief for capital expenditure

2.37 The core of the current tax system sets up a situation where business expenditure is *not* deductible. Unless a special rule says otherwise, the default treatment for expenditure that does not meet the general deductions test[11] is no deduction. This creates inequity and means that the current law is not durable (in the sense of not being able to cope with developments in the economy).[12]

2.38 A good recent example of this was the need in 1999 to amend the law to add *3 separate regimes* to give deductions for capital expenditure on software development, spectrum licences and indefeasible rights of use over international telecommunications submarine cables ('IRUs'). These were new fields of economic activity created by technological advances.

2.39 There were no special rules in the law before 1999 that gave deductions for expenditure in these fields. That meant that taxpayers spending amounts in these fields had to satisfy the general deductions rule. But, because this sort of expenditure was usually capital in nature, the general deductions rule denied any deduction. So, before the amendments, the default treatment they received was no treatment. This could only be remedied by amendments.

2.40 The uniform capital allowance regime has standardised the treatments in this area somewhat. But the problem remains even after its implementation because it still only allows deductions for capital expenditure on certain *specified* assets.

2.41 When a new field of economic endeavour opens up, or a new form of transaction arises, as it inevitably will, there will be a need to further amend the law. In the interim, the affected taxpayers will suffer the inequity of no deductions for their business expenditure, and economic development in the new area may be retarded as a result, to the detriment Australia's international competitiveness. They will have to come 'cap-in-hand' to the Government seeking changes. The bureaucracy will have to consider the issues and develop solutions. The valuable time of parliamentary counsel and of Parliament itself will be consumed by the amendments.

2.42 We know already that tax relief should be given for the expenditure. The law should reflect that outcome at its core.

Large volume of legislation

2.43 Most people know that the income tax law in Australia has grown massively since it was first enacted in 1915. That first effort consumed only 24 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 have been added in the last 16 years.

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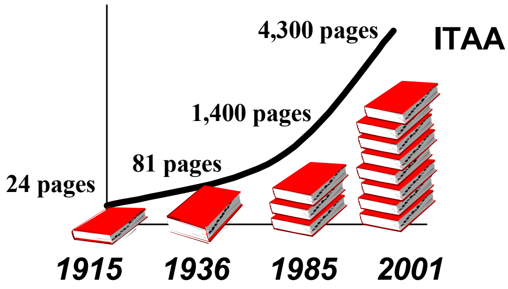
11 Section 8-1 of the *Income Tax Assessment Act 1997* (1997 Act).

12 That is, it is not 'hard wearing'.

Diagram 2.5 The evolving volume of existing income tax law



2.44 Rules have been added to the law for a number of reasons but a key one has been the desire to develop the tax base. That desire was perhaps never coherently conceived. Rather it asserted itself as a series of unrelated amendments to bring this receipt or that expense within the tax net. But, in total, those additions have brought us to the point where we can say that the tax base now largely covers all business gains and losses.[13]

2.45 The law though does not describe the tax base in that way. Rather, reflecting its history, it appears as the original core rules and a large body of extensions. It is our contention that the fact that the law has grown in that way – as a series of *ad hoc* extensions without a coherent vision – has contributed to the excessive volume of the law. For instance, instead of stating a concept once, we find that the law has many variations on each concept. So, we do not have one rule for the 'cost' of things; we have one rule for the cost of depreciating assets, one for CGT assets, one for trading stock, one for traditional securities and so on.

2.46 Further, legislating the tax base in a cumulative way has meant that the various extensions do not always marry with each other. The boundary anomalies have meant that further rules were added to cover gaps, to deal with overlaps, to counter arbitrage opportunities and other exploitable defects and to extend policy concessions granted in one area into other areas. All of these extra rules have added to the volume of the law. Examples are:

- the continuous accumulation of capital allowance provisions; and
- Subdivision D of Division 3 of Part III of the 1936 Act (which are anti-avoidance rules modifying the effect of the general deductions rules);
- rules preventing double counting between asset regimes (like sections 40-50 and 118-20 of the 1997 Act).

2.47 Lengthy law is not inherently a bad thing. 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.

A case study – capital gains tax

2.48 The capital gains tax (CGT) rules in the existing law were added in the 1980's when

13 See Abbey & Keating, op. cit.

the income tax base was expanded to encompass capital gains and losses. Those provisions act as an add-on to the system.

2.49 Thus, under the current law, capital gains (including capital receipts) are only included in taxable income because special rules make it so.

2.50 The need for such rules has a lot to do with the historical development of our income tax law. The current income tax system was founded on the judicial concept of income (called 'ordinary income'). However, the common law concept of ordinary income does not include capital gains, even though they represent realised increases in net assets.

2.51 To overcome this deficiency, the law was amended to include 'net capital gains'[14] in taxable income. That outcome was achieved by deeming net capital gains to be 'statutory income'. (Both ordinary income and statutory income make up 'assessable income', which is included in taxable income.) However, this change only applies to assets acquired, or receipts received, after 19 September 1985. Thus, pre-CGT assets (i.e. assets acquired before 20 September 1985) cannot give rise to net capital gains.

2.52 A capital gain (or loss) can only result if a certain type of event happens (a 'CGT event'). There are almost 40 different CGT events. They differ according to:

- the *type* of gain they bring to account (receipts, gains on disposing of a CGT asset, gains on the expiry of a CGT asset and gains arising under specific anti-avoidance rules);
- *when* the gain is accounted for (e.g. on entering a contract for the disposal of the CGT asset, or when the CGT asset is first used); and
- *who* accounts for the gain (e.g. the legal owner of an asset, such as a trustee, or the equitable owner, such as a beneficiary).

2.53 Capital gains on CGT assets made by some taxpayers are subject to a discount, so that only part of the gain is taxed (e.g. the 50% discount applying to individuals).

2.54 While net capital gains are included in taxable income, net capital losses are not. Instead, these are quarantined and may only be used in reducing the capital gains of future years. As with the discount, unused net capital losses from previous years are taken into account in working the net capital gain of a year.

2.55 The CGT provisions also have their own rules for:

- working out the cost of CGT assets;
- working out the disposal proceeds of CGT assets;
- converting non-cash consideration into monetary amounts; and
- dealing with the overlap that arises when an amount is taxed as a capital gain as well as under another provision.

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14 A net capital gain is a positive amount and is worked out as, the capital gains of an income year *less* the capital losses of that year *less* any unused capital losses from previous years.

2.56 These CGT rules described in this case study occupy a large number of pages in the current law.

Recognising gains and losses that will never exist

2.57 The current law often recognises gains or losses that will never exist economically. It usually does that because it 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.

2.58 For instance, at its core, the law 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 isn't (but may be 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 does not care whether the payment actually leads to an economic loss or not.

2.59 Suppose, for example, that money is borrowed. Repayment of the principal sum will be characterised as capital and so not deductible. Any payments of interest on the principal will be characterised as revenue and therefore deductible. However, if the transaction can be set up 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.

2.60 Special rules are sometimes added to the law to overcome these deficiencies in particular cases. The most recent example is Division 240 of the 1997 Act,[15] which deals with hire purchase arrangements.

A case study – the Metal Manufactures case

The facts

2.61 In this case a sale and lease-back transaction was presented as a means to provide finance to Metal Manufactures. Under the arrangement they sold plant fixed to their land to a financier, and in return agreed to lease it back. For the term of the arrangement they retained the use of the asset and had the practical opportunity to repurchase the asset at the end of the lease.

The outcome

2.62 The choice of the sale and lease-back rather than a simple loan was coloured by the tax advantages afforded by that arrangement. This characterisation enabled Metal Manufactures to get tax recognition for a loss that they never suffered. In particular, the payments made by Metal Manufactures under the arrangement were characterised as lease payments rather than repayments of principal and interest. The result was full deductibility of the payments instead of only the actual loss, the notional interest.

What the case shows about the current system

15 Enacted on 30 June 2001.

2.63 The current law treats many transactions according to their legal form rather than their economic substance. A result of this is that the current law distorts commercial decisions and diverts resources to tax planning.

2.64 This case study is illustrative of a wider systemic problem that has meant that, in a number of areas, the current law:

- recognises gains and losses that will never exist; and
- has been, or has to be, amended in an *ad hoc* fashion to remedy these defects.

Timing anomalies

2.65 The current law does not have a general philosophy about when a gain or loss should be recognised. Instead, it has a body of rules that are independent but that, collectively, prescribe the points of recognition. Their defining characteristic is not principle but variety.

2.66 The current law's lack of a guiding principle means that it often does not conform to an economic treatment. That means that it often does not match the business or accounting treatment of a transaction. The resulting discrepancy increases the need to reconcile the accounting or business result with the tax result, increasing the compliance costs of business.

2.67 The starting point in the current law for working out when a gain or loss is recognised is to ask whether a loss or outgoing is of a revenue or a capital nature.

Revenue items

2.68 If it is revenue, whether it is brought to account is usually determined by the words 'incurred' and 'derived'. Although it may be broadly true to say that those terms have a settled meaning today, the evolving view of the courts still has the capacity to surprise. The *Arthur Murray* decision[16] in 1965 and the *Coles Myer Finance* decision[17] in 1993 are 2 prominent examples of unexpected changes in the judicial interpretation of these terms.

2.69 Even if a revenue item is incurred or derived (and so brought to account), specific rules can sometimes change *when* it is brought to account. Division 16E of the 1936 Act, for example, ensures that gains on qualifying securities are recognised over the life of the security rather than at the start or end. The prepayments rules in section 82KZM et al of the 1936 Act ensure that deductions for some future benefits are recognised over the period those benefits are received rather than at the start.

Capital items

2.70 On the other hand, if an item is capital rather than revenue there are no general rules about when it is recognised. Instead, there is a special rule to cover each case. For example, the capital allowance rules seek to spread the cost of depreciating capital assets across the period they are used to produce income, with a balancing charge to correct any discrepancies on disposal. The capital gains provisions bring other capital receipts to account at a variety of times under the CGT event rules. So, for instance, CGT event A1 recognises a gain on

16 *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314.
17 *Coles Myer Finance Ltd v FCT* 93 ATC 4214.

disposal of a CGT asset when you enter into a contract to dispose of the asset but CGT event H2 recognises a capital receipt for an act, transaction or event in relation to a CGT asset when that act, transaction or event occurs.

No guiding principle or necessary relationship to economic outcomes

2.71 The current law has many timing rules: general timing rules for revenue items, special rules to change the timing of some of those items in some circumstances, and particular timing rules for each type of capital item. But, despite all of these rules, there is no guiding principle, no coherent approach that explains them. Sometimes they are based on historical treatment, sometimes on an economic treatment, sometimes on whatever is most convenient in the particular circumstances.

What is the outcome?

2.72 The absence of an appropriate guiding principle leads to inequity because amounts can be taxed before there has been an economic gain and deductions deferred even though there has been an economic loss. It also leads to artful planning to exploit timing differences between regimes by re-characterising a transaction. And it leads to law that is hard to understand because it must be learnt, not as a set of coherent principles, but rule by rule.

A case study – the Myer Emporium case

2.73 The facts of this case are discussed in paragraph 2.21 above and in more detail in ***Attachment A***.

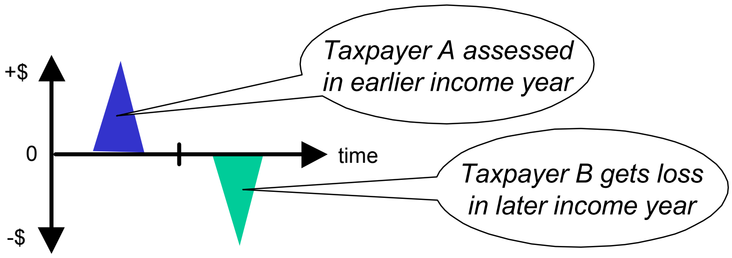
2.74 The High Court's decision was to tax Myer Emporium, at the time it assigned its right to 8 years' interest, on the lump sum it received for the assignment. While the lump sum was a taxable gain, it was not an economic gain at the time of the assignment. Myer had an asset and sold it for its value. There was no gain at that time. Instead, the gain was realised economically over the loan period as the value of the right to repayment of the principal rose towards the principal sum. In assessing the full gain before it was economically realised, the law ensured that Myer received an inequitable treatment.

Asymmetric treatment

2.75 There are usually 2 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. For example, if an expense is deductible to one party but not assessable to the other, there is a strong incentive to incur that expense. The tax savings can be shared between the parties and, in effect, the tax system unintentionally subsidises that form of activity. If the reverse were the case (assessable but not deductible), then the tax system instead operates to discourage that form of activity. Both of those outcomes are undesirable.

2.76 The most common form of asymmetry is not in recognising an amount on only one side of a transaction but in recognising the amount at different times for each party. For instance, a lump sum 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.

Diagram 2.6 Asymmetric treatment of income and expenses



2.77 Inadequacies like these distort the choice of business arrangement, so that tax issues interfere with the allocation of investment funds. This leads to inequity and a lack of robustness in the law.

2.78 The problems caused by lack of symmetry have necessitated numerous amendments over the years. For example, the rule in the *Arthur Murray* case meant that amounts were only included in assessable income when they were earned, not when they were received. The payer, on the other side of the transaction was, however, able to deduct the amount on payment. This timing difference in when the amounts were recognised led to the rules in section 82KZM et al of the 1936 Act designed to spread the payer's deduction for a prepayment over the same period that the amount was earned by the recipient.

2.79 A similar asymmetry problem was revealed by the facts of the *Raymor* case.[18] There, plumbing supplies were ordered towards the end of an income year but not delivered until the following year. The prepayment for plumbing supplies was deductible immediately but only assessable to the supplier on delivery. Because the supplies were not 'on hand' at the end of the first year, Raymor was able to get a deduction without increasing its trading stock value in the normal way. The problem had to be dealt with by specific amendments to deny the early deduction (see subsection 51(2A) of the 1936 Act, section 70-15 of the 1997 Act).

2.80 These amendments are targeted at specific problems. They are not a systemic solution that prevents the problems arising in the first place. Until there is an end to this sort of problem, there will be no end to this sort of amendment. That prospect indicates that the current law has a serious durability problem in this area.

Effects of the current law on major income tax processes

2.81 This part of the paper illustrates how the problems with the current law that were discussed above affect major income tax processes, like making business decisions, interpreting the law, preparing tax returns, resolving disputes, policy making and legislating.

2.82 The table on the following pages discusses the major processes, the effects of the problems on them and which stakeholder groups in the community are most impacted by those problems.

18 *FCT v Raymor (NSW) Pty Ltd* 90 ATC 4461.

Table 2.1 Effect of problems in the current law on major processes and stakeholders

Process	Effects	Stakeholder groups impacted
Making business decisions	Complex, expensive research to: ➲ determine tax implications; ➲ minimise tax implications. Transfers resources from productive business processes.	Significant negative impact on large businesses because of complex business arrangements. Small and medium businesses also negatively impacted, but perhaps less significantly. Need for a large tax practitioner population.
Interpreting the law	Complex, expensive research. Hard to know all relevant rules discovered. Harder to understand the rules. Little interpretive guidance from unclear policy.	Tax practitioners and ATO negatively impacted.
Resolving disputes	Multiple bases for argument make litigation expensive and uncertain. Precedent value of decisions diminished by legislative complexity. Implications of judicial decisions on the whole system hard to foresee.	Judges, tax practitioners and ATO negatively impacted. Court resources diverted from other issues.
Preparing tax returns	Number and complexity of underlying decisions increases cost of preparing returns.	Significant negative impact on large businesses because of complex business arrangements. Small and medium businesses also negatively impacted, but perhaps less significantly. These effects flow through to tax practitioners and the ATO.

Process	Effects	Stakeholder groups impacted
Policy making in response to: ➲ Government priorities ➲ business behaviour ➲ inequitable outcomes	No clear basis on which to determine policy on a whole-of-system basis. Promotes reactive responses to problems. Legislative complexity itself requires policy responses. Harder to explain to those not well versed in tax law.	Government, Parliament, Treasury, ATO and Office of Parliamentary Counsel negatively impacted. Negative downstream impacts on small, medium and large businesses and tax practitioners.
Legislating in response to policy making	Extensive, complex research to fit new law into existing law, meaning drawn out project cycle times. No overarching principle on which to base drafting (creating heterogenous regimes). Reduced chance that legislation accurately implements intended policy. Legislation so complex that technical mistakes occur. Constant repairs to fix mistakes.	ATO and Office of Parliamentary Counsel negatively impacted. Negative downstream impacts on small, medium and large businesses and tax practitioners.
Administration of the law: ➲ promoting compliance (e.g. education) ➲ verifying compliance ➲ 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.	ATO negatively impacted. Negative downstream impacts on small, medium and large businesses and tax practitioners.

3. The TVM hypothesis

A paradigm shift in addressing the income tax base

3.1 Since 1915 the income tax law has been amended in an *ad hoc* fashion to reflect changes in the intended tax base. The increasing number of changes in the last 20 years or so has made that trend obvious.

3.2 As a result of those changes the modern income tax base is very different to the one originally envisaged in 1915. Today, it is closer to an economic concept of income.[19] That shift has meant that the original framework of the income tax law has become less and less suited to describing the intended tax base, leading to all of the problems in the current law described above.

3.3 TVM follows the paradigm shift that has already occurred in accounting; that profit or loss is determined on the basis of net asset and liability movements. Professor Malcolm Gammie in his draft paper to the Board of Taxation/ATAX TVM conference in July 2001 acknowledges this shift and discusses its relevance for tax purposes. His paper acknowledges what current accounting practice is:

> "Financial performance is currently reported in two statements – the profit and loss account and the statement of total recognised gains and losses, (which includes the profit or loss in the former) and which gives a more comprehensive measure of income than the traditional one. Gains and losses are … the consequence of recognised changes in assets and liabilities (although not all changes in an asset or liability give rise to a gain or loss, but might be matched by a change in another asset or liability)."[20]

> "The explanation of financial reporting offered by the (Statement of Principles) is often referred to as the 'balance sheet' approach because its starting point is to establish whether there are assets and liabilities, and then what is their value, with the profit and loss falling out as the change in value of those assets and liabilities…"[21]

3.4 But the shift that has occurred in accounting is a reflection of what has been happening in the income tax law in any event. The income tax law has been implicitly moving towards an asset and liability paradigm, particularly since 1985. The RBT recommendations on the treatment of black hole expenditure, rights and financial arrangements more or less complete that movement. On the assumption that those recommendations will be implemented, the income tax base now truly reflects an economic idea of income that is closer to commercial reality, rather than a judicial one. TVM says that reality should be explicitly recognised in the way the legislation is drafted.

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19 'Economic income' here doesn't mean a Haig-Simons comprehensive income tax base. It means an idea of income that is based on commercial reality; the way that business determines its profit or loss for commercial purposes.

20 Malcolm Gammie, *TVM and the relationship between taxation and commercial accounting methods*, page 19.

21 Ibid, pages 21 and 22.

The Tax Value thesis – a shift to an integrated approach based on assets and liabilities

3.5 TVM is essentially about fixing the foundations upon which the calculation of taxable income is based. It is not about changing the nature of our tax base as an income tax base. Nor is it a ‘trojan horse’ for introducing a tax on unrealised capital gains. An analogy helps to illustrate the true intent of TVM.

3.6 Compare the income tax system with a road.

3.7 The driver travelling along the road suffers the effects of potholes, cracks and bumps in the road and believes there are problems with the tarmac. However, the problems are often caused by the road's poor foundations, not the weakness of its surface.

3.8 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 (hence the Tax Law Improvement Project). However, like the road, the underlying problem is often not the law's expression, but its foundations.

3.9 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 user will have a better journey but will still only experience how the road is to travel upon, not what is under the surface.

3.10 Many of the problems with the income tax law are due to the law’s concepts and themes. This is the level that determines the way taxable income is expressed in law. The thesis is that the best plan is to fix the law by fixing this foundation.

3.11 The *analogy* is that good road builders do not keep working on the surface. They look at the whole structure of the road and fix the part that causes the problem.

3.12 The analogy may not prove anything about TVM, but it helps us understand the solution it proposes.

3.13 These diagrams illustrate the analogy.

Diagram 3.1 The road as it now is

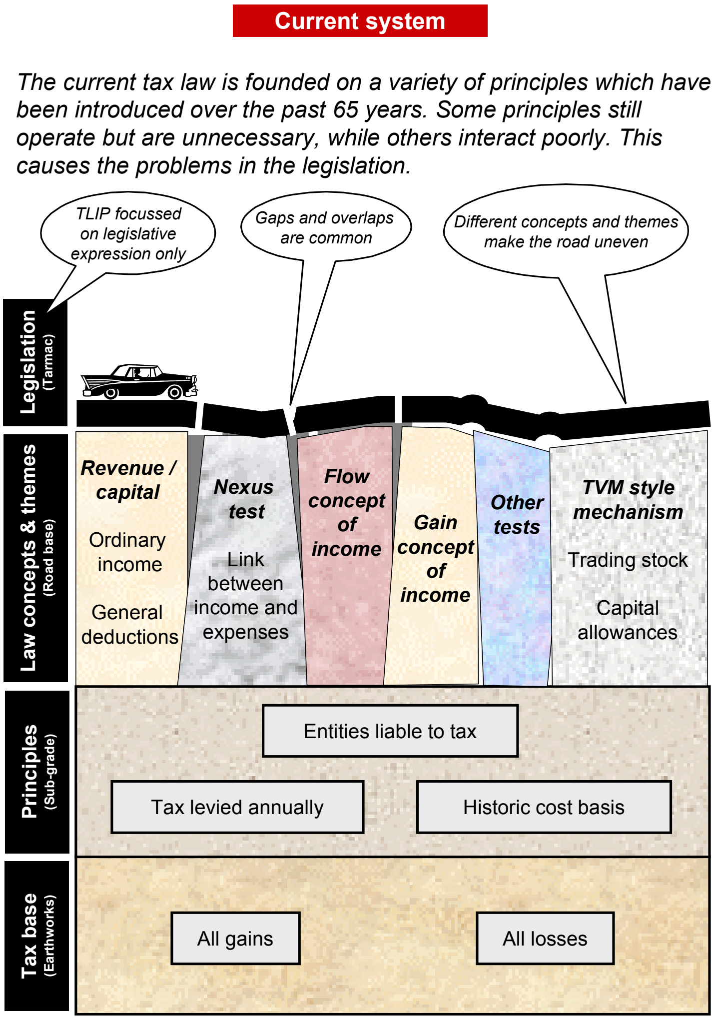
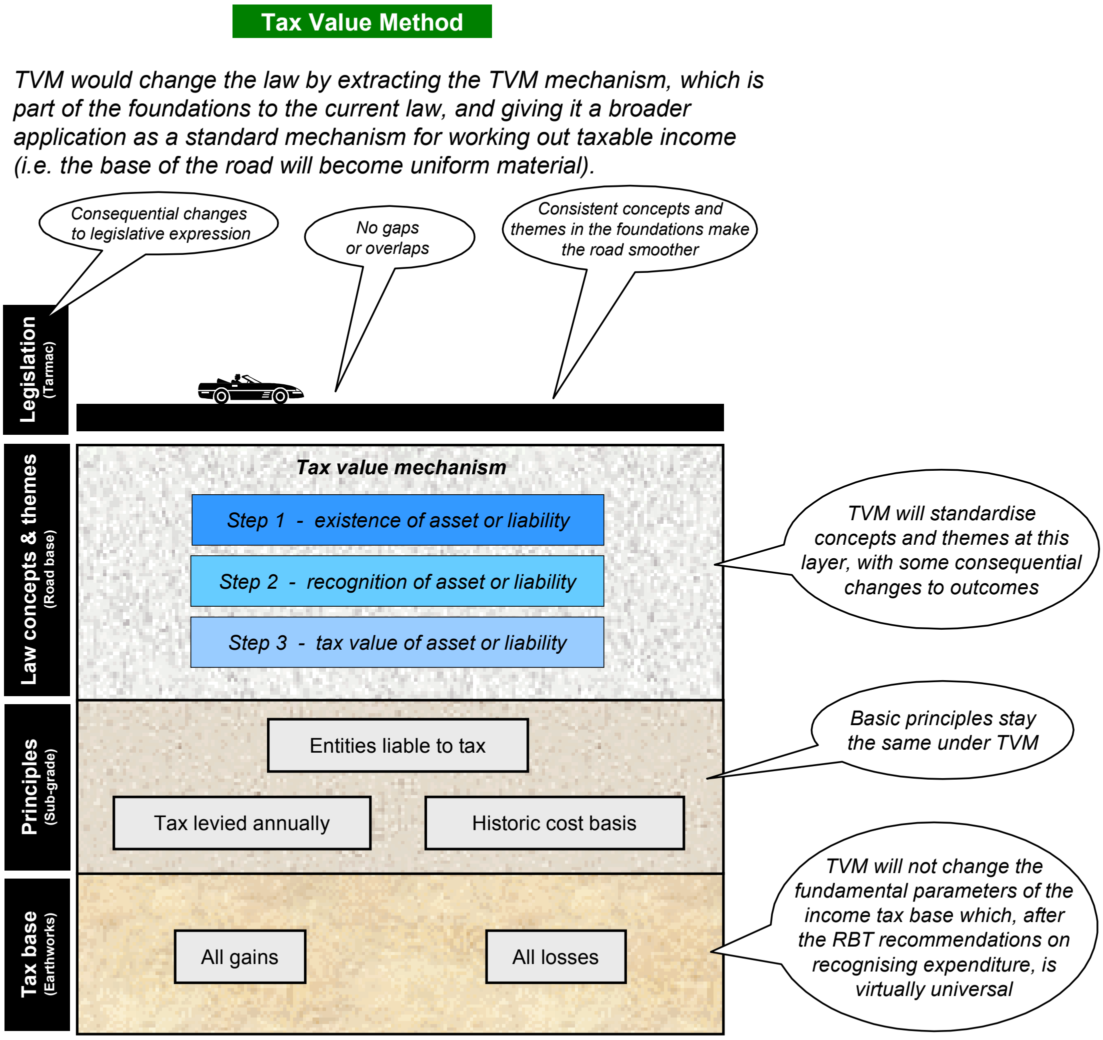


Diagram 3.2 The road as it could be



Outcomes sought from TVM

3.14 These outcomes are sought from TVM:

- A standardised concept of income that reflects the post- RBT income tax base.
- Standardised core rules to support that concept (e.g. uniform cost rule).
- Shorter, clearer, more concise and intuitively accurate income tax law (making it easier to learn and use).
- Fewer disputes between taxpayers and the revenue authorities.
- Income and expenditure treatments more closely reflect economic outcomes.
- All income and expenditure gets a standard (default) treatment closer to the intended tax base.
- Improved implementation of future policy changes.

- Greater assurance of accurate policy implementation (departures from stated policy will be easier to identify).
- A better platform for developing tax products (e.g. tax returns and related instructions).

3.15 These outcomes seek to provide improved *simplicity, certainty*, *durability, transparency, equity* and *robustness*.

Revenue outcomes

3.16 TVM should not change the nature of the existing income tax base and should produce overall revenue neutrality. This does not mean the same result for every taxpayer in every case. Changes to particular tax outcomes may occur:

- because of the standardisation inherent in TVM; or
- because TVM is a platform for policy changes (e.g. tax relief for black holes, improved treatment of rights and financial arrangements).

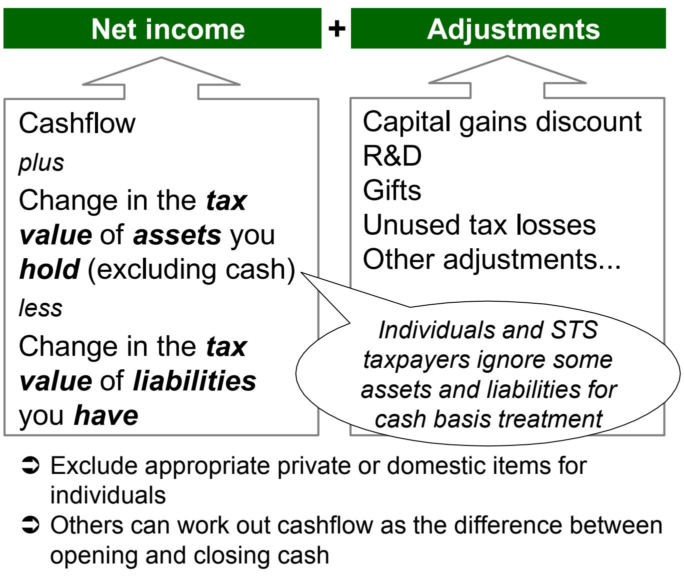
3.17 Significant changes will be identified and costed.

The TVM mechanism – an integrated approach to working out taxable income

A new legislative mechanism for working out taxable income

3.18 'Taxable income' is the amount on which income tax is levied. The concept already exists under the ITAA 1997 but the Tax Value Method would work it out in a new way.

Diagram 3.3 TVM's legislative expression of taxable income



When is there 'income' under TVM?

3.19 There is 'income' under TVM when there is an unmatched increase in cash or the tax value of assets, or an unmatched decrease in the tax value of liabilities.

When is there a 'deduction' under TVM?

3.20 There is a 'deduction' under TVM when there is an unmatched decrease in cash or the tax value of assets, or an unmatched increase in the tax value of liabilities.

The TVM mechanism uses a 3-step diagnostic to work out net income

3.21 The net income calculation allows the income tax effects of every transaction to be analysed and explained using a common conceptual framework. This framework can be described as a 3-step diagnostic.[22]

Diagram 3.4 TVM's 3-step diagnostic

Step 1 - existence	
Is there an asset? An asset is a source of future economic benefits	***Is there a liability?*** A liability is an obligation to provide future economic benefits

These definitions draw on the accounting meanings

Step 2 - recognition	
Do you hold the asset? Normally, you only *hold* an asset if it is property or a right that you own	***Do you have the liability?*** Normally, you only *have* a liability if it is a present legally recognised obligation that you owe

Step 3 - tax value	
What is the asset's tax value? Most assets have a tax value of cost (i.e. unrealised gains not taxed).	***What is the liability's tax value?*** Most liabilities have a tax value equal to the amount received to assume the liability.

Adjustments to net income

3.22 This diagnostic gives the basic pattern for TVM. However, Government policy will always require special treatment for some kinds of asset and liability. The 'taxable income adjustment' accounts for this and some other issues.

3.23 Examples of adjustments are the 50% CGT discount and research and development incentives.

22 Note that receipts and payments are not referred to in this 3-step diagnostic. The receipts and payments aspect of the net income calculation is simply a way of describing in the legislation the change in a taxpayer's cash assets and so can also be analysed in terms of the 3-step diagnostic. As discussed in Diagram 3.3, taxpayers who are not individuals can work out their receipts minus payments as the difference between their opening and closing cash.

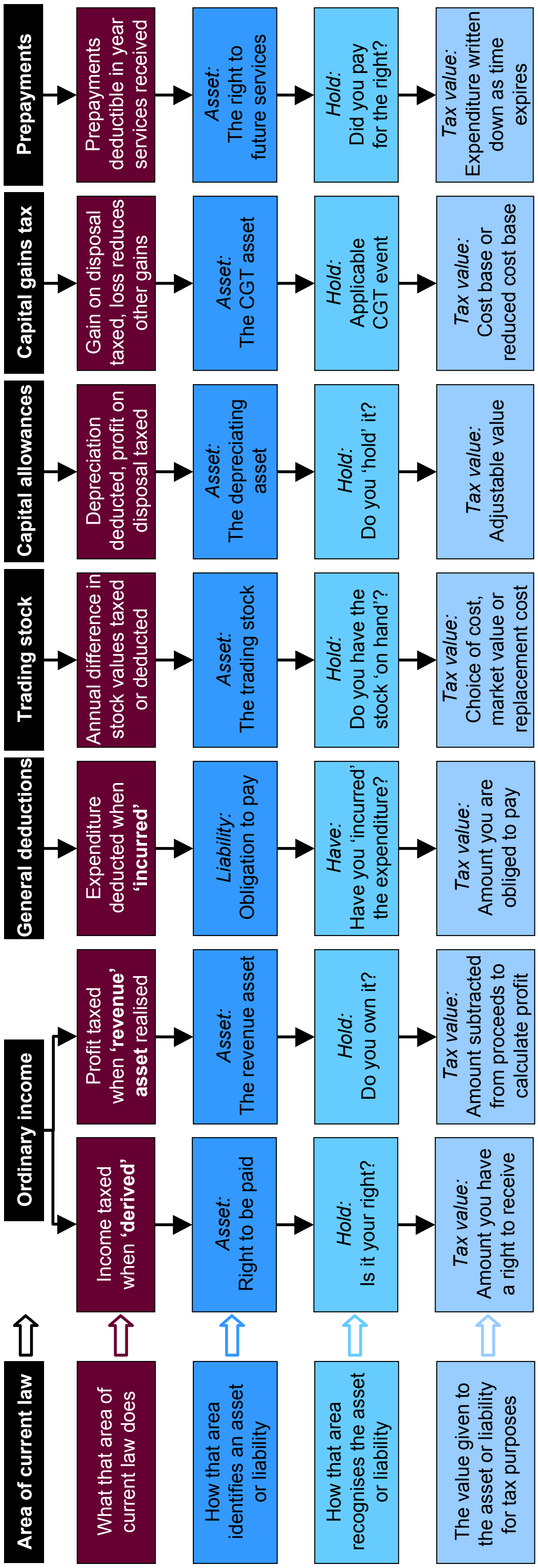
The link between existing law and TVM - mechanism is a theme in existing law

3.24 The 3-step diagnostic that lies at the heart of TVM[23] can be seen as a theme of the existing law. As discussed in paragraph 1.2 that is not surprising given that recognising assets and liabilities is a feature of any income tax system.

3.25 However, the theme in the existing law is obscured by the way its structure has developed and in the language used to express it. TVM lays a new foundation by distilling the theme into a set of universally applied principles.

[23] See paragraph 3.21.

Diagram 3.5 Examples of how TVM's 3-step diagnostic is found in the current law



How TVM deals with current problems

One way of doing things — the asset and liability framework

3.26 As already discussed, the net income formula allows the tax effects of every transaction to be analysed and explained using this common conceptual framework.

Diagram 3.6 The framework for analysing transactions

Transaction

Change in ***assets***? Do you ***hold*** it? What is its ***tax value***?	Change in ***liabilities***? Do you ***have*** it? What is its ***tax value***?

3.27 For example, assume that you pay legal fees relating to an asset. The fees are for advice about zoning laws applying to land.

3.28 ***Currently***, you have to ask yourself these questions:

- is the payment ‘incurred’ in producing ‘income’?
- is the payment ‘revenue’ or ‘capital’?
- is the payment ‘private or domestic’?
- is the asset covered by one or more statutory income regimes?
- is the payment part of the ‘cost’ of the asset?
- do one or more statutory deduction rules apply?
- does a rule preventing overlaps apply?

3.29 These questions are necessary precisely because the current law does not have just one regime that can apply to this transaction. It has many different regimes that could apply here. Because the different regimes work in different ways, the questions you have to ask are different for each of them. Potentially, many of the regimes could apply at the same time, hence the need to ask questions about priority and overlaps. Even if it turned out that only one regime did apply here, you would still have to ask these questions to be sure that it did apply and that the others did not.

3.30 By comparison, under ***TVM***, these questions arise:

- is the asset ‘held’?
- is the payment part of the tax value of the asset?
- is the payment ‘private or domestic’ (only individuals need to ask this question)?
- does an adjustment apply?

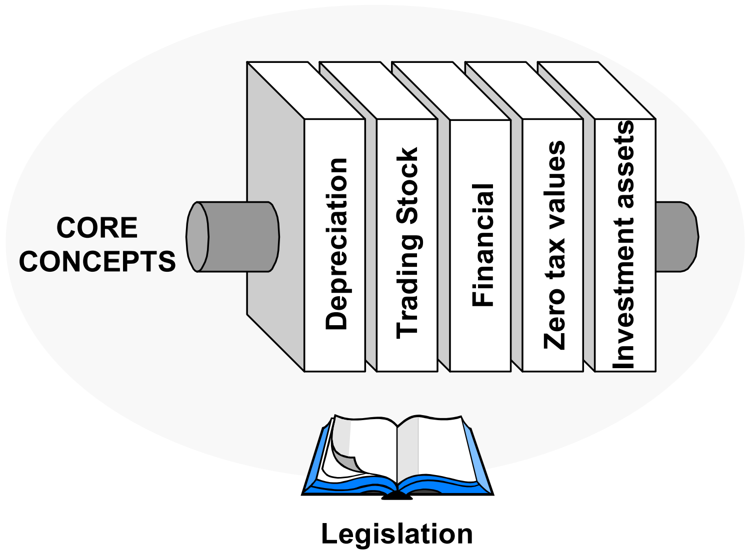
3.31 These are the same questions that you would ask yourself under TVM no matter what the transaction was. That is because TVM has only one regime, one common conceptual framework that works for all transactions.

Standardised core concepts to support calculation of 'net income'

3.32 The net income calculation under TVM is supported by the use of common core concepts that apply universally. These are:

- asset and liability definitions;
- holding rules for assets and liabilities;
- tax value rules;
- cost and proceeds rules;
- non-cash transaction rules; and
- rules for splitting and merging of assets of assets and liabilities.

Diagram 3.7 Core concepts that support net income through each asset and liability class



Downstream effects of doing things in one way

3.33 The consistent application of these underlying principles means:

- simpler analytical processes to determine the income tax consequences of a transaction, because all transactions can be explained using the 3-step diagnostic;
- appropriate timing (gains and losses are recognised at the correct time);
- the elimination of double counting;

- no black holes;
- a cohesively defined platform for future developments; and
- an improved legislative development process.

A case study — applying TVM to the Myer Emporium case

3.34 The problems raised under the current law by the *Myer Emporium* case were discussed at paragraphs 2.20 to 2.27 and are expanded upon in ***Attachment A***. The following illustrates the application of TVM to those facts.

The outcome under TVM

3.35 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, 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 2 new assets in accordance with their relative market values.

3.36 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 RBT 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.

3.37 The key observation to be made of the TVM treatment 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. In conjunction with the RBT recommendations on financial arrangements, TVM makes it possible to recognise financial gains on an appropriate economic basis.

What the case shows about TVM

3.38 The application of TVM to the *Myer Emporium* case tells us:

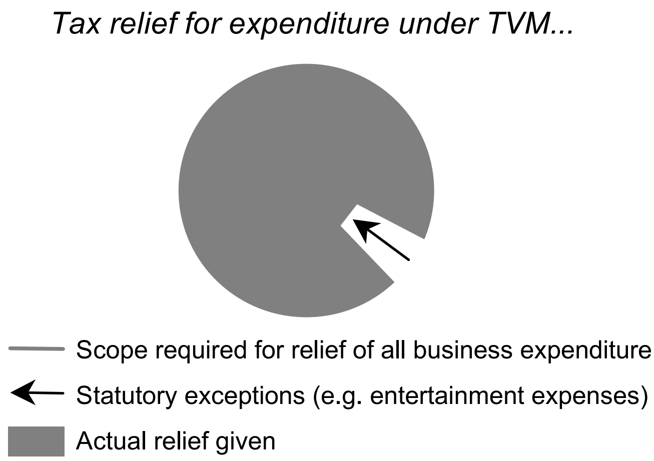
- the many, often overlapping and inconsistent, mechanisms that can apply to a single transaction under the current law would be replaced by a single mechanism under TVM, simplifying it;
- the time and money spent in understanding, explaining and disputing the current law will be less under TVM; and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

Appropriate default treatment

3.39 The foundation of TVM is a closer reflection of the intended tax base. If we accept that the scope of the post-RBT income tax base is more or less universal,[24] then the default treatment under the income tax law should reflect that reality. TVM does this because it encompasses all non-private gains and losses within its basic framework. It then uses explicit exceptions to exclude gains or losses where policy requires a departure.

3.40 So, for example, tax relief is given for all business expenditure unless there is a special rule to prevent it. The timing of the relief is set by the tax value of the asset or liability concerned and its rate of decline or increase.

Diagram 3.8 Systemic relief for business expenditure



3.41 A default treatment that is a closer reflection of the intended tax base simplifies the law and improves equity and durability because:

- less law is needed
- intended treatment is given more often (because it deals better with future developments)
- there is less need to amend law to meet future developments.

A case study – tax relief for capital expenditure

3.42 The current problems with tax relief for capital expenditure were discussed in a case study at paragraphs 2.37 to 2.42. The following illustrates how TVM would have operated.

3.43 Suppose that TVM had been in place rather than the current law when technological developments led to taxpayers making expenditure on computer software, spectrum licenses and indefeasible rights over submarine cables. Where the current law could not recognise the expenses until it was amended, TVM would have treated the purchased assets as merely new examples of depreciating assets. The cost would have been counted in the asset's tax value

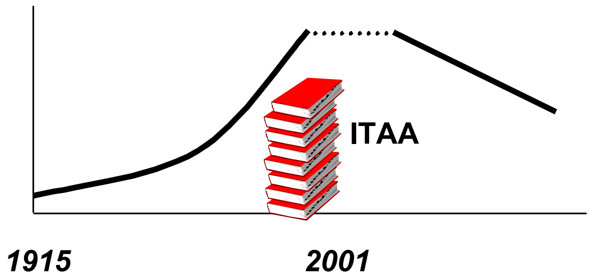
24 See Abbey & Keating, op. cit.

which would have declined gradually over the asset's effective life, allowing the law to recognise the loss over an economic period.

3.44 Under TVM, there would have been no need to amend the law. That is more equitable because there would have been no period when the tax law failed to recognise necessary business expenditure. Economic decision making would not have been distorted in favour of tax preferred expenses during the same period. The valuable time of parliamentary counsel and of Parliament itself would have been freed to work on matters of greater significance.

Reduced volume of legislation

Diagram 3.9 A rough projection of the trend?



3.45 TVM will reduce the volume of the income tax law by distilling the 3-step asset/liability diagnostic that is a theme of the current law and elevating it to the higher level core rules.[25]

3.46 In similar fashion, the volume of law would be reduced by the use of common core rules across all the asset and liability classes.[26]

3.47 The robustness inherent in TVM[27] should reduce the volume of law by eliminating the need for some special rules, including some anti-avoidance rules.

3.48 Shorter legislation makes the law easier to learn and use.

A case study – simplified capital gains provisions

3.49 The current problems with the volume of law were discussed in a case study on CGT at paragraphs 2.48 to 2.56. The TVM re-draft of CGT illustrates the reduction in the volume of law that is possible under TVM.

3.50 TVM's core mechanism brings all economic gains and losses to account without the need for special rules. Therefore, it would automatically bring capital gains and losses to account. However, there are policies that require capital losses to be quarantined and for some capital gains to be discounted. TVM requires adjustment provisions to achieve those policies.

3.51 To give effect to that, the TVM legislative group has redrafted the part of the CGT provisions discussed in the earlier case study.[28]

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25 See paragraphs 3.26 to 3.33.
26 See paragraph 3.32.
27 See paragraphs 3.39 to 3.44.

3.52 The draft has one main CGT event – ceasing to hold an asset. No rules are needed to describe that event because it is merely the end of a state of affairs (holding) already described in TVM's core rules. Most of the CGT events in the current law are collapsed into that event, so do not need to be separately described. The rules about the amount of a gain and its timing, that are currently repeated for each of those collapsed CGT events, are reduced in the draft to a single set of rules.

3.53 Only 2 current CGT events have not been collapsed under the TVM draft into the main 'ceasing to hold' event. They deal with returns of capital to shareholders and beneficiaries.[29]

3.54 The draft is limited to only the assets intended to come within those policies, so, unlike the current law, there is no overlap with any other provision. The draft contains no rules for the cost of the assets or for their disposal proceeds because TVM's core rules already cover those topics for the entire system. Similarly, the non-cash provisions in the core rules already apply to acquiring and disposing of these assets, as they do to all assets.

3.55 These things have meant that the present re-draft of the capital gains tax rules has reduced 126 pages of rules to only 28, a reduction of more than 70% in the areas re-drafted. This may be an unusual case but is indicative of the considerable advantages that TVM offers in shortening the current law.

Only actual gains and losses recognised

3.56 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 or combined will not change the final outcome unless the economic substance itself is changed.

3.57 The current law usually deals with transactions by prescribing a treatment based on the character of the transaction. It inevitably follows that the tax outcome can often be altered simply by re-characterising the transaction.

3.58 TVM takes a different approach. It deals with the underlying receipts, payments, assets and liabilities directly, not by attaching a result to how they can be characterised, individually or collectively. It follows that, for so long as the final outcome of those receipts, payments, assets and liabilities is unchanged (i.e. for so long as the underlying economic substance is unchanged), TVM will produce the same outcome regardless of the form of the transaction.[30]

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[28] See paragraphs 2.48 to 2.56.

[29] 5 others will need to be considered further as drafting of TVM proceeds.

[30] Because the tax value of assets under TVM sometimes depends on characterisation, the timing of a gain or loss, although not its existence, can be altered by changing the form of a transaction. This result is the product of a policy decision to value different types of assets in different ways.

A case study — applying TVM to the Metal Manufactures case

3.59 The problems raised under the current law by the *Metal Manufactures* case were discussed at paragraphs 2.61 to 2.64 and are expanded upon in ***Attachment B***. The following illustrates the application of TVM to those facts.

The outcome under TVM

3.60 Under TVM, the characterisation of the arrangement as a sale and lease-back, a hire purchase or any other form of asset-based finance is irrelevant. TVM applies to the actual receipts, payments, assets and liabilities that are involved regardless of the legal form of the overall arrangement. The result is a principled treatment that accords with the economic substance, which is based on the underlying reality of the agreement.

3.61 TVM recognises only the economic losses that Metal Manufactures makes. This means that tax relief is not given for the component of the lease payments that is economically equivalent to repayments of principal. However, tax relief is given for the component that is economically equivalent to interest payments under the finance arrangement.

What the case shows about TVM

3.62 In contrast to the current law, TVM better accords the tax treatment of transactions with their economic substance. This means that tax considerations will not distort commercial decisions and fewer resources will be diverted to tax planning. Therefore, it can be asserted that TVM:

- is more ***robust*** because it only recognises gains and losses that will actually exist; and
- is more ***durable*** because it removes the need for the law to be amended to correct defects in the amounts it recognises.

Timing anomalies removed

3.63 Under TVM, working together with RBT recommendations on black holes, rights and financial arrangements,[31] there is a clear philosophy about when gains and losses should be recognised. It is that each gain and loss should be recognised over the relevant period in accordance with economic principles.

3.64 That philosophy is achieved through TVM's 3-step diagnostic that identifies each asset and liability, works out who holds it and then assigns it a tax value.

3.65 Many asset and liability movements (including movements in cash caused by receipts and payments) do not create immediate tax consequences under that mechanism because they give rise to offsetting changes in the tax value of other assets and liabilities. These are 'matched' movements. For example, buying plant does not produce an immediate deduction because the taxpayer's payment (reduced cash) is matched by the plant's tax value.

[31] Recommendation 4.14 and sections 9 and 10 of *A Tax System Redesigned*.

3.66 In such cases, the asset or liability movement is recognised for tax purposes, as the tax value of the matching asset or liability declines over its effective life. That means that the movement is recognised gradually by TVM and that accords with economic principles about timing of recognition. The case study on the *Myer Emporium* case, discussed at paragraphs 3.34 to 3.38 above, illustrates how TVM, together with RBT recommendations on financial arrangements, resolves the timing inequity evident in the case.

3.67 Some asset and liability movements are not matched by an offsetting change in the tax value of any other asset or liability. They are called 'unmatched' movements. For example salary payments to staff reduce cash but usually produce no long-lasting asset. Unmatched movements create immediate tax consequences.

What are the economic principles about timing of recognition?

3.68 In general terms the economic principles guiding the development of TVM in terms of timing are set out below.

Tax recognition of expenditure

3.69 The policy being applied in this area is that tax relief for non-private expenditure should be afforded when the economic benefits the expenditure brings are received or consumed by the taxpayer.[32] The benefits we are talking about here are not necessarily income generated by the expenditure, although sometimes that is the case,[33] but rather the direct benefits the taxpayer acquires from the expenditure.

3.70 So, for example, the future benefits from expenditure on plant are consumed as the plant is used in the manufacturing process, even though income from the goods produced may not be seen for some time.

3.71 Similarly, the economic benefits from expenditure on a right to services are consumed when the services are received even though the services may be an input into the business that does not generate income immediately. The question is always whether that expenditure itself should form part of the cost of another asset to which the services may have contributed.

3.72 This basic policy is always subject to compromise for policy reasons, as pointed out by the RBT.[34] So, for example, immediate tax relief is given for expenditure on mining exploration even though the benefits the expenditure brings may not be realised for some time.[35]

3.73 The policy outlined above can also be seen in the current income tax law in the way expenditure is recognised under, for example, the general deduction rule (section 8-1 of the 1997 Act), the trading stock rules, the prepayment rules, the capital allowance rules and the CGT rules.

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32 *A Tax System Redesigned*, p. 157. This principle underlies the recommendations in section 10 of that report.

33 Most notably with financial assets where the future benefits of expenditure are cash flow that is income.

34 *A Tax System Redesigned*, pages. 157-158.

35 See subsection 6-40(3) of TVM Prototype 2.

Tax recognition of income

3.74 Because a key feature of TVM is a symmetrical treatment of income and expenses, the main policy being applied here is that income should be recognised for tax purposes when the future economic benefits that generate the income are provided. So, the mere fact that you receive cash is not enough. If the cash is in return for you promising to do something in the future, the cash should only be recognised when you do those things, or at least when your liability to do them ceases to exist.

3.75 This basic principle can be seen in the existing law in the 'derived' concept. The classic example comes from the *Arthur Murray* case[36] which held that income had to be 'earned', and not merely received, before it was assessable.

Accruals on some financial arrangements

3.76 In the limited case of some financial assets, the policy is that gains or losses that are 'certain' should be accrued and so recognised for income tax purposes even though there has been no cash incoming or outgoing. That reflects the RBT recommendations on financial arrangements and the treatment that some financial assets currently get under Division 16E of the 1936 Act.

Symmetrical treatment

3.77 The problems caused by the asymmetric treatment of some transactions under the current law were discussed at paragraphs 2.75 to 2.80 above. A key design principle of TVM is that the treatment of income should mirror the treatment of expenses.[37] This principle addresses the most common form of asymmetry in the current law — recognising an amount at different times for each party to a transaction.

3.78 The symmetry of TVM can be seen in the way that:

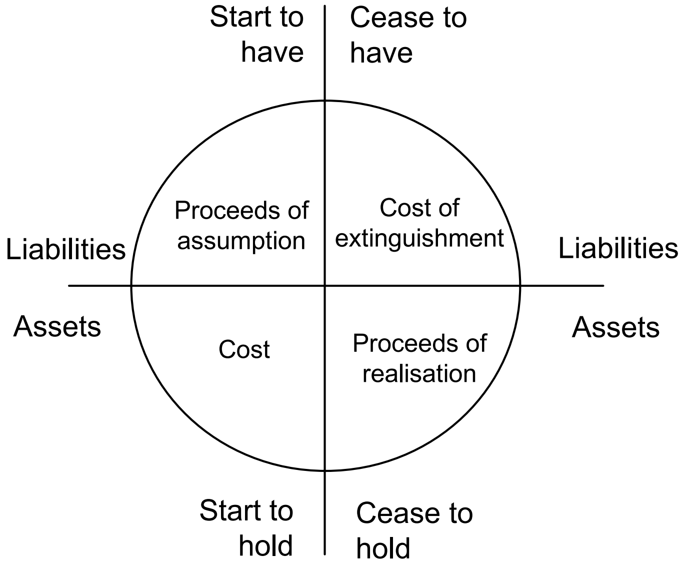
- the rules defining assets mirror the rules defining liabilities; and
- the rules about *starting* to 'hold' mirror the rules about *ceasing* to 'hold';
- the rules setting the tax values of assets mirror the rules setting the tax value of liabilities.

3.79 This can be represented in the following diagram:

[36] *Arthur Murray (NSW) Pty Ltd v FC of T* (1965) 114 CLR 314

[37] The only variation is where policy decisions require it.

Diagram 3.10 Symmetrical treatment of assets and liabilities



3.80   For instance:

- most assets are acquired by an entity as the result of a corresponding disposal by another entity. The TVM treatment is symmetrical because the amount a purchaser pays for an asset is both the cost of acquisition to the purchaser and the proceeds of disposal to the vendor; and

- every right an entity holds typically corresponds to a liability of another entity. For example, the TVM treatment is symmetrical because the amount a creditor advances to a debtor is both a cost of acquisition of a financial asset for the creditor and the proceeds of assuming a liability to the debtor. Furthermore, the amount a debtor pays to discharge a liability is both a cost of extinguishment of a liability for the debtor and a proceeds of realisation of an asset for the creditor.

3.81   For instance, consider the situation when there is a prepayment for services. The asymmetry of the current law in this respect was discussed in the context of the *Arthur Murray* and *Raymor* cases at paragraphs 2.78 and 2.79. Under TVM, as a general proposition, if you pay money, you should get tax relief for it when you get the benefits of the expenditure. Symmetrically, if you receive money, you should be taxed on it when you give the benefits for which you received the money.

3.82   Symmetry makes the law more equitable. It is equitable because the treatment of one party to a transaction is mirrored by the treatment of the other. The symmetry of tax treatments means that tax considerations should not influence the choice of particular forms of business arrangement, so not interfere with the way in which investment funds are allocated. This also means that it will be more difficult to arbitrage timing differences between taxpayers removing the incentive for some tax planning activities.

3.83   In addition, the asymmetry has added legislative and administrative complexity to the current law as specific rules have been added to address the problem (e.g. the prepayment rules, Division 16E[38], the debt forgiveness rules and recoupment rules). The symmetry of TVM will mean that such amendments would not be required to eliminate double counting and resolve timing anomalies.

Effects of TVM on major income tax processes

3.84 It is anticipated that improvements to the processes discussed at Table 2.1 will flow from an implementation of TVM.

3.85 Some have suggested that TVM will require taxpayers to undertake new processes that will add to compliance costs. However, TVM will not:

- require a 'balance sheet' to be kept; or
- require annual valuations of all assets and liabilities.

Effects of TVM on major stakeholder groups

3.86 Table 2.1 listed the effects of the problems in the current law on processes and the stakeholders who use those processes. TVM should, because of all the benefits discussed above, have positive effects on those processes (making business decisions, interpreting the law, resolving disputes, preparing tax returns, policy making, legislating and administration of the law).

3.87 The table below sets out the potential impact on these positive effects on each of the major stakeholder groups. These impacts could be verified through testing and consultation.

Table 3.1 Effects of TVM on major stakeholder groups

Stakeholder group	Potential impact of TVM
Small and medium businesses	Insignificant transitional impact. Downstream benefits through improved compliance processes and support products (like rulings and other publications).
Large businesses	More significant transitional impact. Improved certainty in making business decisions and less disputes. Less 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).

38 Which deals with deferred interest securities.

Stakeholder group	Potential impact of TVM
Tax practitioners	Significant transitional impact, particularly for those with large business clients. Significant medium to longer term benefits through improved processes for interpreting the law and preparing tax returns and less disputes. Lower tax practitioner population?
ATO	Significant transitional impact. Significant medium to longer term benefits through improved processes for interpreting the law and ensuring compliance and less disputes. Improved processes and shorter cycle times for legislating new policy.
Office of Parliamentary Counsel	Significant transitional impact. 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.

A case study – effect of TVM's simplification of CGT on costs

3.88 ***Attachment C*** outlines the potential benefits of 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 enquiries, correspondence, amendments, etc.

3.89 Preliminary indications from the analysis are that TVM may result in a 51% reduction in CGT related rulings and a 32% reduction in CGT related litigation. TVM could potentially reduce the need for taxpayers to deal with the ATO on CGT matters, annually, as follows:

- the number of calls to the ATO by 180,000;
- the number of requests for amendment by 19,000;
- general correspondence by 15,000;

- the number of objections by 770 ;and
- private binding rulings by 800.

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

4. Demonstrating and measuring the benefits of TVM

4.1 Work done to date on TVM has focussed on developing the core legislative rules. This has been necessary because the core rules form the platform from which TVM legislation and administrative products can be further developed.

4.2 Testing of TVM to date has been limited but has provided useful feedback on the legislation produced so far. Importantly, it has shown that there are no ‘show stoppers’ with TVM. Clearly more testing is required, as is an evaluation of TVM on the basis of a sufficiently developed suite of legislative and administrative products.

4.3 The table on the following pages demonstrates how the benefits of TVM discussed above can be classified using the 6 high level values. It also suggests how the success of TVM in achieving those values can be measured, and to what extent that measurement has occurred to date.

Table 4.1 – Demonstrating and measuring the benefits of TVM

Value	How TVM achieves it	How to measure TVM's success	What's been measured so far
1. Simplification *Beneath the necessary complexity of policy-based treatment of various gains and losses, the system is based on as few and as simple concepts and mechanisms as possible.*	One way of doing things Appropriate default treatment Symmetrical treatment Reduced volume of law	Ways to measure simplification include: ➲ to look at the reduction in the law TVM achieves as provisions are drafted; ➲ to compare the number of different treatments in the current law with the equivalent TVM provisions; ➲ projecting the reduction in rulings, litigation and enquiries required. ➲ surveying opinions.	We have started measuring the reduction in the size of the law and are developing a methodology to project future reductions. We have started to project the reduction in rulings, litigation and enquiries (see ***Attachment C***).
2. Certainty *The tax treatment of a given business activity can be reliably predicted.*	One way of doing things Appropriate default treatment Reduced volume of law Only recognises actual gains and losses Timing anomalies removed Symmetrical treatment	Improvements in certainty can be measured by: ➲ appropriate comparative testing of hypothetical cases under both the current law and TVM with test subjects; ➲ working out the percentage of recent disputes that dealt with issues that do not arise under TVM; ➲ analysing historical court cases.	In relation to the first point, the board has arranged for Professor Cooper to undertake comparative testing in conjunction with the ANU's Centre for Tax System Integrity. In relation to the second point, The ATO's Centre of Expertise for TVM has commenced work. In relation to the third point, we have started analysis of historical court cases (e.g the *Metal Manufactures* and *Myer Emporium* cases discussed in this paper).

Value	How TVM achieves it	How to measure TVM's success	What's been measured so far
3. Durability *Future changes in tax policy (as far as they can be predicted) can take place within the legislative framework.*	One way of doing things Appropriate default treatment Only recognises actual gains and losses Timing anomalies removed Symmetrical treatment	Improvements in durability can be tested by analysing amendments to the law over a recent period to see what percentage of them solved problems that TVM would have solved without amendment.	This work has commenced, as can be seen in the case study dealing with capital expenditure at paragraphs 2.37 to 2.42 and 3.42 to 3.44.
4. Transparency *The tax treatment of a given business activity can be easily linked to the policy on which it is based.*	One way of doing things Reduced volume of law	Improvements in transparency can be tested by comparative testing of current law and TVM provisions with test subjects to see which more often reveals the underlying policy.	Nothing yet due to the need for more complete drafting (especially in non-core areas) before useful testing could begin.
5. Equity *Different taxpayers with the same economic circumstances are treated in the same way.*	One way of doing things Appropriate default treatment Only recognises actual gains and losses Timing anomalies removed Symmetrical treatment	Improvements in equity can be tested by: ➲ applying a case-by-case analysis to various transactions under both the current law and TVM (e.g. analysing historical court cases and transactions tested in the Baxter testing exercise); ➲ measuring the percentage of recent amendments made to correct inequities that would not have been necessary under TVM.	We have started analysis of court cases (e.g the *Metal Manufactures* and *Myer Emporium* cases discussed in this paper).

Value	How TVM achieves it	How to measure TVM's success	What's been measured so far
6. Robustness *The legislative framework effectively covers the variety of business activities.*	One way of doing things Appropriate default treatment Only recognises actual gains and losses Timing anomalies removed Symmetrical treatment	Improvements in robustness can be measured by: ➲ comparing the number and length of specific anti-avoidance provisions needed under TVM to shore up the main provisions with those needed under the equivalent current law provisions; ➲ analysing historical court cases to see what percentage of litigated schemes would not have been litigated under TVM.	In relation to the second point, we have started analysis of court cases (e.g the *Metal Manufactures* and *Myer Emporium* cases discussed in this paper).

5. Are there any alternatives to TVM?

5.1 It has often been suggested that alternative options to TVM should be considered. The only 3 options so far put forward are:

- piecemeal reform of particular problems (like black holes and overlaps);
- trial TVM with some particular regimes (e.g. the taxation of financial arrangements);
- adopt accounting profit as the measure of taxable income;
- [‘Option 3’ being developed by TVM Working Group sub-group].

Piecemeal reform versus an integrated solution

5.2 Our work on TVM to date has led us to think that TVM might provide a good solution to a range of problems that bedevil tax legislation currently. When those problems are identified, it is clear that TVM is not the only solution to all of them. For example, there are probably many ways of fixing the problems of black hole expenses, overlaps and gaps. There are, however, some problems with the current law that would *only* be solved by TVM. For example, only TVM seems to offer a solution to the problems of complexity created by having many different ways of doing things or a lack of any clear platform for future developments of the law. The alternative solutions to the earlier problems would probably compound the current law’s complexity by adding to the current morass.

5.3 Even where there are alternative solutions to problems, only TVM has so far been proposed as providing a single, integrated solution rather than a series of piecemeal solutions to particular problems.

5.4 A single, integrated solution, especially if it is based on clearly articulated and accepted principles, is likely to provide a better end result than a series of piecemeal solutions to particular problems. This is especially so given that many of the problems that bedevil tax legislation currently arise from a long-standing practice of adopting piecemeal solutions to particular problems as they are identified, rather than attempting to deal with the structural or conceptual inadequacies in the law that have caused the problems in the first place.

Trialing TVM

5.5 As this paper shows TVM cannot be trialed in any piecemeal sense, since its main objectives are to standardise the definition of income and use common core concepts across the law. Instead, this option suggests using a TVM style mechanism to implement particular reforms (such as the taxation of financial arrangements). However, as discussed at paragraphs 3.24 to 3.25, this has already been done extensively in the existing law, the most recent example being in the uniform capital allowance rules[39] that commenced operation on 1 July 2001.

[39] Division 40 of the 1997 Act.

5.6 It can be seen then that this option amounts to continuing to develop the law in the same way that it has always been developed, by piecemeal extension.

Using accounting profit as taxable income

5.7 A frequent reform suggestion is to align taxable income to accounting profit, the profit figure arrived at after preparing accounts in accordance with generally accepted accounting principles.

5.8 However, if taxable income is to equal, or be closely proximate to, accounting profit, strategies need to be developed to overcome the following issues of significant concern (***Attachment D*** explains in detail what these issues are):[40]

- accounting profit is calculated for a different purpose;
- accounting profit can be used as a starting point, but it cannot provide the end result (e.g. tax policy is that not all accounting provisions should be recognised for tax purposes);
- most taxpayers do not need to comply with accounting standards;
- accounting is moving away from determining profit on a realisation basis;
- applying the concept of materiality in a tax system is at the 'expense' of fairness;
- accounting is not as 'certain';
- accounting brings losses forward;
- concessions that are currently available to taxpayers will be removed (or limited);
- the international harmonisation of accounting standards may influence the tax base (or itself may be at risk);
- the accounting profession will be placed under added pressure; and
- management may resist the shift.

[40] At this point it should be noted that most of these points refer to adopting accounting profit as the measure of taxable income. However many of the points made also apply to the other options (see paragraph 1 of Attachment D).

6. Planning for the reform

Current stocktake

6.1 In the time since the TVM project commenced under the auspices of the Board, the main focus has been law development. This has been necessary so that the Working Group and others can better understand the TVM concept and commence the evaluation and testing process. However, the law that has been developed is not receiving the close attention we expected. We can speculate why this is the case - *tax reform fatigue*, other reform measures needing attention and a potentially long lead time are no doubt contributing factors.

6.2 At the Working Group meeting on 6 September, the TVM CGT provisions were discussed. The CGT provisions are a good example of how the use the TVM net income formula will remove the need for significant amounts of existing law. The case studies with this paper are further illustrations of how TVM would avoid the need to amend the law (as has occurred in the past with unfavourable court decisions).

6.3 Even though law development is critical for testing and evaluation purposes, more emphasis is now being given to developing material that would communicate and explain the TVM concept and provide the connectors between taxpayers and a tax system incorporating TVM. This paper is one example of that work. Sample return forms and associated education/communication material are another. Further development of this material and the law is crucial for TVM to be *properly understood, tested and evaluated*.

A realistic timeframe is needed

6.4 Implementing recent tax reform measures has shown the need to have realistic time frames for the development and testing of both the law and other material through which taxpayers comply with the law. Involving potential users in this way will enhance the acceptance of TVM should the testing and evaluation prove successful.

Rolling out and transition

6.5 A full implementation of TVM will require an examination of all existing provisions in the 1936 and 1997 Acts that are relevant to the calculation of taxable income. This will require cataloguing and categorising of existing provisions in this way:

- Cataloguing of each provision in the existing income tax law and each other provision in the Commonwealth statute book that refers to assessable income and deductions.
- Categorisation according to the following:
  1. Provisions subsumed by the core rules – these provisions would be repealed.
  2. Provisions that will be subsumed by other business tax reforms not implemented before the implementation of the TVM – these would be repealed as part of the implementation of those reforms.

3. Other provisions that need to be examined for continued relevance and rewritten, if necessary, in the TVM platform.

6.6 If TVM was to proceed, this roll out could occur in a number of ways. Two possible approaches are discussed below.

Approach 1 – Iterative approach

6.7 TVM could continue to be progressively developed as amendments to the 1997 Act. The best structure for the Act is a matter for the Board and the Working Group to consider. When the TVM amendments were complete, that Act could continue to remain as *1997* or another year.

6.8 This approach would involve implementing TVM as the new method of working out taxable income from the start date by enacting the TVM core rules and any other legislation fitting into the 3rd category above that could be drafted before that date.

6.9 Any existing provisions describing items of assessable income and deductions that could not be re-drafted before the start date would need to be bridged into the TVM framework. This would involve a transitional mechanism to make the provisions function within the tax value framework pending an examination and rewrite (if necessary) after the TVM start date.

Approach 2 – One step approach

6.10 This approach would involve creating a new Act from scratch and having it develop in parallel with the existing Assessment Acts, but not be implemented until the entire TVM law was drafted. This new Act would then be separately enacted.

6.11 As a drafting exercise either approach is consistent with migrating the 1936 Act into the 1997 Act, a task which has to occur irrespective of whether TVM proceeds. In fact, TVM will provide leverage to simplify the task of re-drafting the 1936 Act by enabling existing rules to be standardised.

Cost of transition to TVM

6.12 These costs need to be considered from the perspective of business, the Government and the community.

6.13 At this early stage of development, it is difficult to estimate the transitional costs for taxpayers in moving to TVM, the main reason being that the law is in early stages of development and has scarcely been tested and evaluated. In addition, TVM administrative products such as return forms and communication packages which are the vehicles for different taxpayers to interact with a tax system (incorporating TVM) are currently in early stages of development. We are keen to get user input, possibly through the Working Group and other organisations, in both the development and testing of those products.

6.14 A paper presented to the July 2001 Board of Taxation/ATAX TVM conference[41] on compliance and administrative costs associated with TVM identified the boundaries and suggested a methodology to appraise the operating cost implications. The paper concluded that there was very little information thus far to examine the impacts.

6.15 This area of evaluation and testing needs to take place once sufficient testing material (law and administrative) is further developed.

[41] Chris Evans & Binh Tran-Nam, *The compliance and administrative costs of the TVM*.