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The Board of Taxation  
c/- The Treasury  
Langton Crescent  
PARKES ACT 2600

### **TVM SUBMISSION**

I have been involved with TVM as a member of the working group and as a consultant in some of the early testing.

In my report to the Board of Taxation dated 15 July 2001 I advised in response to the question of whether TVM contained "conceptual flaws" which would not allow it to be effectively applied, that no such flaws were discovered in the testing undertaken.

At the time of preparing the report to the Board I held the view that TVM was a concept worthwhile pursuing. Based on further exposure to TVM in the period since that testing was conducted I no longer hold that view. In my opinion TVM should be abandoned. My opinion is based on the following:

- TVM contains systemic weaknesses which are likely to produce unacceptable tax outcomes or an unacceptable "fix".
- TVM is unlikely to deliver benefits which outweigh its costs and risks.
- The benefits which the TVM project has identified can probably be delivered under a far less costly and less risky reform measure.

Each of these points is discussed below.

#### **Systemic weaknesses**

My report to the Board contained an example of a situation in which TVM produced a different result from the current scheme of the tax law (an exploration permit). I am also aware of an example Mr. Lehmann has identified which similarly produces a different result (a "low ball" audit). In recent weeks I have developed another example, which has been agreed with the legislative group, of how the most recent version of TVM prototype legislation produces a different outcome (a 'take or pay' long term supply contract).



These three examples are not simply anomalies which can be fixed by specific legislative clauses. All three involve situations where rights and obligations arise contemporaneously, but the routine rights and liabilities rules do not provide appropriate relief. No doubt many more examples could be identified if time were devoted to the task. Geoff Lehmann summed up the essence of the problem in a recent email when he said that TVM bifurcates assets and liabilities.

Almost inevitably a system which uses assets and liabilities as its functional basis will encounter these problems. To say that the routine rights provisions do not alleviate the problem is not a criticism of the drafting of those provisions. These examples are evidence of a weakness in the basic and necessary mechanics of TVM, and no clever drafting can overcome that.

Nor would it be appropriate to have a provision which operates on the basis of concessional interpretations i.e. the Tax Commissioner has a discretion to treat things as routine rights when they would not otherwise qualify. This sort of administrative "fix" is quite inappropriate for what is a cornerstone provision of TVM.

Another key provision which has inherent difficulties is the "have" rule for liabilities. It is necessary to define "have" such that it recognises most liabilities. To revert to an example where contemporaneous assets and future obligations are created there would be quite strange outcomes under TVM if the taxpayer were considered to "hold" the asset but not to "have" the liability. Therefore all sorts of future obligations must fall within the scheme of TVM liabilities. It is the amortisation of the liability which, over time, offsets the decline in the asset which produces an equilibrium in the TVM outcomes (ignoring year on year timing). If the liability is not recognised the revenue would be significantly disadvantaged. The difficulty is that taxpayers cannot "have" certain other liabilities for policy reasons, in particular employee leave provisions. If they are considered to "have" these liabilities then they become immediate deductions, generating an unacceptable timing advantage.

Again, this is not an area that lends itself to remedial drafting. If, for example, the "have" rules were made more expansive and a special exception were made for employee leave provisions, it would still leave enormous scope for taxpayers to argue early recognition on all sorts of other liabilities. There are potentially significant dangers for the Revenue in this area.

### **The cost/benefit of TVM**

There has been no definitive study on the possible benefits of TVM and only some preliminary work on the costs. Therefore it is only possible to make comments in relation to the possible cost/benefit based on experience of the tax system at large and exposure and knowledge of the TVM prototypes.

In my opinion the possible benefit of TVM (leaving aside for the present the systemic flaws referred to earlier) is that it would create a single, comprehensive platform on which the tax system would operate. Such a platform should, theoretically, deliver benefits in terms of structural integrity and even simplicity. Whether TVM would produce these outcomes is, as already noted, merely a conjecture as there has been

virtually no testing done in this regard. However if we proceed, for present purposes, on the optimistic assumption that these sorts of benefits could arise then it is useful to consider the likely costs. Costs fall into two broad categories; transition and maintenance.

Again, no significant work has been done on transition costs, but it is quite apparent to anyone who has spent time on the TVM prototypes (especially the later versions which contain more detail) that transition costs will be very high. Costs will include:

- Retraining the tax profession and all who use it. This means tax practitioners, ATO staff, corporate accountants, educators, judges, small business etc.
- Replacing all tax systems
- Redrafting numerous Acts of Parliament and possibly Tax Treaties to make them function in the context of the structure and verbage of TVM.
- Educating foreign investors in TVM

Realistically transition will take a decade or more. The possible benefits simply cannot overcome this sort of economic burden. Ongoing costs will include the constant need to explain TVM to anybody with whom Australia does business.

The risks of TVM being open to tax abuse have not begun to be assessed. I recommended in my report that "stress testing" be done. I considered this vital in the context of any Government wanting to introduce a radically different scheme for determining income tax liability.

In my 30 years of practising income tax I have seen two decades in which tax avoidance rose to 'industry' status (the 1970s in particular was a time during which tax avoidance was endemic, the 1990s perhaps witnessing a more limited and directed suite of schemes). The introduction of an entirely new set of rules with the potential for tax administrators to be overstretched, an absence of legal precedents and the possibility for mass confusion could produce an environment ripe for a new wave of clever schemes.

#### **Benefits of TVM in another form**

The work done by the legislative group has identified some clever ways of streamlining the structure of the tax system which have nothing to do with TVM. You do not need an assets and liabilities based model, for example, to fold capital gains tax into the basic scheme of the legislation (thus doing away with all those "events"), nor is TVM the only broad based model which can deal with black hole expenditure.

The very preliminary work done on 'Option 3' suggests that it has the ability to solve these problems and may also provide the single platform which would deliver the hoped-for benefits in terms of structural integrity and simplicity. It would do this using a far less radical (and therefore less risky) and far more familiar (and therefore less costly) scheme of base mechanics. The other important advantage of 'Option 3' is

that, because it relies on familiar concepts, it is far more likely to be accepted by the tax profession and business.

It is disappointing to me that 'Option 3' has not been given more support by the Board. Nevertheless, I understand that it is not a specific part of the Board's current brief to develop 'Option 3'. I would hope that it may become so in future.

In closing, in terms of the working group, congratulations to Chris Jordan for a difficult job well done as Chairman, and thank you to Murray Edwards and Fiona Spry in the secretariat for their untiring support.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Tony Baxter', written in a cursive style.

Tony Baxter