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TAX VALUE METHOD

Transitional costs of moving to the Tax Value Method (TVM) aside, the Board of Taxation's package of TVM papers makes a convincing case for implementation of TVM as soon as possible. The shortcomings of current law are underlined, for example, by the demonstration legislation, which is so very easy to read and understand, by the regular telling comparisons made in the explanatory material between the demonstration legislation and the current law and by the Myer Emporium example in the information paper. Some of the improvements over the current law are a result of changes to the treatment of, for example, rights and liabilities – but the TVM itself enables easy implementation of those changes.

TVM's immediate advantages and broader benefits

2. Taken at face value, the 'cashflow/tax value' approach recommended by the Review of Business Taxation presents four areas of clear practical improvement over current law:

- handling the 'revenue/capital' distinction – or when to decide whether a particular item of business expenditure is to attract immediate write-off or write-off over a number of years – in a way that is soundly based both from commercial and accounting points of view. Having the decision turn on whether an asset (or liability) exists at the end of the year of expenditure also provides, as an additional benefit, a generally applicable definition of assets and liabilities in the law. For policy reasons, immediate write-off can be imposed on any expenditures, such as mining and petroleum exploration expenditure even when the exploration is successful and results in an asset at year's end;
- providing for a general treatment of business interest costs. Prepayments aside, essentially all interest costs would be deductible in the year incurred if they were non-private. This would clean up, in a conceptually sound way, a messy set of possible outcomes in different circumstances – and relieve the High Court from a costly and seemingly ongoing role in determining how business interest costs are to be treated. Again, in practice, particular business interest costs, such as interest costs relating to coastal holiday houses, could be given different treatment;

- handling ‘black hole’ expenditures – expenditures that were excluded from any form of write-off. Changes in this area have been added to current law; and
- providing a common ‘tax value’ nomenclature across the law for all current variants of that, such as depreciated value and CGT cost base.

3. The TVM package, however, makes clear the broader overarching advantages beyond these four practical improvements of pursuing TVM. The package shows that TVM offers relative simplicity, clarity, brevity, comprehensiveness and longevity by providing one simple principle to underpin all business income tax law – taxable income essentially being annual net receipts plus the change in tax value of assets and liabilities. Because underlying assets and liabilities produce all the income to be taxed, this offer applies to all business income tax law, including ultimately that applying to entities and international transactions.

Income tax systems around the world already have ‘tax values’

4. It is not surprising that the Board of Taxation has not been able to identify any other country that has comprehensively introduced an approach like TVM. Other countries, like Australia, started off early in the 20th century with ‘income tax systems’ that were not really income tax systems at all. Those early systems were designed only to tax regular receipts from business activity less associated expenses. They did not attempt to incorporate changing values of assets and liabilities. And yet it is changing values of assets and liabilities that are a crucial part of income. All owners of shares know that the dividends from their shares do not form the only income from them. Those shareholders are vitally interested in the income that they hope will come from the increasing value of their shares – just as the farmer is vitally interested in the loss in value of his farm machinery.

5. Australia, like many other countries, attempted during the 20th century to move their fledgling income tax systems towards genuine income tax systems by acknowledging some changes in values of assets and liabilities. Those attempts necessarily involved grafting provisions dealing with changing asset and liability values on to underlying structures that were not designed to handle them. The TVM package explains well how in Australia a patchwork of complexity developed from this *ad hoc* accretion process: from depreciation provisions to handle declining values of tangible assets, to provisions to handle changing values of particular financial assets selected usually on the basis of being a threat to the revenue base, to CGT provisions to handle increasing values of certain specified assets. Very little attention was given to liabilities.

6. From such ‘grafting on’ processes, income tax systems around the world already incorporate changing tax values. They just call them something different, like depreciated values or cost bases, and have gaps in the coverage of changing values of business assets and liabilities between these ‘tax value’ provisions of varied nomenclature.

7. Other countries may not yet have moved to collapse the various nomenclatures to one and remove the gaps. But the wide-ranging proposals for reform from the Review of Business Taxation necessarily put a focus now in Australia on whether to continue the ‘grafting on’ process or to make a fresh start. Grafting on to current law the Review’s proposals to reform the treatment of financial assets and liabilities, rights and leasing, for example, would put a great deal of strain on the already over-stretched current law. The opportunity is here to introduce fresh integrated law that is capable of embracing current proposals and future developments through the establishment of TVM as the fundamental building block for the whole business tax law.

Tax value versus actual value

8. The fundamental building block under TVM is concerned with changing tax values of assets and liabilities. ‘Tax value’ rather than ‘value’ is crucial to ensuring that the fundamental building block of the law is a practical one, allowing governments to decide whether, and when, changes in value of assets and liabilities are to be assessed over time. As an important illustration of this is how TVM allows the purposely biased treatment to continue where, on the one hand, annual accrued losses in value of depreciating tangible assets are allowed year by year but, on the other hand, annual accrued gains on appreciating tangible assets are not taxed year by year and are either taxed on the sale of the asset or not at all if the half CGT exclusion applies.

9. Annual ‘income’, the focus of a genuine annual income tax system, incorporates the change in *actual value* of assets and liabilities – not just the specified *tax value* changes of practical business tax law. There is no reason to apologise for the fact that ‘income’ includes annual changes in actual values of assets and liabilities. Picking up again on shares, income in the form of increased share value does not depend on whether the shares are sold or not. A sound definition of income cannot depend on the arbitrary distinction of whether or not a sale of shares happens to occur. Similarly, income from an appreciating asset does not suddenly materialise in a year just because the person owning the asset decides to be taxed on a ‘mark to market’ basis. The issue is not the definition of income but when, or whether, to tax it.

10. The substitution of tax value for actual value means, as now, that – in the absence of specific exemptions like the half CGT exemption – income associated with a taxpayer’s business assets and liabilities is taxed at some time. That is the effect of such things in the current law as balancing adjustments on disposal of depreciating assets and CGT on realisation of CGT assets. The specified tax value structure across business assets and liabilities simply determines when the income from them is taxed. As noted, people are most comfortable with the idea of allowing accrued losses year by year on depreciating tangible assets but not so comfortable with taxing accrued gains year by year on appreciating tangible assets and shares. Substituting tax value for value accommodates such differences. Moreover, crucial to tax design is the link between income and changing values and tax values of assets and liabilities (value and tax value match at the start and end of a taxpayer’s holding of assets and having liabilities). This link means that the specification of the fundamental TVM building block in terms of

generic ‘tax value’ provides comprehensive coverage and a conceptually sound basis for the whole business income tax law. It is not surprising that the Board of Taxation in its detailed assessment of TVM found that the method was not conceptually flawed and did not have gaps in coverage. Under TVM, absent specific exemptions, business income will be taxed at some stage, just as the patchwork of asset regimes attempts to do now – it is just a question of when.

Transitional costs of TVM

11. Were income taxation about to be introduced in Australia for the first time there could be no doubt that the TVM would be chosen over any complex alternative such as our current system. It must therefore only be transitional costs that stop it being introduced now. For most taxpayers, the move to TVM should not involve significant change. Here it is important to distinguish between TVM itself and other reforms – such as those to financial assets/liabilities and leasing – which, while adding to the case for TVM, are separate from it. Identification of most taxpayers’ business assets and liabilities is straightforward and should not be affected by TVM. Moreover, changing depreciated value and CGT cost base to the common term ‘tax value’ should not affect most taxpayers. As the package points out, taxpayers do not need to read or understand the law to follow the instructions of Tax Pack.

12. There will inevitably be transitional costs on those that do need to read, understand, apply and administer the tax law. Balanced against those costs would be expected future time and cost savings from simpler, principle-based law by those same people and future additions to their ranks. Nevertheless, if transitional costs mean that the opportunity is not taken now to make a clean break from the past, the path-breaking work of the Board of Taxation will not be wasted. The legislation and associated explanatory material, and other TVM material, will stand as a blueprint for the future. If TVM is not picked up now, no doubt the growing complexity and volume of the law will ultimately require its implementation.

13. Attached are some more detailed comments, mainly on drafting in the demonstration legislation relating to financial assets and depreciating assets. Most important is the suggested general tax value design for financial assets to substitute for the approach in the demonstration legislation that puts a focus on regulations specifying the treatment of financial assets/liabilities on an instrument-by-instrument basis.



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TAX VALUE METHOD DEMONSTRATION LEGISLATION

FINANCIAL ASSETS AND LIABILITIES

The approach taken in the latest TVM demonstration legislation, where regulations would be used to specify the accruals treatment of particular financial assets and liabilities on a case-by-case basis, has some similarities to the *ad hoc* approach to the tax treatment of financial instruments in the current law. The case-by-case approach may be driven by difficulties seen to be associated with financial assets (read liabilities as well throughout) having future uncertain benefits (read obligations as well throughout) in a multitude of different forms.

A2. Much of the work over many years on the taxation of financial arrangements (TOFA) can be viewed as involving the search for a general tax value design that requires minimal reference to specific financial arrangements. The TOFA design has been shaped by widespread and lengthy consultations with interested private sector participants, including during the Review of Business Taxation – but does not separate design based purely on valuation practicalities from policy influences on that design. A general tax value design for financial assets that would form a robust base for future developments, with minimal use of associated regulations, can be formulated for the demonstration legislation by:

- including in tax value for accruals treatment (in the body of the tax value formula, as well as in ‘Reset amounts’) previously uncertain benefits that become known during the life of the financial asset, whether or not those known benefits are in the form of receipts. The general specification of tax value then could be seen as a pragmatic response to practical problems associated with determining changes in value of many financial assets consistent with the general tax value design for other assets (eg effective life arrangements for depreciating assets); and
- specifying separately in the legislation, or in regulations, assets that are to be excluded for policy reasons from this general accruals treatment – and are to attract realisations treatment. This would separate specification of tax value that reflected only practical problems with measuring change in value from tax value that reflected policy considerations (that could change from time to time).

A3. Those assets to attract realisations treatment, such as ordinary shares, would be the same as with no such separation of basic design and policy effect. But the framework would form a more robust foundation for future development.

Uncertain future benefits that become known

A4. The latest demonstration legislation already includes in tax value for accruals treatment benefits in the form of ‘certain receipts’ – both in the body of the tax value

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formula (because 'Rate' is determined on the basis of future certain benefits), as well as in 'Reset amounts':

$$[\text{Last tax value} \times (1 + \text{Rate})] - \text{Reset amounts}$$

When a known receipt that was previously an uncertain future benefit occurs at a time after the 'previous test time', however, the receipt is not included in tax value (although is included in net income). That is illustrated with SPI-linked payments in Example 14.11 of the explanatory material. Under this formulation, any known benefits that were previously uncertain would not be included either in tax value or net income if those benefits were accrued and not payable receipts.

A5. The suggested change is to include in the body of tax value (and thereby net income if not also in 'Reset amounts') previously uncertain benefit that becomes a known benefit but is not necessarily in the form of a receipt – referred to as 'Known amounts' in the tax value formula below. It may be a benefit that was previously a future uncertain benefit but at this 'test time' becomes either a known receipt (eg the SPI-linked payments in Example 14.11 of the explanatory material) or a known benefit but not a receipt receivable at this test time.

$$[\text{Last tax value} \times (1 + \text{Rate}) + \text{Known amounts}] - \text{Reset amounts}$$

With Example 14.11, it may appear superfluous to include the SPI-linked payments in both 'Known amounts' and 'Reset amounts'. In that example, these two amounts offset each other at each test time and the net income is as presented in the explanatory material. But the above formula caters for the situation where a known amount is accrued, but not payable, at the test time as is the case with, say, a CPI-indexed bond – where a known amount accrued, but not yet payable, is determined by CPI times prior indexed face value (and a known receipt may also be determined by a fixed coupon rate times prior indexed face value). The SPI-linked and CPI-indexed examples are illustrated in the annotated Tables 1 and 2 in this attachment.

A6. Moreover, the inclusion in tax value of 'Known amounts' at this test time of what were previously future uncertain benefits (along with known amounts at this test time of what were previously future certain benefits) means that the tax value formula would handle a wide range of financial assets, where the known amounts would include:

- change relating to the interest rate implicit in known future payments – setting the basis for 'Last tax value \times (1 + Rate)' in the current tax value formula;
- variable interest – on, say, a bond or bank account;
- changes in listed ordinary share – listed shares, for example, are very easy to value and not taxing them on an accruals basis is a separate policy decision (and they need not be defined out of financial assets, having an associated right to payment when sold);

- change in value of open futures contracts and options over futures contracts;
- the effects of changes in CPI, commodity price indices, share price indices – as discussed above – either when adding one-off amounts each test time (as with the SPI-linked example) or when changing the ongoing tax value base (as with the CPI-indexed case);
- changes in exchange rates – to handle the effect of exchange rate movements on any benefit received/obligation paid, or accrued, at this test time relating to foreign assets and liabilities, such as foreign debt.

A7. The general idea is that while the effect on future (and even current) value may be uncertain (or difficult to measure) in relation to changes in things like interest rates, exchange rates, company profitability and any relevant indices, include in tax value the known or readily-measurable change in value now. As usual, the remaining value change (including with hybrids) would be picked up via tax value effect on disposal of the financial asset (the same effect as balancing adjustments on disposal in current law).

Policy-based exclusions

A8. Under this approach, the list could be very short of financial assets to be taxed purely on a realisations basis because of difficulties in getting a fix on value change. In practice, of course, this list would be extended because of concerns over imposing tax when cash has not been realised – as with held listed shares – or imposing tax on a value that might not be ultimately realised. But such exclusions from annual taxation would result from policy decisions – the explanation of which would ideally be clear in the law – not from tax value design principles (which themselves include pragmatic responses to practical problems associated with determining changes in value).

A9. As noted, those assets to attract realisations treatment, such as ordinary shares, would be the same as with no such separation of basic design and policy effect.

Assets with varying benefit base and discounts/premiums

A10. Beyond the above suggested treatment of future uncertain values that become known, consideration should be given to specifying in the legislation the tax value of financial assets when the basis of known receipts or accrued amounts varies over time according to uncertain events – and is not fixed at, say, face value of the asset. CPI-indexed bonds are an example of this form of asset. The tax value formula in section 45-80 of the draft legislation of the Review of Business Taxation deals with this situation.

A11. Consideration should also be given to including in the tax value formula the general treatment of assets sold at a discount or premium to face value, also incorporated in the tax value formula in section 45-80 of the draft legislation of the Review of Business Taxation.

Summary

A12. In sum, the demonstration legislation handles financial assets with mixtures of certain and uncertain benefits in a neat, practical way. The general specification of tax value could, nevertheless, be extended significantly, thus reducing the need for special regulations, by incorporating in the tax value formula:

- future uncertain benefits that become known at a particular test time, regardless of whether those known benefits are receipts or accrued amounts;
- components of the tax value formula from the Review of Business Taxation's draft legislation which handle the situation where known amounts at test time, be they in the form of known receipts or known accrued amounts, are determined by a changing index and not by fixed face value;
- components of the tax value formula from the Review of Business Taxation which handle discounts or premiums over the face value of financial assets.

A13. The resulting tax value specification would be generally applicable to a very wide range of financial assets and liabilities. Nevertheless, regulations would still be necessary, for both policy exclusions purposes and to clarify the treatment of particular assets or variables, but these latter regulations would be limited and would be set against clear specification in the legislation of tax value across a wide range of circumstances. The more comprehensive the general specification of tax value in the legislation the less need for specific regulations and the sounder is the guidance given by the legislation to the formulation of regulations.

DEPRECIATING ASSETS

Effective lives

A14. Logically, taxpayers should be subject to the same provisions to self-assess effective lives of their depreciating assets both when the assets first start to decline in tax value (section 72-100) and when the taxpayers are recalculating effective life later in the lives of the assets (section 72-105). In the exposure legislation, however, there seems to be a number of inconsistencies between the treatment of taxpayers in these two circumstances, as well as between taxpayers who are expected to scrap or abandon an asset while they still hold it and other self-assessing taxpayers:

- Examples in section 72-105(1) illustrate the wide range of changed circumstances against which effective lives may be recalculated.

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- The same range of circumstances against which to self-assess effective life may not always be available to a taxpayer when a depreciating asset first starts to decline in tax value. That is because, under section 72-100(2), the only variables specified to be taken into account are standard maintenance (reasonably good order and condition) – in section 72-100(2)(b) – and wear and tear under specific conditions of use – in section 72-100(2)(a). (Incidentally, this latter specific wear and tear provision, combined with the assumption of potential future use by any entity, nicely links effective life self-assessment to the current user's circumstances of use even if the current user believes the same user will dispose of the asset before the end of its effective life.)
 1. The specific provision relating to scrapping, section 72-100(3), might appear to allow taxpayers to take into account any influence on the asset's effective life when the asset first starts to decline in tax value.
 2. But this provision would seem to apply only if the current user believes that the same user will scrap or abandon the asset.
 3. Thus, a taxpayer buying a new asset with, say, a scheduled 20-year effective life could apparently not set an effective life of 10 years, based on the taxpayer's view of influences beyond specific wear and tear, such as those influences listed as examples in section 72-105(1), if the taxpayer plans to sell the asset in, say, five years.
- In addition, section 72-100(3) is not subject to the requirement relating to maintenance in section 72-100(2) – which, appropriately, would appear to allow specific conditions of use to be taken into account.

These apparent inconsistencies could be addressed with relatively limited change to the demonstration legislation.

A15. In addition, some change might be appropriate, if there is any doubt whether the legislation would give authority for the Commissioner or self-assessing taxpayers to take into account general (in the case of the Commissioner) or specific (in the case of self-assessing taxpayers) market value data to determine effective lives *indirectly*. One way of removing any such doubt might be to include explanatory notes in the law along the lines of:

The Commissioner's (taxpayer's) determination (self-assessment) of effective life may include consideration of the rate of decline in the profile of average (specific) market value of the asset, with the rate converted into an effective life equivalent according to the following formula which explains relevant relationships:

$$\text{Rate of decline in value} = \text{declining balance rate} = 1.5 \times \text{prime cost rate} = 1.5 \times 100/\text{effective life.}$$

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A16. Such an explanatory note would clarify the relationship between, on the one hand, the indirect measurement of effective life from evidence of declining value and, on the other, effective life defined as an estimated fixed number of years. It would underpin an appreciation of the possibility that the value of an asset with a 10-year effective life could be declining not in equal annual dollar amounts but at an approximately constant rate of 15 per cent (matching the declining balance write-off rate obtained from the 10-year effective life) and could be in use well beyond 10 years.

Horticultural plants/trees

A17. It would seem that effective life arrangements could be extended easily to include horticultural plants/trees. Of the specific provisions that may need to be added to accommodate these assets would be a specification that tax value starts to decline when the plants/trees are first used to produce business receipts. While tax value increases would not be expected to be included over the period where the value of the plants/trees was likely increasing prior to first receipts, the general provision would be for tax value decline to be delayed until business receipts are first earned (and not to start when the plants/trees are planted).

NON-FINANCIAL RIGHTS

A18. Non-financial rights are handled in a practical way in the demonstration legislation without recourse to any use of general market interest rates. The approach means, for example, that straight line write-off is attracted by rights that provide expected equal benefits over a given number of years. The general tax value formula for financial assets shows that, for a financial asset with equal certain receipts over the same number of years, tax value will decline by increasing amounts over those years, not in equal amounts as under straight line. That demonstrates, on the one hand, the extra approximation associated with the treatment proposed for rights and, on the other hand, the necessarily arbitrary nature of classifying business assets and liabilities into different categories. Classifying non-financial rights along with other depreciating assets provides any understandable practical treatment of tax value change with these assets.

TAX VALUE METHOD INFORMATION PAPER

A19. The Metal Manufacturers' sale and lease-back example in Attachment A of the TVM Information Paper probably should have the up-front obligation to pay \$18.75m at the end added to liability tax value. The effect of the change is to produce a different net income stream to that in Diagram A-4 – particularly shifting forward what in the diagram is an effective deduction of the full \$18.75m in the last year. Separate, more detailed comment has been provided earlier.

TABLE 1: SPI-LINKED ASSET - WITHDRAWAL OF SPI AMOUNT

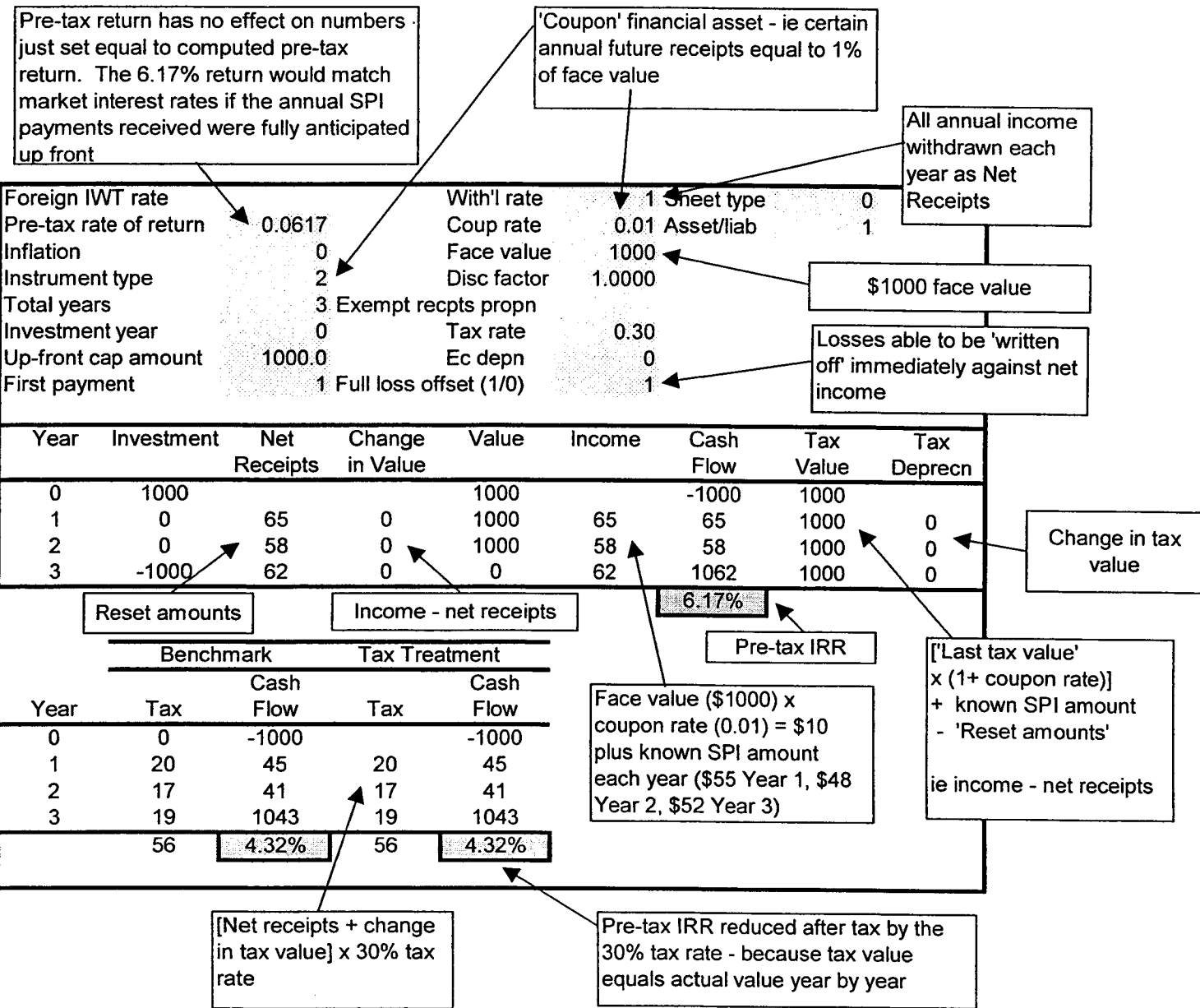


TABLE 2: CPI-INDEXED ASSET

Pre-tax return has no effect on numbers just set equal to coupon rate plus CPI (in turn, set equal to pre-tax return of SPI-indexed asset). The 6.17% return would match market interest rate if the annual 3.17% CPI was fully anticipated up front

CPI-indexed financial asset - ie annual income = indexed face value x fixed 3% coupon (received as annual net receipts) + indexed face value x annual CPI (accrued income, not in net receipts)

Coupon payments on indexed face value withdrawn each year as Net Receipts

Foreign IWT rate		With'l rate	1	Sheet type	0
Pre-tax rate of return	0.0617	Coup rate	0.03	Asset/liab	1
Inflation	0.0317	Face value	1000		
Instrument type	2	Disc factor	1.0000		
Total years	3	Exempt recpts propn			
Investment year	0	Tax rate	0.30		
Up-front cap amount	1000.0	Ec depn	0		
First payment	1	Full loss offset (1/0)	1		

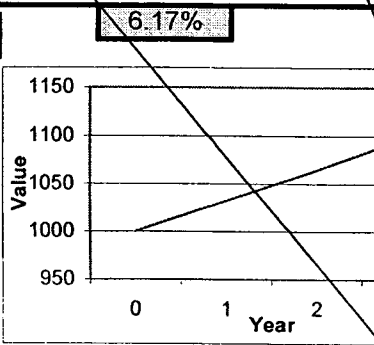
\$1000 initial face value
Losses able to be 'written off' immediately against net income

Year	Investment	Net Receipts	Change in Value	Value	Income	Cash Flow	Tax Value	Tax Deprecn
0	1000			1000		-1000	1000	
1	0	30	32	1032	62	30	1032	32
2	0	31	33	1064	64	31	1064	33
3	-1098	32	34	0	66	1130	1098	34

Change in tax value

Reset amounts Income - net receipts

Year	Benchmark		Tax Treatment	
	Tax	Cash Flow	Tax	Cash Flow
0	0	-1000		-1000
1	19	11	19	11
2	19	12	19	12
3	20	1110	20	1110
	57	4.32%	57	4.32%



'Last tax value' + indexed face value x coupon (net receipts) + indexed face value x CPI (known accrued amount) - 'Reset amounts' ie income - net receipts

Indexed face value x coupon (net receipts) + indexed face value x CPI (known accrued amount)

[Net receipts + change in tax value] x 30% tax rate

Pre-tax 6.17% IRR reduced after tax by the 30% tax rate - because tax value equals actual value year by year