

# **TVM ISSUES TESTING REPORT**

## **PRESENTATION TO THE TVM CONFERENCE SYDNEY 23-24 JULY 2001**

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The Board of Taxation (the Board) wished to test the core provisions of TVM in some real life situations and obtained the assistance of three large corporate groups in this regard. The companies involved are Australia Post, BHP Limited and Telstra Corporation Ltd. My firm was engaged with these companies, to devise a test program, carry it out and prepare a report for the Board. That report was delivered on 17 July. In addition the firm of Chartered Accountants, Pitcher Partners was engaged to perform some testing of TVM in relation to small and medium sized enterprises (SMEs). Their findings and report was included in the AJ Baxter & Associates report to the Board.

This paper discusses the process undertaken and the key findings and recommendations.

### **Terms of Reference**

The key objectives of the testing program as set out in the Board's consulting contract with AJ Baxter & Associates were:

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

The criteria which TVM was to be tested against are those suggested in the Review of Business Taxation (RBT), being simplicity, transparency, durability and certainty in the law.

A further output required of the testing program was a recommendation of an approach to the practical application of TVM.

### **Approach adopted**

Australia Post and BHP both undertook to prepare calculations of taxable income based on actual year ended 30 June 2000 data. Pitcher Partners also prepared 4 calculations on SMEs drawing data from their client base. The results of the Australia Post and Pitcher Partners testing are provided in their separate reports.

In addition to the calculation undertaken the program involved identifying a range of transactions and testing them under the TVM core rules as drafted at the time. The version available to the corporate participants was that dated 30 April 2001 and this meant

that many transactions could not be tested or not fully tested. For example, there was no Division 45, so financial instruments testing was inconclusive. There was, and is, no set of rules for foreign transactions. Nevertheless we were able to test over 60 transactions and determine how the core rules, as drafted, operated on them.

The SME testing involving Pitcher Partners was added to the testing program at a later date and the 28 June 2001 release of the draft legislation became available before they concluded their part of the program.

The approach adopted by the test participants has been to take the words of the pro-forma legislation as drafted and to seek to interpret them and apply them to the test data and test transactions. This approach was considered to be the only valid one: a testing of policy or announcements would not provide a test of any practical relevance. The test participants were asked to apply themselves to the task of interpreting legislative provisions in relation to actual transactions and data.

## **ISSUES TESTING**

### **Results summary**

Let us look at some of the results in a summary form. The business activities covered aspects of manufacturing, mining, petroleum, telecommunications, corporate treasury and a postal operation. Obviously, for reasons of confidentiality, I cannot say which companies in the test program related to which of these activities! The transactions selected for testing tended to be the more unusual types, or transactions which are known to be problematic under the current law. I cannot say that there was any more science to that part of the process than that.

As noted there were no TOFA rules so the testing of financial instruments was inconclusive. However the outcome of the analysis performed was sent to the ATO in the course of the project (consistent with the second of the terms of reference) and hopefully that provided some useful assistance to the process of drafting Division 45. Perhaps there is still a way to go, as we know the current version of Division 45 is rather thin.

Interestingly the performance of TVM in covering black holes was exceptional. That is one of its lauded traits of course, and it did not come up wanting. There were a number of black hole situations in the selected transactions (8 out of 66), which is what might be expected in looking at large manufacturing, mining and petroleum businesses. In each case TVM would give a deduction not currently available.

In some transactions the TVM analysis clearly produced the potential for a different result to arise than would be the case under current law in circumstances where there is no policy charge intended. An example is covered in a case study at the end of this paper. This possibility sits uncomfortably with the perception that TVM will never do this absent a clear policy change. It is a matter which needs to be addressed.

The potential differences were not so great or consequential that it would suggest any fatal flaw in TVM, but it is a factor to be considered in assessing TVM. Some differences eg, the absence of a deduction for lost cash, will be fixed by drafting or by special rules. Other differences may simply have to be accepted. I discuss this at more length later in the paper.

The ATO TVM experts have seen the test results and my report and do not agree with everything contained therein. However, the final differences of opinion on specific transactions are not great in number. Interestingly the ATO disagreed with the current tax analysis on two occasions, so you can be reassured that all parties were coming from their own corner of the ring. This was no love-in, the testing was real.

## ASSESSMENT OF PROCESS AND OUTCOMES

In assessing the testing program and its results it is appropriate to consider the four criteria mentioned by the RBT in connection with TVM being *simplicity, transparency, durability* and *certainty in the law*. These criteria have been accepted by the working group as relevant to assessments of TVM. The most recent version of the Explanatory Material contains an outline in Ch.3 of what is meant by each of these terms in the context of TVM and I will use that analysis as the basis for the discussion which follows.

This section of the paper contains both analysis and opinion. Where the opinion is my own, that is made obvious in the way it is presented. The opinions are based on the knowledge gained through the testing program. I should make it clear that neither the ATO nor Treasury TVM experts are endorsing the opinions expressed in this paper.

### Simplicity

#### *Structure and statutory interpretation*

The EM says that an aim of TVM is “to explicitly recognise a single conceptual base for the whole income tax law: the principle of changes in the tax value of net assets”. Of course that proposition can only be tested properly when all, or substantially all, of the new law is written, especially the capital gains provisions. However it is possible to state from the testing conducted that the core income tax non-CGT provisions are true to the single conceptual base of changes in net assets, and it is not too difficult to envisage that CGT (which is, after all, to do with assets) would quite easily fall into place within a TVM framework.

There are, however, other elements to simplicity. In particular in relation to tax statutes, the structure, style and comprehensibility of the language. In that regard the current TVM draft legislation rates well in some areas but has been criticised by test participants in other areas.

It rates well in terms of the phased structure: the approach of beginning with asset and liability in a very broad sense and then refining the taxable income calculation first through the have/hold rules and then through the tax value rules was found to be easy to understand and follow in a structural sense.

Criticism has been levelled however at some of the mechanical detail, in particular the non-cash benefits provisions. In fact the main job of these provisions is simply to “put a number” on a deemed payment or receipt but, because this applies to every credit transaction, it is said to be cumbersome and “counter-intuitive”. In fact the participants had little difficulty with the provisions in practice because most often they could be ignored. However when needed to be used the actual provisions (apart from their counter-intuitive nature) were found to be cumbersome in their approach – not “user-friendly” was the term used.

The quite extraordinary prevalence of tables in the drafting was also a feature disliked by some, however it is recognised that tables are becoming commonplace in recent tax legislation and the criticism is perhaps nothing more than an expression of a personal view.

The EM also makes the rather bold suggestion that simplicity is improved because the need to consider “the great body of case law on what is ordinary income and when expenditure is on revenue or capital account ... should disappear”. As discussed later in this paper, the capital/income dichotomy does not entirely disappear and further, many would disagree that losing decades of case law and the vital input of keen legal minds over a lengthy period can be seen as a benefit. While it may be simpler not to have to look at it, I am not convinced that is necessarily an advantage.

TVM also increases complexity in some areas. In particular when there is a complex transaction it is likely to give rise to one or more assets and liabilities and each of these must be dealt with under the relevant rules and the sum of the results of those individual dealings must produce a correct outcome. An example is mineral exploration expenditure. Currently exploration expenditure is simply a deductible outgoing, under TVM it will constitute a payment (reduces taxable income) and one or more assets (physical assets which are property such as core samples, intangibles such as knowledge which are not property, plant and equipment etc). It may also contribute to the reduction of a liability eg. an obligation to undertake exploration as committed under the terms of a permit or pursuant to a joint venture agreement. The example set out in the case studies illustrates this. Obviously the TVM analysis is considerably more involved.

Another example of how TVM actually complicates matters is found in the treatment of a royalty situation. Under current law a royalty payment is deductible when incurred. Under TVM the same arrangement gives rise to two non-cash transactions (Division 8 consideration), routine rights and liabilities (S.6-45 application) and contingent obligations (S.7-22 application). The end result is the same but the TVM pathway to it is considerably more involved.

### *Accounting compatibility*

The RBT makes the comment that TVM will “align more closely taxation law with accounting principles” (P.155) and that defining income “in a manner structurally consistent with both economic and accounting approaches to income measurement ... supplies [a] high level of unifying principle ...”. No doubt, if true, this would lead to simplicity ie. the suggested similarity between accounting and the TVM approach to income tax.

In using the draft legislation in the course of the testing program there was little evidence to support the proposition that TVM aligns more closely with accounting. Certainly the first phase of the three-step process applies concepts of asset and liability that draw on accounting but beyond that (the next two phases) there is very little compatibility. That is in fact what you would expect – taxation is a matter of law, and revenue law at that, which by its nature must try to be precise. The prescriptive approach to the have/hold questions and the determination of tax values does not draw particularly on accounting.

The detailed approach to cost and proceeds in fact draws away from an application of accounting principles in general use and replaces them with a legalistic construct (which undoubtedly draws in some of its parts on accounting principles, but does not adopt them for the purposes of setting any primary rules).

Further, to base a system on cash received and paid (this is what DIVS. 7A and 8 cover in detail) is not moving *towards* accounting principles and practice but away from them. Accounting (except in parts of the public sector) is based on accruals. Even quite small and unsophisticated businesses today use accruals accounting, typically through simple accounting packages such as MYOB or Quicken. Accruals accounting is the normal practice.

Accountants presently do not need legislation to explain expenditure (and there is, famously, no definition of income in the law). TVM does require a significant amount of legislation to deal with cost, non-cash transactions, changes in status of assets and liabilities etc.

For these several reasons I do not think that the proposition that TVM produces a greater degree of compatibility with accounting can be supported. (There may be a favourable argument in terms of durability which I discuss under that head).

### *Gateways*

One factor which may add to simplicity is the narrowing of the gateways. This is also discussed under ‘certainty’ in this paper. I think it can justifiably be claimed that having a single test for when a liability is incurred should lead to a simpler tax system, however it may come at a cost for some taxpayers. Simplicity and flexibility in this sense are at odds. It is an open question as to which is to be preferred.

### **Transparency**

The EM states that a “transparent law is one that allows its users to see through to the policy that guides it ... it provides the context that binds many legislative rules”. It further comments that Governments use the tax system to target various special interests, which is undoubtedly correct, and suggests that under TVM any such treatment would be more obvious because it would have to be effected outside the basic “building blocks” of the system (being changes in net assets). It would have to be done, the EM states, through taxable income adjustments or the tax value rules.

This line of reasoning is valid, up to a point. The existing law already deals with some special interest groups in quite obvious ways eg. the research and development concessions. Equally TVM would deal with some special interests in its core structure eg. the zero listed tax values for mining exploration.

Ultimately the policy of any Government will include the need to raise revenue and to provide concessions where deemed appropriate. To the extent that revenue is raised by a tax on income and realised gains and that concessions are granted through the income tax system, there will always be the potential for obfuscation. I do not think that TVM would significantly change that.

### **Durability**

The EM states the “something is durable if it is able to endure long into the future while remaining efficient and effective”. On that basis, which I accept, it is not possible to say much about TVM’s durability at this stage: it will be a matter which can only properly be assessed historically.

Nevertheless it is possible to make some pertinent observations. TVM’s claim to likely durability is based on its conceptual framework (assets and liabilities) being both broad and simple and its structure (assets/liabilities  $\Rightarrow$  have/hold  $\Rightarrow$  tax value) being simple and adaptable. To the extent that it is possible to analyse this proposition from the testing process and results I suggest that it is supportable.

The testing participants did not find many situations where the existence or non-existence of an asset or liability was of itself an issue (there were issues in identifying, and separating, particular assets and issues with cash, which is specifically excluded). Thus, at its broadest, the conceptual framework seemed to work effectively. Certainly much of what is current blackhole expenditure was adequately dealt with and that arose out of the coverage afforded by the conceptual framework.

It was also found that some quite complex transactions were quite simply and efficiently treated under TVM eg. take or pay contracts, purchase of an income stream.

However the adoption of a very broad starting point creates its own issues (complexity of law in the narrowing process is one obvious area, discussed elsewhere), and these may impact on durability. Two illustrations (not specifically from the issues testing program) follow.

#### **(a) Reliance on single “private or domestic” gateway**

The general provision for deductions in the current legislation (and indeed most of the special deductions provisions) include a provision that the loss, outgoing or

expenditure, as the case may be, must be incurred in a manner which connects it to a business activity or to particular income. This is an important and generally effective limitation which is not reflected in TVM legislation. In fact the scheme of TVM would probably make it quite difficult to introduce such a limitation in a “gateway” situation and therefore it would need to be dealt with by a range of special provisions or perhaps by one overriding denial (add back) provision. In either case I envisage difficulties both in drafting and in interpretation.

Some examples of situations which could give a result under TVM different from the current situation include:

- An Australian resident paying expenses of a foreign associate (Question whether the transfer pricing rules apply effectively?)
- A company paying expenses for its sister or associate
- Pre-operating expenditure

To the extent these results are not acceptable from a policy viewpoint special rules would need to be introduced.

(b) Potential for abuse via receipts and payments

Receipts and payments are a fundamental part of the TVM net income formula and there is a risk that this may give rise to abuse.

Receipts and payments are hard, readily identified factual matters. The making of payments in effect gives rise to a prima facie “deduction” while the receipt may give rise to income. Taxpayers could abuse this, particularly at year-end. There are no complex tests to determine “deductibility” or “assessability” nor when an amount is incurred or derived, and therefore income transfers between taxpayers might be quite easily effected eg. from a profitable company to a loss company or a foreign company.

If there is no purpose test then there is also no limit on the amount which can be deductible. The “commercially realistic” criterion adopted in *Phillips Case*<sup>1</sup> would not apply.

## **Certainty**

### *Structure and statutory interpretation*

The EM states that an aim of TVM is to provide a structural solution to many problems, adding to certainty.

The new legislation will not necessarily make interpretation of the tax law more certain, in my opinion. A tax system based on what happens to assets and liabilities rather than income and expenditure will likely have an equal number of areas where interpretations are open and difficult, and answers complex and subject to fine judgment.

The present method differs fundamentally from TVM in its approach in the sense that it immediately poses the big questions eg. is it income? That question requires a great deal of analysis in complex situations and the test criteria are provided in case law rather than in the statute. TVM by contrast asks a series of questions: is there an asset or liability, does the taxpayer hold it or have it, and if so, what is its tax value. Only the first question represents a concept which is not exhaustively defined. The have/hold and tax value

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<sup>1</sup> 78 ATC 4361  
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questions are subject to numerous detailed machinery provisions. However, within these provisions are contained many legal concepts and matters of interpretation.

Whether this more prescriptive approach will prove to be better will not be known until it has been in use for some time and has been considered by the Courts. There would seem to be no reason for TVM to be the occasion for less tax litigation and, in the short and medium term may well give rise to more.

On one view TVM simply provides a different set of issues for taxpayers, administrators and Courts to consider. For example, what is the asset or liability (including sometimes nebulous rights and obligations), when does it arise/cease to exist, what is its cost and when is it paid or deemed paid, what are proceeds or deemed proceeds and when do they arise, who is the legal or equitable owner of an asset, what is a present legal or equitable obligation and how do you apportion amounts between different assets and/or liabilities. Then of course there are the new machinery provisions such as routine rights and non-cash transactions which bring with them new questions of interpretation.

The testing program has begun the process of analysing these sorts of issues in a real world sense. It has probably done no more than confirm that they are, indeed, questions.

#### *The capital/income dichotomy*

The separation of receipts/benefits on the one hand and losses/outgoings/expenditures on the other between revenue and capital has been one of the most troublesome aspects of Australian tax. The TVM approach was expected to overcome the problem by creating a scheme of taxation in which it did not feature.

While that objective has been largely satisfied there remain areas where the capital/income tests must still operate. These include:

- Repairs
- Capital losses (quarantining purposes)
- Capital gains (pre-CGT exclusions or CGT discounts)

The absence of a capital/income test in other respects may create its own issues.

For example, expenditure which falls to be considered on revenue account often gives rise to the creation of assets. Under the existing law 'enduring benefit' is only one indicia considered under the capital/income question and is not automatically determinative of capital eg. advertising, some feasibility studies. Under TVM every time an asset is created in circumstances where the taxpayer should get a deduction there will need to be a special rule. A number of these situations were found in the course of testing transactions in the mining/petroleum area eg, that part of development expenditure which is currently treated as being on revenue account.

Another example of fine judgments handled by the capital/income question is feasibility studies. Generally on capital account (*Griffin Coal Case*<sup>2</sup>) but in some circumstances treated as deductible revenue outgoings (*Ampol Exploration Case*<sup>3</sup>). The difference between the two essentially is the nature of the business activity carried on by the taxpayer. TVM does not recognise that as a point of differentiation and presumably would treat both the same ie. allocate the costs of the study to a depreciating asset.

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<sup>2</sup> 89 ATC 4745

<sup>3</sup> 86 ATC 4859

It might be argued that in an Ampol Exploration situation the costs of the feasibility study do not relate to an asset (the ATO view on this), however I can see no real difference between the two situations in that regard. In any event to accept such a view simply recreates the uncertainty that currently exists under the capital/income question. The price of certainty in this case is the non-outright deduction to taxpayers in an Ampol Exploration situation.

Native title payments deductions is another area where TVM would be unlikely to produce the same outcome as would arise based on a determination of whether or not it was on capital account.

This is not to suggest that TVM is fatally flawed in not following the capital/income path, but it must be recognised that it will produce results which can be significantly different: both to the advantage and disadvantage of taxpayers.

### *Incurred test*

The timing of deductions under the current law is generally determined by the incurred test. The test has seen a great deal of judicial action, perhaps beginning with the statement by Dixon J in *New Zealand Flax Investments Ltd v FCT* (1938) 61 CLR 179 at 207:

“incurred” does not mean only defrayed, discharged, or borne, but rather it includes encountered, run into or fallen upon. It is unsafe to attempt exhaustive definitions of a conception intended to have such a various or multifarious application. But it does not include a loss or expenditure which is no more than impending, threatened or expected.’

The Courts have adopted different key words or phrases through the years in considering the test. These include “definitely committed” or “completely subjected” (*FCT v James Flood Pty Ltd* (1953) 88 CLR 492), “properly referable to the year in question” (*Coles Myer Finance Pty Ltd v FCT* 93 ATC 4214) and “presently existing liability” (*Nilsen Development Laboratories Pty Ltd v FCT* 81 ATC 4031). Thus “incurred” may mean one of a number of things, depending on the circumstances. The adoption of a single test should go some way to addressing the uncertainty which no doubt can exist in some situations. However, these are two points to note here. First, any increase in certainty may come at a cost of flexibility and will very likely produce different results for some taxpayers (absent special rules which of course lead down the path of complexity). Second, the single test itself is still open to interpretation. For example, two cases which could be a focus of further study in this regard are *FCT v Woolcombers (WA) Pty Ltd* 93 ATC 5170 and *Ogilvy & Mather Pty Ltd v FCT* 90 ATC 4836.

This is a significant issue which requires considered and careful thought. The situation of taxpayers likely to be disadvantaged by a narrower test (insurance companies for one) should be taken into account.

The ATO view expressed in their response to the analysis of annual leave is that the “incurred” test in S.8-1 of the Income Tax Assessment Act 1997 is ‘virtually identical’ to TVM’s “have” test in draft S.7.23. It would be useful to test that proposition further.

If however that is true then the proposed new provisions do not simplify the law in relation to this aspect of it.

### *Cost allocation*

One of the most critical aspects of a TVM system will be the attribution and allocation of costs. Undoubtedly taxpayers will be looking to maximise the “write off rate” eg. by allocating costs to a listed zero tax value asset, or to no asset. The Revenue is likely to have an opposite view.



S.7A-20 provides that the first element of cost is the total amount you have paid in order to start holding the asset (to the extent that the amount relates to the asset).

S.7A-120 provides that an amount relates to an asset to the extent that it is reasonably attributable to it. Further, you must have regard to the relative market values of assets in determining how much is reasonably attributable where it is necessary to allocate amongst assets.

Obviously these words leave a great deal of room in which taxpayers and the ATO will seek to move, in terms of cost absorption.

A Discussion Paper on TVM prepared by Treasury in February 2000 (refer paragraph 3.35) and, by implication, the most recent EM (paragraph 9.24) both make reference to *Philip Morris Ltd v FCT* 79 ATC 4352 as providing some authority in this area. The *Philip Morris* case in fact is generally considered to be unsatisfactory: on one view the Court failed to adequately come to grips with the accounting and left many open questions. This is unsatisfactory from the taxpayer's viewpoint because there is a lack of clear guidance (the tax ruling IT 2350 only partially overcomes this) and no doubt it is unsatisfactory from the Revenue's viewpoint because it leaves an important area open to exploitation. The value of trading stock under absorption cost systems is frequently an area of dispute in large case tax audits. If the point needs reinforcing, in the only test issue in which it came up for direct consideration the participant and the ATO fundamentally disagreed on whether certain costs should be absorbed.

If cost becomes a more critical area of the tax law, as it would under TVM where the cost of every asset comes up for consideration (not just trading stock, depreciation and CGT assets as at present) then the rules should be made very clear. One option would be to adopt the accounting standard in full, not in the partial, subject-to-adjustment approach reached in *Philip Morris*.

Adopting the accounting standard would also go some way to meeting the consistency in approach between tax and accounting professed by the RBT Report.

The Treasury Paper states that it would be a question of fact and degree in determining the expenditure incurred to hold and/or to bring an asset to its present condition (the rules currently proposed). Questions of fact and degree always leave considerable room for debate. Unless this area can be tightened up it will be fruitful ground for disputes under TVM. The ATO approach of providing examples is not completely satisfactory, these are inevitably not totally comprehensive of every situation which can arise and are, in any event, open to interpretation.

#### *Asset identification*

The asset identification issue is best illustrated in a situation where money is spent in circumstances that give rise to information but potentially that information forms part of one or more physical assets. An engineering design feasibility, and the preliminary capital feasibility study are examples from mining encountered in the test program. Feasibility studies in non-mining identified the same potential issue. The participants on mining and manufacturing considered that the work carried out could give rise to something more than just information but the ATO view was that, apart from any design registration costs, the expenditure would likely give rise only to information which would not be "held" pursuant to s.6-20 item 3. The petroleum case participant did not express the same concerns ie. agreed with ATO's view.

The point here is not to focus on the disagreement between the participant and the ATO but to highlight the potential for disputation. When does expenditure relate to information which is a stand-alone asset as opposed to a part of another asset? The TVM tax result will be quite different depending on the answer.

## LEARNING ISSUES

The experience of the participants (there were about 20 people involved in total) would suggest that the basic structure of TVM was quite easy to understand and to assimilate. The calculation methodologies also were found to pose no difficulties in comprehension for a group that probably comprised a majority of accountants (certainly of those involved in the test calculations this would have been the case).

The area which caused difficulties was the interpretation of some of the provisions. A number of these in the financial instruments area were either incomplete or have now been re-written and the problems the corporate participants had to grapple with may have been addressed. However Pitcher Partners had these re-written provisions (Division 45) and still expressed concerns in interpreting them.

There was a consistent thread among the participants, a difficulty in applying the provisions of TVM to fact situations which called for a possible application of the routine rights and liabilities provision (s.6-45), the contingent rights provisions (s.6-18(3) and (4)) and the non-cash benefits provisions (Division 8).

No doubt part of the problem was that this legislation was not only new but that it formed part of an entirely unfamiliar conceptual framework. (Tax practitioners are used to new legislation but can generally fit it into an existing and well understood legal framework). Part of it is undoubtedly in the drafting – this has been discussed elsewhere in the report. And partly it will have been due to a lack of familiarity with some of the underlying legal concepts.

There are many concepts which, if not entirely new to tax practitioners, do take on far more critical roles and therefore need to be better understood. This will be particularly true of tax accountants who will be very familiar with certain currently relevant areas of law but not in all areas of law.

These important but unfamiliar concepts include:

- What is property?
- What is a legal right?
- What is an equitable right?
- What is a legal obligation?
- What is an equitable obligation?
- What is a contingent/non-contingent right?
- What is a contingent/non-contingent liability?

On a positive note the participants did manage, even in a very short time and with quite limited instruction, to find their way around the provisions and generally to apply them appropriately. Ignoring those transactions for which insufficient legislation was available at the time of drafting, the number of outright differences of opinion between the participants and the ATO experts was relatively small.

Finally, while it has nothing to do with TVM (or some might say it has everything to do with TVM), the tax education industry in Australia is very large and quite competent. If a full and workable system of TVM legislation were produced I would expect that it could be learned and applied in practice in a relatively short period.

## **CONTENTIOUS AREAS IN DRAFT LEGISLATION**

### **Division 8**

The concerns expressed by participants in relation to Division 8 were directed partly at its relevance ie, what is it there for, and partly at its construction.

There was confusion initially as to whether it was solely about barter transactions or also included normal credit transactions. Once it became known that it covered both the typical response was “why?” (People in business simply do not think of credit transactions as being “non-cash”). While these questions can be answered in a logical way it might be better, in terms of “selling” the legislation to tax practitioners at large, for the two to be separated. Some consideration could be given to treating normal credit transactions in a separate provision which simply deems them to be a payment.

The issue of construction was also raised and relates to the circular nature of some of the drafting. Again the provisions seem to work but the process of getting there can be somewhat tortuous. A separation of credit transactions might avoid much of this in practice.

### **Routine rights and liabilities**

Section 6-45 is an important provision. Its purpose is to ensure that the scope of the tax system is appropriately contained, but, because it is in effect a “get out” provision ie, gives a zero tax value to an asset, it must not be open to abuse. (The reverse is also true: taxpayers will not want liabilities being given a zero tax value incorrectly).

Particular issues have been raised in the course of testing in relation to the requirement that the asset and liability must arise under the same contract, and the year on year matching of benefits. The ATO have acknowledged that issues do exist here and intend to consider further options.

Given the vital role that S. 6-45 plays it must work effectively for both taxpayers and the Revenue. Although it is much disliked by taxpayers generally, there may be no better option here than to keep the drafting relatively tight but to provide a Commissioner’s discretion with guidelines as to when it might be exercised. However other drafting options should be explored before adopting this approach.

### **Contingent rights**

One issue with the provisions at 6-18(3) and (4) dealing with contingent rights is determining in what circumstances they apply – the issue came up for example in relation to unbilled client disbursements. A similar problem arose in relation to a diesel fuel rebate issue.

The examples provided in the legislation are undoubtedly useful and participants had no difficulty in applying the provisions in an insurance situation. Perhaps more examples (possibly in the EM) would assist.

### **Multiple assets**

A number of the participants had difficulty with items 10 and/or 11 in the table at S.6-21. It is understood that these provisions are already under consideration for redrafting. The current wording is particularly difficult to follow.

## CONCLUSION

### General comments

There are certain things which TVM does very well. The scheme of it facilitates emerging profits being brought to tax and depreciating assets giving rise to taxable income reductions. The treatment of a whole range of assets under a single set of rules is also advantageous; things as apparently different as plant and equipment and prepayments of revenue outgoings all fall under the same rules. Trading stock is easily accommodated within TVM.

There are certain areas where the scheme of TVM leads to difficulties. Cash is currently still a potential problem ie. cash losses. The fact that multiple assets and liabilities arise in some transactions and the potential for there to be different outcomes are issues.

This matter which is likely to give rise to criticism: the fact of TVM producing different tax outcomes to that achieved under the existing law where there is no change in policy.

The RBT recommended that TVM be “revenue neutral” – refer recommendation 4.1(c). That does not necessarily mean that it produces no different result, merely that the sum of those different results will not increase the Revenue’s take. However there is a strong perception that TVM must not produce any different result unless it is pursuant to a policy change eg. to cover black hole expenditure. The RBT Report is perhaps largely responsible for this view – refer page 162 in discussing the two options considered for calculating taxable income where it was stated:

“Both options are intended to, and would, produce the same outcome. They would also produce the same outcome that the current system is intended to do, under the same policy prescriptions.”

A more adventurous statement of this proposition appears on p.159 of the RBT Report:

“Unless other recommendations in this report expressly propose variations to the existing law, the presumption should be that identifiable variations to policy will not be implemented by stealth.”

The testing indicates that there will be situations where a different result will occur. The exploration situation set out at the end of this paper illustrates one example. In some cases complex and even potentially risky legislative provisions would probably be required to seek to ensure no difference arises eg. in a “Whitfords Beach” situation.

In the writer’s view the likelihood of different results should be acknowledged by the Government with a further comment that they will be dealt with in an appropriate manner. Appropriate responses might include:

- Accepting the particular difference and adopting it as a policy change.
- Providing transitional legislative remedies such as grandfathering existing positions or granting certain specified concessions.
- Establishing a set of guidelines under which disadvantaged taxpayers can apply for ex-gratia relief within a given timeframe, say 5 years.

### Responses to the test program questions.

1. Does TVM contain conceptual flaws such that it could not be effectively applied?

*No fundamental flaws were discovered in the legislation as drafted.*

## 2. Key issues to be addressed in developing the legislative framework

*These are covered throughout the paper and include:*

- *Addressing gaps in the legislation such as the treatment of lost cash*
- *Clarifying parts of the legislation by redrafting*
- *Further testing of legal concepts*
- *Stress testing for potential for abuse*

## 3. Identification of key compliance issues

*Essentially the practical side of compliance would seem to be capable of being dealt with. Existing data will generally be sufficient but new tax software would be necessary for different forms of calculation.*

### **Recommendations of matters for further testing**

#### *Interpretation issues*

A program such as the one undertaken, in a very short timeframe and necessarily covering a great deal of ground, cannot be expected to test fully the legislative drafting of the provisions. It can, and has, assessed whether the provisions could work in a practical sense and raised issues relevant to that. It does not test all the meanings that could be given to a particular provision.

It is recommended that a program be devised under which tax lawyers are asked to interpret key provisions, to determine whether they do what they are intended to do and only that.

At times in the course of looking at particular issues the thought occurred to participants as to how seminal or otherwise important cases would have fared under TVM. To the extent that TVM is not intended to change the law the results in those cases should be the same.

It is recommended that a list of cases be prepared to test the “same outcome” proposition. The testing might be done by obtaining the opinion of a panel of senior tax barristers.

#### *Industry testing/structures testing*

The program conducted thus far is still quite limited in its overall scope of taxpayer types. There was no bank or insurance company tested, for example. As further drafts of the legislation become available it will be more meaningful to test these types of businesses.

Other special groups would include primary producers and small business taxpayers, again subject to relevant legislation being available.

It will also be critical to determine how various structures are treated under TVM. Trusts will no doubt throw up many issues which will be of great interest both to small business and the investment community.

#### *Stress testing*

At various places in this paper comments are made in relation to the potential for abuse of the provisions of TVM and the need to “stress test”. No doubt this is a difficult area to test in terms of external assistance. One option might be to create a TVM team drawn from ATO Officers who have experience in the programs directed at tax avoidance. Some

useful analysis might also come out of the interpretation project suggested above for lawyers to analyse key legislative provisions.

### *Future testing program*

It might be useful if there was a program set out in advance for future testing of different aspects of TVM so that taxpayers and tax practitioners are aware of what is likely to happen. The testing program obviously would track the legislative program and should assist by feeding into it.

## **EXAMPLE**

### **EXPLORATION PERMIT ISSUE/EXPLORATION SPENDING**

Assume you apply for and are granted an exploration permit which is given on the basis of your promise to drill 5 wells within 5 years. The projected cost of drilling the wells is \$10,000,000 and will occur over 4 years. There is an asset (permit) and a liability (obligation to expend exploration moneys).

The tax value of "any other asset" (6-40 item 9) is the cost. The cost of an asset in what you pay (s.7A-20). If you get a non-cash benefit you are taken to pay under s.8-29 the amount you are taken to receive under s.8-28. Where you give a non-cash benefit you are taken to receive the market value if it is a cash-like benefit. So when you give and get a non-cash benefit you are taken to pay the market value of what you give. However, if the benefit you give is not a cash-like benefit you are taken to receive the market value of the non-cash benefit you get.

In the exploration permit situation, the tax value of the asset is the market value of the exploration permit.

The tax value of "any other liability" is the proceeds as at that time of assuming the liability (s.7-75 item 9). The proceeds of assuming a liability (first element) is the amount you have received because you started to have the liability. In a non-cash/cash-like transaction, you are taken to receive the market value of the benefit you give. However, in a non-cash, non-cash-like situation you are taken to receive the market value of what you get.

In the exploration permit situation the tax value of the liability is the market value of what you get, being the exploration permit.

If you are prepared to expend \$10m over four years then presumably the market value of the permit is something like the discounted value of the expenditure commitment. In this example, say \$9.5m.

Thus the initial tax value of the asset and the liability is \$9.5m. The asset reduces over 5 years ie. \$1.9m pa being the term of the permit. The liability reduces over 4 years, being the projected period over which the drilling program is expected to run. The \$10m is spent over four years.

The TVM net income calculation is as follows (assuming the arrangement is entered into at the start of year 1 and everything flows evenly throughout the relevant periods).

Year 1		\$	
	R-P (0-2.5)	-2.5	
	Decrease in net assets (7.6-9.5)	-1.9	
	Decrease in net liabilities (7.125-9.5)	<u>2.375</u>	
	Net income	-2.025	-2.025

Year 2			
R-P (0-2.5)	-2.5		
Decrease in net assets (5.7-7.6)	-1.9		
Decrease in net liabilities (4.75-7.125)	<u>2.375</u>		
Net income	-2.025		-2.025
Year 3			
R-P (0-2.5)	-2.5		
Decrease in net assets (3.8-5.7)	-1.9		
Decrease in net liabilities (2.375-4.75)	<u>2.375</u>		
Net income	-2.025		-2.025
Year 4			
R-P (0-2.5)	-2.5		
Decrease in net assets (1.9-3.8)	-1.9		
Decrease in net liabilities (0-2.375)	<u>2.375</u>		
Net income	-2.025		-2.025
Year 5			
R-P (0)	0		
Decrease in net assets (0-1.9)	-1.9		
Decrease in net liabilities (0)	<u>0</u>		<u>-1.9</u>
			<u>-\$10.0</u>

The total "deduction" is \$10 claimed over 5 years. The spending occurs over 4 years. Under the current law the deduction is available over 4 years.