FOR DISCUSSION PURPOSES

OPTION 3 CORE RULES DEMONSTRATION DRAFT (11 April 2002)

EXPLANATORY MATERIAL

Prepared by PricewaterhouseCoopers for the Board of Taxation.

This document is solely for the purpose of benchmarking prototype 4 of the Tax Value Method legislation. It should not be relied upon in any way as a basis for determining the taxation treatment of transactions or for any other purpose.

Table of contents

Glossary 4

Status of Option 3 5

What is Option 3? 9

Table comparing Tax Value Method and Option 3...... 20

Explanation of some provisions in the Draft Option 3 legislation…………………………………………………...24

Some worked examples of the operation 34

Glossary

The following abbreviations and acronyms are used throughout this explanatory material.

Abbreviation	*Definition*
ATSR	*A Tax System Redesigned: Overview, Recommendations, Estimated Impacts*
EM	Explanatory Material
CGT	Capital gains tax
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
SAC 4	Statement of Accounting Concepts 4
STS	Simplified tax system for small business
TLIP	Tax Law Improvement Project
TOFA	Taxation of financial arrangements
TVM	Tax Value Method

Status of Option 3

1.1 This Explanatory Material accompanies the Demonstration Draft Option 3 legislation that has been prepared under the auspices of the Board of Taxation. The Option 3 legislation and this EM have been prepared solely to allow the benchmarking of the TVM legislation 4th prototype that was released by the Board of Taxation on 6 March 2002.

1.2 The Option 3 Demonstration Draft legislation and this EM have no status other than for benchmarking purposes. Because the Option 3 legislation has been conceived and prepared by just a few individuals with limited resources over a short period of time (probably less 2% of the resources devoted to TVM) , it is likely to contain a number of errors and gaps. The objective is not produce something that is equivalent even to an Exposure Draft of legislation. It is simply to test whether such legislation may possibly work (as a benchmark must be able to work) and to demonstrate what the core rules of Option 3 legislation might possibly look like, giving some impression of the complexity and prolixity of its core rules compared with those of TVM.

An appropriate benchmark?

1.3 The TVM 3 Legislation Group have implicitly questioned the appropriateness of Option 3 as a benchmark. They say[1]:

> "… that:
>
> - Option 3 does not currently demonstrate any motivating principles, or if it does, they are not clear. Instead, it appears as a patchwork of miscellaneous rules. Its lack of coherence could cause it to be interpreted and applied in unintended ways.
> - The policy foundation is unclear. To be a benchmark against which to assess the tax value method (TVM), it would need to apply the same policies as the TVM draft (e.g. *A Tax System Redesigned* (ATSR) recommendations on rights and financial arrangements).
> - As a result of the above, the current structure of the legislation is complex.
> - The legislation relies too much on the legal form of arrangements, meaning that it could lead to inequitable outcomes and is not robust.
> - There appear to be a number of technical flaws in the current draft."

1.4 Most of the technical flaws referred by TVM Legislative Group arise from a misunderstanding/lack of completeness of the Option 3 core rules legislation. The comments regarding complexity are puzzling as the core rule of the Option 3 Demonstration Draft are much shorter than those of TVM, and they do not contain the many deeming rules and invented concepts of TVM that contribute greatly to TVM's complexity. The

[1] *Comments on Option 3*, circulated on 26 March 2002

comments of the TVM Legislation Group regarding errors and complexity in Option 3 legislation therefore seem to fall wide of the mark.

1.5 However their comments regarding Option 3 as not demonstrating "any motivating principles…or policy foundation " and "as a patchwork of miscellaneous rules" are correct. The same comments are also, of course, true of TVM. TVM does not tax a concept that is recognised by economists, for example the Haig-Simons concept of income, nor does it tax a concept developed by accountants for determining the profit or loss of a reporting entity, which some European income tax systems aim to do. In a number of respects TVM is further from accounting concepts than the current income tax rules as it would defer income, by recognising liabilities that accounting standards would ignore as not material, and it would also defer the recognition of expenditure, for example in the case of some long term supply contracts, such as the supply of minerals, which would be recognised by accounting standards under the conservative principle, that if money has been paid, the prima facie rule is that it should be expensed.

1.6 TVM, like Option 3, is a "patchwork of miscellaneous rules" eg the table of tax values for 6 different types of assets at section set out at section 10-40 of the TVM legislation (Prototype 4) only one of which adopts market value, and the table of tax values for 7 different types of liabilities in section 12-40, only one of which adopts market value. TVM uses *tax* values that essentially replicate the pragmatic compromises and adulteration of economic principles of the current system (as modified by the amendments proposed in ATSR (ie "Ralph Report")) rather than the economic or market values adopted by economists and accountants. The central mechanism of TVM (being the changing tax values of assets and liabilities) provides an illusion that TVM has a policy foundation as it adopts a comparison of annual balance sheets approach such as accountants may use. This apparent policy foundation disappears, however when it is realised that the values that are inserted into this conceptual matrix are *tax* values and not the economic values. The view implied by the TVM Legislation Group that Option 3 is not an appropriate benchmark for TVM as Option 3 lacks a policy foundation is therefore fallacious. Neither TVM or Option 3 have a policy foundation.

1.7 Option 3, in this respect, has an advantage over TVM as it is deliberately a patchwork of miscellaneous rules and does not pretend to be anything else. This allows for simpler and plainer drafting – the rules may not be particularly coherent, but there is no need to try to make them appear coherent. Much of the convoluted and complex drafting of the TVM legislation comes from the almost impossible attempt to "shoe horn" this miscellaneous patchwork of rules into TVM's standard mechanism.

1.8 The TVM Legislation Group point out correctly in their critique of Option 3 that the Option 3 core rules do not incorporate the ATSR recommendations on rights and financial arrangements and again imply this is a reason why Option 3 should not be used as a benchmark. The Option 3 core rules have deliberately not attempted to incorporate the

recommendations of Section 9 of ATSR ("Financial assets and liabilities") as this would be most appropriately incorporated in TOFA legislation, which could equally well be part of an Income Tax Assessment Act based on Option 3, or TVM legislation. (In this respect it is worth noting that TOFA, which *does* incorporate accounting concepts, has a policy foundation which is unfortunately lacking in both TVM and Option 3.) In addition the Option 3 core rules have deliberately not incorporated the recommendations in Section 10 of ATSR regarding leases and rights. There are two reasons for not incorporating these recommendations in the core rules of Option 3.

1.9 Firstly, it is possible to tax a sale and lease back of plant or equipment, which seems to have been one of the main targets of the recommendations in Chapter 10, as a loan and the repayment of principal with interest, in a separate regime that does this explicitly. One of the remarkable achievements of TVM is to treat such a transaction in this way within the core rules, but it does this implicitly, and by means of the operation of a multiplicity of provisions, which mean that an ordinary intelligent reader cannot ascertain how this outcome is achieved by reading the provisions themselves.[2] While acknowledging the ingenuity of the achievement of TVM in this respect, there is a good policy reason for an explicit rather than an implicit treatment of sales and leases back and similar transactions – so that affected taxpayers can determine how and if they are affected and, when legislation is introduced, they may make representations to legislators.

1.10 The likely reply of the TVM Legislation Group is that explicit and special regimes to treat particular fact situations have led to much of the complexity in the existing legislation. However, much of this complexity has been the result of bad drafting, and in particular drafting that is excessively specific rather than principle based. As an experiment, subsection 9-75(6) has been inserted into the Option 3 draft legislation to tax payments by a lessee under a sale and lease back as payments of principal and interest. This provision should be reasonably robust as it addresses the position of the lessor, the lessee and a lease back to an associate of the vendor as well as the vendor. The provision, including a note to eliminate doubt on a particular issue, occupies 7 lines. This compares with more than 20 lines of explanation in *Tax Value Method Information Paper* which explains how 6 TVM provisions interact to produce an equivalent result.

1.11 There is a second reason for not making provision for a rights regime within the Option 3 core rules. In a technical sense the Government may have endorsed the treatment of leases and rights recommended in Section 10 of ATSR (although many of the recommendations in ATSR that were originally endorsed seem to have been abandoned – for example the entity regime – or not acted upon for the time being, for example Recommendation 6.1 ("Operation of the

[2] See Geoffrey Lehmann, *TVM: An Assessment* at 48 and the TVM Legislation Group's *The Tax Value Method Information Paper* at 71-2.

general anti-avoidance rule")). But it is clear that *the Government has not endorsed TVM.* Recommendation 10.7 of ATSR in respect of "routine leases" refers to "routine rights". The meaning of "routine rights" has changed from Prototype 1 (which was released at the same time as ATSR) to Prototype 2 and again in Prototype 3. We may therefore conclude that, in view of this protean definition, Recommendation 10.7 cannot really be claimed as a core recommendation endorsed by Government. It has not been treated as such by the TVM Legislation Group as they have changed the meaning of routine right since Recommendation 10.7 was first formulated. In a technical sense there is therefore no requirement for Option 3 to incorporate a rights regime, as the TVM Legislation Group has incorporated a different rights regime from what was initially recommended in ATSR and may have been, in a technical sense, endorsed as government policy.

1.12 This position is strengthened by the fact that the rights regime in TVM has become intertwined with the TVM treatment of liabilities *which are clearly part of TVM and not endorsed Government policy.* For example, section 68-45 of Prototype 4 defines routine rights and liabilities in terms of each other – you cannot get one without getting the other. It should be pointed out, there is no reason why a rights regime could not be included in Option 3 legislation, among the rules of general application, if the Government formed the view that there was a need to legislate for rights as recommended in Section 10 of ATSR. However, it is also likely that once the Government realised all of the implications of the ATSR recommendations regarding rights, it might not wish to implement them to the full extent envisaged in ATSR. There is opposition to a broad ranging rights regime from those sections of the business community who are aware of the possible implications.

1.13 One aspect of the TVM Legislation Group's apparent views regarding benchmarking seems strange. They say about Option 3 in the passage quoted earlier: "To be a benchmark against which to assess the tax value method (TVM), it would need to apply the ***same*** policies as the TVM draft (e.g. *A Tax System Redesigned* (ATSR) recommendations on rights and financial arrangements)"(emphasis added). Applying the same policies as TVM in Option 3 legislation would result in legislation that was similar if not identical to TVM. The implication of the TVM Legislation Group's statement is that TVM can only be benchmarked against itself.

What is Option 3?

The objectives of the Option 3 group

2.1 Option 3 was conceived by a group of private sector members of the TVM Working Group that has been appointed to review and advise the Board of Taxation on the Tax Value Method legislation The group had two objectives.

2.2 The main objective was to provide a benchmark for Prototype 4 of the TVM legislation when it was released. There was a recognition that the existing law, being ITAA 1936 and ITAA 1997, was not an appropriate benchmark against which TVM could be tested, as it is generally acknowledged that the existing legislation is "broke". Many of the building blocks it uses are obsolete and refer back to the income/capital dichotomy, which is no longer as fundamental as it was once. Many of the rules in the existing law duplicate other rules – sometimes producing slightly different outcomes, which makes choosing between the rules difficult, with the choice sometimes being determined by small factual differences. In a few instances as many as 4 overlapping rules may apply to a transaction. The existing law is also poorly structured, does not use common definitions and rules have been developed in an ad hoc manner. Last, but not least, the existing law comprises two Acts written in quite different styles.

2.3 It is widely recognised that for benchmarking or testing in the social sciences an appropriate "control" is required for comparison purposes. As well as the existing law, potential controls included the income tax systems of other countries. However, benchmarking against the income tax systems of other countries is not necessarily valid, because each country's income tax system has been shaped by its unique history, and it is not easy to transplant an income tax system from one country to another country when there is already an operating income tax system which has created certain taxpayer expectations and revenue needs. While Australia's income tax legislation is generally recognised as uniquely bad in its design compared with other countries, nevertheless it would not be realistic to replace Australia's income tax rules with those of another country, which, it was decided, were superior. For these reasons it was decided that the benchmark for testing TVM should be a reconstructed, idealised model of the existing tax law, with obsolete concepts and duplication of rules eliminated, common definitions used throughout the legislation where possible and some existing areas of uncertainty removed. Where aspects of the existing law were regarded as worth preserving, these would be preserved. Where aspects should be jettisoned, they would be jettisoned. Option 3 was therefore conceived as radical reconstruction of

an existing structure, rather than its replacement by an entirely new building which is the approach adopted by TVM.

2.4 The Option 3 group had a second objective. There was concern that TVM legislation was becoming excessively complicated, compliance might become more rather than less onerous under TVM, and that there might be some unexpected changes. More recently there has been a realisation that, in particular, significant timing changes caused by TVM may mean that for some taxpayers, typically suppliers entering into long term supply contracts, the timing of the recognition of income may be significantly different from current rules. There is concern as to whether these timing changes are appropriate. Secondly there is concern that if TVM were to be introduced, these timing changes might cause significant transitional issues for such taxpayers. To avoid double deductions and double tax it may be necessary for such taxpayers to account for contracts entered into before the start date of TVM under current rules while accounting for contracts starting after that date under TVM rules. The possibility that parallel systems (current rules and TVM) might have to apply by some taxpayers for some years after TVM's introduction could substantially increase the transitional costs.

2.5 All of these factors taken together have motivated members of the Option 3 group to look for some replacement for TVM, as they are concerned about maintaining the momentum for fundamental tax reform if TVM does not proceed. The Option 3 group agreed it is not sustainable to continue with two Acts written in entirely different styles even for the medium term. They also agreed that if those Acts are to be replaced with a single Act, this should not be a continuation of the Tax Law Improvement Project which involved a mechanical rewriting and re-arrangement of the ITAA 1936.

2.6 The second objective in developing Option 3 was therefore to provide a prototype that could replace the ITAA 1936 and ITAA 1997 and maintain the momentum for basic tax reform, in the event that TVM proved too ambitious to implement. This is however a second objective, and not the primary objective, as the Government might wish to consider alternatives other than Option 3, as a vehicle for fundamental reform of the income tax system. Other possibilities include taxing reporting entities on the basis of their accounting profits.[3]

What is Option 3?

2.7 Option 3 would involve preparing a new Income Tax Assessment Act to replace the existing two Acts, and would eliminate where possible reliance on the income/capital dichotomy, as it is now

[3] However if reporting entities are to be taxed on the basis of their accounting profits, the revenue authorities will have to live with an increase in imprecision. See the comments at 2.26.

largely obsolete. It would employ some of the common architecture of TVM, but not the mechanism of the changing tax values of assets and liabilities (except where this mechanism is used now, as in the trading stock rules). Elimination of a reliance on the income/capital dichotomy would be achieved by exceptions rather than TVM's changing tax values of assets and liabilities. The reforms proposed by ATSR (with the possible exception of some aspects of the Ralph proposals regarding rights) would be incorporated in Option 3 legislation. In particular CGT treatment would be limited to a restricted class of assets, TOFA would be incorporated, and black hole expenditure would be deductible.

2.8 The hypothesis that underlies Option 3, in the words of Romano Nenna "is to achieve maximum improvement of the legislation with the least possible disruption to existing, well-known and reasonably understood words and concepts. Therefore, words would be changed **only** where very clear and demonstrable improvement could be established."

2.9 The reason for the hypothesis is that "changing words and concepts for change sake adds to transitional uncertainty, disruption and risk…. Potential valuable precedent will be lost. Transitional retraining and compliance costs will increase".

2.10 The Option 3 group endorsed two alternatives for Option 3. One is known as the "Minimalist Approach" and the other is known as the "External Approach".

Minimalist Approach

2.10 The Minimalist Approach involves in the words of Romano Nenna: "Retention of the ***income*** concept to avoid the need for separate exclusionary provisions for private or domestic receipts" which are otherwise required under TVM or the Extended Approach.

2.11 The Minimalist Approach also includes capital gains as an element of assessable income. Section 6.1 of the "Minimalist Approach Option 3 Legislation" shows how this might be achieved. The argument in favour of this treatment of capital gains is "to diminish the practical significance and difficulties of the capital–income dichotomy (on the assessable income side) for most taxpayers in most situations" while preserving concessional capital gains treatment and offsets for capital losses. It would also, as Romano Nenna points out, reduce the need for many categories of statutory income and would simply include directly in assessable income gross capital receipts not involving asset disposals. Fewer special CGT rules would be required, and a simplification of CGT, similar to what can be achieved under TVM, might be achieved.

2.12 In other respects, the Minimalist Approach is identical to the Extended Approach. Despite its use of the concept of "income according to ordinary concepts" to bring amounts into assessable income, it does not employ the income-capital dichotomy as a basis for allowing general deductions. Rather, all outgoings are deductible, subject to exceptions and modifications that arise under capital allowance rules and for assets that come within CGT rules. In this respect the Minimalist Approach is identical to the Extended Approach.

Extended Approach

2.13 The Extended Approach is the approach which has been adopted in the Option 3 Core Rules Demonstration Legislation. This approach has been used, because it was a more challenging drafting task, with the larger number of exclusions required (compared to TVM or the Minimalist Approach) and also because the rules that potentially include the market value of non-cash benefits in assessable income presented a greater drafting challenge in the Extended Approach format (compared to the Minimalist Approach).

2.14 Essentially the Extended Approach includes in assessable income all amounts derived during the income year subject to exceptions and modifications, and it allows a deduction for all outgoings incurred and properly referable to the income year, subject to exceptions and modifications in particular for outgoings that are deductible under capital allowances rules or are included in the cost base of assets that come within the CGT rules. The general deduction provision, being section 8-1 of the Option 3 Demonstration Legislation (which would be identical to the general deduction provision in a Minimalist Approach Act) lacks a nexus test of the type that is included at paragraphs (a) and (b) of subsection (1) of Section 8-1 of the ITAA 1997. Nor does it exclude outgoings because they are outgoings of capital, or of a capital nature as does paragraph (a) of subsection (2) of Section 8-1 of the ITAA 1997.

Minimalist and Extended Approaches compared

2.15 The Minimalist Approach might be preferred because it does not require the numerous exclusions (for assessable income) that are required for the Extended Approach. In addition it integrates more neatly with existing source rules which have developed around amounts that are income according to ordinary concepts. Although in theory there may often be uncertainty as to whether a particular gross amount is ordinary income or a capital gain when coming within the Minimalist Approach general provision for assessable income, in almost all cases where this uncertainty exists, it will be either one or the other, so that from a practical viewpoint there will be no dispute.

2.16 The Extended Approach might, on the other hand, be preferred to the Minimalist Approach for the following reasons:

(i) the term “capital gains” is not a well understood term and might require evidence regarding what are and are not capital gains in various CGT regimes that have existed here and elsewhere. If there is a gap in the concept of capital gains there is a risk that some amounts that would be taxed under current rules/TVM/the Extended Approach might not be taxed under the Minimalist Approach;

(ii) some taxpayers will argue that an amount (or non-cash benefit) they receive is neither income according to ordinary concepts, nor a capital gain, nor statutory income. The income/capital dichotomy may therefore survive for determining “assessable income” although not for deductible outgoings. This argument in essence is similar to (i) above;

(iii) The exclusions necessary to eliminate reliance on the income/capital dichotomy for deduction purposes are essentially the converse of the exclusions necessary to eliminate reliance on this dichotomy for determining assessable income. For consistency therefore, reliance on the income/capital dichotomy should be removed for determining assessable as well as deductible amounts.

Three criteria for Option 3

2.17 The first criterion is that Option 3 legislation must use only what has come to be known as **principle based drafting**. Option 3 legislation would not be subject to the limits on policy changes that applied to the TLIP so that it would not be constrained by the need to preserve policies that were identical to those of the existing law. The outcomes should be similar, but the policy detail, and legislative design and drafting should be subject to the basic criterion that what is included in the legislation must be capable of being legislated in provisions which employ principle-based drafting. To the extent that existing policy was incompatible with that criterion, policy detail and legislative design must be modified, subject to revenue constraints.

2.18 An example would be the substantiation provisions. At present there are more than five pages of detailed requirements in Subdivision 900-B of the ITAA 1936 regarding the documentation that employees must retain to establish what are known as “work expenses”. These 5 pages could be rewritten in the following terms: “To claim a *work expense you must retain appropriate, and where possible independent, documentation, that verifies the expense, such as invoices or bank or credit card records, for not less than 5 years.” An exception would be provided for this requirement, provided the expenses were reasonable, for overtime allowances, expenses while travelling except accommodation,

laundry expenses, and minor and infrequent expenses. This would be followed by the section 900-30 definition of work expense, which together with a note occupies less than 4 lines. In this way more than 5 pages could be shrunk to perhaps less than half a page. Nor would the redrafted law provide an incentive, as section 900-35 of the ITAA 1997 does, for employees to claim up to the non-substantiable limit of $300.

2.19 A second criterion must be that the policy detail and legislation design do not add to, and should, where this is realistic, **reduce compliance costs**. It is the general view of the Option 3 group that compliance costs are likely to be less under Option 3 than under TVM, because unlike TVM, Option 3 will not require some taxpayers to prepare income tax returns by reference to balance sheets. It is generally recognised that preparing an income tax return using a profit and loss account as the source of information is less time consuming. Identifying assets and liabilities as required by TVM could also increase compliance costs as sometimes the recognition of assets and liabilities required by TVM will not coincide with payments recorded in cash books. TVM may also create additional compliance costs in determining what portions of amounts are referable to what assets and liabilities.

2.20 Before proceeding with the detailed design of Option 3 legislation, there should first be an investigation of the main causes of compliance costs. Policy and legislative detail should then be designed around eliminating or modifying significant contributors to compliance costs, where this is realistic, and with a view to compliance costs savings. This would be in accordance with the objectives of Integrated Tax Design. This process does not seem to have been followed in the case of TVM, which began with a "bright idea" being the TVM formula. The catalyst for this seems to have been to provide a policy foundation for Treasury officers with responsibility for tax[4]. An investigation of the causes of compliance causes must *precede*, and *not follow* as in the case of TVM, the formulation of policy detail. Not all changes that would result in compliance cost savings will reduce revenue. Some may increase revenue, where for example some concession or additional choice, that involves additional compliance costs, is eliminated. A rigorous analysis of the choices available in the existing legislation could be undertaken to determine their usefulness and what real value they provide for taxpayers.

2.21 A third criterion should be to **preserve useful concepts and language** where this is compatible with the first two criteria. For example the words "derived", "incurred" and more recently "properly referable" have been the subject of court decisions. Their value for precedent purposes means that concepts and language such as these should not be jettisoned lightly. The "preservation" criterion also extends to the work of the TVM Legislation Group. Much valuable work has been undertaken by them towards building a common architecture. While Option 3 will not utilise the central mechanism of TVM, Option 3 should not, unless there

[4] Comments by Dr Alan Preston from the floor at the *Tax Value Method: Consultative Conference* held at Coogee on 23 to 24 July 2001

are substantial reasons, try to reinvent concepts that have already been developed, and no doubt subjected to intensive scrutiny, by the TVM Legislation Group.

Some details regarding Option 3

Capital gains tax rules

2.22 Capital gains tax rules would continue to apply to the acquisition and disposal of:

- shares and other membership interests
- land and buildings (non-depreciable/not trading stock)
- goodwill
- certain statutory licences, crown leases and other rights
- collectibles
- anything else added by Regulations to the list

It is likely that many of the existing CGT events could be eliminated – for example, CGT events D1 (former s 160M(6)) and H2 (former s 160M(7)) would no longer be required as the proceeds of these events would be assessable income under the main income provision.

TOFA

2.23 The Demonstration Draft Option 3 Core Rules does not attempt to integrate the proposed Taxation of Financial Arrangements (TOFA) regime. As it proposed here that timing recognition should be in accordance with accounting standards, this may make the task of integrating TOFA simpler, as TOFA in general relies on accounting standards – however, taxpayers subject to TOFA may recognise certain unrealised gains and losses that are recognised under accounting rules and are not recognised under the main income and deduction provisions, which would require modification to give effect to TOFA.

General anti-avoidance rule

2.24 There would be a role for a general anti-avoidance rule similar to Part IVA. It is likely that many of the specific anti-avoidance rules could be eliminated.

A central timing rule

2.25 A central timing rule is not an essential feature of Option 3 legislation and would only be adopted if benefits could be demonstrated in respect of the first two criteria, namely consistency with principle based drafting and a compliance cost benefit. However the Demonstration Draft Option 3 legislation provides for a central timing rule that would operate subject to other provisions of the legislation. The preliminary indications are that this might facilitate principle based drafting and reduce compliance costs.

Why Option 3 legislation may be preferred to TVM

2.26 The Demonstration Legislation of the Option 3 Core Rules indicates that **Option 3 legislation is likely to be much simpler than TVM** legislation. The reasons for this greater simplicity would appear to be:

- *TVM uses the wrong model.* The traditional model for income taxation is amounts that come in less amounts that go out. Amounts that come in and go out are easily identified. Option 3 preserves this basic model. TVM however is built around a trading stock model – the comparison of last year's balance sheet with this year's balance sheet. Changes in the values of assets/liabilities are more difficult to identify, as you must identify whether there is an asset/liability, who holds it and its value.

- *TVM's model requires more rules to produce the same result.* The basic structure of Option 3 is that taxable income equals amounts that come in, subject to exceptions, less amounts that go out subject to exceptions. In broad terms this means that the legislation only has to make rules for amounts that come in and go out. As well as dealing with amounts that come in and go out, TVM requires extra rules to deal with assts and liabilities as well. An example is the exception under Option 3 for private or domestic amounts that come in and go out. Two core rules are necessary, being paragraph 6-10(a) that excludes a receipt of a private or domestic nature, and paragraph 8-5(a) that excludes a payment of a private or domestic nature. In addition section 9-10 borrows concept from the TVM legislation to give an extended meaning to receipts and payments of a private or domestic nature. By way of comparison TVM has more than 17 pages dealing with receipts, payments and assets and liabilities excluding private items in working out taxable income. Some of the additional TVM rules, for example, regarding the non-deductible private percentage of depreciation for a depreciating asset and providing a cost base of market value for private assets when they become trading stock, would also have to be provided for in Option 3 legislation, but

some of the TVM rules, in particular regarding private liabilities, such as section 222-150 ("Downward adjustment for private percentage of decline in tax value during income year") and section 222-155 ("Further adjustment if cost of extinguishing liability differs from final tax value") are unnecessary under Option 3, as Option 3 does not try to track liabilities. The TVM formula throws up awkward and initially confusing concepts such as a "further adjustment" if "the cost of extinguishing a liability differs from its final tax value".

- *Some of the concepts TVM has invented to allow its model to work are conceptually complex.* An example is routine rights and liabilities which are defined at section 68-45. Unless these are eliminated from the rights/liabilities component of the TVM formula, large extra compliance costs result. Very broadly rights and liabilities are "routine" where rights and liabilities each year over the course of the contract (as the proportion of all rights and liabilities under the contract) are broadly matched. Conceptually this is far more difficult than the first draft of the notorious "terrible twins", subsections 160M(6) and (7) which caused so many problems for the Australian courts. Supposedly employment contracts come within this definition and are therefore excluded from the asset/liability mechanism. It is not clear that this is always so. If a 3 year employment contract contains a front-loaded payment (perhaps to compensate the employee for giving up a previous position) the total value of economic benefits provided under the contract by the employee at the end of each income year (as a proportion of the total value of all benefits to be provided) will not be substantially the same as the total value of economic benefits received by the employee (as a proportion of the total value of all economic benefits received or to be received under the contract). Not being routine, the employee and the employer will both have to account for the tax value of the rights and liabilities under the contract over its life. The recognition of some income by the employee will be deferred and the recognition of some deductions by the employer will be deferred. What if deferred bonuses are payable by the employer, based on the employee's perceived economic contribution or the employer's economic performance, or both, to provide a "golden handcuff" for the employee? What if the bonuses are not deferred? The legislation tells us: "In working out the total values…assume that the *market value of the economic benefits has not changed since the contract was entered into." How can this rule be applied meaningfully when the market value of the future economic benefits to be provided or received (in this case bonuses) cannot be estimated at that time? Can you value economic benefits at the start of a contract when you do not know what they are? Routine rights and liabilities are central to TVM; three attempts have been made at a definition, but it is arguably still incoherent as a legal concept.

- *Accounting standards are easier to understand than TVM legislation.* A comparison between two balance sheets is an accounting-type concept, but TVM uses legalistic language to try to recreate this in legislation, while often inserting into the conceptual matrix different values from those accountants would use (tax values rather than economic values). Much of the convoluted drafting of TVM results from this mishmash of two cultures – it is neither one nor the other. Balance sheets are intended to convey information to investors and lenders on the basis of which they make investment decisions – the numbers do not have to be exactly right. Tax returns require greater precision. The default rule for the tax value of a liability (item 7 of the table in subsection 12-40(1)) states that this is: "The *proceeds (as at that time) of incurring the liability". Except where the proceeds are non-monetary (and therefore require a valuation) these proceeds will be an exact amount, which is therefore less subject to dispute in the potentially adversarial context of a tax assessment. Accountants and economists value liabilities on the basis of the likely cost to the person who has the liability. The proceeds of assumption although usually a precise amount, may be quite different from the likely cost, and the TVM approach may produce timing recognition problems.[5] Routine rights and liabilities are based on an accounting concept which is defined and explained in Statement of Accounting Concepts 4 (SAC 4) in the following terms: "Agreements equally proportionately unperformed are agreements in which neither party has fulfilled any promises, and agreements in which both parties have performed to an equal extent some of their promises while other promises have yet to be honoured. Examples of such agreements include purchase orders for materials or equipment, leases, forward exchange contracts, commodity futures contracts and certain types of employment agreements."[6] The assets and liabilities arising from "agreements equally proportionately unperformed" do not have to be recognised for accounting purposes. The SAC 4 explanation reads lucidly (although the concept lacks precision). The equivalent provision in TVM (section 68-45) does not. It has to be drafted with greater precision because its three audiences – revenue collectors, taxpayers and courts – require something that operates with precision. Despite three attempts[7], this translation of an accounting concept into a legal definition has so far been a failure. The word length is also indicative. The TVM definition occupies almost a page. The SAC4 definition, quoted above, occupies just 4 lines. Some examples in SAC4, also quoted above, occupy another 4 lines. There is also some commentary in SAC4, not quoted here.

[5] See the worked examples in Geoffrey Lehmann *TVM: An Assessment.*

[6] SAC 4 at paragraph 76

[7] The first attempt at defining routine rights and liabilities is section 96-205 of Prototype 1, which defined a "routine lease" or "routine right" over a non-depreciating asset. This was succeeded by section 6-45 in Prototype 2, a two page definition of "routine rights and liabilities". This was shortened to one page in section 6-47 of Prototype 3. The Prototype 3 definition has been replicated in Prototype 4, where it has now become section 68-45.

- *TVM legislation is long-winded.* This is because it tries, rather laboriously because of the specificity required by legislation, to translate accounting concepts (frequently with modifications) into legislative form. In itself the extra word length of the definition of routine rights and liabilities (compared with the SAC4 definition) would not matter. However TVM is a serial offender in this regard. Option 3 does not attempt to translate accounting concepts into legalistic language (as does Option 3). It is based on legal concepts which permits simpler and less long-winded drafting.

- *TVM legislation is not robust.* The TVM Legislation Group claim that Option 3 "relies too much on the legal form of arrangements", so that it could "lead to inequitable outcomes and is not robust". Academics and others have criticised TVM because it is not robust.[8] TVM is unstable because it is an amalgam of partly assimilated accounting concepts that attempt to have the precision of tax law concepts – it is, as stated above, a mishmash.

2.27 Option 3 legislation is likely to result in **lower compliance costs than TVM.** Both Option 3 and TVM would eliminate the income/capital dichotomy as the foundation concept of income tax legislation (although in this dichotomy may survive in the outcomes). If eliminating reliance on this dichotomy will reduce compliance costs, both score equally on this measure, which is not likely to be very significant. The reasons why the compliance costs for TVM are likely to be higher relative to Option 3 (and most likely the current law) are:

- Some taxpayers under TVM may have to start with a balance sheet to prepare their tax returns – this has been reported as requiring more effort than preparing a return from a profit and loss account.[9]

- Assets and liabilities are broadly defined in TVM, and there is no TVM materiality concept regarding these. Consequently under TVM it would be an ongoing challenge may be to identify 'assets' and 'liabilities' not shown on financial statements. Off balance sheet transactions may need to be captured and given tax values.[10]

---

[8] See Yuri Grbich "Tax Vale Method: the Problem, the Proposed solution and the Outstanding Issues" and Graeme S Cooper "How Well Does TVM Express the Current Income Tax Base?" (both in *Tax Value Method: Consultative Conference* 79-145, edited Grbich and Warren, published by Australian Tax Research Foundation 2001) and Geoffrey Lehmann *TVM: An Assessment.*

[9] See Pitcher Partners' paper "Testing the Tax Value Method on Small and Medium Enterprises" reproduced in *Tax Value Method: Consultative Conference* published by the Australian Tax Research Foundation at 69. Pitcher Partners explain in some detail the steps for the Profit Reconciliation Method which starts with a calculation of the operating profit (loss) before tax, extracted from the financial statements, and of the Balance Sheet Method, which starts with the preparation of a "Tax Value" balance sheet at the beginning and end of the income year for all assets and liabilities. Pitcher Partners conclude that the Profit Reconciliation Method "appears to provide the shortest route to the determination of Net Income", but that while "the Balance Sheet Method may require more work, an advantage in using this method may be perceived as ultimately resulting in fewer errors.

[10] Ibid.

Extra records may be required to capture the information required by TVM, that is currently not captured.

- Where an amount relates to two or more assets or liabilities, there may be additional costs in apportioning the amount between the assets/liabilities – sometimes requiring independent valuations. Apportionment issues arise of course under the existing law and would arise under Option 3, but TVM recognises many more assets and liabilities, and the apportionment issue is therefore more significant.[11]

- Item 3 of the table in subsection 72-40(1) and Item 2 of the table in subsection 72-55(1) relate to the decline in value of certain assets and liabilities and would cause major compliance problems and disputes. They require you to "reasonably estimate the percentage" based on total economic benefits received (provided) in the income year as a proportion of total benefits to be received (provided) over the life of the asset (liability). Worked examples are currently being undertaken across a number of industries (contracts in the retailing, mining and accounting industries) and indicate this may accelerate/defer recognition. Neither the current law, nor Option 3 require this type of calculation which because it is based on a reasonable estimation is self-evidently not robust and adds to compliance costs pointlessly as it relates only to timing and not permanent differences.

[11] Geoffrey Lehmann *TVM: An Assessment* at 17 and elsewhere in his paper.

Comparison Table of Tax Value Method and Option 3

Issue	Tax Value Method	Option 3
Central mechanism	All receipts and outgoings (excluding private/domestic) assessable/deductible plus/minus the changing *tax* values of non-monetary assets and liabilities. Non-individuals may elect to ignore receipts and outgoings and rely on changing tax values of monetary assets/liabilities	All receipts subject to specified exceptions assessable, all outgoings subject to specified exceptions deductible. Does *not* rely on the changing values of assets/liabilities except in the case of trading stock
Motivating principle and policy foundation	TVM is a "patchwork of miscellaneous rules" eg the table of tax values for different types of assets. TVM is to be distinguished from an income tax based on accounting principles or the Haig-Simons economic concept of income which would properly be described as having a policy foundation. TVM uses *tax* values that essentially replicate the pragmatic compromises and adulteration of economic principles of the current system. The central mechanism of TVM provides an illusion that it has a policy foundation	A patchwork of miscellaneous rules that does not pretend to be anything else
Income/capital dichotomy	Does not rely on the income/capital dichotomy except in isolated instances eg repair versus capital improvement	Does not rely on the income/capital dichotomy except in isolated instances eg repair versus capital improvement
Common architecture	For costs and proceeds, time of acquisition/disposal	For costs and proceeds/ possibly for time of acquisition/disposal

Issue	Tax Value Method	Option 3
Timing rules	Timing rules of great power and elegance implicit in the central mechanism of the changing tax values of assets and liabilities (“the black box”). For example lease payments on sale and lease back of plant/equipment taxed as principal and interest without the need for specific provisions	Proposed rule that subject to legislated exceptions (eg deductibility of employee leave provisions), accounting standards apply with a carve out for individuals/small business. This proposed timing rule is not essential for Option 3 to operate, it is an “optional extra”
Black hole expenditure	Where specified in the legislation, deductible under TVM. TVM Prototype 4 has departed from the Ralph Report legislation default rule that expenditure is immediately deductible, unless some other treatment is specified	Always deductible under Option 3. Option 3 preserves the Ralph Report legislation default rule in favour of immediate deduction
Taxation of financial arrangements (TOFA)	Can be incorporated in TVM, but special rules would have to be legislated, as TOFA uses market value more extensively than TVM	Can be incorporated in Option 3, but special rules would have to be legislated
Do outcomes change from 1936/97 Acts?	Yes. Timing rules accelerate the recognition of some amounts and defer the recognition of other amounts. Rules proposed in Ralph re taxation of rights implicit in TVM, but business has not endorsed this approach	No, except where 1936/97 timing rules unclear, accounting principles *may* provide a clearer answer. Ralph proposal re rights would have to be specifically legislated
Simplicity – core rules	Core rules complex and confusing, because TVM has to deal with 4 main concepts, being receipts and outgoings, assets and liabilities (and changes in their value and nature eg private becomes non-private, contingent becomes non-contingent). Invented concepts are used (eg routine rights and liabilities), complex deeming rules necessary to enable the non-cash rules to work. Few (perhaps no other) income tax systems account for changing tax values of liabilities as TVM does. The operation of the “black box” is implicit, rather than explicit, not easy for even tax experts to understand	Core rules simpler, shorter, easier to understand than TVM. Option 3 deals with only 2 main concepts, being receipts and outgoings.

Issue	Tax Value Method	Option 3
Simplicity – non-core rules	TVM's black box can deal with many situations (eg sale and lease backs) without additional legislation. CGT core rules greatly simplified, but not many of the rules that cause telephone calls to the ATO, for example principal residence exemption, roll-overs. Uncertainty about how TVM will mesh with international rules (in particular source rules) and other parts of legislation	Option 3 can allow simplification of CGT in a way similar to TVM. Again principal residence exemption, roll-overs will remain complicated, unless specific action is taken to simplify these rules. Option 3 can eliminate some provisions, eg Div 16E (Deferred interest and discounted securities) if proposal to base timing rules (subject to legislated exceptions) on accounting principles is adopted. Option 3 will mesh easily with other parts of legislation
Anti-avoidance	TVM may allow the elimination of many specific anti-avoidance rules, but its treatment of liabilities may open up avoidance opportunities by allowing the deferral of income in some instances. Radical tax change usually opens up anti-avoidance possibilities, perhaps real, perhaps imagined	Option 3 may not eliminate as many specific anti-avoidance measures as TVM, but it is unlikely that it will open up new avoidance opportunities
Certainty	The elimination of the use of the income/capital dichotomy as a foundation will remove some uncertainty, but new uncertainty will result in particular from apportionment, complexity of "black box", and there is the possibility of unpredictable outcomes from new rules involving assets and liabilities	The elimination of the use of the income/capital dichotomy as a foundation will remove some uncertainty

Issue	Tax Value Method	Option 3
Compliance	Big savings unlikely. High additional compliance costs on transition. New systems required for some taxpayers. Small business practitioners' unfamiliarity with concepts, particularly assets/rights/liabilities and holding rules will cause initial and possibly continuing confusion. At best small compliance savings in the medium to long term from eliminating duplication of rules and income/capital dichotomy. However, compliance may be more expensive long term because: (1) more effort possibly required for taxpayers preparing tax returns from a balance sheet; (2) some events, such as entering into contracts, have important TVM consequences, but are not currently recorded in cash books. Need to record events that create TVM assets and liabilities or a change in their status. Difficulty in persuading businesses to create new record keeping systems – eg more than 16 years after the introduction of CGT, many businesses do not have adequate CGT registers	Big savings unlikely. Few additional compliance costs on transition. Some small savings in the medium to long term from eliminating duplication of rules and income/capital dichotomy. In general no new systems required. Few new concepts to confuse small business practitioners. Income tax returns would continue to be prepared from profit and loss statement subject to adjustments. No need to record information, events that are not currently recorded now
Transition	Rulings would have to be extensively rewritten. Extensive taxpayer education required. Changes to timing rules may mean that TVM and 1936/97 Acts will have to operate as parallel systems for some years	Some rewriting of rulings and some taxpayer education required. Timing changes (if any) could be dealt with in year of change. No need for parallel systems after year of change

Explanation of some provisions in the draft Option 3 legislation

General comments

4.1 This Demonstration Legislation covers only the core rules. Being intended only to demonstrate how Option 3 Core Rules might be drafted it is likely to contain errors and gaps. The legislation employs the TLIP drafting style of the 1997 Act, but is not intended to be a rewrite. Where there were differences between provisions of the ITAA 1997 and ITAA 1936 on the one hand, and their equivalent in Option 3 legislation on the other, there would be no implication from a provision such as section 1-3 of the ITAA 1997 ("Differences in style not to affect meaning") that concepts were preserved where the language was different.

4.2 By way of a general comment, where words are asterisked and not defined in the Option 3 draft itself, it is intended to adopt the definitions in the TVM legislation, the 1997 Act or the GST legislation. A very short Dictionary (section 995-1) has been appended to these core rules. In particular the use of the word "money" seems to have caused problems for the TVM Legislation Group, as from a TVM perspective "money" does not include a promise to pay money. It had always been intended to define "money" using the GST legislation definition with an additional paragraph stating that "money" includes a promise to pay money. In a more refined version of this legislation it might be necessary to distinguish a promise to pay money in the immediate future from promises to pay money that came within TOFA. However that is not a matter for Demonstration Legislation.

4.3 The following "explanations" are not intended as the equivalent of "Explanatory Material" and are intended to explain what is new/why the particular approach/concept/words have been adopted.

Division 4 – working out the income tax payable

4.4 These provisions are borrowed with little alteration from the ITAA 1997. They preserve the concept of taxable income being assessable income less deductions. The one difference is section 4-11 "Substituted accounting periods" which is adapted from section 18 of the ITAA. Subsection (3) is an innovation. In practice it has been found that when a taxpayer is given an initial substituted accounting period of a period longer than or less than 12 months, provisions of the legislation that assume a 12 month income year may operate in an inappropriate manner. Subsection (3) is intended to deal with that situation and possibly simplify transitional rules when new provisions are introduced. It does raise a constitutional issue – what would the powers of the Commissioner be in this instance?.

Division 6 – assessable income and exempt income

4.5 The concept of "eligible income" has been introduced after section 6-1 which deals with assessable income, to make the reference to "all *Australian sources" in para 6-1(2)(a) meaningful. The source of a cash payment or amount is the place from which payment is forwarded. If an amount of $100 is forwarded from Botswana as payment for services performed in Australia, the source of the payment is Botswana. However once that payment has been turned into "eligible income", a court will be more comfortable in finding that the source of the eligible income is the place where the services were performed, being Australia. Although it is an "invented concept", "eligible income" therefore serves a useful, and probably necessary task. It is not too hard to understand and it means what it says.

4.6 The TVM Legislation Group claim that section 6-5 causes the following problems:

> "Another difficult issue arises from the 'amounts that you derive' approach, even if we assume that it means something similar to section 6-5 of the ITAA 1997.
>
> "This difficulty is analogous to the difficulty in the current income tax law, which contains both gain and flow concepts of income, yet provides us with no coherent principles for distinguishing between the two.
>
> > Example
> > "Willford Pty Ltd acquires a building in Year 1, to secure access to beachside accommodation for its shareholders. Willford's principal function is to hold the building for that purpose. In Year 13, all the shares in Willford are purchased by an insurance company and a land development company for $1.6 million. This amount represents the market value of the building.
> >
> > "Willford's articles are changed on that date to enable refurbishment of the building. The article relating to the original purpose of providing shareholders with access to the building is removed. Willford commences refurbishment of the building on a massive scale, spending $6 million in the following 5 years. The building is then sold at the end of Year 18 for $13 million.
> >
> > "What 'amount' has Willford derived? $7 million, $5.4 million, or $13 million?"[12]

The difficulty perceived by the TVM Legislation Group (which arises under the current law) does not arise under Option 3. A note to section 6-5

[12] TVM Legislation Group *Comments on Option 3,* 25 March 2002, at paragraphs 8.18 and 8.19

states: "The term 'all amounts' is not limited to amounts that are income according to ordinary concepts." Hence, the concept of income according to ordinary concepts is not relevant for section 6-5. This eliminates the argument (based on case law involving the concept of income according to ordinary concepts referred to by the TVM Legislation Group) that $5.4 million is the amount that is derived. In the absence of subsections (2) and (3) of section 6-5, the amount derived would be $13 million. However land is an asset which is subject to capital gains tax rules. The cost of an asset subject to these rules is not deductible (see section 8-1(2)(a)). What is included is the net capital gain of $7 million. See item 3 of the table in section 10-5. Option 3 provides a single answer, as would TVM in this instance, but arguably not the existing law.

4.7. Section 6-5(4) is identical to section 6-5(4) of the ITAA 1997 (except that the second "derived" is not in bold italics). The TVM Legislation Group see this problem in replicating this provision from the 1997 Act:

> "An entity is taken to have received an amount as soon as it is applied or dealt with in any way on the entity's behalf or as they direct: subsection 6-5(4). This provision raises the prospect of economic double-taxation because there is no symmetrical constructive payment rule.
>
> > Example
> > "Federal Coal Pty Ltd is a subsidiary of Bembi Co Ltd, a coal producer. Bembi's supply contract with a French nickel company Societe Anonyme Le Dime is cancelled. Le Dime offers to pay Bembi $1 million in compensation for lost revenue, but upon legal advice, Bembi instructs Le Dime to pay the money to Federal instead.
> >
> > "Federal is arguably taxed on $1 million under subsection 6-5(1). Meanwhile, Bembi is also taxed on the same amount under subsection 6-5(4)."[13]

This analysis is not correct. This problem of double taxation may arise under the existing law, but it does not arise under Option 3. While both companies will include the amount of $1 million in their assessable income, Bembi will be able to deduct from its assessable income the amount of $1 million as an outgoing arising from its constructive on-payment of the money to Federal. This is an "outgoing". (If it were not an "outgoing", section 8-15 would convert it into an outgoing – however a correct analysis does not involve section 8-15 as "money" includes promises to pay money, see section 995-1). Unlike the current law, which might exclude the deduction because it does not satisfy the nexus test, or because it is on capital account, these arguments would not apply in the context of Option 3. There would only be double taxation, if the outgoing were not at arm's length (see paragraph 8-5(1)(k)), which would be an appropriate outcome for a value shifting transaction. The payment,

[13] Ibid at paragraph 8.24

however, is presumably at arm's length, as it has been made on legal advice.

4.8 The modifications to "eligible income" are listed in a table in section 10-5 which is outside the core rules. No attempt will be made to populate this table – a few examples are provided.

4.9 Section 6-10 ("What is not eligible income") lists the exceptions to what is eligible income. This list of exceptions is very much a demonstration draft. Doubtless it can be made more rigorous. What is surprising is that it is not longer. Subparagraph 6-10(b)(ii) is otiose as a deposit with a bank is a loan to a bank but has been inserted for less sophisticated readers who are the audience for core rules.

4.10 Section 6-20 ("Consideration not in money") provided one of the most difficult drafting challenge. The function of this section is to treat a person as deriving the market value of non-cash consideration given in a transaction. There is no equivalent provision in the ITAA 1997 and section 6-20 is based on section 21 of the ITAA 1936. The old-fashioned word "consideration" has been used as it appears in section 21 of the ITAA 1936 and it has been preferred to the more modern word "benefit". If you happen to find a gold doubloon in the gutter that is a "benefit", but it is not "consideration" even in the extended meaning of that term adopted in section 6-20(2). It is not intended to adopt the definition of "consideration" appearing in section 9-15 of the GST Act.

4.11 Section 6-20 needs careful drafting because it is not backed up by the income/capital dichotomy as it is in the 1936/1997Acts. In the ITAA 1936, the main function of the equivalent provision is as an anti-avoidance provision – to prevent barter transactions escaping income tax. Interestingly the ITAA 1936 does not limit its operation to assessable income – it could apply to deductions. However, to simplify the Option 3 drafting it has been limited to eligible income and there is an equivalent provision, section 8-15, that applies for non-cash outgoings and operates more narrowly than section 6-20.

4.12 The TVM Legislation Group see these problems in section 6-20(1):

> "Section 6-20 refers to 'an amount equal to the market value' of the consideration, but gives no indication of the time at which that market value is to be worked out…
>
> "An executory promise is good consideration under a contract. Seemingly, Option 3's non-cash transaction rule will tax an entity on the market value of any unperformed promise it gets, even if it is contingent in nature.
>
> > Example
> > "On 30 June, Year 1, Accountant Henderson agrees to perform accounting services for client Coughlan. In return Coughlan promises to pay Henderson in the future, should the services be

performed and be properly billable.

"Under subsection 6-20(1), the market value of Coughlan's contingent promise is included in Henderson's assessable income for Year 1.

"Does Henderson have an offsetting deduction under subsection 8-15(2)? Clearly not, as Henderson does not 'use' the contingent right to payment in circumstances which make the market value of his services deductible (indeed, these are *never* deductible)."[14]

The first criticism, namely that section 6-20 does not indicate when a market value is to be worked out, could also be levelled at section 21 of the ITAA 1936, on which section 6-20 is based. No case-law is cited by the TVM Legislation Group showing that this has been a problem over the years since 1936, nor did the drafters of TLIP attempt to replace this provision. The approach suggested by the TVM Legislation Group may be seen as inappropriate for principle-based drafting. The claimed problem regarding executory promises results from a typical TVM-type analysis and is inappropriate for legislation that uses principle-based drafting and does not employ the TVM mechanism. It would not arise under section 21, on which section 6-20 is based, as the ITAA 1936 would treat the promise to pay money as money. Option 3 does the same – see the definition of "money" in section 995-1(1), being a definition that was not available to the TVM Legislation Group when they prepared their comments.[15]

4.13 Subsection (3) is adapted from subsection 9-10(4) of the GST legislation – the concept, but not the words, which are quite different. The example shows why this subsection is necessary. The TVM Legislation Group see these problems in section 6-20(3):

"Subsection 6-20(3) provides for a very harsh anti-avoidance treatment.

"Subsection 6-20(3) excludes deemed derivation only where what is received is 'arm's length' consideration for money. This means that where the payment of money is *not* arm's length consideration, an entity is deemed to derive the market value of the asset received under subsection 6-20(1).

"The treatment is unfair if the party paying money pays a less-than-arm's-length amount:

Example
"Buckstar Pty Ltd purchases professional services from Max Macro for $5,000 cash. Buckstar and Mr Macro are not dealing at arm's length. The consideration which might reasonably be

[14] Ibid at paragraphs 10.4 and 10.5

[15] There are other misunderstandings of Option 3 on the part of the TVM Legislation Group, in particular at paragraph 10.3 of their "Comments", arising from the Option 3/ITAA 1936 approach to "money" differing from the TVM approach. These misunderstandings may not have arisen if the definition of money had been included in the draft available to them when their comments were prepared.

> expected to have been received for the services in respect of this transaction between arm's length parties is $10,000.
>
> "Under subsection 6-20(3), Buckstar must include $10,000 in its income (the market value of the services). As there is no arm's-length rule for below-market payments, Buckstar only gets a deduction of $5,000 for the services. Overall, therefore, Buckstar has taxable income of $5,000. Buckstar is being taxed on a net sum of $5,000, when in fact it should be getting a deduction for the $5,000 it has paid.
>
> "Mr Macro has received $5,000; there is no rule to increase this amount to the arm's length value."[16]

The TVM Legislation Group's analysis is correct. Section 6-20(3) has therefore been redrafted by deleting the words "arm's length". The TVM Legislation Group correctly points out that there in no rule to increase the amount received by Mr Macro to $10,000. Whether there should be rules to increase the amounts received by Buckstar and Macro to $10,000 (and allow a deduction to Buckstar for $10,000) is an issue for a domestic transfer pricing regime, and is not an issue for Option 3 Draft Demonstration Core Rules.

4.14 Subsection (4) deals with an issue which already arises under CGT but is generally ignored.

4.15 The TVM Legislation Group make these comments regarding the treatment by section 6-20(6) of Government grants and licenses:

> "Subsection [6-20(6)] represents a departure from current tax policy in some cases. Approvals, permits, licenses and other rights received in consideration for the performance of services could be assessable under section 6-5 of the ITAA 1997 and section 21A of the ITAA 1936."[17]

This is a fair comment. Section 6-20(6) was inserted to flag a narrow, but significant issue. More information is needed to resolve it.

Division 8 – deductions

4.16 Section 8-1 abandons the nexus test and the exclusion of for outgoings of capital or of a capital nature. The TVM Legislation Group make these comments:

> "The default outcome arising from section 8-1 seems to be that if something is not specifically listed, it is deductible, even though some enduring or future benefit is created by it. This approach will give rise to 'white holes' (that is, tax relief for non-existent expenditure). It implies that the legislative process would involve constant amendment to section 8-5, in order to respond each time economic circumstances

[16] Ibid at paragraphs 10.8 to 10.10.
[17] Ibid at paragraph 10.11.

> arise that do not fall within the narrow legal confines of the section 8-10 list."[18]

The phrase "non-existent expenditure" is presumably intended to be "expenditure that should not be expensed". (If there is no expenditure nothing can be deducted under Option 3.) When rephrased as "expenditure which *should* not be expensed" the unstated value judgment in the TVM Legislation Group's comment becomes apparent. The comment by the TVM Legislation Group is merely an assertion. The opposite claim can be made of TVM: that it has the potential to create new black holes. At present TVM has a list of 8 "listed zero tax value assets" at subsection 68-10(1). This list could require constant amendment as new black holes are discovered. In the past the Government has been zealous in eliminating what it regards as inappropriate deductions and has been less zealous in eliminating black holes. Placing the onus on the Government to remove "white holes" as they emerge is a more honest approach than what the TVM Legislation Group seem to prefer. The default rule, resulting from 8-1, that expenditure is deductible unless some other treatment is specified, is the converse of the rule in section 6-5 that an amount derived is assessable, unless some other treatment is specified.

4.17 The approach in Option 3 is that an amount that comes in is assessable, or that goes out is deductible, unless:

- this is eliminated under the various exceptions at sections 6-10 and 8-5, which are broadly symmetrical (one significant exception to symmetry is the arm's length rule, section 8-5(1)(k)); *or*
- or modified under rules to be listed at section 10-5 and 12-5, such as the capital allowance regime, the CGT regime, or TOFA (or perhaps a rights regime if the Government decides that a rights regime or some form of rights regime is needed). These modifications, like the exceptions, should operate symmetrically.

Assuming that the exceptions and modifying regimes in Option 3 have a slightly narrower scope than the assets and liabilities recognised under TVM, more expenditure would be immediately deductible and more receipts would be immediately assessable. This flows from these exceptions/regimes being symmetrical. To claim that Option 3 creates the possibility of white holes is therefore misleading, as any immediate additional deductions it gives (compared to TVM) should be matched by additional amounts that would be immediately assessable.

4.18 A concern with TVM is that a rights/liabilities regime will expand the opportunities for deferring income by the creation of liabilities. An example is a "golden hello" payment at the start of a 3 year employment contract, as such a contract would not give rise to a routine right or liability. Under TVM, the employee's tax on the payment would be spread over the 3 years of the contract as the employee will have a

[18] Ibid at paragraph 12.2.

liability to provide services over that period. The employer's deduction for the payment would also be spread over the 3 years as the right to the employee's services would be a depreciating asset. How PAYG withholding rules would deal with this is not apparent. However, there would be an incentive for the employee to negotiate for a 5 year contract to spread the tax over a longer period. A constraint on such a development would be that the employer would have to spread the deduction of the golden hello payment over 5 years rather than 3 years. Nevertheless the circumstances of taxpayers differ, and the deferral of a deduction under TVM rules will not, for example, be a constraint on a non-resident to whom a liability may be owed.

4.19 ATSR recommendation 10.2 would tax personal services contracts on a receivables basis, which would eliminate this particular TVM white hole, if it were legislated, but it would add yet another patch to the patchwork. It has been acknowledged that there will be winners and losers under TVM. Because of the wide scope of the asset/liability concept in TVM, income received that is taxed now will be deferred (if the payment results from the assumption of a depreciating liability) and outgoings that are recognised now will be deferred if the payment relates to a depreciating right. There will be considerable resistance to this change, which may reflect *tax* values and not the underlying economic position in any event. In general taxpayers prefer to pay tax on their cash flow, except those industries, such as insurance where there are large deferred liabilities. Consequently taxpayers and the revenue authorities (as in ATSR Recommendation 10.2) will lobby hard for exceptions to TVM rules to preserve the current treatment if in broad terms that taxes them on their cash flow. The outcome of these numerous exceptions could be a patchwork that is even more compromised than the existing tax laws.

4.20 The TVM Legislation Group also make these comments regarding section 8-5 of the Option 3 legislation ("Outgoings that are not deductible"):

> "The problems outlined above with respect to section 6-10 apply equally to section 8-5.This provision removes the income-capital dichotomy from the law and replaces it with a list. Because this list is made up of narrow legal categories, this is likely to be an inefficient structure. We believe this provision would be better put together if it expressed some type of principle in a more abstract sense, which could then have an operation in a range of circumstances."

Once the income/capital dichotomy is eliminated there is, unfortunately, no "principle in a more abstract sense" that can be conjured up for Option 3 or TVM. This is apparent from TVM's current list of 8 listed zero tax value assets, that are immediately expensed. These are a higgledy-piggledy lot, including routine rights, office supplies that are not trading stock, mining or quarrying exploration results, and a right to a dividend. Option 3 is unable to do any better in this respect

4.21 Paragraph 8-5(1)(k) states that outgoings to the extent that they are in excess of an arm's length amount are not deductible. While the Option 3 core rules do not in general provide for domestic transfer pricing, in the absence of a nexus test for outgoings such as paragraphs (a) and (b) of subsection 8-1(1) of the ITAA 1997, it is necessary to have an arm's length test for expenditure – otherwise the core rules could be misunderstood as open to abuse.

4.22 Section 8-15 ("Outgoings not in money that were previously assessable income") is convoluted in its expression. The concept it expresses is also convoluted. Fortunately the two subsections are fairly brief, and the examples hopefully explain the purpose of the provision.

Division 9 – some general rules

4.23 Section 9-10 ("Extended meaning of private or domestic nature") has been replicated from various provisions in Prototype 3 of TVM. Where private assets are converted to trading stock or assets amortisable under the capital allowances rules, provisions in the trading stock/capital allowance rules should give a deduction for the "cost". Similarly the capital gains tax rules should have some appropriate rules to cover asset exchanges.

4.24 Sections 9-20 to 9-70 (rules regarding cost and proceeds) have been replicated from Prototype 3 of the TVM legislation.

A central timing rule

4.25 Section 9-75 ("Timing of assessable income and deductions") is an attempt to provide a central timing rule, based on accounting standards, that is lacking in the current income tax legislation. A provision such as section 9-75, although it would be highly desirable if it worked, is not an essential component of Option 3 legislation.

4.26 It is envisaged that timing rules legislated in the ITAA 1936 and the ITAA 1997, such as the rules in regard to employee provisions, the pre-payment rules and the capital allowance rules, would be retained and override section 9-75. Subsection (1) states that the section has effect *subject to the other provisions of the Act.* Section 9-75 would therefore operate as a default rule. But where there was no specific legislated timing rule, it would in effect require the courts to apply accounting standards rather than the "gut feel" of the particular judge. The assumption is that accountants have a better feel for these issues than courts. In addition section 9-75 would be a step towards bringing tax returns into closer alignment with accounts, which is a compliance saving.

4.27 If a decision were made to adopt something resembling section 9-75, provisions such as Division 16E of the 1936 Act could be dropped. Perhaps the Taxation of Financial Arrangements (TOFA) regime could be

made much shorter than it would be if it were inserted into the ITAA 1997.

4.28 This Explanatory Material does not attempt to deal with the many comments regarding timing issues by the TVM Legislation Group on section 9-75 and other provisions. The Option 3 core rules are not, at this stage, intended to provide a definitive answer on timing issues. In addition the comments of the TVM Legislation Group were made in respect of an earlier version of section 9-75, before it had been considered by a accounting expert. The changes since then made on the recommendations of that expert may or may not answer some of the criticisms of the TVM Legislation Group. They make a perceptive comment however:

> "Subsection 9-75(2) provides that the 'treatment' that would result from applying generally accepted accounting principles determines the timing of derivation and referability for income tax purposes. Yet there is no 'treatment' of income or deductions in the accounting standards; these are revenue law concepts. Accountants do not recognise derivation, nor do they rely on any concept of referability (even though they may recognise concepts which are arguably analogous to these things)."[19]

When initially drafting subsection 9-75(2), the point made by the TVM Legislation Group was a prime consideration. If, for example, the provision had read: "Accounting standards in Australia will determine when assessable income is derived during an income year and when outgoings are referable to an income year" the criticisms made by the TVM Legislation Group would possibly be valid. That pitfall was avoided by the wording used in the subsection. In effect the subsection requires the amounts to be considered as part of their overall commercial context, and a determination of how, for timing purposes, they *would* be treated under those standards if they applied. Most taxpayers subject to subsection 9-75(2) will in fact prepare accounts subject to those standards. When preparing an income tax return from their profit and loss account for an income year, the treatment prescribed in subsection 9-75(2) would automatically apply – there would be no need for them to "invent imaginative economic analogies in order to comply with the taxation laws" as claimed by the TVM Legislation Group.[20] They would only have to adjust the treatment in their accounts where there were special timing or other rules in the legislation that differed from the accounting treatment.

4.29 The Option 3 legislation does not try to reconstruct accounting standards (subject to modifications) as TVM does. Rather, it incorporates those standards subject to other provisions, and then only for timing purposes. The assumption is that legislation cannot reproduce accounting standards. This is more akin to the UK approach. It is therefore, to some extent, a tried and tested approach unlike TVM. The Option 3 use of

[19] TVM Legislation Group *Comments on Option 3,* 25 March 2002, at paragraph 15.1.
[20] Ibid at paragraph15.5

accounting standards is arguably neater, less prolix and less subject to error and surprises than the TVM approach.

4.30 Section 9-80 ("No assessable income or deductions lost on change of timing treatment") is necessary in case section 9-75 caused a change of timing treatment, but it also would deal with a gap in the current law, for example when a taxpayer taxed on a cash basis moves to accruals taxation. Because Option 3 deals with receipts and outgoings, rather than changes in the values of assets, any change in timing rules that occurred under it (which might be quite limited in any event) could be dealt with in the transition year. The transition under TVM might be more complex as you would have to take account of changes in the tax value of assets and liabilities.

Examples

5.1 The following examples show how Option 3 rules would work in practice and have been designed to test its robustness.

Example 5.1 A government grant

A government promises to pay a business $1 million annually over 5 years. The promise is subject to no conditions and is stated to be irrevocable. The promise to pay $5 million is “money” – see section 995-1(1). Section 6-20 therefore has no application. Whether the money is assessable income when the promise is made or in the years when it is paid, will depend upon when it will be recognised by accounting standards, in accordance with section 9-75(2). If it recognised up front, perhaps subject to a discount factor, as the instalments are paid, the discount would most likely be progressively recognised. Section 9-1 would ensure there was no double taxation. Progressive recognition of the entire $5 million would be more likely if conditions were attached, which is more likely in the real world.

Example 5.2 A valuable sole agency

Manufacturer awards Agent a valuable sole agency to distribute its products. Agent does not pay to obtain the agency, but enters into onerous undertakings to sell a minimum annual value of Manufacturer’s products and to promote the products, including an advertising budget with a specified minimum annual spend. Subsection 6-20(1) would have the effect that each of these mutual covenants is an amount received or receivable. However, subsection 6-20(4) has the effect that neither covenant is an amount received or receivable. Under the existing CGT rules, there is a problem for Manufacturer and Agent as there is a potential CGT event D1 for both of them, which is ignored in practice. Under Option 3 this is not an issue as there is no disposal of goodwill or any other asset that is subject to the Option 3 CGT rules.

Example 5.3 Holiday packages awarded by a manufacturer to its distributors

In FCT v Cooke and Sherden (1980) 10 ATR 696 a soft drink manufacturer awarded at its discretion free non-transferrable holiday packages to its distributors, who were independent agents and not employees or contractors of the manufacturer. The holiday packages were not ordinary income, as they were non-assignable. The non-cash business benefits rules in s 21A of the ITAA 1936 were enacted to deal with the issue. Section 6-20(1) would treat the money value of these holiday packages as amounts received or receivable, being non-monetary, non-contractual consideration that would not come within section 6-10(a), as an amount of a private or domestic nature. Section 6-20(1) should eliminate the need for a provision such as s 21A.

Example 5.4 A company makes a gratuitous payment to an associate company with tax losses

Under section 8-1 the payment is deductible for the company making the payment, as there is no nexus rule. However paragraph 8-5(1)(k) will adjust the payment to nil as it is not at arm’s length. The amount will be assessable for the associate company and absorb its losses, subject to the continuity of ownership rule. It is likely that the General Anti Avoidance Rule would have applied to such a payment, if paragraph 8-5(1)(k) had not applied.

Example 5.5 Interest on a borrowing to buy a family home

This would not be deductible because it would be an amount of a private or domestic nature (paragraph 8-5(1)(a)) – however if the house later were rented, as there is no nexus or purpose test, the interest would become deductible

Example 5.6 Business-related interest paid before starting or after ceasing a business

Provided the payment is not of a private or domestic nature, the payment would be deductible under section 8-1(1), as it would not be a cost of acquiring an asset subject to the special amortisation rules or the capital gains tax rules.