

9 May 2002

Mr Richard F.E. Warburton  
Chairman  
Board of Taxation  
C/ Treasury  
Langton Crescent  
PARKES ACT 2600

**SUBMISSION ON THE TAX VALUE METHOD**

Dear Dick

We attach a copy of our joint submission on the Tax Value Method.

We would like to congratulate you and the Board for the very open and constructive way you have conducted the development and testing of the Tax Value Method.

We would be very grateful if you could pass on our appreciation of the highly commendable efforts of the Board's Secretariat and the Legislative Group.

We look forward continuing our constructive role in the Board's processes.

Yours Sincerely



Katie Lahey  
Chief Executive  
Business Council of Australia



Frank Drenth  
Chief Executive  
Corporate Tax Association

**Submission to the Board of Taxation**

**on the**

**TAX VALUE METHOD**

**Business Council of Australia**

**and the**

**Corporate Tax Association**

**May 2002**

## **Executive Summary**

The Business Council of Australia (BCA) and the Corporate Tax Association (CTA) appreciate the opportunity to contribute to the Board of Taxation's evaluation of the Tax Value Method (TVM).

### **Complexity, Compliance Costs, Uncertainty and Instability of Income Taxation**

The BCA and the CTA agree strongly with the objectives behind the TVM and have supported the exploration of the TVM as a means of addressing the high compliance and administration costs and the high degree of complexity, instability and uncertainty of income taxation in Australia.

Regardless of whether there is further development and evaluation of the TVM itself, the BCA and the CTA submit that concerted efforts should continue to address the high compliance and administration costs and the extent of complexity, uncertainty and instability of our system of income taxation.

### **Processes for Development and Evaluation of Changes to Taxation**

Our organisations regard the open and consultative processes through which the TVM has been developed and evaluated as substantial advances in the way changes to taxation policy and law are designed and developed.

We submit the open and consultative processes put in place by the Board of Taxation are a model for the way changes in income taxation are developed and evaluated and should be adopted more widely.

### **Tax Value Method**

The BCA and the CTA acknowledge the development and evaluation of the TVM has revealed potential for important improvements in specific areas of income taxation. However, the adoption of the TVM across the entire income tax system would add significant new areas of complexity; create new uncertainties and instabilities over an extended transitional period; and would have little or no impact on significant existing sources of complexity and uncertainty.

### *Recommendation*

*We submit that the TVM project should be discontinued but that the considerable insights from the project should be carried forward into a broader exercise aimed at developing alternative methods of securing reductions in the compliance costs, complexity, uncertainty and instability of income taxation.*

*In view of the backlog that has developed across a range of other areas of income tax reform, we submit that this ongoing exercise be allocated a lower profile in the immediate term.*

# JOINT BCA CTA SUBMISSION TO BOARD OF TAXATION

## SUBMISSION

### Introductory Comments

Both the Business Council of Australia (BCA)<sup>1</sup> and the Corporate Tax Association (CTA)<sup>2</sup> are strong supporters of the need for ongoing reform of taxation in Australia.

In particular, both our organisations recognise the need to address the high costs of compliance and administration, the complexity, uncertainty and the instability of Australia's income tax system.

The need to address these shortcomings in income taxation led our organisations to support and participate in the Board of Taxation's development and evaluation of the Tax Value Method.

Irrespective of whether there is further development and evaluation of the TVM itself, we submit that concerted efforts should continue to address the high compliance and administration costs and the extent of complexity, uncertainty and instability of our system of income taxation.

Throughout its TVM project, the Board of Taxation has introduced some important and welcome innovations into the way policy and legislation are developed and evaluated.

These innovations have included

- the secondment of people with private sector experience into the Legislative Group;
- the development and release for comment of prototype legislative and explanatory material;
- co-design with the assistance of a Working Group that includes non-government tax experts; and,
- opportunities for input from the broader business community and other interested parties.

We commend the Board for these innovations and strongly recommend that they be built on and adapted for wider application in the development of changes to taxation.

The BCA and the CTA would like to record our appreciation of the efforts of all the people involved in the TVM project. The Board, its Secretariat, the members of the Legislative Group and the members of the Working Group all have played important roles in this groundbreaking approach to improving income taxation. Many of these contributions were provided free of charge and we also acknowledge the indirect contributions of the businesses and associations who made their people available to participate in the project.

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<sup>1</sup> The BCA is made up of the Chief Executive Officers of Australia's largest businesses. More information about the BCA is available at [www.bca.com.au](http://www.bca.com.au)

<sup>2</sup> The CTA is Australia's key representative body for major companies on corporate tax issues. More information about the CTA is available at [www.corptax.com.au](http://www.corptax.com.au)

# JOINT BCA CTA SUBMISSION TO BOARD OF TAXATION

## Evaluation of the Tax Value Method

### *Basis of Evaluation*

In order to secure lasting reductions in complexity, costs of compliance, instability and uncertainty, both business and the tax authorities will be asked to make a sizeable investment. This is true regardless of whether these reductions are secured by the TVM or by some other route, and regardless of whether they are achieved through a “big bang” or by a more phased approach.

Before making these investments we believe that there should be a reasonable expectation of a significant return.

### *Benefits and Costs*

#### Benefits

The Tax Value Method has the potential to deliver benefits across a range of areas of income taxation. Some of these benefits arise from the nature of the TVM approach itself while others, such as the consistent use of terms, the principled approach to drafting and comprehensive tax relief for all business expenditure can be secured under a variety of approaches to income tax reform.

The essence of the TVM approach is the Net Income formula.<sup>3</sup> This approach has the potential to deliver reductions in complexity, uncertainty and compliance costs across a variety of areas of income taxation. These include the taxation of financial arrangements, the tax treatment of prepaid expenses<sup>4</sup> and trading stock, the taxation of rights and a number of features of capital gains taxation. The improvements TVM offers in these areas derive from the TVM Net Income formula which provides a clear and relatively straightforward basis for determining taxable income in these areas.<sup>5</sup>

It can be noted that the TVM Net Income formula is already implicit in a number of features of income taxation under present arrangements. The treatment of trading stock is the clearest example. This suggests that at least some of the benefits of the TVM approach could be captured within the context of the present structure of income taxation. The taxation of financial arrangements, for example, could be cast along the lines of the TVM Net Income formula without implanting TVM as the basis of the entire income tax system.

Claims have been made to the effect that the TVM has the potential to provide income taxation with a “coherent foundation” and, as a result, that it will be more “durable”, more “robust” and will give the taxation of income a greater “structural integrity” than the present income tax system.

Convincing evidence and argument in support of these potential areas of benefit have not emerged over the three or so years over which the TVM has been developed and evaluated, and these claims still rest on little more than intuition. Even at the intuitive level, however,

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<sup>3</sup> Under this formula Net Income = Receipts - Payments + Change in the Tax Value of Assets - Change in the Tax Value of Liabilities.

<sup>4</sup> The benefits of TVM in respect of prepaid expenses do not apply to the tax treatments for prepaid expenses under the Simplified Tax System for small business and for individuals not conducting a business. If anything these exceptions become more complex under TVM.

<sup>5</sup> In these areas the tax base can fairly clearly be identified as the combination of flows of receipts and payments and changes in the (tax) values of stocks of assets and liabilities.

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the arguments have not caught on and many, indeed most, of those with a passable level of familiarity with the TVM are either unconvinced or have developed a strong (albeit no more or less intuitive) position against benefits in this category.

Certainly, nothing has emerged over the past few years to suggest that there is a reasonable expectation that any benefits of greater durability, robustness and integrity would contribute significantly to a return on the investment in the TVM.

### Costs

#### a) New areas of complexity

There is a reasonable expectation that the TVM approach would create new areas of complexity and instability. Under the current income tax system there are many areas where the tax value of assets or liabilities do not play an apparent role in the determination of taxable income. In these areas it is likely the TVM would also add to compliance costs.

- The net income formula has a number of comprehensive elements (receipts and payments) which imply that there has to be a degree of negation or reversal by some means or other. Changes in tax values of assets and liabilities will achieve some of this negation (as well as creating additional inclusions). Another portion will be achieved by the “tax law adjustments” that need to be made under the TVM.

In many instances, the TVM approach of putting everything in and then taking certain things out is more convoluted than simply leaving them out in the first place. In some cases the TVM legislation has to make counter-intuitive adjustments to ensure the appropriate amount is brought to tax. In these areas the TVM would add complexity and would create a degree of confusion among many taxpayers and tax practitioners.

- The TVM would bring liabilities into the tax equation to a far greater extent than is the case in Australia’s present income tax system or, for that matter, any other system of income taxation. The whole area of liabilities stands out as a very likely new source of significant complexity and instability.

An increase in the tax value of a taxpayer’s liabilities will reduce a taxpayer’s taxable income. This area will, therefore, become the focus of the tax authorities in their assessment and prevention of risks to the revenue. Ideally, a reciprocal increase in another taxpayer’s assets would assure the tax authorities that no additional scope for tax planning was created. However, experience suggests that the potential for asymmetries of tax treatment between resident taxpayers with different tax rates or between resident and non-resident taxpayers, will certainly attract attention and will open up new avenues for complex and evolving anti-avoidance provisions.

- To date very little work has been done on the implications of the TVM for businesses with offshore operations. The translation and adjustment of the foreign tax accounts of companies or trusts for the purposes of assessing Australian tax liabilities stands out as a major source of probable additional ongoing complexity. Adjustments, which are already very complex under the existing law, would be likely to become much more complex if Australia unilaterally introduced the unique TVM approach.

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### b) Transitional costs, uncertainties and instabilities over an extended period

We estimate that the Tax Value Method would take close to ten years to implement. This would include the further development work required, the passage of the legislation through the Parliament and the subsequent refinement of the legislation in the face of unanticipated consequences.

In addition to the formal implementation period, the transitional period could reasonably be expected to extend for several more years. This second component of the transition would involve the courts settling key definitional issues, the taxation authorities reacting to court decisions with new legislation and rulings, and the creation of sufficient precedent for taxpayers to regard the new regime as having stabilized.

These costs are compounded by uncertainties surrounding the status of case law precedent, and the status of cross-jurisdictional comparability that would arise with the introduction of a new and unique approach to income taxation.

The transition would involve a significant call on the resources of business, other taxpayers and the taxation authorities. As far as business is concerned, these costs would include the costs of involvement in co-design and consultative processes, expenditure on education and re-training and systems changes.

In addition to these costs, there are a number of implementation risks based on the experience with the implementation of recent and current reforms that need to be taken into account.

- Business has less-than-complete confidence in the ability of the taxation authorities<sup>6</sup> to deliver changes (including rulings) in a timely, orderly and non-disruptive manner.
- There are doubts surrounding the willingness of the tax authorities to engage in ongoing and open consultation during the full implementation phase.
- There is a likelihood that smaller-scale reforms and routine repairs and maintenance to tax law would be deferred while attention is concentrated on the implementation of the TVM.

While not all of these costs of transition are specific to TVM but would be encountered regardless of the mode of reform, the sheer scale of the TVM project magnifies them considerably.

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<sup>6</sup> In “taxation authorities” we include the Australian Taxation Office, the Treasury, the Office of Parliamentary Counsel and the Government.

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c) Significant sources of complexity, uncertainty, instability and high compliance costs would remain unaffected by the TVM.

The TVM specifically seeks to address the problems of the income tax system associated with the haphazard and unprincipled way the tax system has developed. The TVM seeks to address these by introducing a generic “footprint” (essentially the Net Income formula) into the core rules for the taxation of income.

While the haphazard nature and unprincipled way the income tax system has grown is an important source of uncertainty and of the high costs of compliance, it is not the only one.

- Specific provisions abound in Australia’s tax income tax system. Examples include grouping arrangements, loss duplication measures, value shifting rules, capital loss quarantining restrictions, franking rules, anti-capital streaming rules, provisions relating to the attribution of foreign source income, foreign tax credit arrangements, trust loss provisions, non-commercial loss provisions, alienation of personal services income measures and numerous other specific anti-avoidance measures.

These areas include some of the most complex and high compliance-cost elements of our income tax system. The TVM would leave these areas largely untouched and the uncertainty, instability, and complexity associated with these areas would remain.

- Similar arguments apply in relation to the specific provisions under which industry assistance and other social objectives are pursued through the income tax system. Examples include the Research and Development provisions and Averaging for Primary Producers. These areas are also a source of complexity and instability that would remain untouched by the TVM.
- Another source of the complexity, instability and high compliance costs of Australian income taxation arises from the nature of the embedded cultures of the taxation authorities. There is little doubt that the ghosts of the poor-compliance era of the late 1970s and the early 1980s still haunt the administration of Australian taxation. They manifest themselves in legislative and administrative practices that are overly pre-occupied with closing off remote and minor tax planning possibilities while adding disproportionately to complexity, instability and compliance costs. The TVM will not address this important source of shortcomings in Australian income taxation.

The TVM makes no claim to address these areas. They do, nevertheless, have an important bearing on the assessment of the balance of costs and benefits relating to the possible investment in the TVM. If Australians are to make a sizeable investment to reduce the costs, complexity, instability and uncertainty of income taxation, the breadth of impact of that investment needs to be closely considered.

Business faces the prospect of finding, after an extended transition period, that significant causes of these problems remain uncorrected.

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### Conclusion

The BCA and the CTA have supported the development and evaluation of the TVM proposal which was put forward as a means of addressing the complexity, uncertainty, instability and high costs of compliance of Australian income taxation.

We regard the open and transparent processes introduced by the Board of Taxation to assist in the development and evaluation of the TVM as representing a path-breaking advance in the way proposals to change taxation are developed and assessed.

Our participation in these processes has allowed us to reach a greater understanding of the strengths and weaknesses of the TVM proposal.

On the basis of this greater understanding, we do not support the continuation of the TVM project.

The TVM would imply a substantial investment on the part of taxpayers and the taxation authorities over an extended period and there is not sufficient evidence to expect that investment would yield a significant return.

Notwithstanding this conclusion, our commitment to the objectives of reducing the complexity, uncertainty, instability and costs of compliance of Australian income taxation is unshaken and we recommend that momentum on the search for ways to achieve these objectives through alternative routes should continue.

In the prioritisation of effort in the shorter term we recommend that a higher priority should be attached to the immediate tasks of:

- implementing and bedding down the outstanding business tax reforms – particularly the consolidations regime; and
- developing and implementing much-needed changes to international taxation.

The concentration of effort in these areas, however, should not prevent a start being made on a research and development project aimed at investigating solutions to the fundamental flaws in our income tax system. From its outset, this project should draw on the expertise of the business community. The BCA and the CTA would be keen to explore options with the Board of Taxation.