

Business Coalition for Tax Reform

Tax Value Method

Submission to the Board of Taxation

10 May 2002

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Executive Summary

The Business Coalition for Tax Reform (BCTR) welcomes the opportunity to provide a submission to the Board of Taxation on the Tax Value Method (TVM).

The BCTR is strongly of the view that ongoing reforms are needed to reduce the complexity, uncertainty and the costs of compliance associated with Australia's income tax system.

The BCTR commends the Board for the open and consultative process it has undertaken in relation to TVM. We support the adoption of similar consultative processes more widely in the development and evaluation of changes to Australia's taxation system.

After a careful and considered assessment over an extensive period, the BCTR does not support the continuation of the Tax Value Method project. The reasons for the BCTR not supporting TVM include:

- The TVM legislation is complex
- The TVM is based on an economic concept that does not translate readily into an operational tax base
- The TVM calls for the identification of assets and liabilities, many of which are not currently identified in all taxpayers' accounting records
- The net income formula has proved difficult to understand and to explain and will give rise to considerable confusion
- There are risks to the integrity of the tax base through opportunities for arbitrage around liabilities involving cross-border transactions. These risks will, in turn, give rise to new areas of complexity, instability and uncertainty
- There is a strong likelihood that the TVM will add uncertainty and complexity to Australia's international tax arrangements
- The changes proposed under the TVM apply only to the core rules and significant complexity will remain in the many specific policy measures that exist outside the core rules
- There would be significant transitional costs over an extended period
- Many benefits claimed on behalf of the TVM either have not been established convincingly or could be achieved by other, less disruptive means.

In our view, it certainly has not been demonstrated that the benefits of TVM are likely to outweigh the costs and the BCTR is not convinced that it would represent a significant improvement over the present system.

In short, due to the substantial transitional costs, the fact that some benefits have not been established convincingly, that other benefits are capable of being captured under alternative approaches and the additional sources of complexity, compliance costs and the uncertainty that would be associated with its introduction, the BCTR does not support the TVM.

The way forward

The BCTR attaches considerable importance to ongoing efforts to address the complexity, instability, uncertainty and high compliance costs associated with Australian income taxation. Further development and evaluation of a broader range of options than have been considered in the TVM project should proceed within the consultative framework introduced by the Board of Taxation.

During the course of the TVM project, a number of positive concepts have been identified and should be developed into a broader review process to look at the tax system as a whole.

The BCTR believes that momentum needs to be maintained in relation to fundamental tax reform. However, consideration needs to be given to the pressures on business due to other tax reform measures.

Over the next couple of years there are pressing areas of business tax reform that will require immediate attention by the business community. These include:

- the implementation and bedding down of the new consolidation regime and a range of other business tax reform measures arising from the Review of Business Taxation; and,
- the development and implementation of the program of reforms to modernise Australia's international taxation arrangements.

Simultaneously, a process should be put in place to investigate the nature of the flaws in the income tax system. This should involve early external input in the identification and assessment of problems with our current tax system and options to address them. The BCTR would be keen to work with the Board to develop this process.

Section 1. Introduction

The Business Coalition for Tax Reform (BCTR) is an apolitical organisation whose members are industry and professional associations from all sectors of the economy representing small, medium and large businesses. A list of BCTR members is at Appendix B.

The BCTR members have a common desire to provide a unified approach to building a better tax system that enhances both international and domestic business competitiveness and fairness and which assists in creating a business climate conducive to investment, growth, job creation and private saving.

The Tax Value Method has been identified by the BCTR as having cross-sectoral importance due to its impact on all income taxation.

The BCTR has been closely involved in taxation reform since its inception in 1997. Our approach to tax reform is based on clearly stated principles and is guided by our desire to build a better tax system that meets our objectives and principles for taxation reform.

The objectives and principles for taxation reform adopted by the BCTR are set out in full at Appendix A. The Business Coalition considers that all reform proposals, including the TVM proposal, should be evaluated in the context of these objectives and principles.

Our recommendation against proceeding with the Tax Value Method reflects our assessment of TVM against our objectives and the following principles in particular:

1. The tax system should be simple, transparent and should minimise uncertainty.
2. The design, administration and operation of the tax system should be undertaken with full and effective consultation with relevant stakeholders including the business community.
3. The tax system should fairly balance the need to protect the taxation revenue base with the principles of a good tax system, i.e. efficiency, fairness (horizontal and vertical equity), simplicity, clarity, certainty and low compliance costs.

Section 2. The BCTR agrees with the objectives of the TVM approach and the processes adopted for its development and evaluation.

The BCTR supports reform in relation to certainty, complexity, stability and lower compliance costs. Further, the BCTR remains committed to a tax system that enhances fairness and both domestic and international business competitiveness that assists in creating a business climate conducive to investment, growth, job creation and private saving.

We agree the current system is far from world's best practice and requires major reform. We therefore strongly support the *objectives* of the TVM approach to the extent that they are aimed at addressing the problems of complexity, uncertainty and high costs of compliance.

Our conclusion not to proceed with the TVM does not imply any disagreement with these objectives. Our argument is that the TVM does not solve these problems.

The BCTR commends the Board for the open and consultative processes it has introduced in the development and evaluation of the TVM. These include the public exposure of prototype legislation and explanatory material, co-design with the assistance of the Working Group and the use of private sector secondees on the Legislative Group. This consultation process has enabled the BCTR and its members to continue to have input and involvement in vital stages in the development of the TVM. We appreciate this further opportunity the Board has made available to provide input into its deliberations.

The BCTR recommends that further development of any tax reform measures should adopt these rigorous, open and consultative processes for wider application in the development and evaluation of changes to Australia's taxation arrangements.

Section 3. Why the BCTR Does Not Support the Tax Value Method

In short, the BCTR does not support the TVM because it does not meet the objectives of reduced complexity, uncertainty, instability and compliance costs.

a) The TVM legislation is complex

The core rules of the TVM are complex. Essentially this arises because the TVM combines an exclusion-based approach with the introduction of tax values of assets and liabilities alongside the cash flows that are the main subject matter of the existing law.

Even for the most simple transactions, the core rules of TVM are required to deal with all amounts that come in and go out (receipts and payments) as well as the opening and closing tax values of all relevant assets and liabilities.

This implies that the TVM legislation has to add additional (often artificial) layers to the tax treatment of even very simple transactions in order to avoid double counting or to exclude the unwanted amounts swept into consideration by the comprehensive nature of the elements of the net income formula. These problems are illustrated in the following examples.

- The receipt of a non-cash benefit in exchange for the supply of a service. The TVM legislation achieves the desired outcome of including the value of the non-cash benefit in taxable income by including the same amount twice (once as a receipt and once as an asset) and then 'backing out' one half of this double count

by recording a deemed payment (to reflect the notional purchase price of the non-cash benefit).

- A Loan. The desired tax treatment of leaving taxable income unaffected by the loan itself is achieved under the TVM legislation by negating the inclusion of the amount of the loan as a receipt with an equal increase in tax value of the taxpayer's liabilities.
- A Gift. The desired tax treatment of leaving taxable income unaffected by gifts (other than payments to approved charities etc.) is achieved by reversing the inclusion of the payment of the gift (other than if the gift is of a private or domestic nature and therefore not counted as a payment) by making an upward adjustment to taxable income.¹

These examples illustrate the inherent difficulties the TVM legislation has to deal with as a result of the combination of the exclusion-based approach with the added dimension of the changing tax value of assets and liabilities.

The dimension of assets and liabilities is responsible for another source of complexity in the core rules, namely the need to accommodate certain changes in the status of assets and liabilities. (For example an asset can change status from private to non-private and a liability can change status from contingent to non-contingent). In order to do this, the TVM has to track assets and liabilities that split, merge, transform or are substituted.

b) The TVM is based on an economic concept that does not translate readily into an operational tax base. Further, the TVM calls for a degree of precision in the measurement of assets and liabilities not evident in accounting practice and requires the identification of assets and liabilities many of which are not currently identified in all taxpayers' accounting records

The TVM is built on a concept that originated in economics and which has been (or, more correctly, is in the process of being) adapted into accounting practice.

Much has been made of the virtue of this association with an economic or accounting concept even though some critical differences and difficulties arise in the translation of the concept into an operational basis for taxation.

In their use of the concept of 'economic income' from which the TVM is derived, economists do not generally have a need to move beyond the purely conceptual level that is comfortably remote from actual valuation and measurement. Two difficulties in translating the economic conception of income into something that could be considered as an operational tax base are the need to remove the requirement for periodic market valuations of assets and liabilities and the need to avoid the adverse cash flow

¹ If, on the other hand, the gift is of a private or domestic nature and not included as a payment, but a deduction is allowed, a downward adjustment achieves the desired result in much the same way as under the present law.

implications of the taxation of unrealised gains.² Once these adjustments are made, the purity of the comprehensive income approach is lost³ as is much of the *economic* rationale for its adoption as the basis of income taxation..

Accountants, while much more closely involved with valuation and measurement than economists, are typically quite happy with a range of values and can exercise judgment in determining what assets and liabilities are recognised. Accounting rules allow things to be ignored if they are not material.

In contrast, for tax purposes, a greater level of precision is required because a tax calculation must produce a definitive amount of taxable income.

This requirement for greater precision means that a wider range of assets and liabilities would have to be recognised under TVM than under accounting rules. The TVM treats all property, all legal and equitable rights that are not property and certain information as assets that are ‘held’. While some of these assets will be listed as ‘zero tax value assets’, an asset which does not fit within this definition (but is regarded as being ‘held’) must have its tax value determined, even if for accounting purposes the asset is not material.⁴

This level of specificity of values to individual assets and liabilities requires considerable additional work to determine taxable income compared to the current method.

These points are associated with the concern that the TVM could create significant additional compliance costs due to the need to keep and refer to records that are currently not relevant when preparing tax returns. There may be unsuspected assets and liabilities, not identified in cashbooks, which will require an adjustment to the accounting treatment. This would create both transitional and ongoing costs in relation to the recognition and valuation of assets and liabilities.

For these reasons, the translation of the concept which has its uses for the purposes of economic analysis and which informs accounting practice, into an operational basis for taxation creates a set of problems not encountered in its application for economic or accounting purposes and could impose additional compliance costs on business.

² A related point is that the use of economic or comprehensive income as the tax base would extend the inter-temporal and anti-growth distortions of income taxation by lowering rates of saving and capital accumulation.

³ The purity - such as it is - could be reclaimed by adjusting tax values at the time of realisation to offset the deferral ‘benefits’. This would, however, add considerably to complexity and would leave the inter-temporal distortions of income taxation uncorrected.

⁴ An additional difference between the accounting and tax uses of the concept is that the tax values assigned to assets and liabilities may (and generally will) differ from the values used by accountants. For example the TVM default rule for determining the tax value of a liability states that its tax value (in default of some other rules applying) will equal the proceeds of assumption, i.e. what you get for assuming the liability is its initial tax value (before it starts to depreciate). This may sometimes be more than or less than the economic cost of having the liability - which is the value that accountants would normally use.

c) The net income formula has proved difficult to understand and to explain and will give rise to considerable confusion

Over the three years or so that TVM has been discussed in the public domain it has become clear that the concepts behind the net income formula and, in particular, the tracking of changes in the tax values of assets and liabilities, are quite difficult concepts to explain and grasp. These difficulties are evident among lay people, business advisers and tax practitioners.

The current system of assessable income and allowable deductions, while not simple in itself, is intuitively easier to understand for most people as the core rules of the Tax Value Method contain more variables than the present core rules.

Under the present income tax law

$$\text{Taxable income} = \text{assessable income} - \text{allowable deductions}$$

Under the TVM

$$\begin{aligned} & \text{Taxable income} \\ & = \\ & \text{receipts - payments} \\ & + \\ & \text{the changes in the tax value of assets} \\ & - \\ & \text{the changes in the tax value of liabilities} \\ & +/- \\ & \text{taxable income adjustments} \\ & - \\ & \text{unused tax losses} \end{aligned}$$

The greater number of variables contained in the core rules suggests a greater level of complexity and an even greater potential for error than under the existing income tax system.

For many, the role that changes in the tax value of assets and liabilities and taxable income adjustments play in excluding some of the receipts and payments included under the net income tax formula is conceptually confusing.

Assessable income and deductions, while complex in some instances are, for large parts of the taxpaying community, much more easily understood and applied in practice. By comparison, changes in asset values immediately conjure up notions of annual valuation of all assets and the taxation of unrealised gains which are dispelled only when the asset value rules are taken into account.⁵

⁵ These rules themselves are segmented into various categories and can, in admittedly limited cases, lead to complex valuation questions.

Even in the case of receipts and payments, which are straightforward concepts in lay terms, there is an overlay of adjustments - particularly on the payments side - that undermines the apparent simplicity.

The counter-intuitive nature of the TVM concept will give rise to new sources of confusion among taxpayers. This in turn will increase errors in tax returns and increase the costs of compliance.

d) There are risks to the integrity of the tax base through opportunities for arbitrage around liabilities involving cross-border transactions. These risks will, in turn, give rise to new areas of complexity and instability.

The focus on liabilities has played a less prominent role under Australia's tax system.⁶

Under the TVM, a net increase in liabilities directly reduces a taxpayer's liability to income tax. This will inevitably put pressure on the concept of tax liabilities in much the same way as pressure is now placed on many deductions.

Receipts which, under the present system would give rise to a tax liability because of the operation of the capital gains tax rules or the ordinary income principles, could give rise to significant deferrals under the TVM if ways can be found of assuming liabilities in connection with the particular receipt.

The Ralph Report addressed one of the more obvious opportunities for this type of tax planning by recommending that consideration in respect of restrictive covenants be taxed upfront (Recommendation 10.4).

For example, in relation to lease incentive payments, however, the TVM relies on the natural symmetry the tax system would impose on the payer and the recipient. That is to say, for every recipient who defers tax by way of a long-term liability there will be a payer whose deduction for the same amount has to be claimed over the same period. However, where a taxpayer has a lower tax rate than a recipient, this would create opportunities for arbitrage. Such opportunities would be compounded where transactions were conducted between residents and non-residents across different jurisdictions.

While it may be possible to limit the scope for arbitrage through specific or general anti-avoidance rules (and their associated complexity, uncertainty and instability), the BCTR considers that aggressive tax planning around liabilities could represent a significant threat to the integrity of the revenue base.

⁶ This may change in a small way through the introduction of the thin capitalisation rules with effect from 1 July 2001 and the expected introduction of the consolidation regime with effect from 1 July 2002. Neither the thin capitalisation rules nor the proposed consolidation regime, however, contemplate anywhere near the same pivotal role for the concept of liabilities as does TVM.

e) Uncertainty and potential additional complexity arising from international tax arrangements

Unfortunately, international taxation considerations have not been addressed in the development of the TVM to date. This area remains of considerable concern to business and raises the prospect of adding to the complexity faced by foreign investors in Australia and Australian investors and businesses with interests abroad. Such an outcome would detract from Australia's international competitiveness.

Foreign tax credit provisions and the Controlled Foreign Corporations and Foreign Investment Fund regimes require complex adjustments to the accounts of foreign entities in order to manage the interface between the tax systems of Australia and other countries. It is feared that Australia's unilateral adoption of the TVM – as a significantly different approach to income taxation – would compound this area of complexity.

f) The changes being proposed to the TVM are to the core rules only and significant complexity will remain in the many specific policy measures that exist outside the core rules

Much of the complexity, instability, lack of certainty and high compliance costs associated with the current tax system are not due to the core rules, but are caused by the myriad of specific provisions that give effect to particular policy measures.

These include, among numerous other specific measures:

- rules dealing with thin capitalisation
- the debt/equity distinction
- rules that attribute certain foreign income to Australian residents
- anti-capital streaming rules
- non-commercial loss provisions
- personal service income measures
- loss quarantining measures
- trust loss measures
- loss duplication measures.

Some other specific measures to come into effect from 1 July 2002 include consolidation, demerger rules, and the general value shifting rules. As a body of law, these specific measures suffer from inconsistent rules and definitions, and in our view, involve a high degree of unnecessary complexity.

TVM will do little to address the causes of the complexity of the body of law outside of the core rules.⁷ Much of the complexity in the detailed provisions relating to assessable income and allowable deductions will be converted to equally complex 'taxable income adjustments'.

⁷ The greater power of the TVM core rules may have an impact on some of the complexity of the areas that lie outside the current core rules. This is countered, however, by the greater need for taxable income adjustments due to the comprehensive nature of the TVM core rules.

Changing the core rules will, therefore, only have a limited impact on much of the complexity, uncertainty, instability and costs of compliance associated with the current income tax law.

g) There will be significant transitional costs over an extended period both for the business community and for the taxation authorities

The BCTR anticipates that the transition period for the TVM would extend to the best part of a decade. This includes the further development and testing work, the implementation itself and the inevitable need for adjustment and refinement after the TVM had been adopted.

There will be significant transitional costs of education of taxpayers and the tax profession both in the public and private sectors. The BCTR would anticipate that there would also be the higher costs of greater use by taxpayers of the tax profession in the short term.

The TVM would imply system changes and a period of adjustment for the tax authorities, tax professionals, individual businesses and taxpayers. There will be transitional costs and uncertainties in relation to the loss of case law precedent and the loss of the legal comparability between the Australian income taxation system and that of other countries.

An important component of businesses' assessment of the transitional costs is the uncertainty surrounding the ability of the tax authorities (including the Government) to manage a smooth implementation. While these uncertainties are present for any tax change, the scope of the TVM magnifies these concerns.

h) Many of the benefits claimed on behalf of the TVM are not convincing and others could be captured under alternative approaches

Many of the benefits claimed on behalf of the TVM, such as the greater 'durability', 'robustness' and 'structural integrity', have only been asserted. Convincing arguments or evidence have not emerged over the three or so years during which the TVM has been in the public domain and the case on their behalf remains strictly intuitive.

The intuitive case has not won many supporters and many other counter claims have been put forward. These claims point to the potential volatility of taxable income adjustments, the vulnerabilities to tax law stability created by the more widespread place of liabilities in the tax law and the unpredictability created by the loss of established precedent.

Other benefits can and should be secured independently of the TVM. These include:

- grant tax relief for blackhole expenditure
- develop an accruals basis of taxation of financial instruments within, at least the financial sector
- establish a principles-based approach to drafting tax law

- simplify capital gains taxation.

Conclusion

Given the substantial transitional costs, the fact that some benefits have not been established convincingly, that other benefits are capable of being captured under alternative approaches and the additional sources of complexity, compliance costs and the uncertainty outlined above, the BCTR does not support the TVM.

In our view, it certainly has not been demonstrated that the benefits of TVM are likely to outweigh the costs and the BCTR is not convinced that it would represent a significant improvement over the present system.

Section 4. The Way Forward

During the course of the TVM project, a number of positive concepts have been identified and should be developed into a broader review process to look at the tax system as a whole. These could include the removal of the nexus test and the capital exclusion from the general deductibility provisions as well as the development of common rules and definitions.

The BCTR believes that momentum needs to be maintained in relation to fundamental tax reform. However consideration needs to be given to the pressures on business due to other tax reform measures.

It is important that certain specific policy measures, which may have been seen as particularly well suited to TVM in terms of their implementation, now proceed without further delay.

The specific issues include:

- developing, implementing and bedding down outstanding business tax reform measures
- implementing and bedding down consolidations, the thin capitalisation rules, demerger rollover provisions and the new value shifting rules
- developing and implementing reforms to Australia's international tax arrangements.

Simultaneously, a process should be put in place to investigate the nature of the flaws in the income tax system. This should involve early external input in the identification and assessment of problems with our current tax system and options to address them. The BCTR would be keen to work with the Board to develop this process.

APPENDIX A

Business Coalition for Tax Reform Objectives and Principles

BCTR Objectives

The BCTR is an apolitical organisation of business and professional associations from all sectors of the economy representing all businesses in Australia, irrespective of their size, nature of operation or ownership.

The members of the BCTR have a common desire to provide a unified approach to building a better tax system that enhances both international and domestic business competitiveness and fairness and which assists in creating a business climate conducive to investment, growth, job creation and private saving.

BCTR Principles

1. The tax system should be simple, transparent and should minimise uncertainty.
2. The design, administration and operation of the tax system should be undertaken with full and effective consultation with relevant stakeholders including the business community.
3. The tax system should fairly balance the need to protect the taxation revenue base with the principles of a good tax system, i.e. efficiency, fairness (horizontal and vertical equity), simplicity, clarity, certainty and low compliance costs.
4. The tax system should enhance competitiveness by providing a climate conducive to improved investment in Australia and from Australia for Australian-based entities and individuals.
5. Indirect taxation at the State and Territory level should be more efficient and competitive.
6. The pattern of Federal/State financial relations should be transparent, efficient and sustainable.
7. The tax treatment for savings should be consistent with an overall savings policy that encourages the sustainability of strong, ongoing growth.
8. The tax, and social security, treatment of personal income and fringe benefits should conform to the principles of fairness, efficiency and simplicity.
9. The tax system should avoid the double taxation of business income and provide relief for all business expenses.
10. The tax system should not impede organisational restructuring.

APPENDIX B

Members of the Business Coalition for Tax Reform

Association of Consulting Engineers
Association of Superannuation Funds of Australia
Australian Bankers Association
Australian Business Limited
Australian Chamber of Commerce and Industry
Australian Constructors Association
Australian Food and Grocery Council
Australian Gas Association
Australian Hotels Association
Australian Industry Group
Australian Institute of Company Directors
Australian Institute of Petroleum
Australian Retailers Association
Australian Stock Exchange
Business Council of Australia
Business SA
Chamber of Commerce & Industry of WA
Corporate Tax Association of Australia
Council of Small Business Organisations of Australia
CPA Australia
Electricity Supply Association of Australia
Employers First
Federal Chamber of Automotive Industries
ICC Australia
Institute of Chartered Accountants in Australia
Insurance Council of Australia
International Banks and Securities Association of Australia
Investment & Financial Services Association
Master Builders Australia
Meetings Industry Association of Australia
Minerals Council of Australia
National Association of Forest Industries
National Farmers' Federation
Property Council of Australia
Restaurant & Catering Australia
State Chamber of Commerce NSW
Tasmanian Chamber of Commerce and Industry
Urban Development Institute of Australia
Victorian Automobile Chamber of Commerce
Victorian Employers' Chamber of Commerce & Industry