

THE REVIEW OF BUSINESS TAXATION'S "OPTION 2" – PROBLEMS IN CONCEPT AND IN PRACTICE

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Option 2's "cash flow/tax value" approach to computing tax liabilities according to accounting principle is not a desirable change. An example is used to test the rejection of traditional legal concepts, focusing on the replacement of the capital and income distinction with statutory rules. Inconsistency is suggested between the Review of Business Taxation's "benchmark" of a comprehensive income tax base, on the one hand, and its concurrent acceptance of the "realisation principle" for capital gains, on the other. Established tax values are disregarded under Option 2 - to the extent that those values require the appropriate matching of items of income and expense. Excessive allowable deductions are a striking consequence. Option 2 is then viewed in a wider context. Systems of tax and financial accounting are shown to serve different purposes. One-year taxation periods and containment of tax avoidance cannot be accommodated within the objectives of the "cash flow/tax value" approach. Given that the Australian tax system assumes the rule of law, changeable and indefinite accounting principles are of nature unsuited to the measurement of income for tax purposes.

1. INTRODUCTION

The Review of Business Taxation's ("RBT") "Option 2" approach to the calculation of taxable income makes a dramatic leap

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in the design of Australian income tax laws.¹ Changes in cash flows and in the tax value of assets and liabilities over a tax year are proposed as the measure of business income and loss. Net income under Option 2 will equal a taxpayer's excess of receipts over payments in the reporting period, plus or minus the net change in the tax value of assets and liabilities, excluding private or domestic amounts.² A table of asset tax values replaces much of the function of "capital" characterisation under the existing law. Several legislative schemes for capital allowances under existing legislation are gathered together in one place.³ Many familiar aspects of the present tax system will be superseded, including the judicially derived "concept of income" and the familiar *Income Tax Assessment Act 1997* (Cth) ("ITAA97") s 8-1 control test for determining allowable deductions.

According to the RBT, Option 2 will be "structurally consistent with both economic and accounting approaches to income measurement" and provide a "high level unifying principle that cannot be found anywhere in the current income tax legislation".⁴ For this, the "strategy" was said to be "bringing tax value and commercial value closer together", in order to facilitate "internationally competitive as well as economically efficient business arrangements."⁵

It is argued in this article that the proposed move from traditional legal concepts is undesirable. Option 2 proposals are examined particularly in relation to the allowability of deductions. The

¹ Outlined in RBT, *A Tax System Redesigned* (1999) 155-163 ("A Tax System Redesigned") and RBT, *A Platform for Consultation* (1999) 43-44 ("A Platform for Consultation").

² Subject to "tax policy adjustments": see RBT, *A Tax System Redesigned: Explanatory Notes* (1999) 3.11 ("Explanatory Notes").

³ See the table in RBT, *A Tax System Redesigned: Draft Legislation* (1999) s 6-40 ("Draft Legislation").

⁴ *A Tax System Redesigned*, 157.

⁵ *A Platform for Consultation*, 6.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

significance of matching deductible expenses with their associated income is noted, as well as the reason why capital characterisation excludes certain items from deductibility under the present law. Treatment of borrowing expenses is used to test the compromise between rival principles reached by the RBT. An example highlights how Option 2 allows full deductibility for partially unmatched borrowing expenses. It is suggested that Option 2's shortcomings are endemic to the method of financial accounting, when applied to the measurement of income for tax purposes, and only existing categories provide a workable solution.

2. RALPH PROPOSALS IN GENERAL

"An essential element of income measurement", the RBT reminds us, "is the deduction of expenses consumed in the course of producing gains."⁶ Accounting income can only be established after adequate correlation of expense and revenue items.⁷ Expenses exhausted in an accounting period must be separated from expenses which are unexpired and represented by assets on hand at the period's end.⁸ Generally accepted accounting principles require that the value of assets representing unexpired expenses at the end of a reporting period is dealt with appropriately in order to provide a correct reflex of an entity's economic performance over the period.⁹ Assets constitute accounting revenue to the extent that the entity

⁶ Ibid 37.

⁷ See Y Grbich, "Ralph's Radical New Income Tax Base - Does it Work?" (2000) 23 *UNSW Law Journal* 282, 282; J Godfrey, A Hodgson and S Holmes, *Accounting Theory* (4th ed, 2000) 627-647; RG Schroeder, M Clark and LD McCullers, *Accounting Theory: Text and Readings* (4th ed, 1991) 72; and V Kam, *Accounting Theory* (2nd ed, 1990) 283-296.

⁸ Schroeder et al, above n 7, 73.

⁹ See Australian Accounting Research Foundation: Statement of Accounting Concepts, *Definition and Recognition of the Elements of Financial Statements* (1992) [109] ("SAC 4").

controls the future economic benefits or savings in future outflows that the assets represent.¹⁰

Option 2 has been described by the RBT as a generalised treatment of income, assets and liabilities which is "structurally consistent with both economic and accounting approaches to income measurement".¹¹ Net income, under the cash flow/tax value approach, will equal a taxpayer's net receipts (after deduction of payments) and the net change in the value of his or her assets and liabilities.¹² All private receipts, payments assets and liabilities are to be excluded in determining the value of net income. The idea is certainly straightforward in theory. One adds up all amounts received during the income year, and subtracts all the amounts that were paid. Then one adds the closing tax values of assets held and liabilities owed at year's end and subtracts the tax values of all assets held and liabilities owed at the start of the income year.¹³ Tax value of an asset at year's end is determined by the table in s 6-40 of the Draft Legislation.¹⁴

Making tax law conform to financial accounting concepts is not a new idea. In 1934, the Ferguson Royal Commission on Taxation considered the adoption of generally accepted accounting principles in the federal tax legislation then about to be re-enacted.¹⁵ Both executive and judicial authorities in the United States between 1920 and 1960 supported conformity of tax and financial accounting.¹⁶

¹⁰ Ibid [111]-[112].

¹¹ A Tax System Redesigned, 38.

¹² Explanatory Notes, 3.11.

¹³ Ibid 3.25.

¹⁴ See Draft Legislation, s 6-40; and A Tax System Redesigned, Figure 4.2.

¹⁵ See the *Third Report of the Royal Commission on Taxation* (1934), 551ff ("Third Report"), discussed further at note 69 below.

¹⁶ See H Weinman, "Conformity of Tax and Financial Accounting" (1981) 59 *Taxes: The Tax Magazine* 419, 420. The US Supreme Court relied on accepted accounting principles in *Eisner v Morcomber* (1920) 252 US 189 (realisation principle); and in *United States v Anderson* (1926) 299 US 422 (accrual method

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

The US President's Task Force on Business Taxation in its 1970 report concluded that the then increasing divergence between net income for financial accounting purposes and taxable income for federal income tax purposes resulted in unnecessary complexity and controversy.¹⁷ Conformity is primarily a concern in Anglo-Saxon countries such as Australia, Canada, the United Kingdom and the US. Financial statements based on accounting rules are routinely used to determine the basis of income tax assessments in continental European countries such as France, Germany and Italy.¹⁸

3. THE PRESENT FUNCTION OF CAPITAL CHARACTERISATION

Capital assets are described in the accounting standards as future economic benefits of a lasting nature.¹⁹ An asset is owned by, or is "specific to an entity", where the entity has control over the future economic benefits that the asset confers and is able to enjoy those benefits and deny or regulate the access of others to the same.²⁰ The effect of expenditure to provide or improve an entity's capital assets will often be unexhausted at the end of a reporting period. Both accountancy principles and the comprehensive income definition suggest that the value of any unexpired benefits should be added to the measure of an entity's performance over the period for the computation of liability to tax.²¹ However, for taxation purposes, this will usually not occur. A principle based in fairness is interposed:

suitable for tax purposes), discussed in D Geier, "The Myth of the Matching Principle as a Tax Value" (1998) 15 *American Journal of Tax Policy* 17, 75-113.

¹⁷ J Nolan, "The Merit in Conformity of Tax to Financial Accounting" (1972) 50 *Taxes: The Tax Magazine* 131, 131.

¹⁸ See *European Tax Handbook* (IBFD 2000), 192-194 (France); 215-217 (Germany); 325-327 (Italy); and T Porcano, D Shull and A Tran, "Alignment of Taxable Income with Accounting Profit" (1993) 10 *Australian Tax Forum* 475, 476.

¹⁹ SAC 4, para 14.

²⁰ *Ibid* paras 15 and 24.

²¹ A Platform for Consultation, 11: "the comprehensive income tax base would recognise all unrealised gains and losses".

"[T]ax accounting departs from financial accounting rules" in order to take account of whether the taxpayer, notwithstanding the accrual of income or expense in the economic sense, has actually received the income from which to pay the tax, or has actually incurred the expense which would diminish his ability to pay it.²²

Considerations of convenience, as well as fairness, require that taxes be levied at times when taxpayers are likely to have the means to pay.²³ Often taxpayers will not have the liquidity to meet tax liabilities when value accrues to their assets without realisation. Tax based on increased asset values is deferred until an actual receipt, (or now) a recognised accrual, or the equivalent of either occurs.²⁴ Unrealised gains and losses which accrue in respect of non-revenue assets over the years prior to their being "cashed out" are not included in the annual tax base. This will be referred to as the "realisation principle". The fact that most asset gains must be realised before being taxed is probably the main reason why a fully comprehensive income tax base cannot be implemented.²⁵

Revenue or capital characterisation functions in tandem with the realisation principle. "Capital" is a label traditionally applied to assets, increases in the value of which fall outside the income tax base because of the realisation principle. Not until the occurrence of

²² Weinman, above n 16, 430; see also W Raby and R Richter, "Conformity of Tax and Financial Accounting" (1975) 139 *Journal of Accountancy* 42, 44.

²³ A Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* in E Cannan (ed) (Vol 2, 1950) 351.

²⁴ For instance, an accrual under Pt XI of the *Income Tax Assessment Act 1936* ("ITAA36").

²⁵ A Platform for Consultation, 29, the RBT refers to the realisation principle as a "liquidity or cash flow constraint". It stands in the way of a comprehensive income model together with "a volatility constraint", "a valuation constraint", "a loss offset constraint" and "an international competitiveness constraint". See also P Kenny, "Realisation versus Accruals: Capital Gains Taxation in Australia", 13th Australian Tax Teachers Association Conference, Sydney, 2001.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

defined "CGT events" will increase the value of most assets be included in the tax base.²⁶

A corollary of this concerns allowable deductions. If the values of most of an entity's capital assets do not increase the measure of the entity's economic performance until their realisation, neither should expenses incurred on those assets be deductible from the performance measure.²⁷ Tax symmetry requires as much. Mismatches will occur if capital assets excluded from gross income are the subject of allowable deductions. An unacceptable revenue loss occurs when deductible expenses are not associated with corresponding taxable items.

Capital characterisation of an expense works a kind of rough justice. It identifies non-revenue assets excluded from assessable income by the realisation principle and excludes a corresponding category of expenses from the formula for allowable deductions.²⁸ Distinguishing revenue from capital expenses is a response to inconsistencies between the realisation principle and the comprehensive income definition. Tax recognition is denied both for gains in value of unrealised capital assets and expenses on such assets.

Two conflicting principles are involved. On the one hand, tax justice would suggest that capital expense claims should be allowed in full in the years they are incurred and that taxpayers should be annually assessed on the value of their unexhausted assets. Considerations of fairness, on the other hand, suggest that tax liabilities should not be imposed in respect of gains that taxpayers have not received.

²⁶ See ITAA97, Div 104.

²⁷ See R Parsons, *Income Taxation in Australia* (1985) 12-24.

²⁸ See ITAA97, s 8-1 and note 68 below.

4. THE RALPH COMPROMISE

Inconsistency of the comprehensive income and realisation principles emerges from the construction of the Option 2 scheme which supplants the need for capital characterisation. This is the "tax value of an asset" table contained in s 6-40 of the Draft Legislation. The following depreciation and accruals bases of asset valuation which are set out - referring both to existing and intended legislation.

Item	Asset	Value
1	Trading stock	Lesser of cost/net realisable value "default Rule" - Div 48
2	Depreciating asset	(The familiar) declining value and other formulae - Div 40
7	Financial asset	Cost/market value/accruals methodology - Div 45
9	Non-routine leases/rights	Cost or accruals methodology - Subdiv 96-B

The items are the present and intended formulaic schemes of asset valuation. Centralisation is one virtue of this table. The body of non-standard asset values is gathered together and signposted most usefully. Comparable schemes under the existing law were once (and are still at the time of writing) spread across the *Income Tax Assessment Act 1936* (Cth) ("ITAA36") and the ITAA97 in a somewhat disorganised way. It should be noted that most asset classes have not been dealt with in the table so far extracted. The great majority of assets are typified and dealt with below under the descriptions of residual items in the table in s 6-40. No further reference to value accruals is made.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

Item	Asset	Value
5	Membership of tax entity	Cost (with market value election)
8	Routine lease or right	Nil, or amount due and payable
10	Right to have your tax paid	Amount of the tax
11	Asset capable of ownership (not above)	Cost at the time of reporting
12	Goodwill	Cost if acquired from another and otherwise nil
13	(Other) asset acquired from another taxpayer	Cost of acquisition
14	Any other asset	Nil

Cost, face value or nil are the asset values which obtain in all residual cases. Value changes which occur in relation to these assets after they are acquired are either ignored, or enter the income equation when the assets are realised.

The comprehensive income tax base chosen as a "benchmark" by the RBT does not recognise unrealised gains and losses. This point was emphatically made.²⁹ For not even Henry Simons, a committed advocate of comprehensive income taxes, had included unrealised appreciation of the value of an asset in his income base.³⁰ A gain must have come home to the taxpayer in a realised or ready realisable form as a precondition to liability. However, nothing in the Option 2 income formula suggests that realisation will be required before liability for asset revaluation occurs. Income will equal annual

²⁹ In A Platform for Consultation, 11, the point was underlined: "[recognition of unrealised gains and losses] ... which is not being proposed". There is an exception to this, relating to accruals taxation of financial instruments - see A Tax System Redesigned, 340-341.

³⁰ See H Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (1938) 55.

receipts (less costs) *plus* changes in the value of underlying assets (and liabilities).³¹ In denying the effect of capital characterisation in Option 2 and accepting the realisation principle, the RBT adopts an uneasy half-away position on the way to implementing a truly comprehensive income base. There may be an inconsistency in the RBT giving effect to the realisation principle, on the one hand, and basing the income tax on net cash flows and changes in tax values, on the other.

Option 2 determines taxable income on the assumption that recognised non-private expense deductions in a given year are matched either with receipts in that year or recognised changes in the tax value of assets (other than money).³² If there is no receipt, and either no asset is produced as a result of non-private expenditure, or the tax value of such an asset is nil, then the expenditure directly reduces taxable income - unmatched by any gain. Matching of assets with expense items is essential to the working of the scheme.

Taxable income (or loss) under Option 2 is determined in two main steps.³³ First, one deducts all non-private amounts paid from amounts received during an income year. Secondly, one subtracts the closing tax values of assets and liabilities from the opening tax values of the taxpayer's assets and liabilities.³⁴ Payments subtracted from receipts in the first step are matched, for the most part, by either revenue receipts or changes in the tax values of assets and liabilities in accordance with contemporary accounting practice.³⁵

So if a taxpayer pays a debt existing at the start of the tax year, that payment is deducted in the first step of the income calculation and the closing balance of liabilities is correspondingly reduced.

³¹ A Platform for Consultation, 28.

³² Explanatory Notes, 3.11.

³³ See note 10 above.

³⁴ A simplification of the "method statement" in s 5-60 of the Draft Legislation.

³⁵ As codified in Subdiv 6C of the Draft Legislation.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

Section 6-20 in the Draft Legislation defines the meaning of "liability" as follows:

- (1) A *liability* is a present obligation to provide future economic benefits.
- (2) The obligation need not be legally binding, and the taxpayer to whom it is owed need not be a taxpayer to whom the benefits are provided.
- (3) The balance of the contributed capital account of a tax entity is taken to be a *liability* that the tax entity owes.

This section replicates the relevant definition in the accounting standards with a fair degree of accuracy.³⁶ A "liability" in accounting terms is a presently existing obligation to act or perform in a particular way.³⁷ Obligations are owed to parties who are external to the entity under the liability. Two things are implicit in this. First, the obligee and obligor must be at arm's length. Secondly, the category of liability cannot be created or collapsed other than by the ordinary assumption of an obligation and its discharge. For such is the nature of legally enforceable obligations in commerce. They are undertakings entered upon the exchange of good and sufficient consideration. Accounting standards have not as yet been applied to the containment of tax avoidance. Liabilities, as will be seen, have a manipulable nature. When a liability becomes deductible without the need to show any nexus between its assumption and the production of assessable income, the category is ripe for exploitation by aggressive tax avoiders.

Australian subsidiaries of overseas parent companies might assume present liabilities to make large payments to the parent companies at the end of a financial year. These liabilities could then

³⁶ See SAC 4, para 48.

³⁷ Ibid para 51.

be forgiven at the start of each new accounting period.³⁸ The taxable income of Australian corporate subsidiaries might be artificially lowered in this way. The overseas parent company, for its part, would not be under a corresponding liability under the tax systems in any of Australia's main trading partners. It will not be taxed on the value of the asset constituted by the liability which its subsidiary owes.

If the taxpayer purchases trading stock which is sold in the same income year, the purchase price is deductible and sale proceeds enter the calculation as a taxable receipt. The purchase price of a depreciable asset is deductible and its written down value is represented by a positive change to the tax value of the taxpayer's assets at year's end. To the extent that payments are unmatched by receipts or changes in asset values, they are written off in the year in which they are made. This is a point where Option 2 is not on strong ground. No satisfactory basis on the level of accounting principle has ever been shown for the association of revenue deductions and revenue. Attribution of tax value to assets acquired by deductible payments is correspondingly incomplete. Assets are only ascribed a tax value to counterbalance the payment to acquire them if the assets fall within the descriptions proposed for any of the enumerated "items" in the s 6-40 table of the Draft Legislation. A catch-all category of "other" assets that has a nil tax value signals that there is a class of assets that makes no contribution to the matching exercise. These are very incomplete rules for when payments should be represented by receipts or changes in the balance of assets and liabilities.

The contemplated absence of an income item/tax liability to match each deduction allowed within a reporting period disregards an important feature of the Australian (and comparable) tax

³⁸ Subject to Pt IVA of the ITAA36; see Grbich, above n 7, 26 and generally on liabilities, A O'Connell, "Option 2: Will it Change What is Included in Assessable Income?" (2000) 29 *Australian Tax Review* 68, 75-76 and 79-80.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

systems.³⁹ Australian income tax is levied annually. Tax rates, loss allowances and many preferences are computed on the basis of economic performance within a tax year. Association of matching revenue and expense items in different tax years is an outcome to be avoided in tax accounting. The time-value of money is not safeguarded. Manipulative tax planning is encouraged. Tax policy analysts in the US have warned that:

[F]inancial accounting often ignores the time value of money in its conventions regarding when receipts and outlays are accounted for ... ignoring the time value of money can produce dramatic skewing effects regarding the amount of tax payable.⁴⁰

5. TREATMENT OF INTEREST EXPENSES IN OPTION 2

Option 2's approach to the matching of allowable expenses with income derived in the same or subsequent income periods can be illustrated in the following example.

Joe is a self-employed accountant who works in an expanding, outer suburban area. He earns \$180,000 in fees in the year ended 30 June 2001. Joe's expenses include \$35,000 in wages that he pays to his receptionist, \$20,000 for office expenses and \$40,000 in instalments on a \$500,000 mortgage loan that Joe took out to purchase his business premises. Loan instalments include both interest and principal amounts and the value of his indebtedness has decreased by \$15,000 to \$470,000. A local estate agent advises Joe that the value of his premises has been rising steadily since he acquired them for \$500,000 in 1999. In the past year alone, their worth has increased by about \$40,000. Joe has no other non-private assets or liabilities.

³⁹ J Dodge, J Fleming and D Geier, *Federal Income Tax: Doctrine, Structure and Policy* (2nd ed, 1999) 36-37.

⁴⁰ *Ibid* 730.

Joe's Option 2 income for the year pursuant to the Draft Legislation is as follows:⁴¹

- Step 1* Add up all amounts you received during the income year:
\$180,000 (professional fees)
- Step 2* Subtract from the step 1 result all amounts you paid during the income year:
 $\$180,000 - [\$35,000 \text{ wages} + \$20,000 \text{ expenses} + \$40,000 \text{ instalments}] = \$85,000$
- Step 3* Add to the step 2 result the closing tax value of each asset (other than money) that you held at the end of the income year:
 $\$85,000 + \$500,000 \text{ (closing tax value of premises)} = \$585,000$
- Step 4* Subtract from the step 3 result the opening tax value of each asset (other than money) that you held at the start of the income year:
 $\$585,000 - \$500,000 \text{ (opening tax value of premises)} = \$85,000$
- Step 5* Subtract from the step 4 result the closing value of each liability that you owed at the end of the income year:
 $\$85,000 - \$470,000 \text{ (closing balance of indebtedness)} = (\$385,000)$
- Step 6* Add to the step 5 result the opening tax value of each liability that you owed at the start of the income year:
 $(\$385,000) + \$485,000 \text{ (opening balance of indebtedness)} = \$100,000.$

⁴¹ Draft Legislation, s 5-55.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

$$\begin{aligned}\text{Taxable income} &= [\text{professional fees}] - [\text{wages} + \text{expenses} + \text{instalments}] + \\ &\quad [\text{reduced debt}] \\ &= \$180,000 - [\$35,000 + \$20,000 + \$40,000] + [\$15,000] \\ &= \$180,000 - [\$95,000] + [\$15,000] \\ &= \$100,000\end{aligned}$$

Joe's treatment under Option 2 is in many ways similar to what it would be under the present system. He is entitled to reduce his taxable income by wages, rent and mortgage interest expenses. If Joe is additionally entitled to deduct repayment of the mortgage principal, then, to a corresponding extent, an amount is added back to his income as a taxable reduction in the value of his non-private liabilities. It is the interest component which is problematic. Whilst the interest payment is deductible in effect and reduces Joe's taxable income, there is no counterbalancing revenue item in the year in which the payment is made.⁴² Any additional (unrealised) value of the premises at the end of the year gives rise to no tax liability within the scheme of Option 2. Joe's premises are attributed with a tax value at the end of the year equal to the cost price that Joe paid in 1999.⁴³ Until a CGT event occurs in relation to the premises, there is no tax liability to counterbalance (or "match") Joe's subtraction of the borrowing expense from his taxable income.

The timing of when relevant CGT events occur is something largely under Joe's control. Dealings with ownership interests in his business assets can be undertaken at times which suit his fiscal convenience. CGT treatment for Joe entails the advantages of both a timing benefit, resulting from the tax he has deferred, and a "discounted capital gain" tax-preference, when matching liability is ultimately faced.⁴⁴ Postponement of tax liability and conversion of

⁴² A problem also for the existing system: see discussion of the traditional response at note 50 below.

⁴³ Draft Legislation, s 6-40.

⁴⁴ Pursuant to ITAA97, Div 115, acknowledged in A Tax System Redesigned, 4.18. Section 115-40 provides that the discount percentage for Joe would be 50%. Under ITAA97, Div 152, Joe could also enjoy the 15-year exemption (Subdiv 152-B), the

ordinary into tax preferred income both seem possible in his case. The effect would be accentuated if Joe decided to negatively-gear further borrowing made in order to acquire the shop next door. Interest expenditure for this purpose would be deductible as part of Joe's business and not a private or domestic expense. Or consistently with the "private use of assets" Recommendation 4.13(d) of A Tax System Redesigned, Joe might use a company or some other interposed entity for the generation of private negative-gearing gains on a comparable basis.⁴⁵

Assume now a variation to the example.

Instead of owning his premises and paying them off, Joe leases the premises in return for an annual \$30,000 lease payment. Other outgoings of \$35,000 for a receptionist and \$20,000 by way of office expenses are the same as before.

Calculation of Joe's Option 2 income in this variation would differ at step 2. Rent would be paid instead of instalments of the mortgage loan. Steps 3, 4, 5 and 6 (applying to assets and liabilities) would then have no content. For Joe, we have assumed, has no non-private assets or liabilities other than his business premises and the loan taken out to acquire them.

50% reduction (Subdiv 152-C), the retirement concession (Subdiv 152-D) and the roll-over (Subdiv 152-E).

⁴⁵ See discussion of Recommendation 4.13(d) and "capital gains treatment" for certain private gains made by individuals at note 63 below. Capital gain made by entities will be taxed at the consistent entity rate of 30 per cent, rather than at the lower "discount capital gains" rate, but with increased possibilities for tax deferral and tax-effective distribution.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

$$\begin{aligned}\text{Taxable income} &= [\text{professional fees}] - [\text{lease payments} + \text{wages} + \\ &\quad \text{expenses}] \\ &= \$180,000 - [30,000 + 35,000 + 20,000] \\ &= \$180,000 - \$85,000 \\ &= \$95,000\end{aligned}$$

Joe's taxable income, in this event, has been slightly reduced. Total expenditure subtracted from his incomings is now greater. The rights that Joe has acquired under the business lease have a nil tax value and there is correspondingly no asset value to include.⁴⁶ Joe's tax liability under Option 2 is the same as what it would be under the present system. This is because all expenses are exhausted in the tax year in which they are incurred. This variation serves as a control device. Changes entailed by the cash flow/tax value approach to calculating assessable income are not significant where there are no asset or liability values to be adjusted.

Assume another variation to Joe's income tax affairs.

Joe owns the business premises, as in the example, and is paying off the loan he took out to finance their acquisition. He additionally spends \$15,000 in legal costs to prevent another accountant from commencing business nearby with his name and distinctive style. The expenditure achieves its object, as it has done several times before. An accountancy business broker advises Joe that the semi-monopoly he has achieved in the area contributes to a considerable premium that the practice is now worth over normal valuation.

Calculation of Joe's Option 2 income in the second variation resembles that in the example, except that step 2 now involves subtraction of an additional non-private expense by way of legal costs. The corresponding sub-total for this step is reflected in steps 3, 4, 5 and 6. In the result, Joe's cash flow and taxable income for the year are further reduced as follows:

⁴⁶ Draft Legislation, s 96-200, Item 6.

$$\begin{aligned}\text{Taxable income} &= [\text{professional fees}] - [\text{wages} + \text{expenses} + \text{instalments} \\ &\quad + \text{legal expenses}] + [\text{reduced debt}] \\ &= \$180,000 - [\$35,000 + \$20,000 + \$40,000 + \$15,000] \\ &\quad + [\$15,000] \\ &= \$180,000 - \$110,000 + \$15,000 \\ &= \$85,000\end{aligned}$$

Value has been added to the goodwill of Joe's business. He has also paid \$15,000 in legal costs which have reduced his taxable income. However, no recognised increase in asset value counterbalances the expense that Joe incurred.⁴⁷ Though the payment is deductible, in effect, and Joe's taxable income has been proportionally reduced, the accretion to the value of goodwill which followed from the expense will not be recognised in that year. Joe obtains a tax-timing benefit to the extent that the increase in the asset value of his business does not counterbalance the allowable expense that he incurred. Not until a (tax preferred) capital gain occurs in relation to the business premises will the additional value created by the legal expense re-enter Joe's tax equation. This is a consequence of the "tax value of an asset or liability table" at s 6-40 of the Draft Legislation, which provides that the tax value of goodwill is:

- (a) To the extent (if any) that the goodwill includes goodwill that you have acquired from another taxpayer - the cost of the acquired goodwill when you acquired it; and
- (b) Otherwise - nil.

Accretion to Joe's goodwill has no recognised tax value, given that it was the consequence of legal proceedings he commenced and was not acquired from another taxpayer.

The above example and variations isolate what may be a problem for Option 2. Interest on borrowings to acquire assets which will receive capital gains treatment is deductible in full at the time when the relevant expense is incurred. The corresponding income item is

⁴⁷ Ibid s 6-40, Items 13 and 14.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

postponed and tax preferred. Commentary by the RBT has adverted to the problem.⁴⁸

Before assessing this and other difficulties with Option 2, it must be observed that appropriate recognition of interest expenses is not straightforward in tax systems which acknowledge the separateness of capital and income gains. For years, in Australia, courts and tribunals have troubled over whether interest is like any other outgoing and how to determine its fiscal nature.⁴⁹ Little can be assumed beyond the facts of individual cases. A few prefatory considerations will be advanced. Money borrowed is only a means of exchange. Inherently, money has no fiscal nature. Revenue or capital characteristics of a borrowed sum follow from the way in which it is applied. One traces the use to which borrowed funds are put.⁵⁰ Interest on a loan will be deductible under s 8-1 of the ITAA97 according to whether the borrowed funds are used for the purpose of producing assessable income, or conducting an income-producing business. *Munro* denied the deductibility of interest on borrowing which was secured over the taxpayer's business premises, because

⁴⁸ In A Platform for Consultation, 44-45; and A Tax System Redesigned, 190-191.

⁴⁹ See, for instance, *The Broken Hill Proprietary Company v FC of T* 2000 ATC 4659 (interest or purchase price); *FC of T v Brown* 99 ATC 4600 (interest after business ceased); *Steele v FC of T* 99 ATC 4242 ("*Steele*"); *Travelodge Papua New Guinea Ltd v Chief Collector of Taxes* 85 ATC 4432 ("*Travelodge*") (interest before business commenced); *FC of T v Energy Resources of Australia Ltd* 96 ATC 4356 (interest-like discounts on bills of exchange); *Australian National Hotels Ltd v FC of T* 88 ATC 4627 ("*Australian National Hotels*") (insurance premiums/interest on exchange rate risk); *Case 13* (1951) 2 CTBR (NS) (borrowings by trustees of deceased estate); *Case 46* (1944) 11 CTBR; *Case 33* (1945) 12 CTBR (interest on shareholders' debts assumed by companies); and *Case 2* (1957) 7 CTBR (NS) (whether interest is part of purchase price).

⁵⁰ The "tracing" test is associated in Australia with *FC of T v Munro* (1926) 38 CLR 153 ("*Munro*") and *Hallstroms Pty Ltd v FC of T* (1946) 72 CLR 634, 648 – "what the expenditure is calculated to effect from a practical and business point of view"; see also the recent analysis of Lord Hoffman in *Wharf Properties Ltd v Commissioner of Inland Revenue* [1997] AC 505, 511 (per Privy Council).

the Court found that the real use of the borrowed funds was unrelated to the production of the taxpayer's assessable income.⁵¹

Borrowings for business purposes raise particular considerations in tax law. Often the entire capital base of a business is financed through a loan. If a sufficient nexus exists between the capital assets of a business and the generation of income, interest on funds borrowed to acquire those assets may still be a deductible expense.⁵² This has a slightly counter-intuitive ring to it. Surely borrowings related to the "profit-yielding subject" of a business, rather than "the process of operating it", are of a *capital* nature - pursuant to Dixon J's celebrated structure/process test for distinguishing income and capital in the *Sun Newspapers Ltd v FC of T* decision?⁵³ In the following year, however, Dixon J in *Texas Co (Australasia) Ltd v FC of T* referred to an "Australian system" where "some kinds of recurrent expenditure made to secure capital or working capital are clearly deductible".⁵⁴

Costs of borrowing may be attributed with a revenue nature even though their use can be traced to the acquisition of capital assets. The reason for this lies in the "ephemeral nature" of loans themselves. Interest, the cost of borrowed funds, is payment for the use of money.⁵⁵ The use to which borrowed funds are put depends on the perspective from which the process is observed. Borrowing may simultaneously facilitate (the deductible) conduct of a business and (non-deductible) acquisition of that business's capital assets. Both revenue and capital natures are exhibited. The fiscal nature of the

⁵¹ (1926) 38 CLR 153, 171 (per Knox CJ); 196-197 (per Isaacs J); see S Chapple, *The Vexed Problem of the Deductibility of Interest Expenditure*, 13th Australian Tax Teachers Association Conference, Sydney, 2001.

⁵² *Steele* 99 ATC 4242, 4250-4251 (per Gleeson CJ, Gaudron and Gummow JJ); 5272 (per Callinan J; Kirby J dissenting) applying *Australian National Hotels* 88 ATC 4627, 4632-4634 (per Bowen CJ and Burchett J).

⁵³ (1939) 61 CLR 337, 359-364.

⁵⁴ (1940) 63 CLR 382, 468.

⁵⁵ See the analysis of Bredmeyer J in *Travelodge* 85 ATC 4432, 4441.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

outgoing depends on the perspective of the beholder. It is a form of parallax. Courts adopt the practical solution of not tracing the loan proceeds farther back than the first level of their application. If income is produced or expected in the course of business operations, the words of the general deductions provision are sufficiently satisfied and additional purposes are ignored.⁵⁶

Australian accounting standard AASB 1036 requires that borrowing costs (including interest) be recognised in one of two alternative ways. In some cases, borrowing costs can be written off as an expense in the financial year in which they are incurred. Borrowing costs, in other cases, must be capitalised as part of the "carrying amount" of an entity's "qualifying assets".⁵⁷ For the purpose, "qualifying asset" means "an asset which necessarily takes a substantial period to get ready for its intended use or sale".⁵⁸

The standard requires that borrowing costs be capitalised, rather than written off, if they are attributable to the acquisition, construction or production of a qualifying asset. Attribution depends on whether the same costs would have been avoided in the event that the expenditure on the qualifying asset had not been made.⁵⁹

There is a functional correspondence between a qualifying asset, defined by the standard, and a capital asset, defined by tax law. Both ideas serve the purpose of excluding certain expenses from the measure of an entity's economic performance in the year that the expenses are incurred. A timing lag is usually involved. It is not expected that the value of excluded expenses will be enjoyed, or fully enjoyed, in the year that they are incurred.

⁵⁶ Both the majority and the minority in *Steele* 99 ATC 4242 concurred on this: 4251 (per Gleeson CJ, Gaudron and Gummow JJ); and 4267 (per Kirby J).

⁵⁷ *Accounting Standard AASB 1036* (1997), paras 4.1 and 4.2.

⁵⁸ *Ibid* para 11.1.

⁵⁹ *Ibid* para 4.2.

Conformably with AASB 1036, one might expect the RBT to provide that interest payable on loans to acquire qualifying assets will not be subtracted from taxable income until the asset is used or sold. But this is not the case. Recommendation 4.15 in A Tax System Redesigned entitled "General deductibility of interest" provides:

- (a) That interest expenditure be viewed as the cost of maintaining access to the capital funds underlying a business and hence be deductible in calculating the taxable income in the year incurred except:
 - (i) [where it a private or domestic expense];
 - (ii) [where incurred to earn exempt income];
 - (iii) [when the interest is prepaid]; or
 - (iv) [where the borrowing relates to land owned by an individual not used for income-producing purposes].

Business interest expenditure is immediately deductible for all borrowings except those within excepted classes. A Tax System Redesigned justifies this on the basis that interest is best viewed as:

the cost of maintaining access to the capital funds underlying a business. The financial liability base of a business can be viewed similarly to, but separately from, the real asset base of a taxpayer. Given that interest expenditure does not directly change the asset base of the taxpayer, it is appropriately deductible in the year that it is incurred.⁶⁰

Option 2 is concerned with business and not private activities. It is anticipated that business taxpayers will deduct interest expenses attributable to assets on an annual basis even though no matching income gain is generated until the asset is realised.⁶¹ There is no

⁶⁰ A Tax System Redesigned, 191. Note that the "capital" word qualifies "funds underlying a business", despite the "errors" resulting from "the importation into tax law of the distinction between capital gains and revenue gains" listed in A Platform for Consultation, 45.

⁶¹ A Platform for Consultation, 44.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

requirement that a nexus exists, however tenuous, between the asset acquired and the production of business income.⁶²

The RBT intends that an interest expense will not be deductible if it is within the Recommendation 4.15 exceptions. The last one is of present significance. Interest deductions will be disallowed:

- (iv) in respect of borrowings relating to land which is used by an individual but not used for income-producing purposes (other than the realisation of a capital gain) – see Recommendation 4.13(d).⁶³

Certainly it is a major departure from the present system to allow an annual deduction for interest in respect of assets which produce no income. The idea is contrary to received tax values. Correspondingly, the authors of Option 2 may have been concerned with the potential hole that unrestrained interest deductibility would create in Option 2's cash flow/tax value base. The present system's revenue and capital distinction may be a crude device to match expenditures with future economic benefits, but it does operate "across the board" in respect of all taxpayers and all asset types. Exception (iv) to the RBT's Recommendation 4.15 is a very partial measure.

The problem is that taxpayers may seek current year deductions for borrowing expenses which relate to assets productive of recognised income only on realisation. The mismatch has troubled the Commissioner for years.⁶⁴ Growth units in unit trusts, shares, rare artworks and antiques are the sort of assets concerned – though land, particularly vacant land, is probably the best example. Perhaps this is why in respect of land alone the RBT has recognised the mismatches

⁶² A link discussed in relation to the present system by Kirby J (dissenting) in *Steele* 99 ATC 4242, referring to *Wharf Properties Ltd v C of IR* [1997] AC 505, 511 (per Lord Hoffman).

⁶³ A Tax System Redesign, Recommendation 4.15(a)(iv).

⁶⁴ See the authorities referred to in note 49 above.

which arise in the cash flow/tax value base. The exception in Recommendation 4.15(a) in para (iv) is limited to investments by individuals, effectively in vacant land.⁶⁵ Negative-gearing of the same land and other assets classes are untouched.⁶⁶ A measure of capital gains treatment in place of cash flow/tax value taxation is applied in respect of the borrowing expense in the exception so described. A regime for this is proposed as part of Recommendation 4.13, headed "private use of assets".⁶⁷

Land and buildings (other than a taxpayer's main residence) held by an individual

- (d) That, in respect of land and buildings, other than a taxpayer's main residence, held by an individual and acquired after 30 June 2000, the following treatment apply:
 - (i) include expenditure directly attributable to the land in the tax value of the land to the extent that the land is not used for income-producing purposes (other than the realisation of a capital gain);
 - (ii) [depreciate structures];
 - (iii) [apportion expense between land and structures];
- (e) That in respect of land and buildings held by an individual at 30 June 2000 the existing tax treatment continue to apply.

Inclusion of interest in the "tax value of the land" excludes the expense from treatment as a cash flow payment in the year that the payment was made. It is a small, almost arbitrary, recognition of a

⁶⁵ Land not used for income-producing purposes other than the generation of capital gains, in respect of which the regime for "discounted capital gains" under ITAA97, Div 115 would apply. Note that the Draft Legislation, s 12-20 provides that land (other than the taxpayer's main residence) is never a private asset – hence the deductibility of borrowing expenses is otherwise not precluded.

⁶⁶ Negative-gearing is excluded because the land is then used for an income-producing purpose; in relation to other assets see the reservations of the RBT in A Platform for Consultation, 45.

⁶⁷ None of this material appears in the Draft Legislation.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

problem that exists in respect of all taxpayers and (almost all) asset types.

6. RECOGNITION OF EXPENSES UNDER EXISTING LAW

It has already been noted that interest deductions referable to capital assets represent a problem which exists in the present law and under Option 2. This section of the article considers the general ways in which the problem is contained under the present law. Section 8-1 of the ITAA97 contains the well-known formula:

- 8-1(1) You can *deduct* from your assessable income any loss or outgoing to the extent that:
- (a) it is incurred in gaining or producing your assessable income; or
 - (b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

Words of this provision were transposed from the ITAA36 with very little change.⁶⁸ The language of accountants was avoided, following a decision taken at the time that the ITAA36 was drafted.⁶⁹ "Losses or outgoings" were given deductible status - not the "expenses" referred to in the language of accountants. Section 8-1 of the ITAA97 is a little cryptic. It omits to address the point of

⁶⁸ See *Explanatory Memorandum* to the Income Tax Assessment Bill 1996, 42: "[clause 8-1] essentially restates subsection 51(1) of the *Income Tax Assessment Act 1936*. Interpretation of that provision has evolved over many years in the courts. The Bill rewrites subsection 51(1) with a clearer structure but does not disturb its language and is not intended to affect previous interpretations."

⁶⁹ See Third Report, above n 15, [551]: "[W]e received a great deal of evidence in regard to the deductions allowed in respect of a trade or business ... The most extreme view expressed was that the admissibility of a deduction should be determined by the custom of accountants ... That test is impracticable. Other witnesses took a more reasonable view".

incurring a loss or outgoing. Nowhere in the section does the "purpose" word appear in a sense which bears on deductibility.⁷⁰

Functioning of the provision is suggested by a textual analysis of its terms. It is a subtle provision. The participles "gaining" or "producing" are expressed in the present tense. Contemporaneity is made the controlling idea by the drafter's choice of words. Events whereby a loss or outgoing is "incurred" are linked by a preposition and must share a temporal nexus with "in gaining or producing your assessable income". Deductible losses or outgoings must have occurred whilst "gaining or producing" can plausibly be expressed in the present tense – though, to satisfy this, the two do not need to have shared the same tax year. Contemporaneity is not that strict.⁷¹ Rather, the nexus refers to "the scope of the operations or activities and the relevance thereto of the expenditure."⁷² An outgoing must be incurred *in the course of* gaining or producing the taxpayer's assessable income, in the sense of within that activity's (temporal) scope.⁷³ Subjective purpose of a taxpayer in making a deduction claim is relevant in a subordinate way. It assists in the denial of claims which manipulate the s 8-1 legal control tests and might otherwise be maintainable.⁷⁴ The present system, in short, has a legal control test for allowable expenses which functions independently of economic and accounting theory. Expenditure items are either implicitly matched with income or excluded from its operation.

⁷⁰ See Parsons, above n 27, 6.2.

⁷¹ *Steele* 99 ATC 4242, 4251 (per Gleeson CJ, Gaudron and Gummow JJ): "contemporaneity is not legally essential, and whether it is factually important may depend on the circumstances of the particular case."

⁷² *Amalgamated Zinc (De Bavays) Ltd v FC of T* (1935) 54 CLR 295, 309 (per Dixon J).

⁷³ *Lunney v FC of T* (1958) 100 CLR 478, 498-499 (per Williams, Kitto and Taylor JJ; Dixon CJ agreeing).

⁷⁴ See *Fletcher v FC of T* 91 ATC 4950, 4960-4962, curiam.

6.1 Systematic Mismatching

Australian taxpayers have frequently sought to correlate items of income and expense in order to obtain revenue advantages. A taxpayer may seek to deduct an expense incurred to obtain income which is tax or "timing" preferred.⁷⁵ Individual taxpayers, like Joe in the above example, may seek to deduct the full measure of interest paid on a loan taken out to finance the acquisition of a capital asset, though only 50 percent of a capital gain it generates will be assessed. A variety of other timing advantages may be sought. Both corporate and individual taxpayers sometimes use immediate deductions to offset against current income from another source, even though the gain that the expenditure produces will be deferred for many years. Timing preferred gains may be moved offshore in various ways, or taken in a tax sheltered form by some other member of a corporate group.⁷⁶ During the time which elapses before a timing preferred gain is recognised for tax purposes, the taxpayer enjoys the free use of the value of the tax liability which has been deferred. Tax eventually paid may be denominated in currency which has depreciated since the deductible expense was incurred – representing a further discount for the taxpayer who astutely correlates incoming and outgoing items within the law.

Consider the character of the expenditure in *Fletcher v FC of T*⁷⁷ and the commercial reality of the association of revenue and expenditure in that case. The taxpayers were partners who sought to shelter land development profits made on the central coast of New South Wales. They decided to make "investments" in a 15 year annuity plan, whereby they made annual tax-deductible payments for annuity rights in the first five years and received in return increasing annual payments. Loan agreements were simultaneously entered by

⁷⁵ See G Cooper, R Krever and R Vann, *Income Taxation: Commentary and Materials* (3rd ed, 1999) [8-950].

⁷⁶ See Grbich, above n 7, 26.

⁷⁷ 91 ATC 4950.

the partnership to fund each annual instalment of the annuity's purchase price. The annuity provider and a related company which loaned the funds to the partnership entered an annual "round robin" transaction. The effect of these arrangements was to provide the partnership with a tax deduction in respect of the loan funds which considerably exceeded the annuity payments which the partnership received. The outward flow of funds from the scheme to the partners slowly increased as the annuity payments increased. By the end of ten years, the inward flow of cash to the partnership "tallied precisely" with the partnership's outward flow of funds to the loan provider. Thereafter the annuity became valuable. A very substantial net income of the partnership would arise in the scheme's last five years.⁷⁸ However the agreements provided a mechanism whereby they could be terminated before the partnership obtained any net income from the scheme. In the event of its default, the partnership was under no further liability to repay principal or interest to the loan provider. The partnership could vacate the arrangement some time before the last five years - at a time when it was on equal terms with the annuity and loans providers.

Legal analysis of the facts in terms of s 51 of the ITAA36 dealt with the "purpose" of the partnership in incurring the expenditure. On appeal to the High Court, deductibility of the annuity payments was held to depend on whether, in the nature of the arrangements, the partnership intended to exercise the option to terminate the annuity before it became commercially valuable.⁷⁹ Considerations for allowing and disallowing the deduction claim were nicely balanced. The Commissioner had not established that the "round robin" transactions were ineffective to achieve their legal result. Instead, a superadded criterion of subjective purpose was implied into s 8-1.

⁷⁸ Ibid 4955, curiam - reflecting the relatively high interest rates prevalent at the time that the 15 year agreement was entered.

⁷⁹ 91 ATC 4950, 4957-4958, remitting this factual matter to the Administrative Appeals Tribunal - which found that the deduction claim failed, as the scheme was not intended to last until it became commercially valuable: 92 ATC 2045.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

This legal test was the way in which the taxpayer's claim was ultimately defeated.⁸⁰

Fletcher exemplifies the sort of tax avoidance to which the accounting categories of the existing law have been subjected. Under the scheme, the taxpayer's expense payment was matched with an income-producing asset which had an ambiguous and possibly inadequate value. Option 2 would classify the annuity rights in *Fletcher* as a "financial asset" under item 7 in the Draft Legislation's s 6-40 table. Proposed s 45-80 then contains a (complicated) accruals formula for determining what the asset value of the annuity rights would be at any time during the life of the arrangement. However, the partnership's right to deduct the annual instalments of the annuity's purchase price is unaffected under the cash flow/tax value method. This is what led to the mismatch which brought the case to court. Disequilibrium between the deductible instalments of the price and the value of the annuity rights in the early stages of the arrangement is left untouched. Indeed, Option 2 would appear to confirm the partnership's right to avoid tax by subtracting payment of the annuity's purchase price from its taxable income otherwise arising. Old problems continue. Arguably a legal control test like s 8-1 is needed to defeat this type of scheme.

7. RECOGNITION OF EXPENSES AND MATCHING IN FINANCIAL ACCOUNTING

"Expenses", in modern financial accounting, generally refer to the outflow of resources.⁸¹ An expense is recognisable only where two conditions are satisfied. Both a *probable* inflow or other enhancement or saving in outflows of future economic benefits has occurred and the same must be measurable reliably.⁸² Virtually all

⁸⁰ 91 ATC 4950, 4955-4956.

⁸¹ G Pierson and A Ramsay, *Financial Accounting: An Introduction* (1996) [3.2.5], referring to SAC 4.

⁸² SAC 4.

overseas conceptual frameworks have been noted to adopt probability as the general expense recognition criterion – combined, in most cases, with a more stringent recognition requirement.⁸³ The calculus in SAC 4 is explicitly probabilistic, which reveals something about the nature of the matching exercise in financial accounting. Correlation of expenses and revenues in financial statements is more an exercise of judgment than a deduction from objective evidence.⁸⁴ Paton and Littleton describe the difficulties involved:

[T]he problem of properly matching revenues and costs is primarily one of finding satisfactory bases of association – clues to relationships which united revenue deductions and revenue ... Observable physical connections often afford a means of tracing and assigning. It should be emphasised, however, that the essential test is reasonableness, in the light of all the pertinent conditions, rather than physical measurement.⁸⁵

Adopt, for a moment, the perspective of persons who manage, extend credit to, or invest in businesses. Does it matter to them whether an item of income is derived in the same period as when a particular expense is incurred? The more important consideration is whether the accounts are a "fair and true" reflection of a business's profitability as a whole. Accounting norms have been said to "exude an enticing siren song" for persons insufficiently schooled in tax values.⁸⁶ They exude an apparent precision and exactitude missing from the concepts of tax accounting.

One must not, however, lose sight of the tax values at stake. In particular, regard must be paid to the time value of money – in a system which measures tax liabilities annually and where taxation

⁸³ SAC 4, Addendum A24; cf (US) FASB Concepts Statement No 5 (1984), para 81 and (UK) Accounting Standards Board, Draft Statement of Principles (1992), para 24.

⁸⁴ Weinman, above n 22, 428: "accounting is an art and not an exact science".

⁸⁵ W Paton and W Littleton, *An Introduction to Corporate Accounting Standards* (1940) 15.

⁸⁶ Geier, above n 16, 24.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

deferred is taxation foregone. Practical and theoretical differences have been noted between the existing law and the Option 2 approaches to the common tax difficulties in the example and variation two. Such differences in income measurement reflect long standing variances which exist between tax and financial accounting. Tax and financial accountants regard the problems of fitting capital and qualifying assets within their respective regimes in quite a different light. Tax accountants, in accord with generally accepted accounting principles and Australian accounting standards, try to squeeze increases in asset value into the annualised categories of the tax system – though in many cases this is not possible and increases in asset values are not recognised until they fit. Financial accountants are more comfortable with accruals. An asset's increasing values can and should be recognised over as many years as is required.

8. DIFFERING OBJECTIVES OF TAX AND FINANCIAL ACCOUNTING

Tax accounting is primarily concerned with the determination of taxable income in a fair, timely and efficient way. Consistency is considerably more important than precision in measuring income for tax purposes.⁸⁷ Fairness considerations are of high significance. Subjective judgments, estimations and the making of provisions for future events are alien to the task.⁸⁸ Annual taxation liabilities must be established as a matter of law. A measure is taken of what has transpired, not what is contingent or even likely to occur.

Financial accounting, by contrast, has objectives which cause it to be more prospective in approach. In the early twentieth century, accountants mainly prepared commercial balance sheets to serve as guides for creditors - often bankers considering loan applications.

⁸⁷ See W Raby and B Raby, "Consistency, Matching and Economic Performance" (1996) 71 *Tax Notes* 923, 923.

⁸⁸ See S Cohen, "Accounting for Taxes, Finance and Regulatory Purposes – Are Variances Necessary?" (1966) 22 *Taxes: The Tax Magazine* 780, 785.

Then, as the century progressed, compiling financial information for present and prospective shareholders became an equally significant part of the accounting role.⁸⁹ Conservatism and prudence were appropriate orientations in all roles. Setting aside provisions for likely future events is a prudent necessity in order to give a "fair and true" account of an enterprise's profitability over a period. By contrast, the tax accountant's "snapshot" of performance in a one-year tax period is likely to mislead.

Different treatment of employees' accruing leave entitlements provides an example of this point. Financial accountants will appropriately make provision in an accounting period for an employer's future liability to pay leave earned during that period, even though the leave is not paid or payable by the period's end.⁹⁰ Employee leave entitlements are a cost matched with revenue generated during an accounting period in order to provide a correct reflex of the taxpayer's economic performance during that time. However, s 26-10 of the ITAA97 states that deductions for employee leave entitlements are only available in respect of amounts actually paid to the persons to whom they relate in the relevant income year. Financial accountants measure economic performance. Tax accountants measure money flows. Though each approach is referable to a one-year reporting period, different results will follow.

Financial accounting standards require that likely future events be valued and included in the computation of a year's performance. Tax accounting principles, together with legislative enactments, are confined in scope to legal events which have occurred in a reporting period and to increases in asset values that have become recognisable during that time.⁹¹

⁸⁹ Ibid 783.

⁹⁰ In accord with *Accounting Standard* AASB 1028 (1994), paras 11-13.

⁹¹ As well as the recognised accruals for Option 2 described in Items 1, 2, 7 and 9 in s 6-40: see note 32 above; and Cohen, above n 88, 783-784.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

Conformity of tax and financial accounting has been the subject of debate for years. Sheldon Cohen, a former US Commissioner for Internal Revenue, has observed that,

[o]ne of the most common criticisms made by businessmen is that the determination of their annual federal income tax liability is not based on the accounting system that they use for their financial statements.⁹²

The RBT states that the Australian business tax system would be streamlined if only one set of accounts needed to be prepared for both tax and financial purposes.⁹³ Certainly the removal of a requirement that taxpayers keep two sets of books would seem to simplify the accounting task.⁹⁴ One financial accountant says that the integrity of the self-assessment system would be strengthened if variances between tax and financial accounting were only to result from legislative policy decisions.⁹⁵ The RBT puts the matter even higher. Alignment of taxation law with accounting principles will "optimise" commercial decision making:

so that business investments are made on the basis of sound commercial considerations, as free as possible from distorting tax influences.⁹⁶

Meeting tax liabilities and administering the system will be simpler, fairer and more efficient and the unworthy tax avoider will have no place - a pleasant prospect for the authors of the RBT – though the realism of this has been doubted by many of those who have written about tax and financial accounting. Some of their reasons are gathered under the following headings.

⁹² Cohen, above n 88, 780.

⁹³ A Tax System Redesigned, 155.

⁹⁴ Porcano et al, above n 18, 500.

⁹⁵ Nolan, above n 17, 768.

⁹⁶ A Platform for Consultation, 6.

8.1 Certainty

Use of a single set of accounting principles in both tax and financial accounting may not create additional certainty because of the inherent nature of the accounting principles. Appearances are deceptive. The body of Australian accounting standards is packaged in a way which is at odds with the generality of individual standards and the extent to which variant practices are permitted. Surprisingly little specific is prescribed in the multi-volume set, now arranged with code-like formality.⁹⁷ Only to a limited degree are the standards an articulated structure of norms based on common practice. Commentators until lately were apt to deny that agreement on accounting principles would ever be possible.⁹⁸ Financial accounting as a discipline was said to be too various and disparate in its response to economic conditions to be reduced to rule. Then, in Australia, a change occurred. The quasi-governmental Accounting Standards Review Board was commissioned in 1984 to secure a measure of general acceptance for accounting standards and make recommendations for their legislative recognition.⁹⁹ Compliance with "approved accounting standards" then became obligatory for company auditors pursuant to the *Corporations Law* - subject to their overriding discretion to dispense with compliance if it would not

⁹⁷ See the CPA Australia and The Institute of Chartered Accountants in Australia, *Accounting and Auditing Handbook 2001: Statements of Accounting Concepts and Australian Accounting Standards*, UIG Abstracts, Auditing Standards and Statements.

⁹⁸ See A Blaikie, "The Relevance of Accounting Principle to the Income Tax Assessment Act" (1981) 15 *Taxation in Australia* 690, 691; and C Westworth, "Accounting Standards – a Framework for Tax Assessment" (1985) 2 *Australian Tax Forum* 243, 245-247.

⁹⁹ Following a "spectacular series of crashes of corporate financial empires": see R Craig and R Clark, "Phases in Australian Accounting Standards Setting: Control, Capture, Co-existence and Coercion" (1993) 3 *Australian Journal of Corporations Law* 50, 53-54. Objectives stated in Accounting Standards Review Board, "Procedure for the Approving of Accounting Standards" (1985) *ASRB Press Release 2000*, 5.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

give a "fair view" of a company's affairs.¹⁰⁰ This discretion was removed in 1991.

From a different perspective, the control and uniformity possessed by accounting standards may only be illusory. The standards embody rules which are couched in unenforceably vague and general terms. Where reporting and disclosure are concerned, accounting standards have been described as "conceptually unsustainable, anodyne directives ... primarily ritualised platitudes".¹⁰¹

Openness of texture in the standards becomes particularly apparent when one considers the remarkable number of "acceptable" permutations allowed from the several accounting treatments for individual items that the standards authorise.¹⁰² There seems to be no agreed sense of the terms "accrued" and "accrue" amongst accountants - despite the centrality given to these concepts in the Option 2 Draft Legislation.¹⁰³ Accounting standards, whilst appearing to have a wide, obligatory application, are of more limited use in preventing "creative" or "cosmetic" accounting for the purpose of manipulating regulatory schemes. Little guide is provided where treatment of an item is disputed between a taxpayer and the tax authority.¹⁰⁴ Schemes of the type used in *Fletcher* transgress no accounting norms.¹⁰⁵

The US Supreme Court in *Thor Power Tool Co v Commissioner*¹⁰⁶ as concerned with the tax accounting practices of a manufacturer of hand-held power tools and accessories. An

¹⁰⁰ See *Corporations Law*, s 304.

¹⁰¹ Craig and Clark, above n 99, 58.

¹⁰² Ibid 59.

¹⁰³ See W Raby, "The Meaning of 'Accrued' – Accounting Concepts Versus Legal Concepts" (1992) 67 *Tax Notes* 777.

¹⁰⁴ Discussed in Porcano et al, above n 18, 501-502.

¹⁰⁵ 90 ATC 4559; see note 77 above.

¹⁰⁶ (1979) 439 US 522.

overvaluation of the corporation's inventory in its books of account was one of the agreed facts. "Excess" inventory was written down to scrap value - even though some of these items continued to be sold at original prices. Taxable income in the year of the write-down was dramatically reduced. Although the write-down conformed to then "generally accepted accounting principles" and "best accounting practice", as the US Code required,¹⁰⁷ the Supreme Court nevertheless agreed with the Commissioner and disallowed the write-down in its entirety. It had this to say about accounting standards:

[A] presumptive equivalency between tax and financial accounting would create insurmountable difficulties of tax administration. Accountants have long recognised that "generally accepted accounting principles" are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions. "Generally accepted accounting principles", rather, tolerate a range of "reasonable" treatments, leaving the choice among alternatives to management ... Variations of this sort may be tolerable in financial reporting, but they are questionable in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax. If management's election among "acceptable" options were dispositive for tax purposes, a firm indeed, could decide unilaterally – within limits dictated only by its accountants – the tax it wished to pay. Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable.¹⁰⁸

8.2 Simplicity

Certainty and simplicity together affect administration and compliance costs. Tax systems, in the nature of things, should be economical to administer and convenient for those whose duty it is to comply.¹⁰⁹ Conformity of tax to financial accounting would prima facie avoid the need of many business taxpayers to obtain both tax

¹⁰⁷ Ibid 532 (per Blackmun J for the Court).

¹⁰⁸ Ibid 544.

¹⁰⁹ See Smith, above n 23, 351-352.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

and financial accounting assistance in the preparation of their annual accounts. The entire exercise could be conducted as one. However, as the expense of auditors would very possibly increase in proportion to their new responsibilities, only a small economy might be apparent at the end of the day.

Costs of administering the tax system from the regulator's perspective would possibly be affected quite negatively. It has been suggested that time consumed in unscrambling the variety of methods permitted to accountants for the reporting of identical transactions would increase under the accounting standards regime.¹¹⁰ In making an inference from simplicity to lowered tax administration costs one must acknowledge that:

[T]ax returns would still need to be processed, and it is unlikely that conformity would affect the efficiency with which they are processed. The need for tax audits would also remain. However, costs would be reduced to the extent that conformity reduced taxpayer/IRS/ATO disagreements. Reductions in disagreements require reductions in uncertainty of correct treatment and in grey areas. It also requires a change in CPA's perceptions about fairness of tax accounting methods. Conformity might produce increased perceptions of fairness, although this is not assured ... however it is unlikely that [conformity] would produce a reduction in choices and areas of uncertainty.¹¹¹

8.3 Authority

The work of accounting standard setting bodies will be invested with a new importance if income tax liabilities and accounting standards are linked. Decisions by the Australian Accounting Standards Board ("AASB") could potentially equal changes to income tax legislation, assuming that the financial accounting treatment of a receipt, payment, asset or liability item conclusively

¹¹⁰ See Cohen, above n 88, 786.

¹¹¹ Porcano et al, above n 18, 503.

determined its tax treatment. Alterations in accounting theory will potentially affect the size and timing of income tax liabilities.

Two observations can be made. First, no Australian government is likely to cede a large part of its revenue authority to the AASB without bringing that body under its control, either wholly or in part. This will mean a loss of independence, both for the AASB and the accounting profession generally. Development of accounting standards after the acceptance of Option 2 would doubtless involve the balancing of non-accounting considerations to a much larger degree. Secondly, on democratic grounds, after the acceptance of Option 2 there needs to be a procedure for determining taxpayers' claims to have accounting standards changed or overturned. The AASB is not an elected body. An accounting standards court with jurisdiction to amend or override the AASB's pronouncements may be required.¹¹²

8.4 Fairness

Fairness, tax justice, perhaps should arguably be the first imperative in all tax systems.¹¹³ Advantages of certainty, simplicity and authority arguably are all subordinate to what fairness and equity require. Fairness to taxpayers is an explicit objective in many of the existing features of income tax legislation - particularly those that bear on the timing of tax events and the measure of income derived.¹¹⁴ The realisation principle examined in this article is another example.¹¹⁵ Capital assets are recognised at cost until a realisation event occurs. There is no financial accounting justification for this. Accounting standards recognise qualifying assets for the much more instrumental purposes that applicable

¹¹² Ibid 504-505.

¹¹³ Though in *A Tax System Redesigned*, 13 "tax equity" was put the second to "optimising economic growth"; see generally Raby, above n 103, 777.

¹¹⁴ See discussion of the example and variation two and Raby and Richter, above n 22, 44.

¹¹⁵ See note 25 above.

OPTION 2 – PROBLEMS IN CONCEPT AND PRACTICE

accounting policies prescribe.¹¹⁶ Option 2's allowance of decreasing adjustments for such things as exempt income, contributions to charity, accelerated depreciation and research and development expenses would not go far towards implementing the existing tax fairness regime.¹¹⁷ If the timing of tax events and their measurement is the main practical variation, the difference at a deeper level is one between law's normative categories and accountancy's purely descriptive reference.

9. CONCLUSION

Tax accounting and financial accounting perform different work, for different users and have different imperatives. Excessive deductions allowed under the Option 2 formula pose a serious threat to tax values associated with matching items of income and expense. Systems of tax and financial accounting respond quite differently to the exigencies of one-year tax and reporting periods - which is understandable when one considers the different purposes that each serves. Based on financial accounting, Option 2 simply is not suited to the measurement of income for tax purposes. Existing categories are better suited to the task.

¹¹⁶ AASB 1001; eg ensuring that the *substances* of underlying transactions are reported, that *relevant* financial information is provided, which *reliably* convey the facts.

¹¹⁷ See Explanatory Notes, 57-62 and Table 3.7.