

# BRAD

## Chapter 1



# REDESIGNING THE TAX CODE FOR TAXING INVESTMENT INCOME

## BRAD

### Chapter 1: redesigning Brad's country's complex tax code for taxing investment income

Brad is involved in the funny business and excitement of taxing investment income: the income that comes from saving for future living rather than consuming now.

This chapter works through the trials and tribulations of our very dedicated tax policy team, Claudia, Brad and Sami, as they try to meet the Tax Minister's call to shorten and simplify existing complex income tax law that taxes investment income.

At least some in the team believe this requires principle-based law that promotes fairness and efficiency (minimal impact on decisions).

In order for the team to fix on design with these characteristics that simplifies the relevant tax code, the team has to work through a number of issues like: the difference between income taxation and expenditure taxation; design requirements of taxing investment income to achieve fairness and efficiency; the make-up of investment income, including the difference between capital and current costs; and, alternative ways to specify taxable income that are principle-based yet practical expressions of investment income.

Amazingly, the tax code in Brad's country has close similarity with that in Australia. And, the 1999 Ralph Review in Australia (see Preface) contains recommendations aimed at achieving what Brad's minister wants.

Consequently, that review is a useful reference, as is material produced by Australia's Board of Tax (2002), incidentally, a body established on the recommendation of the Ralph Review itself.

Dr Claudia, look at this mass of complex income tax law on my desk!

See what can you and your tax policy team can do about this, focusing on business income taxation.

We're on it, minister.



Brad and Sami, the Tax Minister has given us some challenging work to do on income tax.

It's not to do with the taxing of wages and its interaction with the welfare system.

Oh, no!

Sounds exciting, Claudia.



We are going to focus on the taxing of investment income: the income that comes from saving, which is synonymous with investing when dealing with income taxation.

Grown..

Sounds exciting, Claudia.





The Tax Minister wants us to simplify the complex and dense tax code we have for taxing investment income.

We will have to bed the aim of simplification within the usual tax policy principles of efficiency, or the minimisation of tax impact on investment decisions, and fairness.

In fact, we will focus a lot on tax design with neutral impact on decisions. Fairness comes naturally from applying neutral tax design to people's annual income regardless of source of the income.

Fairness relating to people with different levels of income then puts a focus on progression in the personal tax rate scale.

I can feel some impractical theoretical purity coming on.



Overall then, we'll have to first be very clear on neutral tax design, then search for associated simplification in practical expression of that design.



Oh, this is so exciting!



I'll get you together when I've given more thought to the task ahead.



Long hours ahead, again!

It will be all good, Brad.





## What does taxing investment income encompass?

So, Sami, we are looking at the taxing of income from investments.

What? From my fridge? From my car? I'm also investing in a uni course to improve my job prospects.

Trying to measure and tax yearly net benefits to you from a dying fridge or, say, an unusual uni course would not be fruitful, Brad.

Mind you depreciation would be allowed on new appliances in rental properties or business premises.

And, higher-value collectables, like antiques, and personal use items, like yachts, may be taxed on capital gains realised on sale - but with no attempt to measure and tax yearly net benefits from them.

Obviously, Sami, all income tax systems have to recognise practical difficulties and sensitivities in their design.

And differences in design are inevitable as additions and changes are made to the law over time.

That's an issue right there, Brad. I'm looking forward to discussing principle-based design to tax income across commercial opportunities funded by borrowing or people's wages not being used for current consumption.

Those opportunities might be direct investments in interest-bearing accounts, business operations in various industries, and so on. Or, they might be indirect investments via, say, companies, family trusts or mutual funds.

Not my family home though!

Not sure, Brad. I could imagine Claudia raising that at some stage.

Hmmm!



People are often arguing that capital is being taxed more or less than income.

Funds, including from wages, which are used to acquire investment assets, are termed the capital invested.



So, you can call taxing investment income a tax on "capital" as opposed to a tax on wages, or "labour".

But whatever you call it, income tax applies to investment income, just as it applies to wages.

And don't confuse the term "tax on capital" with a tax on capital gains of investment assets.

Capital gains on investment assets are just part of investment income.



Yeah, right!



What about saying taxing investment income is "business income tax".



So long as you appreciate that incorporates individuals investing in bank accounts, shares, et cetera.



I suppose you could say it's mainly about taxing the income or profit from the "business", or commercial, investments of any investor.



She's been studying tax theory too long!!



OK guys, taxing investment income simply equates to taxing the commercial profit from taxable investments made by any individual or investment vehicle.

I bet these two have been talking.

That's easy to say, but the provisions covering all related issues comprise most of the thousands of pages of our complex income tax law.



It would be unfair not to tax the investment income of someone who is living off that income when others are taxed on the wages income that they live off.



And unfair not to tax higher investment income more, just as higher annual wages are taxed more.

In addition, as I said before, ideally we would want investment income to be taxed without having much impact on investment decision-making.



Oh, yeah!



We would want minimal impact on decisions about which investments to choose and related decisions like debt versus equity financing, business structure, and so on.

The result would be minimal impact of the tax on productivity and therefore on long-term economic growth.



Oh, yeah!

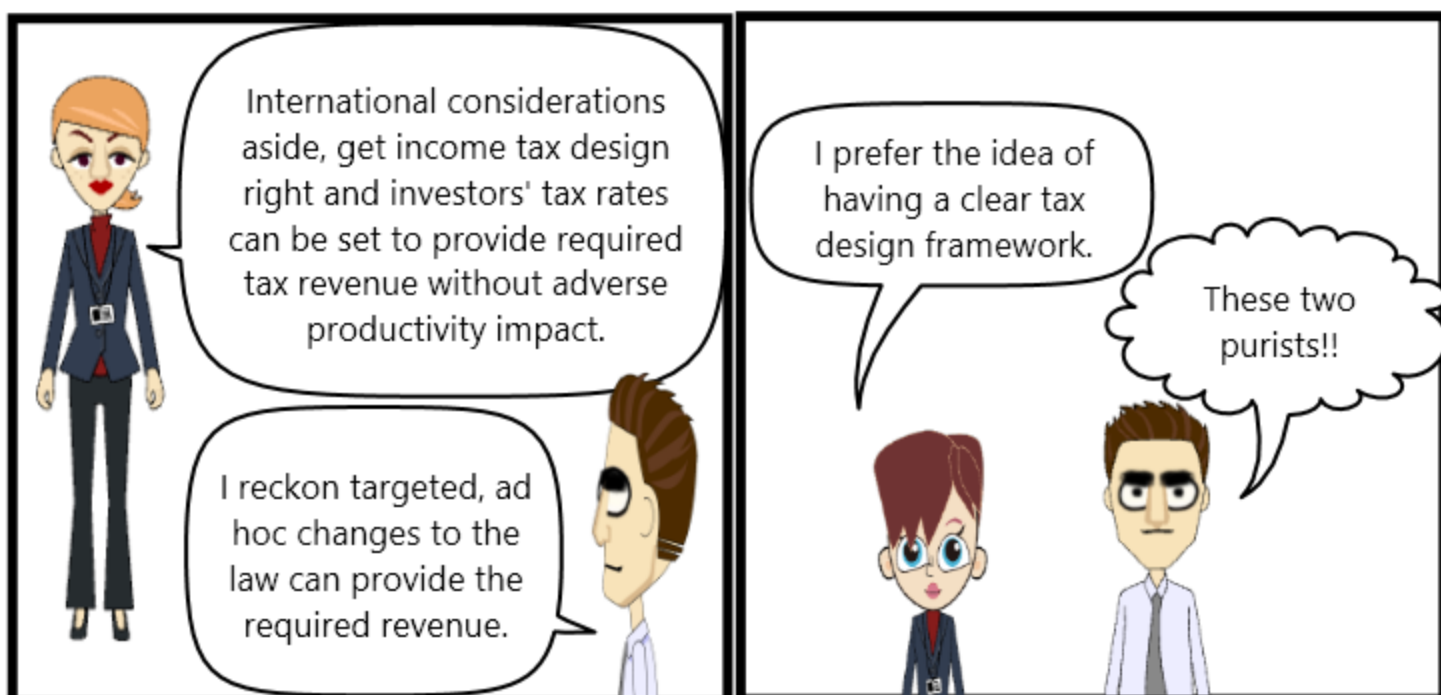
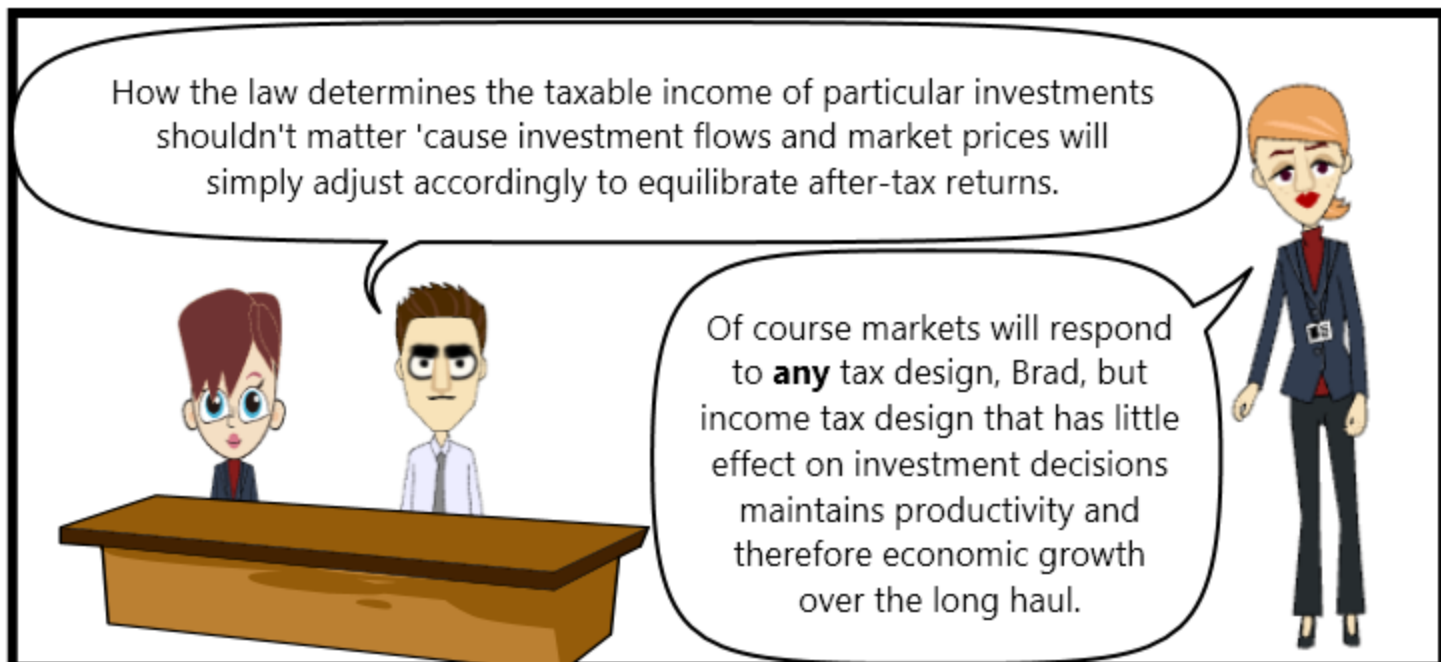
Spot on, Sami.



That's the efficiency principle of tax, to go with the fairness principle.



## Taxing investment income with neutral impact





## NEUTRAL INCOME TAX

Shortly put, the way to keep investment decisions unchanged by income taxation is to take the same percentage of tax from annual commercial profit across all alternative investment opportunities of each investor.

How can the same percentage tax take possibly be achieved?

The percentage is the investor's marginal tax rate.

Say, the investor's tax rate is 50%.

50% comes off the investor's interest from a bank account.

50% comes off the investor's annual return, or profit, from a rental property investment.

50% comes off the investor's annual profit from investing in farming, mining, and so on.

10% to  
5% post-  
tax

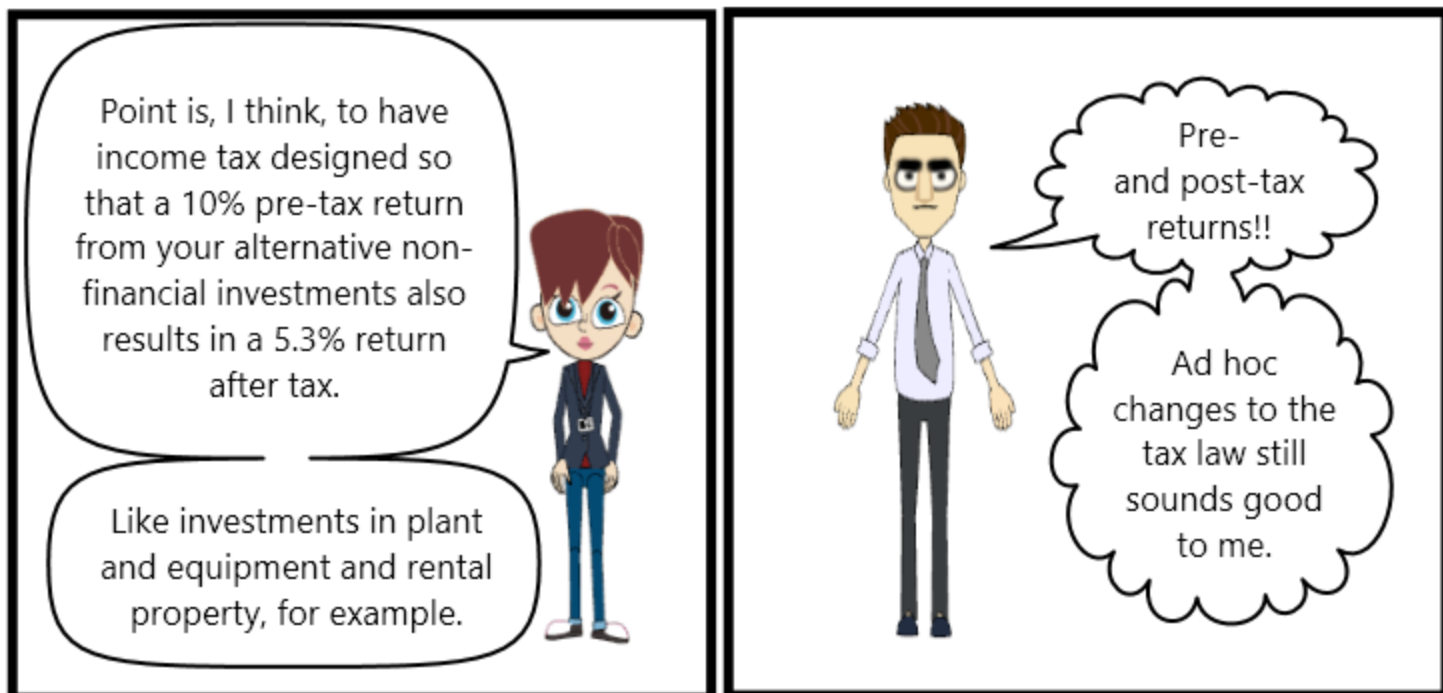
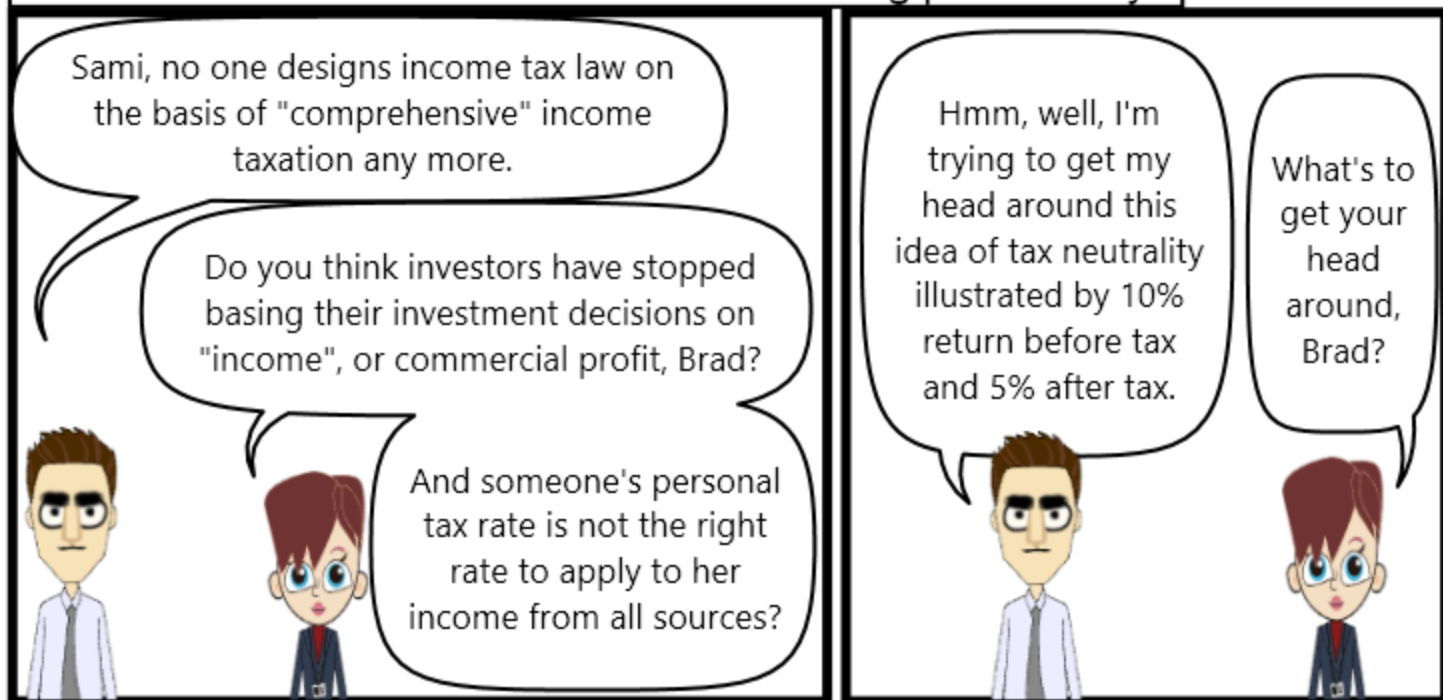
So, for this investor, a 10% annual return, or profit, before tax across all local, similar-risk alternatives becomes 5% after tax. You can see that the investor's decisions should be little affected by the tax.

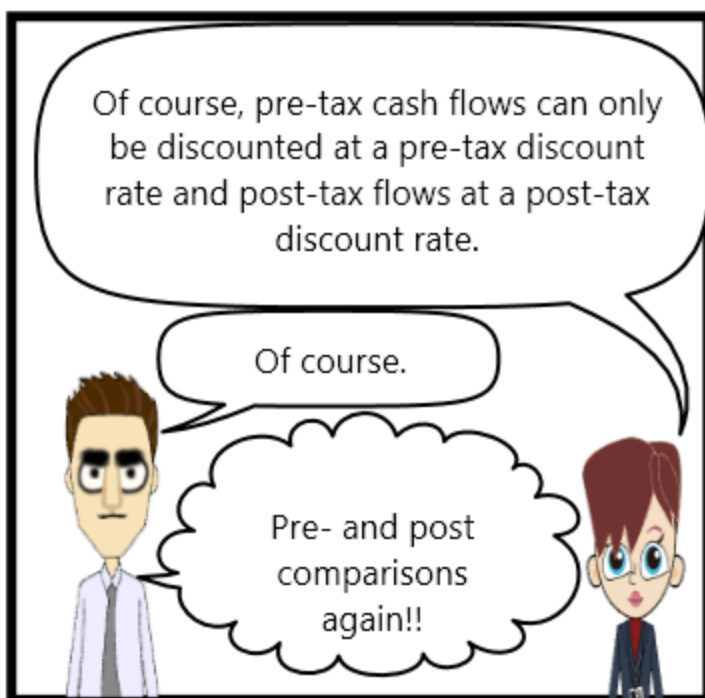
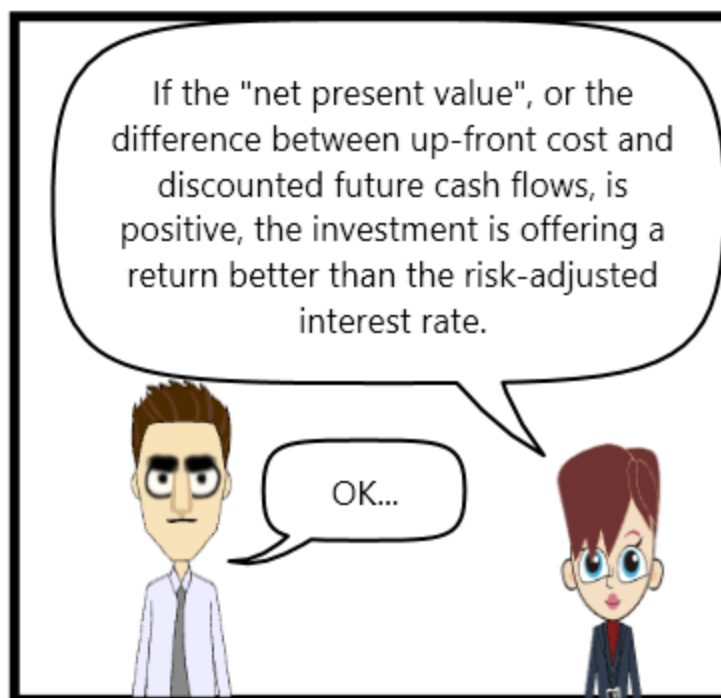
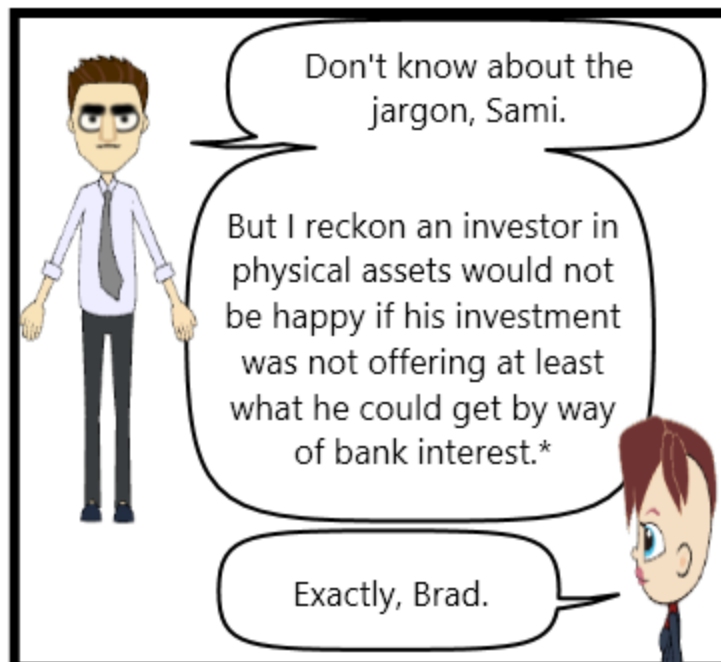
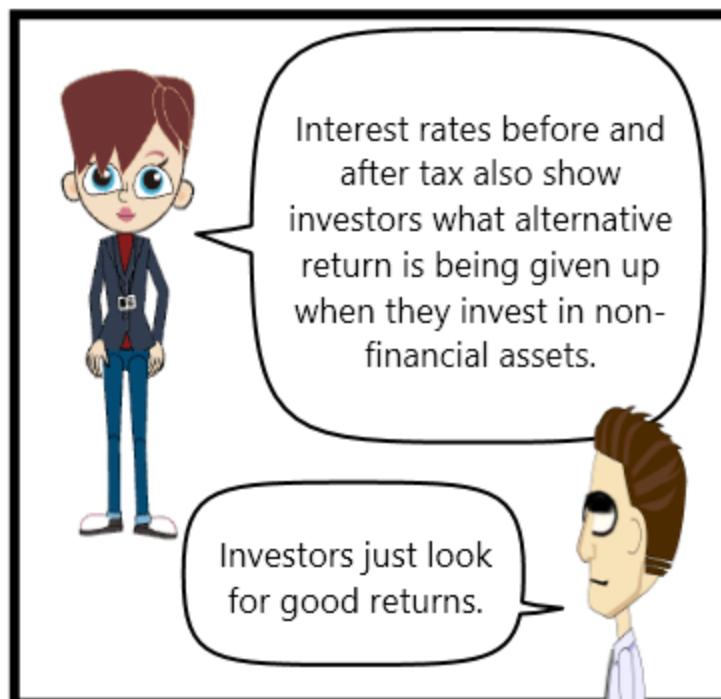
That's just saying tax assessments for a year should include that year's commercial profit from all the investments of a taxpayer.

Gaah! That's "comprehensive" income taxation!

What's wrong with that, Brad?

Not seeking to apply income tax in this way implies a modular, or differential, treatment for different categories of investment income. Let's take a break on that important note.





\* At this margin,  $\text{return\%} = \text{interest\%} = \text{financial cost of capital}$ .



## Income versus expenditure taxation

Sami, for commercial profit, why not just take the difference between annual gross receipts from each investment and all investment costs, both capital and current, in the year?

Call that "income" and tax it. Now, that is simple.



Say, people invest \$100 of their wages in Year 1 to get \$110 in Year 2, or a 10% return over the year.

You're saying they can deduct that \$100 of capital expenditure in their Year 1 tax returns?

The \$100 of wages would then be tax free in Year 1.

What happens in Year 2?

They pay tax, let's say at 50%, on the \$110 they get in Year 2 when they pull their money out.



That's just a delayed tax on wages, Brad.

It's an expenditure tax, or cash flow tax, which does not tax the regular 10% annual investment income at all.

No tax on the 10% return?

Discount the \$55 tax paid on the \$110 payout in Year 2 back at 10% pa to Year 1, or \$55 divided by 1.1, and you'll get \$50, the amount of tax that would have been paid at 50% on the \$100 of wages in Year 1.

It's just like taxing the wages up front, as with payroll taxes, or when spent, as with the GST.

!?!

No tax on regular investment returns would mean that decisions won't be affected as to whether to consume now or to invest to consume more later.



There would not be the tax on saving that income tax imposes.

And, if the investment happens to produce higher than regular returns given the risks involved, the extra returns will be taxed.

That extra amount of return is called economic rent you know.

Certainly taxing annual income or profit from investments will affect people's decision about whether to consume now or save and invest for the future.



Also, taxing investment income imposes tax on both regular income and any economic rent.

But, I've heard Claudia say that, paradoxically, this need not affect the decision to invest.

Sami, you skip the effect of income tax on consumption versus saving and make it sound like an ideal tax with no effect on investment while taxing economic rent as well.



Of course, varieties of cash flow taxation are specifically designed to impose extra tax on economic rent.

And taxing income without affecting investment decisions depends decidedly on the "income" actually being taxed.

Which begs the question: what is the make-up of investment income or commercial profit? I'm going to discuss with Claudia.

Claudia, taxing people's investment returns everywhere at their marginal rates should leave investment decisions little affected. Right?

Right - through the same percentage reduction in returns everywhere.

Like that 10% pre-tax to 5% post-tax outcome we discussed earlier.

But reducing investment returns will affect people's decision about whether to consume now or save and invest for the future.

If I consume my after-tax wages, no more income tax applies - but, returns from investing my after-tax wages would be taxed.

Brad says it's a tax on saving.

It's not a tax on saving. It's a tax on the accretions to wealth, or income, from saving.

The issues around consumption versus saving arise simply because investment income **is** being taxed.

So, decisions about whether to consume now or save will be affected.

Just as both income and expenditure taxes affect decisions over unpaid activities not subject to tax versus work with tax involved.

Brad reckons the distortion on saving versus consumption can be fixed by giving some sort of income tax break to interest returns.

Big problems with that, Sami! The distortion is an inherent characteristic of income taxation.

We will be seeking design for taxing the income from investments that achieves the same 10% pre-tax to 5% post-tax outcome as does taxing regular interest income.

Mess with that pre- and post-tax outcome for regular interest income - the basis of discount rates for judging investment viability - and the notion of investment-neutral income tax design is disrupted.

Income tax's inherent consumption/saving distortion is the source of people's view that income tax is very distortive, or damaging, relative to other taxes - and modelling is often used to estimate the size of the distortion.



Despite the potential of the tax to be investment neutral?

There are also broader effects from taxing investment returns, accompanied, of course, by deducting interest costs.\*

Some people, for example, may borrow more to fund their investments so as to maintain desired current consumption levels.

There are also general effects from re-distributing the tax proceeds.



Maybe macroeconomic modelling could show these effects, including the investment neutrality of sound design on the domestic scene.

Crucial to such modelling is incorporating the cut in investors' discount rates caused by the tax.



But, regardless of economy-wide effects of taxing investment income, the aim remains the same of achieving investment-neutral income taxation by taxing commercial profit across all investments.

Fairness and efficiency depends on achieving that aim.



So, we want the practical specification of taxable income that provides neutral treatment across the various forms of saving, or investing.

Right on, Sami.

We'll resume the team meeting on that very issue.



Oh, I just love this tax design work so much.



\* Swan (1976), p 173.



## What does investment income comprise?

### ALIGNING TAXABLE INCOME WITH INVESTMENT INCOME

Income tax is not like an expenditure tax which has all investment costs immediately deductible regardless of whether they are capital or current costs.

Talking together again I bet!

We saw earlier the ideal of having investors' tax returns capture their commercial profits in the year the profits arise.

Which just says income tax law should actually tax annual income.

Exactly, Brad.

Each investor is investing on the basis of future commercial profit.

So we would like income tax to take a uniform slice from the investor's prospective annual commercial profit across all investments, at the investor's tax rate.

So, we want taxable income to match annual commercial profit from investments.

Producing that result of 10% pre-tax return going to 5% after tax.

Pre- and post-tax returns again!

The income tax law, as drafted by lawyers, is currently collecting tax.

But can we better align taxable income with commercial profit from investments?

Always the purist!

Claudia, I've been thinking more about investors whose 10% pa pre-tax return on investments is reduced to 5% pa after tax because their tax rate is 50%.

Here we go!

Good on you, Sami.

The 10% pa return could come from \$1000 earning \$100 income in a year, with the investor receiving \$1100 at the end of the year.

Right.

The \$100 of annual income or profit is taxed then at 50%, resulting in the 5% post-tax return.

\$1000 to get \$1100 before tax becomes \$1000 to get \$1050 after tax.

Yes.

I've realised that the value of the investment is not changed by the tax.\*

Before tax, \$1100 discounted at 10% to the start of the year is \$1000, giving zero net value with \$1000 invested.

After tax, \$1050 discounted at a 5% post-tax discount rate is still \$1000, giving the same \$0 net value.

$$\text{\$1000} = \text{\$1100}/1.1$$

$$\text{\$1000} = \text{\$1050}/1.05$$

$$-\text{\$1000 invested} = \$0$$

Exactly, Sami. When income and discount rate are cut by the same rate, values of investments are unchanged.\*\*

This is a key illustration of the potential of income tax to be investment neutral.

But how do we measure and tax the \$100 of income correctly across different investments?

These two - at it again!!

\* Samuelson (1964).

\*\* Swan (1976), p 172.

The return or profit from a \$1000 investment comes only from any net receipts produced and the potential sale value of the investment.

So, the investment could produce a 10% return over the first year simply by increasing in value by \$100 to \$1100.



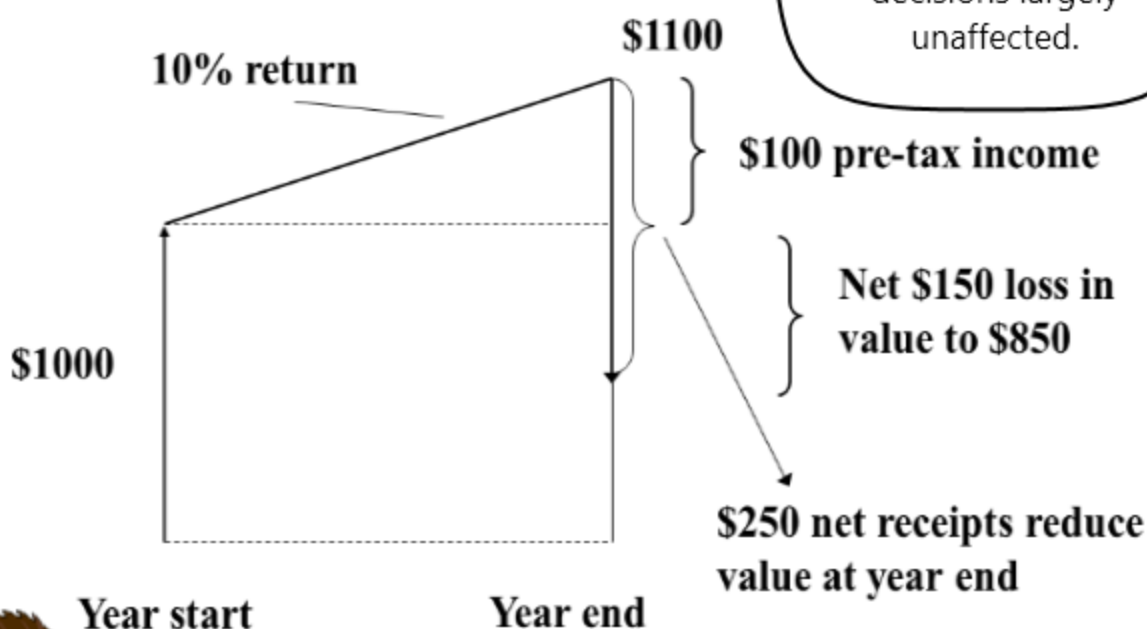
Or, the 10% return could come from, say, \$250 net receipts produced which cover a \$150 loss in asset value, leaving \$100 net profit.

In either case of appreciating asset or depreciating asset, the annual pre-tax profit is \$100; that is, a 10% return on the \$1000 invested.



Here is an illustration of the \$100 profit giving a 10% pa return from either: value increasing to \$1100; or, the \$1100 coming from \$250 of net receipts plus final \$850 asset value - value declining from \$1100 by the \$250 of net receipts\* that a buyer could no longer access.\*\*

It is that \$100 of profit that the income tax law would be taxing everywhere at each investor's tax rate to keep investment decisions largely unaffected.



Yikes, accrued capital gains taxed if the appreciating asset is not sold at year's end!



And accrued capital loss, or depreciation allowed as a tax deduction, if the depreciating asset is not sold at year's end.



The illustration of a 10% return from different assets tells us how to define taxable income so that it captures individuals' annual commercial profit from all their investments.

Most are relaxed about the illustration telling us to include net receipts in taxable income; that is, annual gross receipts from investment assets less **current** costs.

Unlike **capital** costs, which create assets, current costs are all used up in the year....

....like the maintenance costs of rental properties.

But income also includes change in value of assets

Even if the assets are not sold?!!

Brad, income does not suddenly change because an asset is sold - this is about taxing income not cash flow.

To take rental property, everyone agrees with a depreciation deduction for estimated decline in value of the house over a year.

But, symmetrically, if the value of the land increases over the year, the owners feel the benefit of this increase in their wealth as part of their income.

ANNUAL GROSS RECEIPTS  
LESS CURRENT COSTS

PLUS

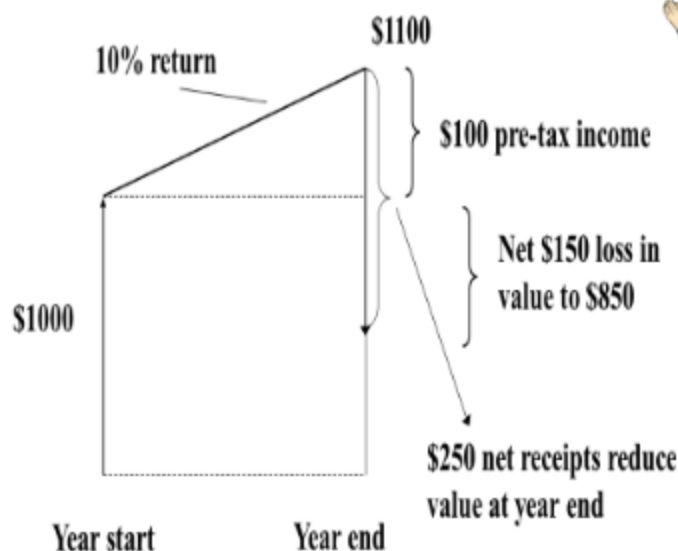
ANNUAL CHANGE IN VALUE  
OF ASSETS (AND LIABILITIES)

So, this is annual "income" that the income tax law would ideally be taxing.

With value change measured for each asset, and liability, held both at the start of, and acquired during, the year

Nice to have a clear framework.

There it is: tax accrued capital gains?!



For our minister, we are initially focusing on simplifying the income tax code without necessarily changing its effect.

But let's take this opportunity to see some tax insights that come from aligning taxable income with this general representation of annual profit from assets; that is net receipts plus change in value.\*

No special treatment of "saving". For income tax purposes, saving is investing. Taxing selected income less, like financial assets' interest returns (which drive discount rates), must distort the pattern of investments.

Taxing real, rather than nominal income, would require inflation adjustments - opening value times annual inflation - to apply not only to appreciating assets but to depreciating assets and financial assets and liabilities. The inflation adjustment, for example, would turn nominal into real interest.

"Negative gearing" of rental properties is not a "tax break". The current ability of taxpayers to write off tax losses (say, current interest and maintenance costs greater than property rents) from one investment against other tax profits, including wages, enables the current value of the losses to be obtained. Such giving back to the downside is important to balance the taxing of the upside. Including accrued capital gains of rental properties in taxable income might turn many annual tax losses into tax profits.

Special income tax treatment of small business creates distortions, artificial boundary lines and adds complexity. Simplicity calls for the same measure of taxable income to apply to all investors.

And, of course, in that measure of taxable income, current expenses are immediately deductible, but the treatment of capital costs depends on change over time in value of assets acquired.

Everyone knows that negative gearing is bad, small business needs special treatment and capital gains need inflation adjustments.

All this from one figure!

\* For marginal investments, the 10% = financial cost of capital..

\* ..and, the \$250 = annual user cost of capital.

## Current versus capital costs in taxable income



So, with an income tax, the boss says current costs are immediately deductible but capital expenditure on assets is not.

That's right, Brad.

But both types of costs support business profit.

Sure, but expenditure creating or buying an asset does not immediately change annual profit. It's just an asset swap.



The impact on profit of capital expenditure comes from the year-by-year change in sale value of the associated asset.

Sale value may increase or decrease depending on expectations of future cash flow from the asset at the time.



But current costs of, say, maintaining the asset or selling product reduce profit in the year of expenditure.

These costs, that are all used up in the income year providing benefits in that year, are rightly immediately deductible.



As Claudia said, it is the annual change in value of an asset - either up or down - that affects annual profit, not the cost of the asset itself.

So asset cost is not immediately deducted from taxable income.



Sounds like hard work!



This is what the taxing of investment income is all about.

Aligning taxable income, as far as practicable, with annual gross receipts less current costs plus annual change in asset value.





What a hassle, having to distinguish between capital and current expenditure when working out taxable income from investments.

I'm pretty sure the Tax Minister will want to tax people's regular investment profits, Brad.



And then the distinction is crucial between capital costs of acquiring assets that produce future benefits and current costs that only produce immediate benefits.

Take that asset that produces \$250 of net receipts in a year, comprising gross receipts from sales less current costs.



As we saw, if the asset producing the \$250 of net receipts declines in value over the year by \$150, the annual commercial profit is \$100.

Which matches taxable income if current costs are deductible from assessable receipts and asset depreciation allowed is \$150.



Capital expenditure, resulting in investment assets, provides benefits beyond the current year - so it is the change in asset value that affects profit, and, ideally, taxable income.



Current costs are all used up in a year providing immediate benefits and reduce profit in that year, as well as taxable income.



At least we know wages will always be immediately deductible.

Not necessarily, Brad.

What? No!







It's not the character of cost items that determines their income tax treatment but their application.

Here we go!!



Say, labour is being applied to create an asset, like a machine or reclaimed land.

In this case, the wages should be capitalised to form part of the capital cost of the associated asset.



It would then, ideally, be the annual change in value of the asset that would be included in taxable income.

Wages would be treated on "capital account".

That's the tax jargon.



But if people were being used for regular maintenance or selling, their wages would be immediately deductible from taxable income.

Wages would be treated on "revenue account".

That's the tax jargon.



So, costs of removing overburden in a coal mine would be either on capital or revenue account depending on whether coal could then be accessed for more than one year or just the current year.



Similarly with costs of repairing, say, some fencing.

But is such a difficult separation worth the effort?

Do you want an income tax system or not, Brad?



## Design framework: aligning taxable income and commercial profit

Remember, the Tax Minister wants us to propose a way of simplifying and shortening the tax code for taxing the income, or profit, from investments.

Every tax minister supports simplification.

And the proposed design must not require the impact of current law to be changed.

Why change then?

Much of the length and complexity of our current tax code has resulted from the treatment of changing values of many investment assets and liabilities being grafted on to existing code in ad hoc fashion without clear tax principles.

We have a number of income tax acts!

And you know that the law that taxes the income from investments should be based on income tax principles of fairness and efficiency.

Oh, yeah!

Of course!

The good news is, we have found a simple design framework that meets these principles, one that includes in income, changing values of assets and liabilities.

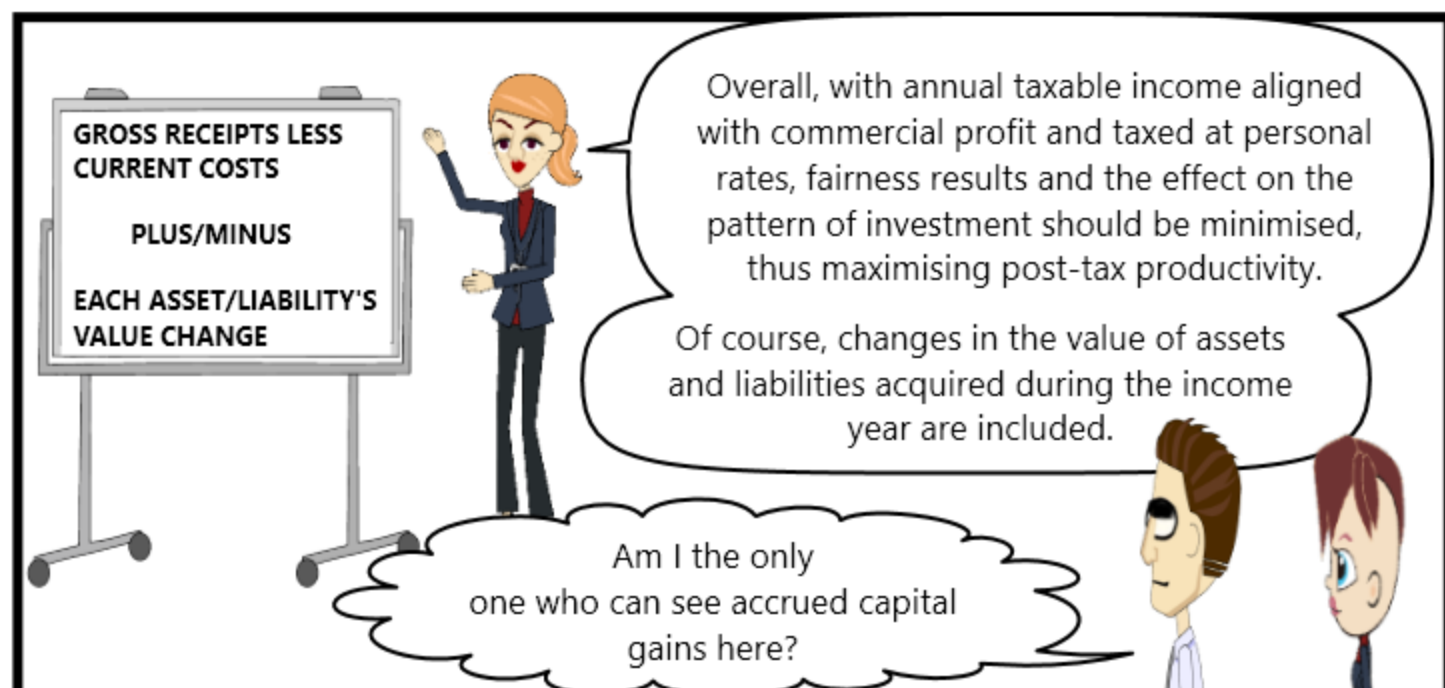
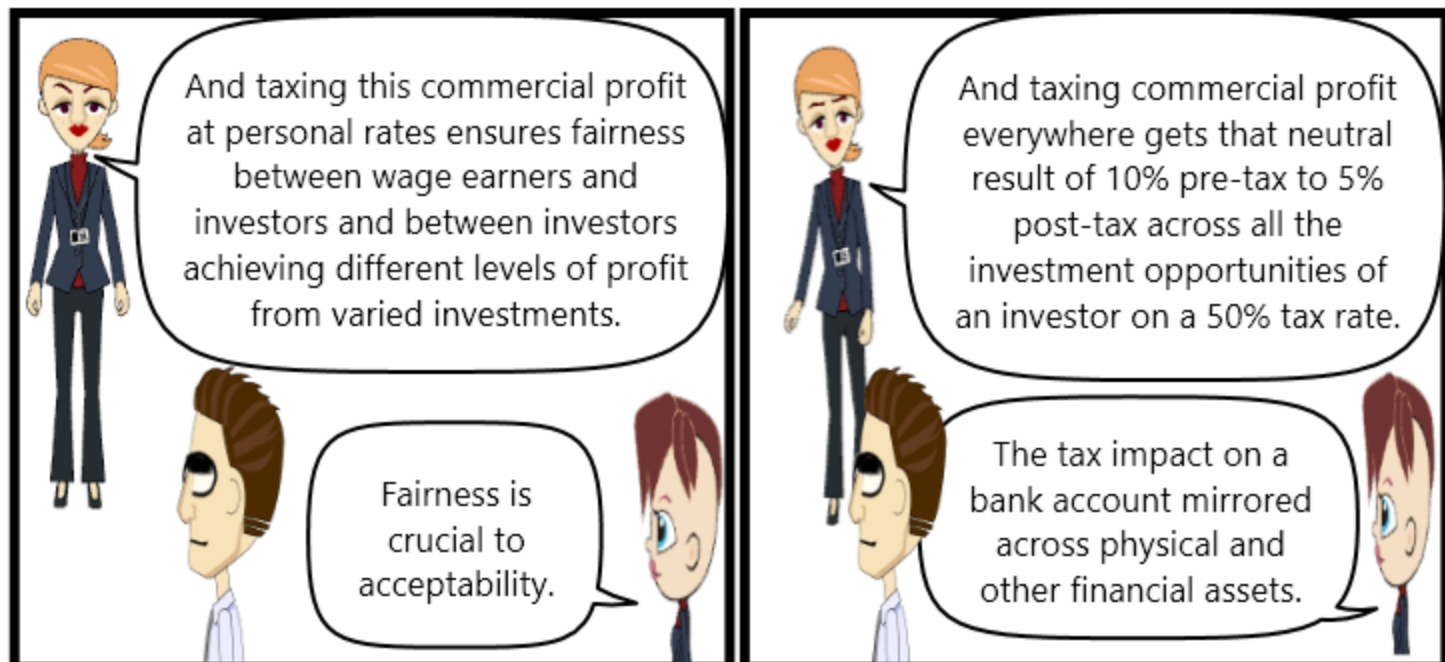
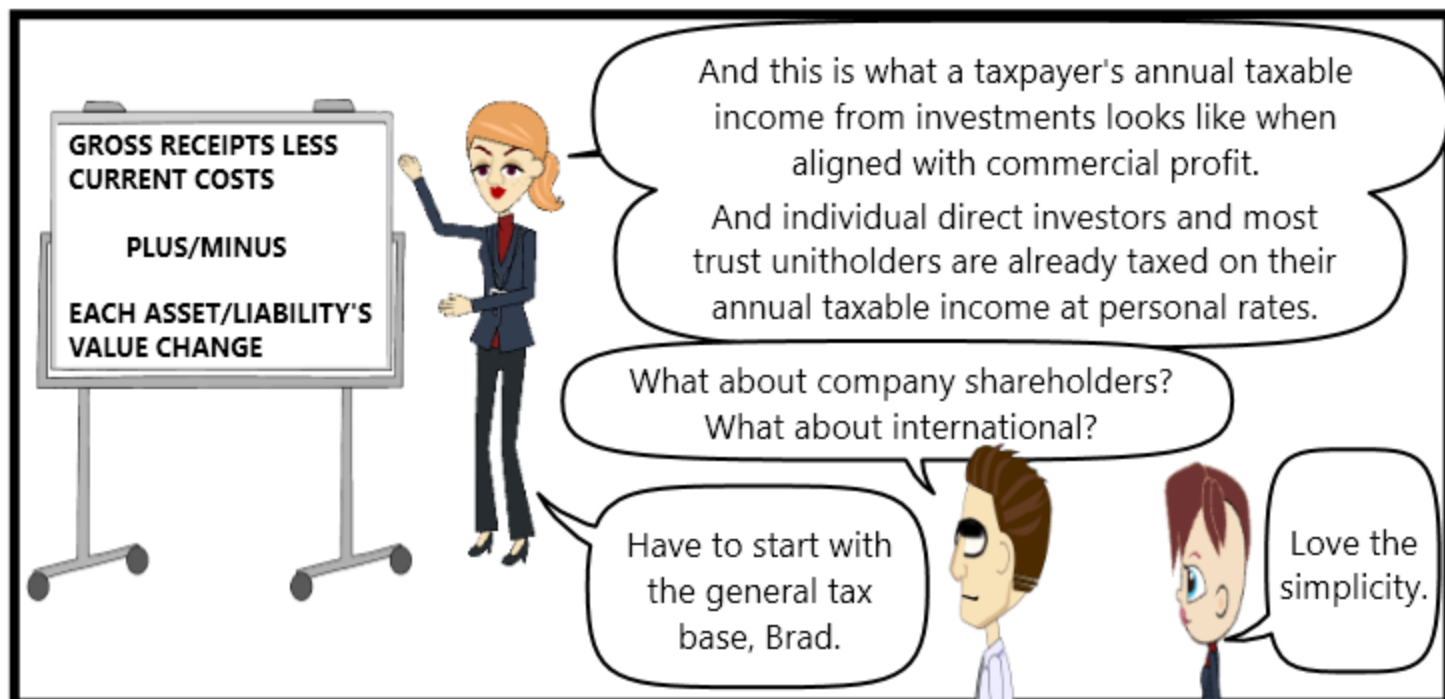
Impractical purity coming.

Exciting, isn't it?

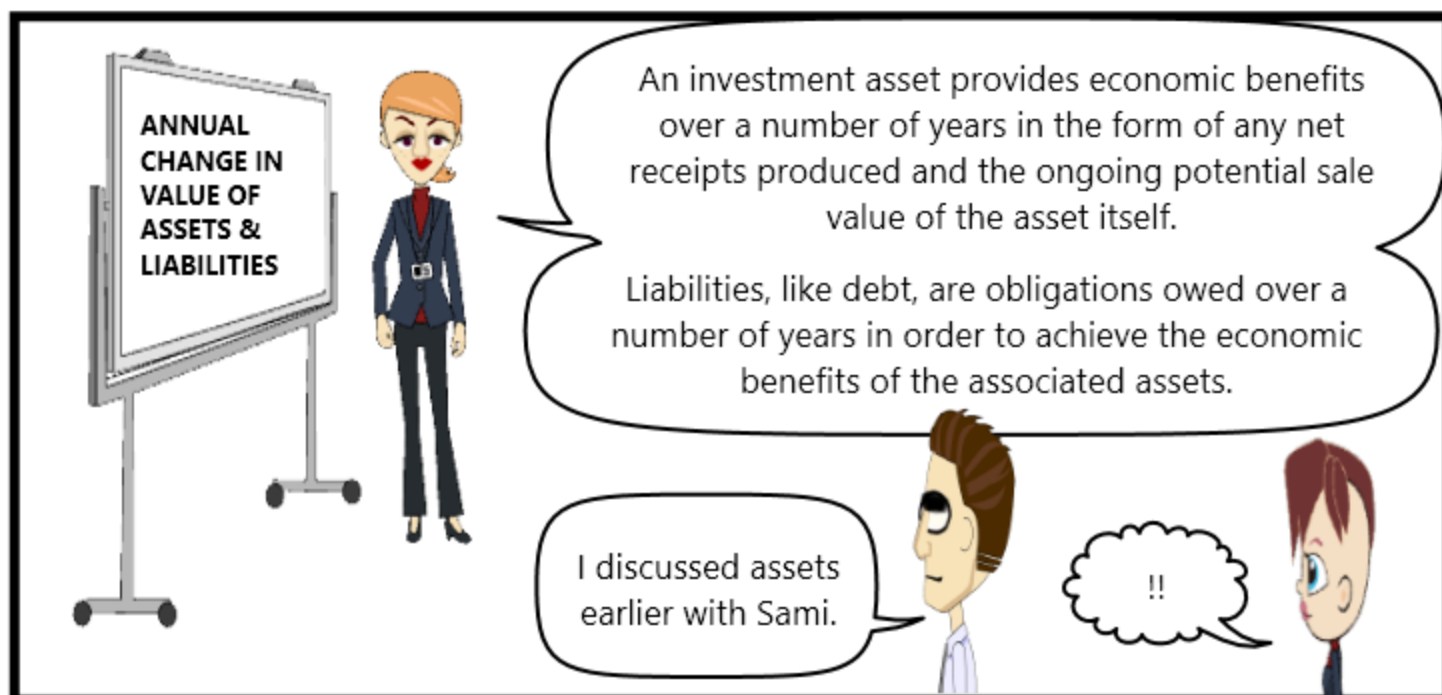
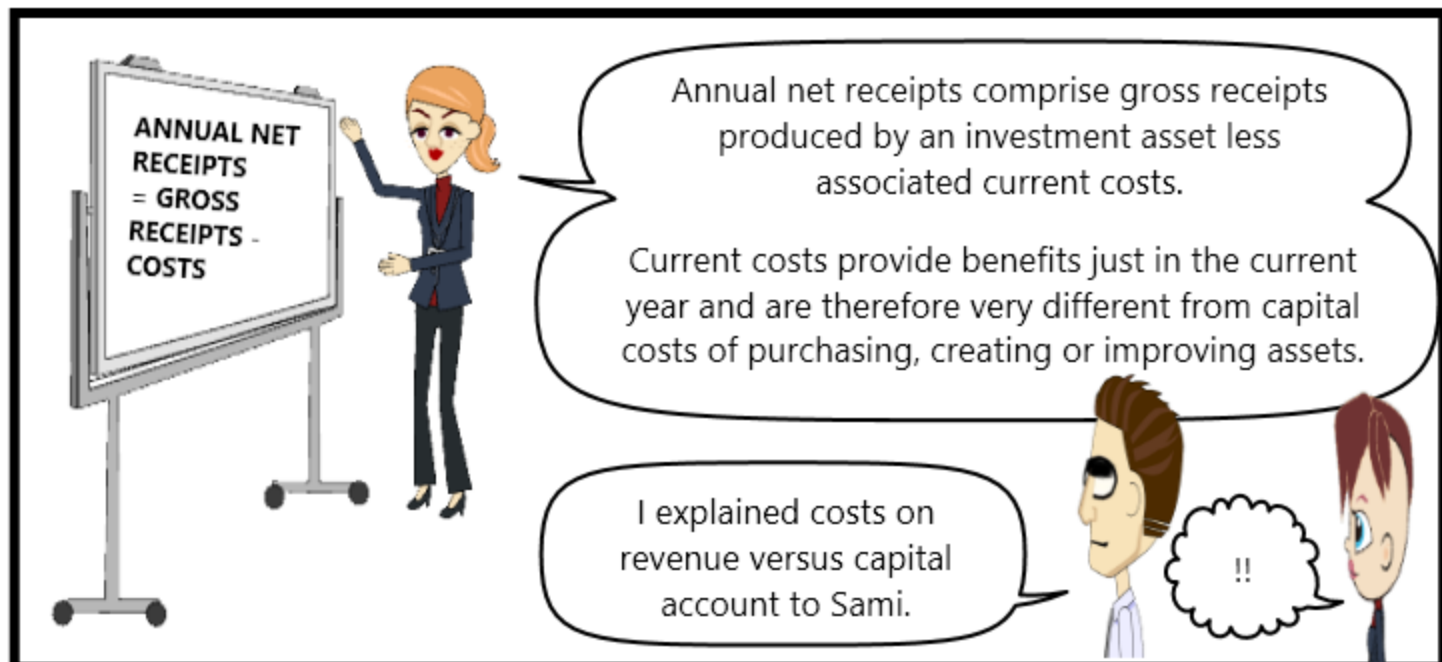
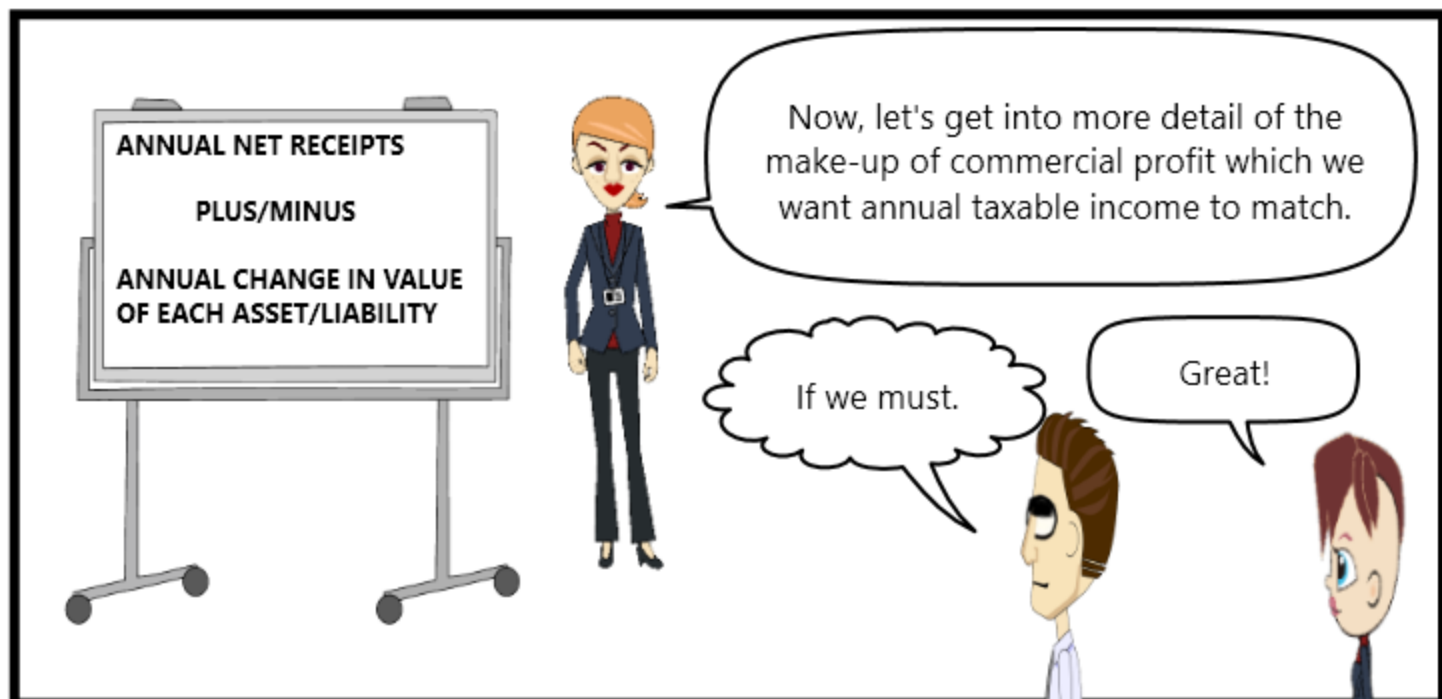
This design framework aligns each individual investor's annual taxable income from investments with commercial profit.

And it taxes that profit at the investor's personal tax rate regardless of business structure involved.

And there it is!







# ASSETS' ANNUAL CHANGE IN VALUE

Increases in the accrued value of an asset like land add to commercial profit and, ideally therefore, to taxable income.

Decreases in the accrued value of an asset, like depreciation of plant and equipment, reduce commercial profit and, again ideally, taxable income.

Yeah, I know. Taxing accrued capital gains!

I like the logical symmetry, Claudia.

# LIABILITIES' ANNUAL CHANGE IN VALUE

In contrast, reductions and increases in the accrued absolute value of liabilities ideally increase and decrease taxable income, respectively.

Delaying payment of interest on investment debt would see the size of the debt's negative accrued value - and consequently the investor's annual income tax deductions - increase year by year. There are increasing assessments, of course, on the creditor's side.

Good luck with all that!

Oh, I like it, Claudia.

By the way, the quality of every piece of current income tax law can be assessed by comparing it to this transparent, principles-based **benchmark income tax tax base**.

And getting back to your point, Brad, dealing with the interface between companies and their individual local shareholders and the international dimension will come in later briefings for the minister.

I'm more focused on the impracticality of all this, especially the implied taxing of accrued gains.

More exciting stuff to come!



What's the point of getting all excited about how change in market value of assets might be part of investment profit, when the tax code is usually not going to include such change in taxable income?

It sets the benchmark for tax-neutral investing, Brad.



Market value change can apply now to assets like trading stock, and some financial instruments.

And, more generally, value for tax purposes, or **tax value**, will often match actual value when an asset is purchased and when it is sold.

Yeah. So?



So, over the period that a depreciating asset with tax write-off is held, the total tax depreciation allowed will match the asset's actual reduction in value.



Yeah, the current "balancing adjustment on disposal" ensures either extra deductions or assessable income if sale value differs from depreciated value.



And there is a similar balancing adjustment for appreciating assets subject to CGT, whose tax value stays at original cost until disposal.



Yeah, when CGT assets are sold, a capital loss or gain is realised depending on whether sale price is higher or lower than the CGT cost base.

Even though only half of a taxpayer's annual CGT gains exceeding CGT losses go into taxable income.

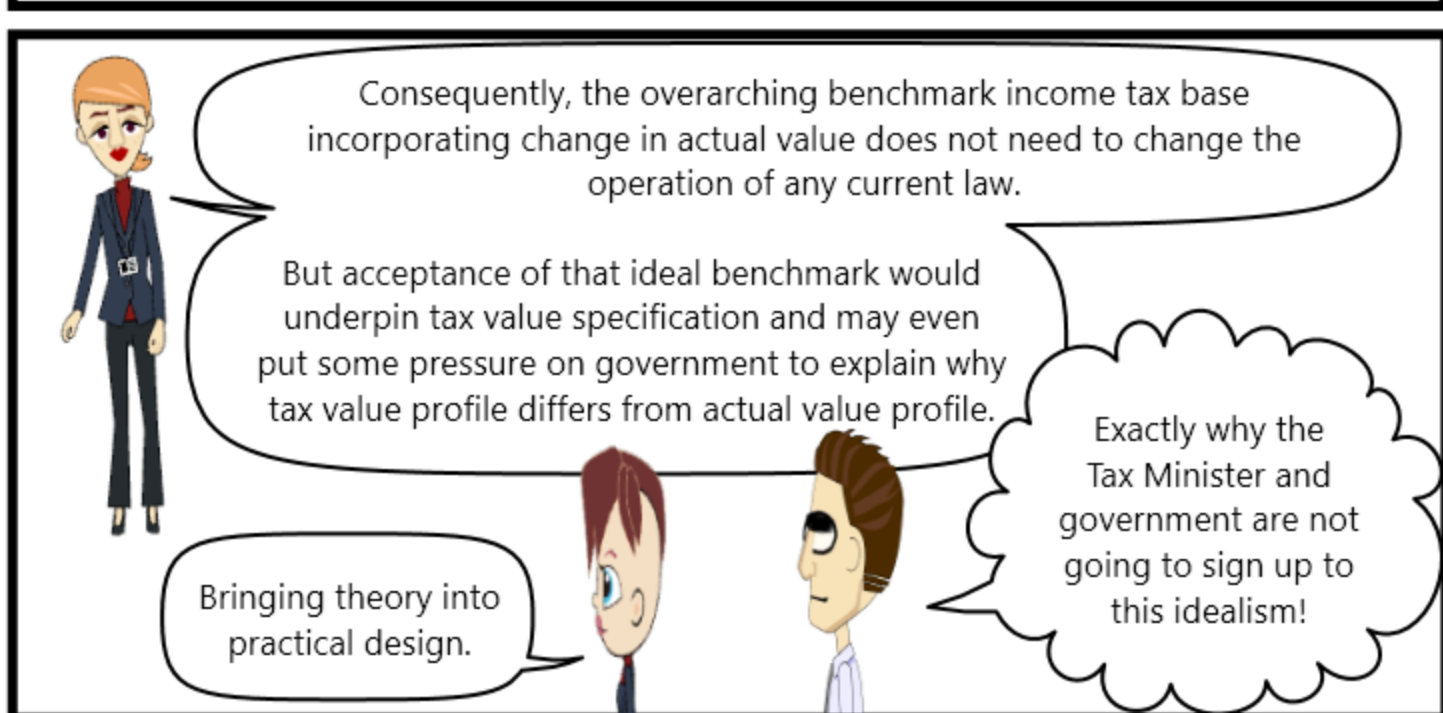
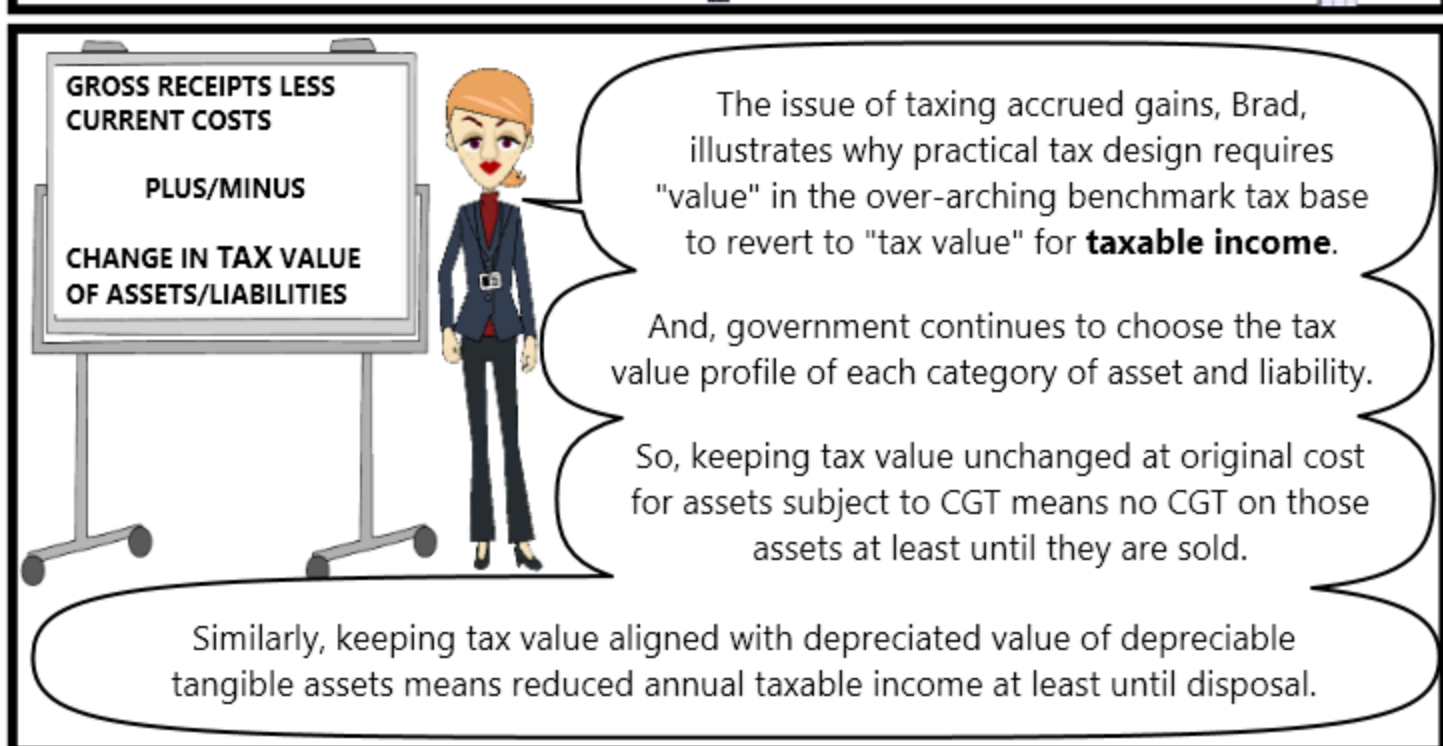
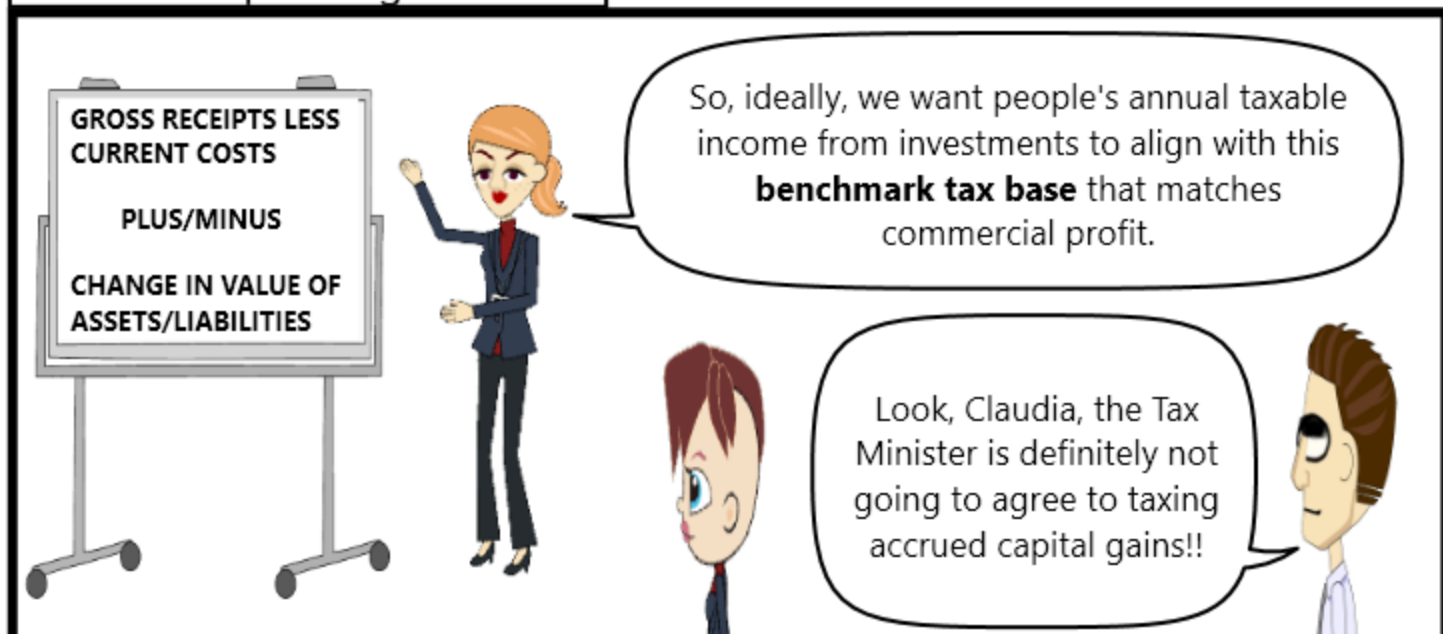
But so what?



You can see that the tax code often matches value with tax value when an asset is acquired and sees the relevance of actual change in value of assets while they are being held.

Doesn't do much for me, Sami.







**ASSETS' VALUE  
CHANGE IN PRINCIPLE**

**TO**

**ASSETS' TAX VALUE  
CHANGE IN PRACTICE**

So, having change in "tax value" substitute for change in "value" in measuring taxable income from investments means that current tax outcomes need not change if the tax code is re-worked against our principle-based design.

Neat!

What about the different ways of taxing capital gains?

Great question, Brad. Absent specific policy measures, an asset's value for tax purposes will match its actual value when bought and sold.

**ASSETS' VALUE  
CHANGE IN PRINCIPLE**

**TO**

**ASSETS' TAX VALUE  
CHANGE IN PRACTICE**

But, in between acquisition and sale, the asset's tax value profile depends on government decisions.

As now, particular tax value profiles for the various categories of assets, as well as possible additional policy measures, need to be separately specified.

To continue to capture the accrued gains and losses of some financial assets subject to accruals or mark-to-market treatment, tax value would match market value year by year with no policy adjustments.

With any value differences year to year made up on sale.

As I explained earlier, Sami.

So-called revenue assets are categorised by taxpayers' buying and selling them regularly to make ordinary business income.

Tax values of this category could continue to remain unchanged at original cost until sale, with realised gains and losses included in full in tax assessments.

What does ordinary income mean?

C'mon, Sami, everyone knows that.

But what about the assets subject to the general CGT regime?

Any realised capital losses can only be written off against realised capital gains on other CGT assets and various discounts may apply to excess CGT gains over CGT losses.

You're right. The amount of excess realised CGT gains included in taxable income varies a lot: 1/2 generally; 2/3 for superannuation funds; and full amount for companies and for assets held for less than a year.

And, Brad, the good news for governments that want to retain such variability is that the income tax code reworked according to the tax value approach I'm suggesting can retain that variability.

Adjustments to taxable income computed on the basis of the general tax value formulation can deal with both the quarantining of realised CGT losses to realised CGT gains and whatever discount on excess gains applies to the particular taxpayer concerned.

Neat!

So no change there.

OK, but why change the overall structure of the law?

Lack of principle-based law caused current lengthy and complex law.

Treatment of assets and liabilities has just been grafted on in ad hoc fashion over time.

OK, how would this tax value approach treat.....

Stop right there, Brad.

No tax treatment needs to change.

!?!?

## Alternative ways of specifying taxable income

So far, I have talked about investment and taxable income in terms of individual assets with a single up-front capital outlay.

What's wrong with that?

How else should we think about it?

Well, investing may involve a series of capital outlays on the same or different activities.

NET RECEIPTS (RECEIPTS  
LESS CURRENT COSTS)

PLUS/MINUS

TAX VALUE CHANGE OF  
EACH ASSET/LIABILITY

This is our benchmark formulation of annual taxable income set against commercial profit.

With a series of capital expenditures made to acquire assets, this formulation requires change in tax value of each asset acquired within a year to be measured for the part of the year it is held.

What's wrong with that?

Nothing, Brad.

RECEIPTS LESS ALL  
COSTS (CASH FLOW)

PLUS

END- LESS START-YEAR  
TAX VALUE OF ASSETS


But, see what happens if I: subtract within-year capital costs from net receipts to get annual cash flow; and measure change in aggregate asset tax value between start and end of year.

I get the same measurement of annual taxable income.

How does that work?

I think I see why.





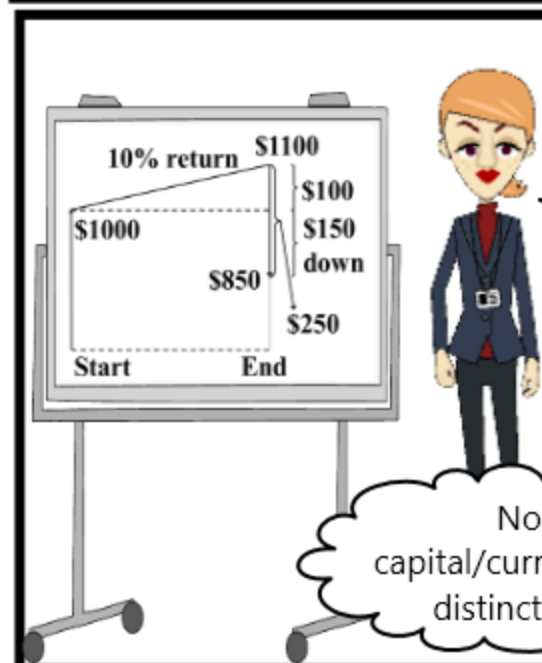
**ANNUAL CASH FLOW**  
**PLUS/MINUS**  
**END- LESS START-YEAR**  
**TAX VALUE OF ALL**  
**ASSETS/LIABILITIES**

Extra capital cost during a year increases the tax value of assets by the same amount because that cost is the associated asset's opening tax value.

So, when an extra asset is acquired during a year, the reduced cash flow matches increased tax value of assets, with no impact on taxable income.

Taxable income is affected though if end-year tax value of the extra asset, whose start-year tax value was zero, is different from its acquisition cost.

Thus, this measure of taxable income is the same as that obtained from summing value change across individual assets.



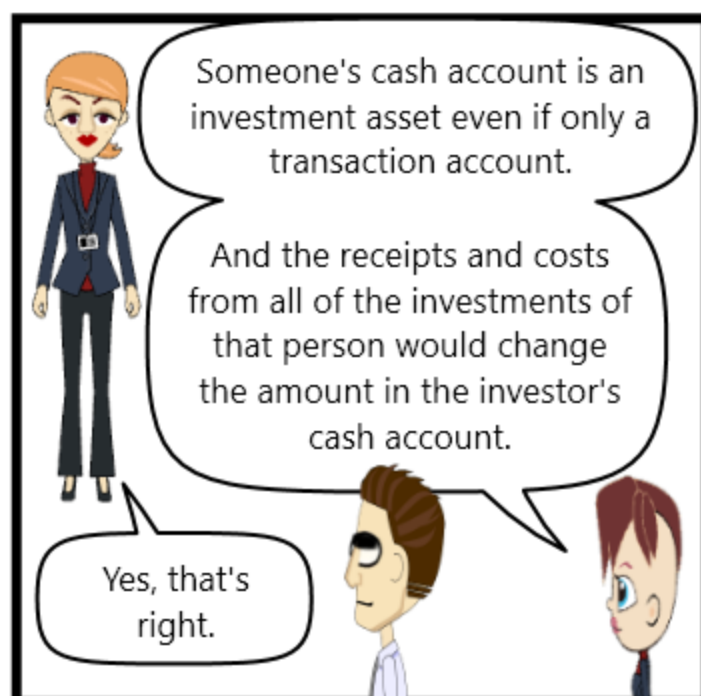
10% return \$1100  
\$1000 \$100  
\$850 \$150 down  
\$250  
Start End

Remember that \$1000 asset with \$100 annual profit from \$250 net receipts and \$150 value decline to \$850? Say, it was acquired just after the start of the year; so, its start-year value was nil.

Under this cash flow method, annual cash flow of -\$750, from -\$1000 plus \$250, added to \$850 end-year value less nil start-year value results in the same \$100 profit.

No capital/current cost distinction?

What about a cash account?



Someone's cash account is an investment asset even if only a transaction account.

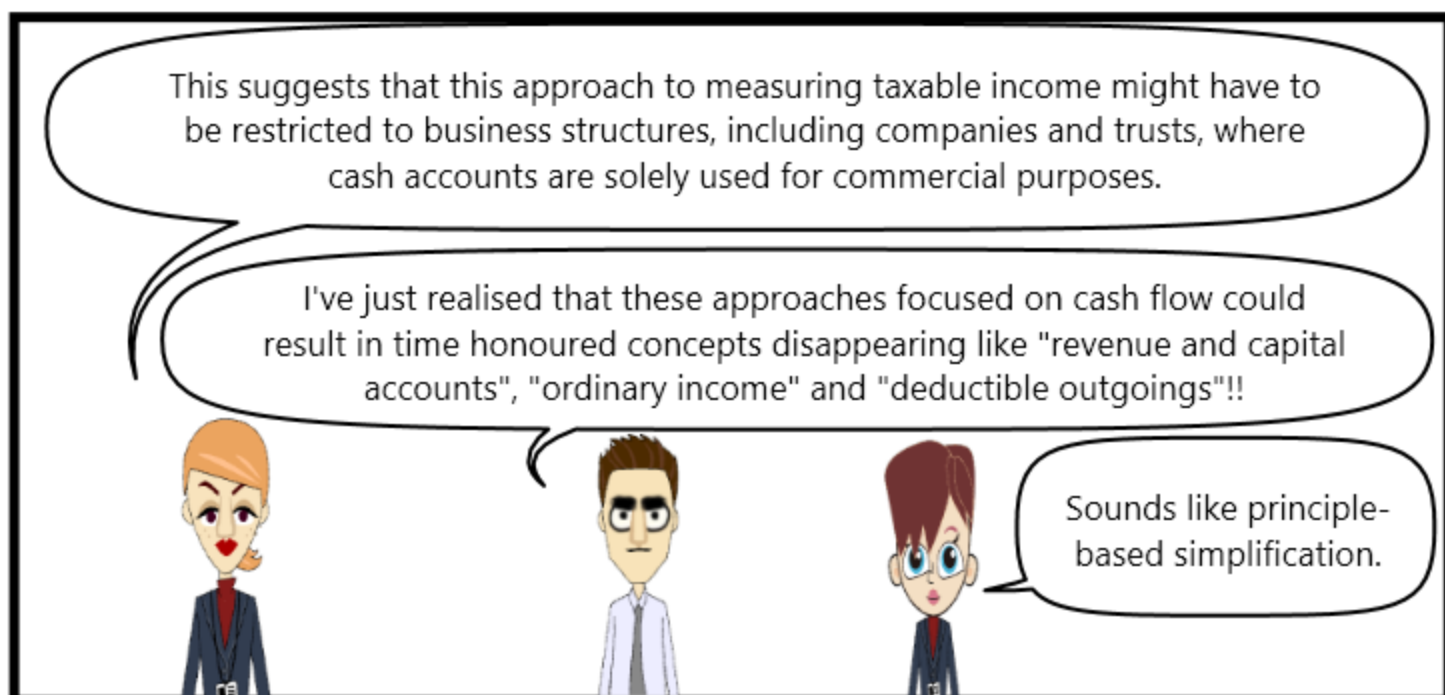
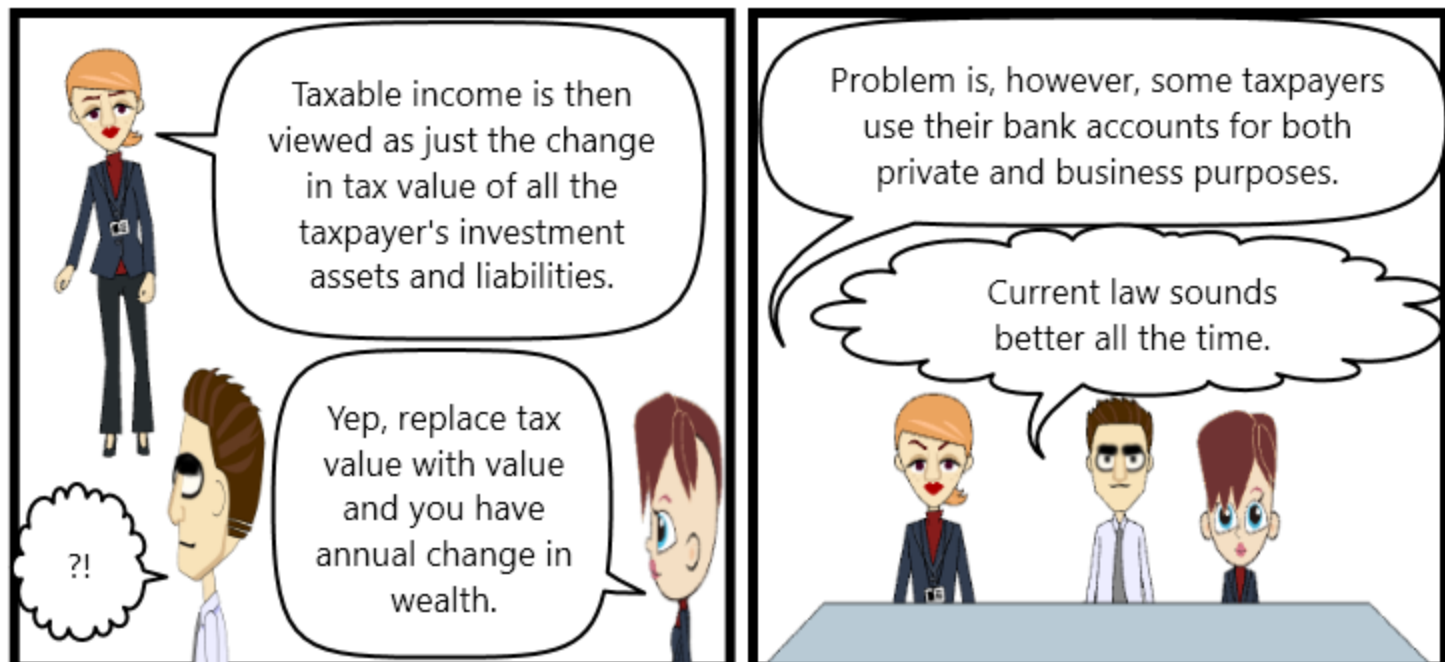
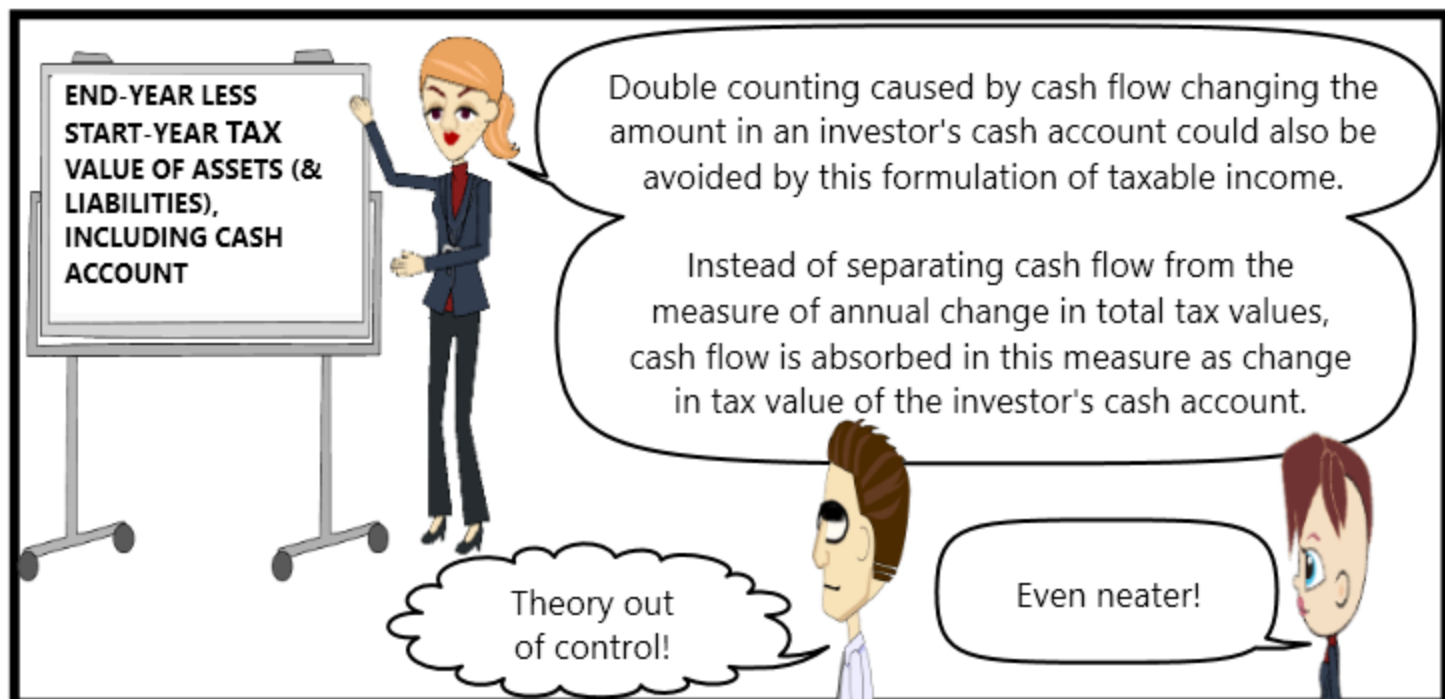
And the receipts and costs from all of the investments of that person would change the amount in the investor's cash account.

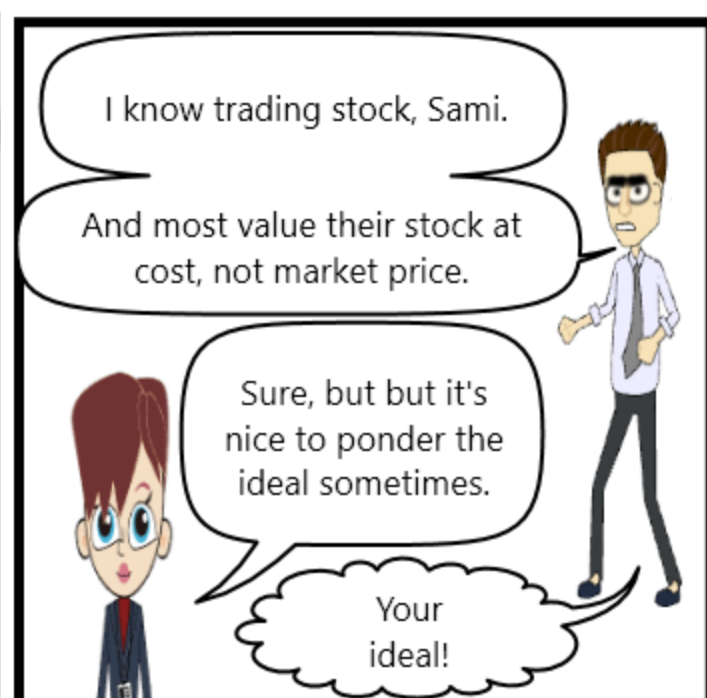
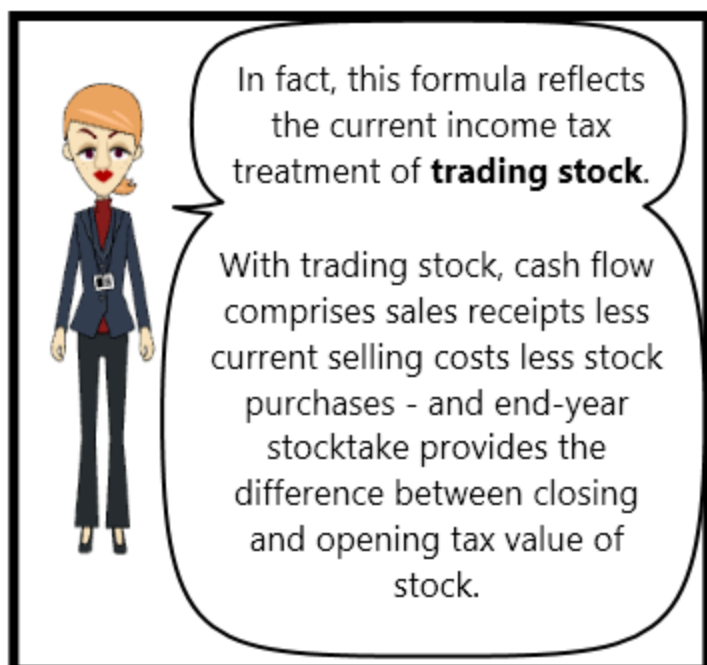
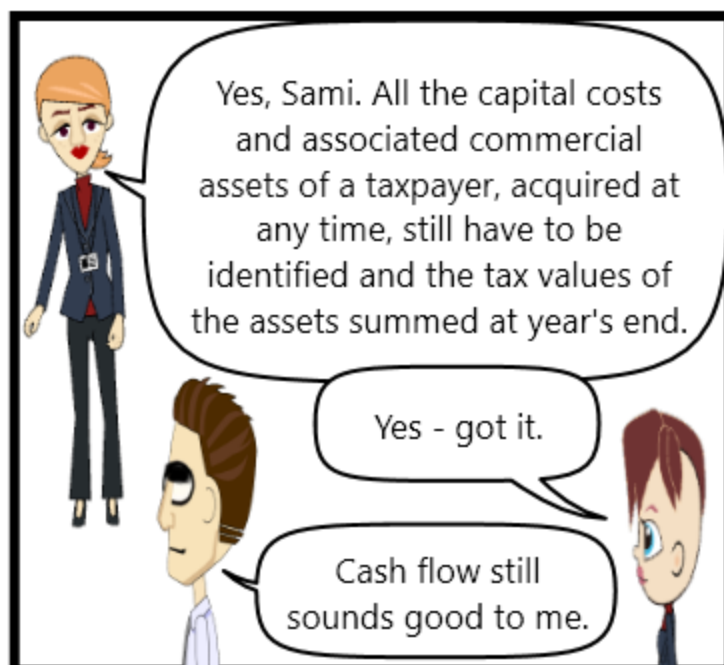
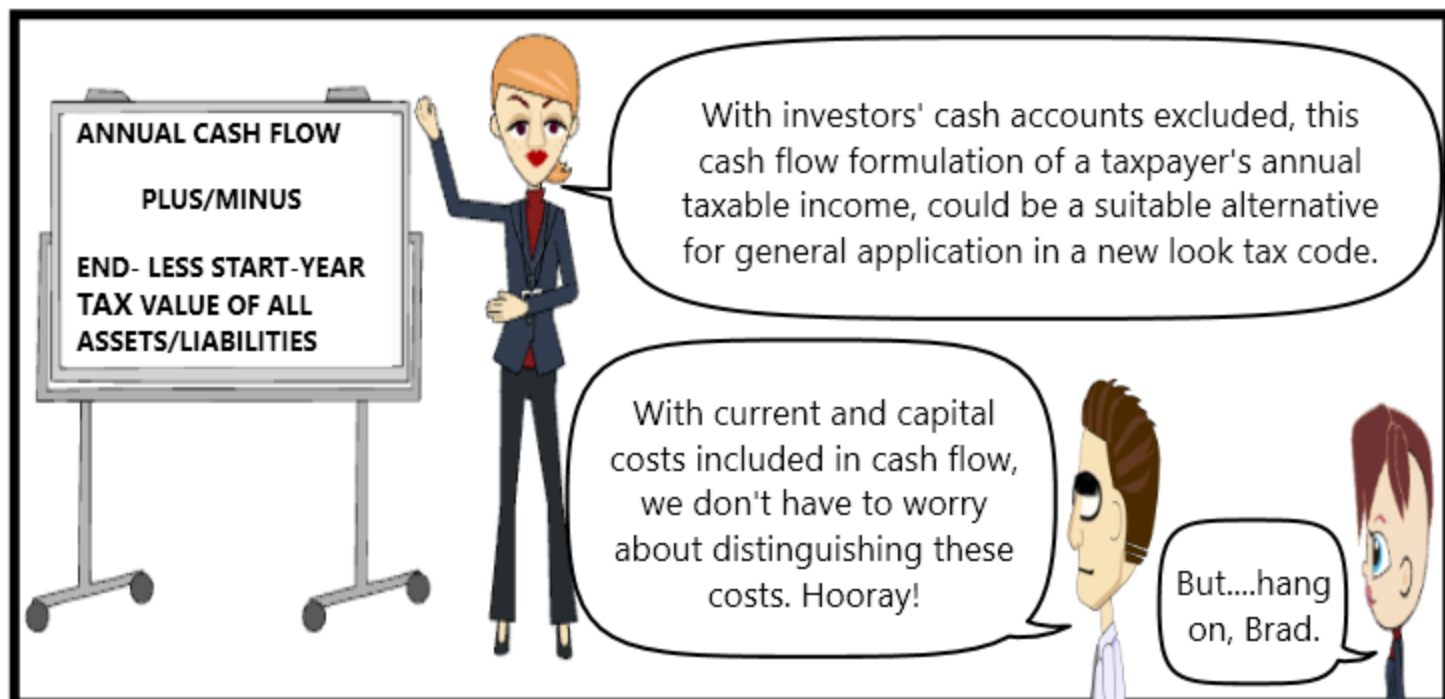
Yes, that's right.

So, under either taxable income formulation, to avoid double counting, investors' cash accounts can't be included in tax value total.

Right on, Sami.

No capital/current cost distinction with this cash flow method. Hooray!





What's the big deal about trading stock and profit measurement, Sami?



It's an existing tax design that shows how ongoing asset purchases neatly fit within the profit measure of cash flow plus value change of non-cash assets.



Any assets being acquired and eventually disposed of are the trading stock.

Trading stock would still include, say, wine being produced and matured before sale and could possibly include assets like plantation timber or even a ring-fenced mineral resource project.



The exciting thing is to imagine the assets being valued in aggregate at market value for tax purposes.



Then annual taxable income would simply comprise any sales receipts less all costs plus annual change in overall value.

No one is going to value those assets at market value for tax purposes.

In the years before these assets yield revenue, their value will be increasing as the sales revenue gets closer.



These accrued capital gains would be taxed!

Sure, but you can see how the ideal treatment would work with a stream of assets acquired at any time during an income year.

Your and Claudia's ideal.




In any case, exactly the same measure of taxable income would arise if the change in value of each asset were determined separately at year's end and any annual gross receipts assessed and current costs deducted as usual.



That's right and separate values for tax purposes are needed anyway for different asset types.








**ANNUAL CASH FLOW**  
**PLUS**  
**END- LESS START-YEAR**  
**TAX VALUE OF ALL ASSETS**


OK guys, which way to go to measure taxable income? This trading stock way, with the added option of getting cash flow directly from a dedicated cash account?



**ANNUAL NET RECEIPTS**  
**PLUS**  
**ANNUAL CHANGE IN TAX**  
**VALUE OF EACH ASSET**

Or, this more traditional way?

Under the trading stock/cash flow measure, each asset would be valued separately for tax purposes at year's end anyway, unless the taxpayer's whole asset bundle could be valued at market price.




Yeah, just as stock items are usually valued now.

That's right. As we know, the tax value profiles of different asset types are determined differently.

And improvements to some assets have to be tracked as separate assets.

Using annual net receipts plus value change of separate assets would also be closer to current design.


That holds a lot of weight given the significant change involved.



I like traditional.

Of course, generalising the existing and familiar trading stock treatment fits in with our overall simplification aim.

But, I think, design closer to current design would be easier for our minister to sell.



I really like traditional.

Nevertheless, companies might find the cash flow measure dovetails neatly with their financial accounts.

They might also appreciate using their cash account change to subsume annual cash flow.

I'm wondering if some taxpayers, like companies, could choose to specify their taxable income as cash flow plus change in aggregate end- versus start-year tax value of their assets....

....even if the general approach is net receipts plus change in tax value of individual assets.



Maybe the cash flow/trading stock design could also apply to a taxpayer's asset bundle, like a ring-fenced mining project, valued annually **in aggregate** at **market value**.

So end-year tax value of each asset is not needed.

These two again!!

Talking about asset bundles reminds me that buildings and land assets are treated as a combined asset even though land attracts CGT treatment and buildings get tax depreciation.

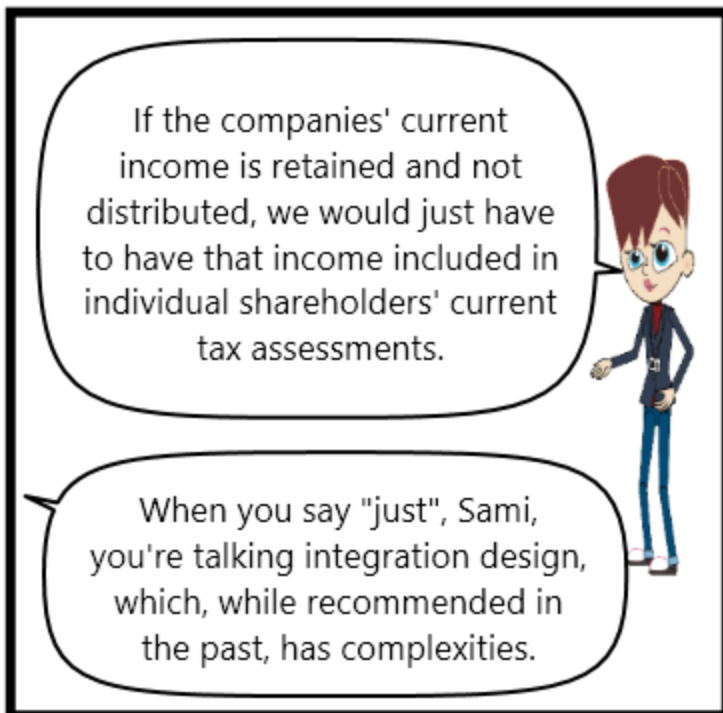
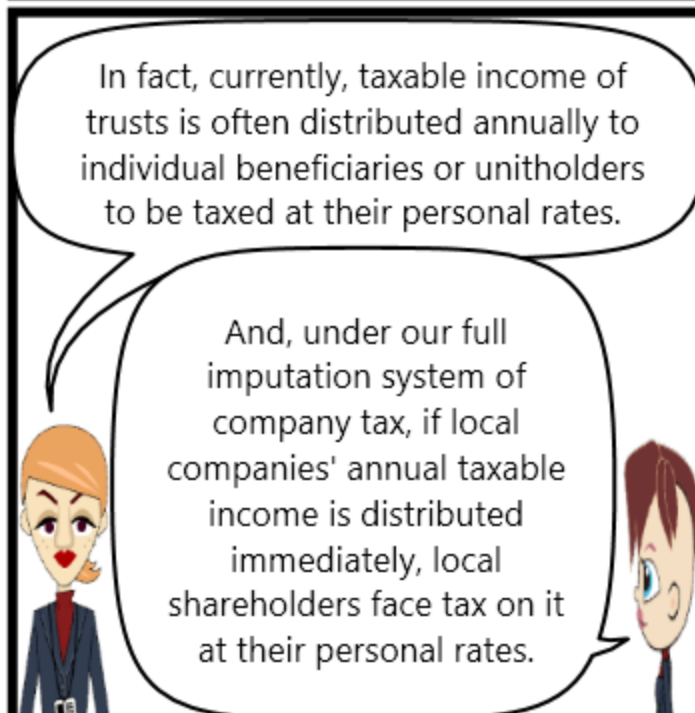
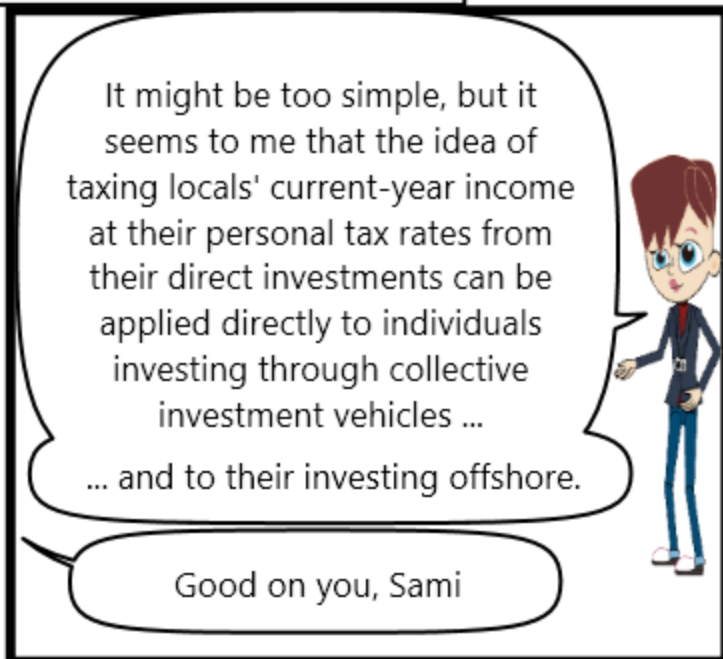
Separate arm's length sale values for the land and the buildings should be used instead so that losses and gains are correctly attributed. But that's for another day.

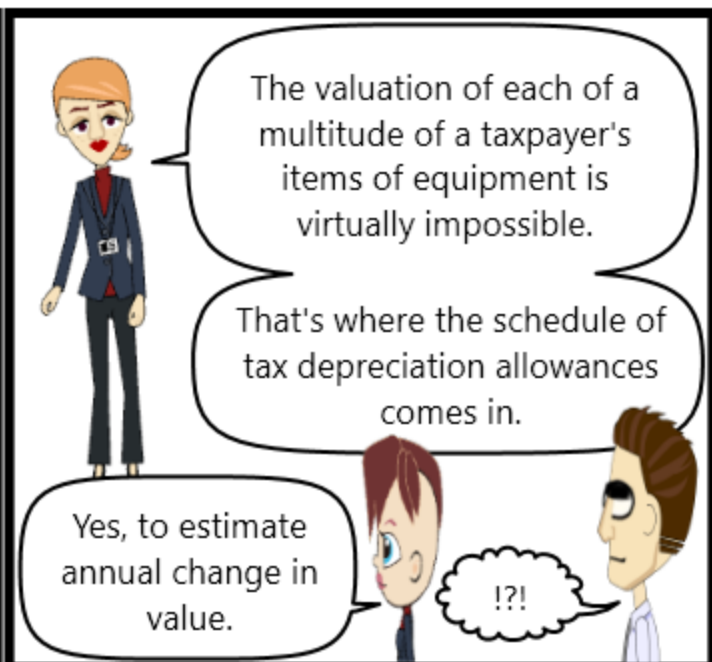
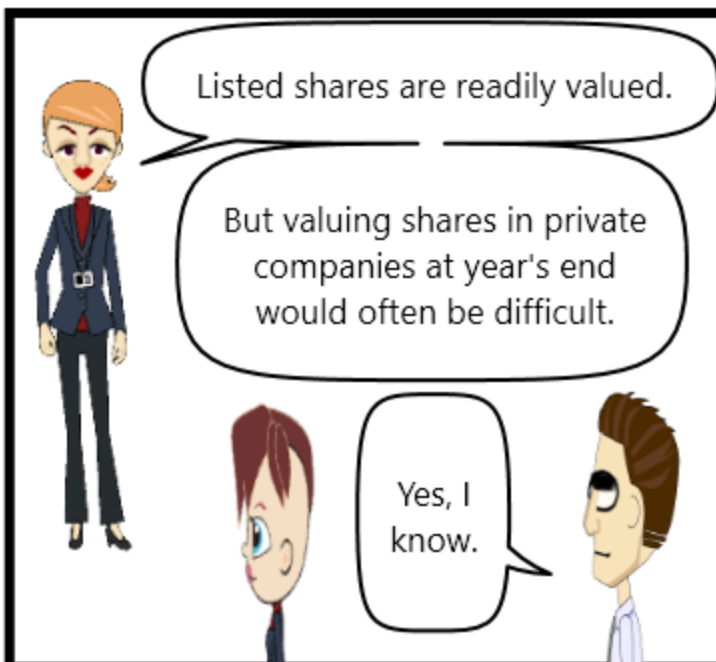
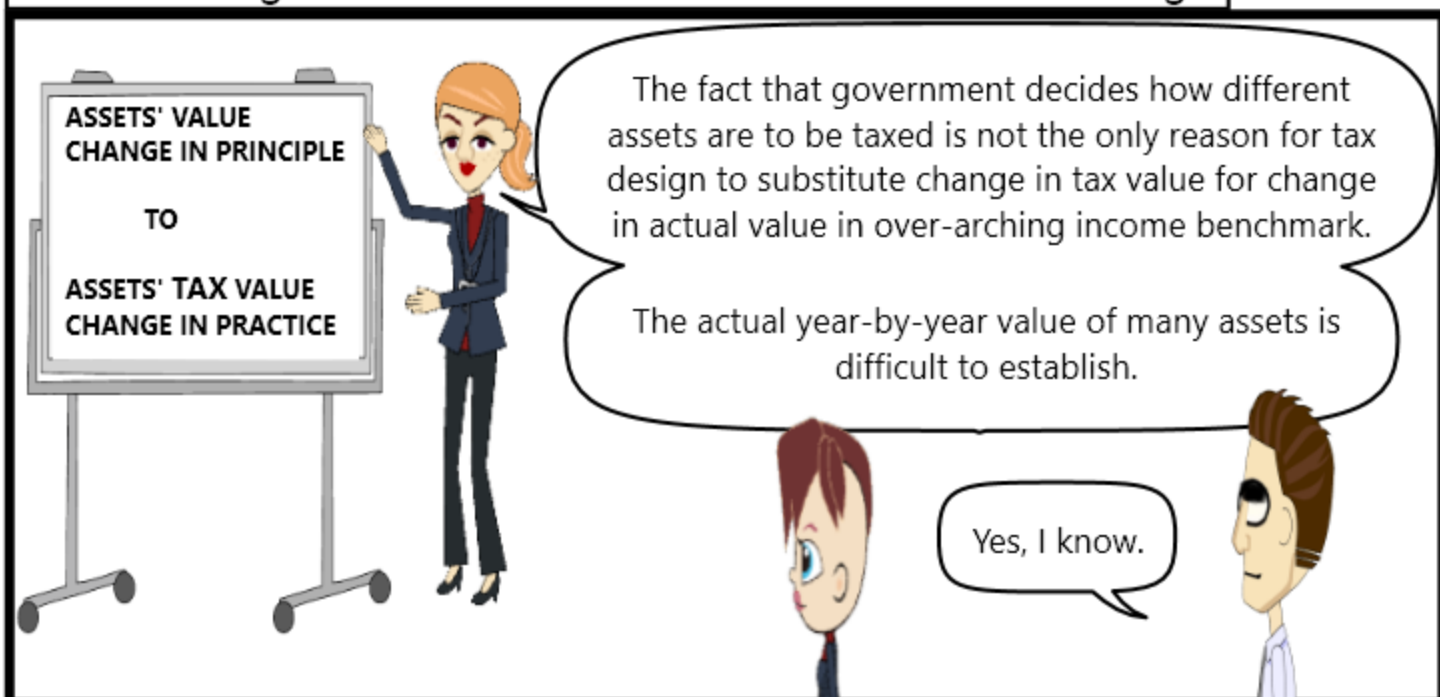
Great discussion! I'll work up propositions for the Tax Minister.

Remind me why are we doing all this. We could just re-write the law in everyday language to make it simpler.

That was tried, Brad, and an extra income tax act was the result.

Income tax law designed in principle to tax income should be like motherhood, Brad.







**GROSS RECEIPTS LESS  
CURRENT COSTS**

**PLUS/MINUS**

**TAX VALUE CHANGE  
OF ASSETS/LIABILITIES**

So, this is annual taxable investment income of taxpayers - the income tax base.

It is set within a tax code that encompasses all commercial, or non-private, assets and liabilities:

potentially drawing in previously excluded assets and liabilities;

requiring clear definitions of assets and liabilities;

specifying how to determine year-by-year tax value of each category of asset or liability;

and, reflecting the overarching benchmark, has a market value default for tax value.

Here is a representation of the operation of the tax code in determining treatment of expenditure: either immediate write-off for current costs; or profile of tax value of associated asset created.\*

The treatment of liabilities, like debt, is the mirror image of that for assets.

What about the treatment of ....?

I'm a believer!

Why are we doing this?!

**Is commercial (non-private) expenditure involved?**

Yes

**Does the expenditure create/improve an asset?**

No

Yes

**Deduction allowed in the year expenditure is incurred**

**Change in tax value based on write-off rate – eg depreciating physical assets, horticultural plants**

**Tax value at cost until sold – eg trading stock, CGT assets like land and shares (with losses quarantined, unless traded)**

**Tax value at cost until production starts – eg forestry, horticulture, mining assets, infrastructure**

**Change in tax value computed from known or assumed future net receipts – eg financial assets, leases, rights**

**Annual mark to market – eg trading stock, financial assets, asset bundle of taxpayer or ring-fenced project**

**Start tax value = cost; end tax value = sale price (ex CGT discount)**

GROSS RECEIPTS LESS  
CURRENT COSTS

PLUS/MINUS

TAX VALUE CHANGE  
OF ASSETS/LIABILITIES

Annual taxable income of each taxpayer is essentially given in one line.

And we are literally talking a one-page method statement for the taxpayer.

The method statement I have chosen combines the traditional approach with the trading stock approach for illustrative purposes.

The one-page method statement for taxpayers' taxable income.\*

1. ADD UP ALL THE AMOUNTS YOU RECEIVED DURING THE INCOME YEAR.
2. SUBTRACT ALL THE CURRENT COSTS YOU OUTLAID DURING THE INCOME YEAR.
3. ADD THE CHANGE IN TAX VALUE OF EACH ASSET YOU HELD AT THE START OF THE YEAR OR ACQUIRED DURING THE YEAR (CASH ACCOUNT EXCLUDED).
4. SUBTRACT THE CHANGE IN TAX VALUE OF EACH LIABILITY YOU OWED AT THE START OF THE YEAR OR FIRST OWED DURING THE YEAR.
5. MAKE REQUIRED ADJUSTMENTS (SAY, FOR EXEMPT INCOME, GIFTS, INCOME TAX PAYMENTS, DISCOUNTS AND LOSS QUARANTINING ON CGT ASSETS, PRIVATE USE OF ASSETS, TAX CREDITS).

Companies could have the option of: subtracting within-year capital costs from Item 2 (with the resulting cash flow from Items 1 & 2 subsumed by the annual change in value of their cash account); and using the difference between aggregate end-year and start-year tax values of liabilities and non-cash assets to substitute for Items 3 & 4. This is the generalised "trading stock" treatment.

With flexibility for companies

But no one would really propose this. Do we really have to do this?

In fact, in Australia back in 1999, the Ralph Review of Business Taxation proposed the trading stock approach of cash flow plus change in tax value of non-cash assets.\*\*

They called it the cash flow/tax value approach or tax value method and four rounds of demonstration law (with zero tax value default) followed during consultations.

I'm a believer!

\* Board of Tax (2002), 'Archived Material' link/Draft TVM Legislation, Version 3, pp 8-9.

\*\* Ralph Review, pp 155-189.

Claudia, I'm struck by your chart of how the redesigned code spreads out to the various asset categories.

This could be viewed as just an illustration of a spruced up version of what we already have.

Another reason to question the whole exercise.



On the contrary, Brad, it provides what the Tax Minister asked us to achieve:\*

much shorter and simpler law, illustrated by how the myriad of CGT trigger events could be stripped out;

all set in a principle-based structure allowing much hazy nomenclature and many ad hoc rules to be excised;

and, not necessarily resulting in change to the impact of the law.

Of course, I will explain to the minister that improvements could also be made to the treatment of assets and liabilities.



Moreover, the restructured code would make little change to the way individuals prepare their tax returns, say, using our on line systems - or the way accountants use their systems to file people's returns.

And those people's returns would continue to accommodate separate line items of taxable income that has retained its character coming out of trusts - as well as aggregate taxable income out of companies in the form of franked dividends plus franking credits.

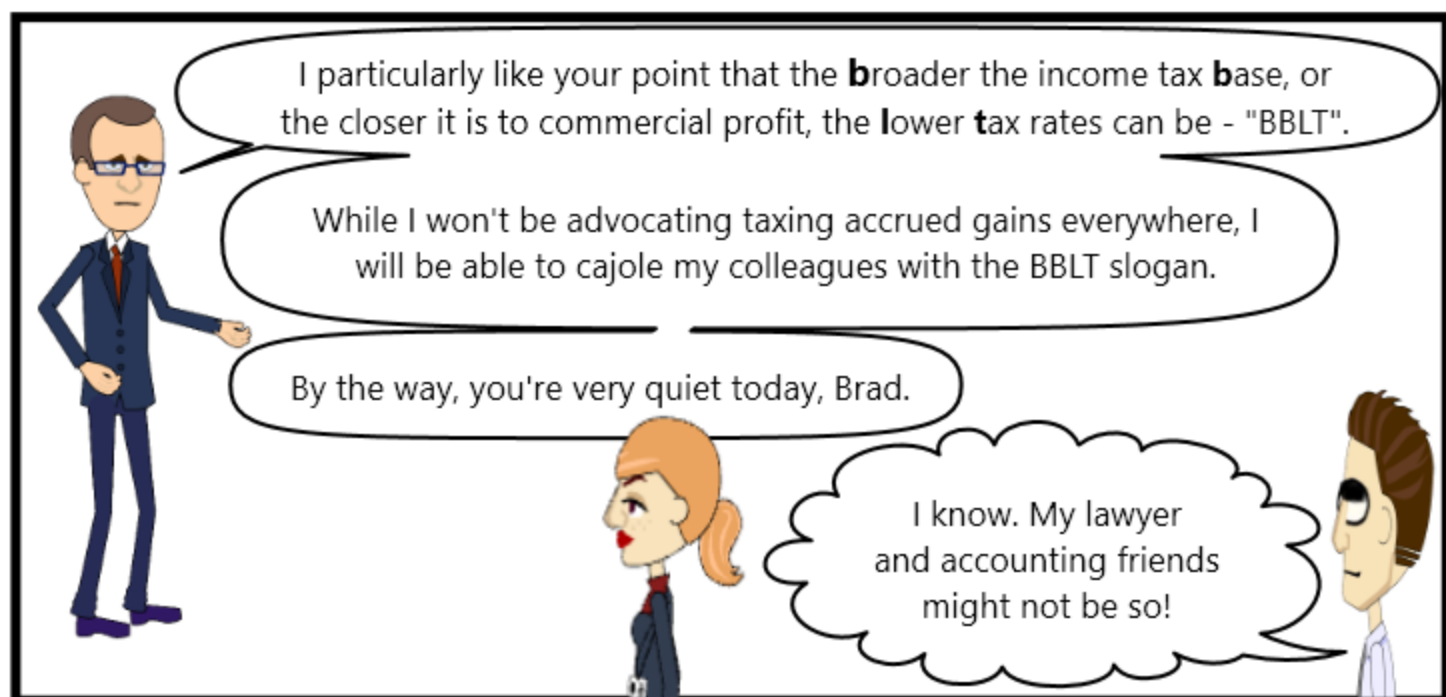
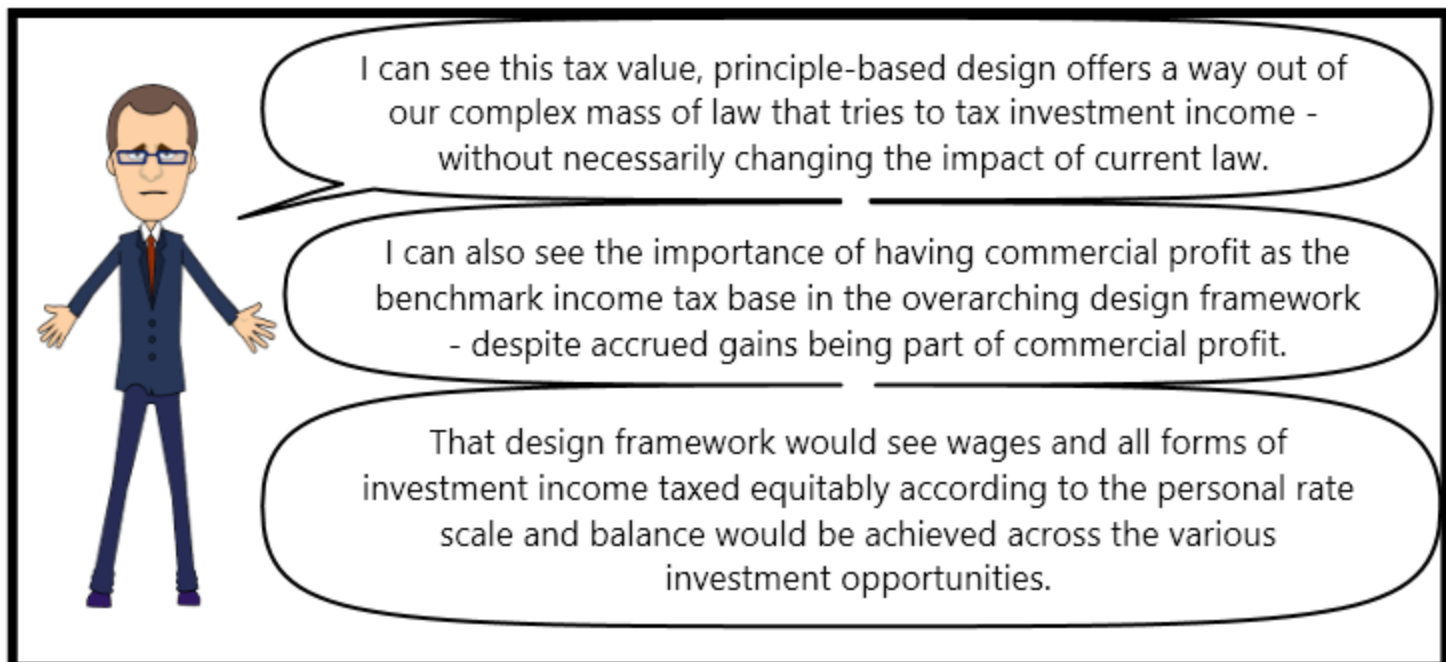
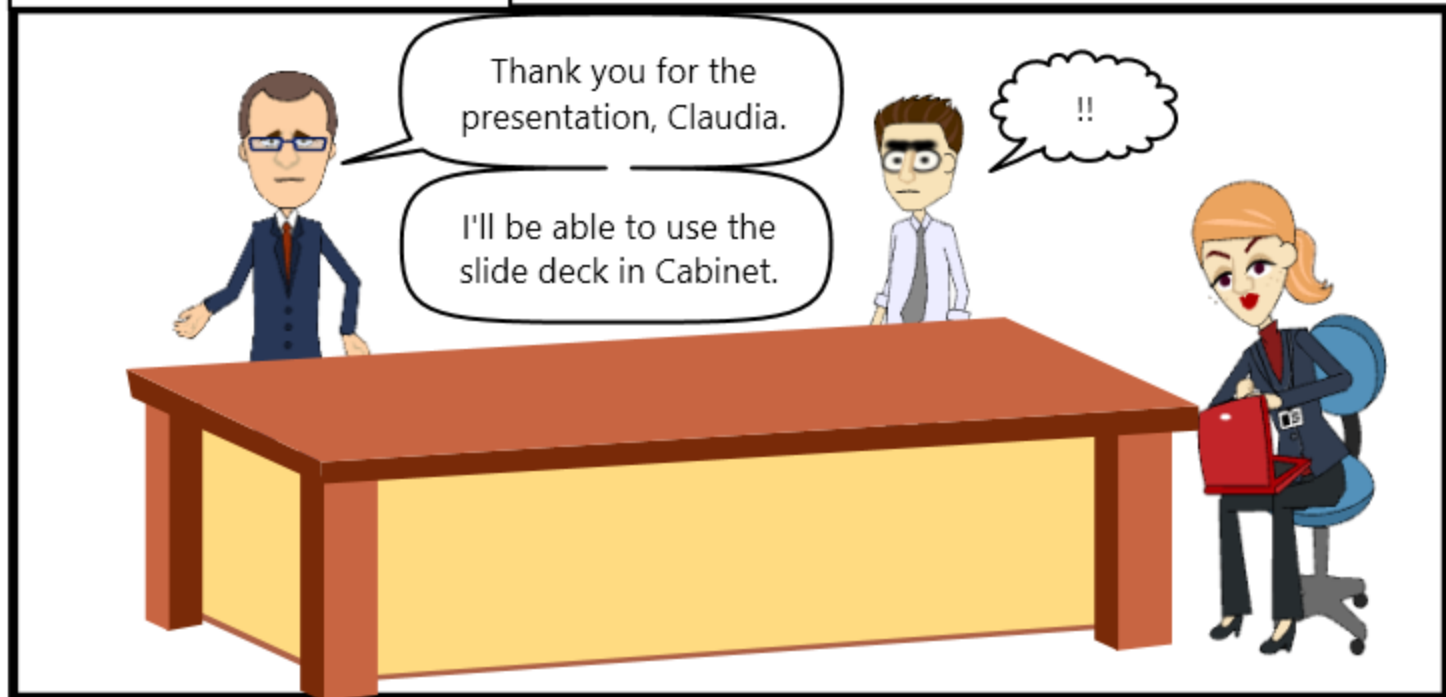
As requested by the Tax Minister, this change is focused on major shortening and simplification of the tax code itself, through principle-based restructuring.

But all this seems to involve much change to the way we, lawyers and accountants approach and deal with the taxing of investments.

And, your overarching benchmark and accompanying default for treatment of assets and liabilities just reeks of taxing accrued capital gains.

I appreciate your honest views, Brad. They will help me sharpen my presentation, which you should attend.









Claudia, I'd like you to put the tax value design through our **Integrated Tax Design** process\* so our tax administrators and lawyers become involved at this early stage.

And, when you go out to business people as part of the process, discuss having the law apply the trading stock approach to all taxpayers, not just companies.

And get back to me with more on capital gains, the setting of tax values across asset types, how all this fits with collective investment vehicles - in particular, companies and their shareholders - and international investments.

There might even be scope to make some changes to the impact of some tax provisions, drawing on the BBLT slogan, with improved productivity the end goal.

And Brad, keep smiling - it can't be that bad.

Yes, minister.

Yes, minister.



Success, Sami.

Now lots to be done.

Wonderful. Let's get at it.



I'd rather continue tinkering with what we have.



Positive change requires: the right timing; solid advice based on economic principles tailored to the thinking of the government of the day; and a far-seeing tax minister who can get the change and the reason for it across to the public.

