ABSTRACT: Since the inception of tax expenditure concept in 1960s, the issue of the most appropriate benchmark tax base has been much debated. The issue is crucial to tax expenditure analysis, as the chosen benchmark decides what should and should not be in the tax expenditure list. While the debate focuses mainly on the choice between comprehensive income tax and consumption tax and variations of the comprehensive income tax, this article proposes the adoption of accounting standards as the basis for determining a benchmark tax base to analyse corporate tax expenditures. The use of accounting standards is tempered with anti-tax avoidance measures to ensure tax revenue is protected.

1. Introduction

Ever since the concept of tax expenditures emerged in the late 1960s, the issue of benchmark tax base for tax expenditure analysis has been the central discussion. The adoption of the first tax expenditure budget in the United States required a definition of the benchmark that would be used to identify features in the tax law that led to over or undertaxation compared to the tax that would follow application of the benchmark. For over four and a half decades there has been disagreement about the benchmark developed by the Treasury for the purpose of the U.S. tax expenditure budget. The Australian benchmark, in use for three decades, is also an ad hoc creation of a Treasury and each year's iteration of that country's tax expenditure statement contains an explanation for the borderlines drawn in the course of developing the benchmark. New Zealand, on the other hand, does not attach itself to a single normative tax benchmark and has not specified any tax base to be adopted, but rather provides a “guiding criteria” to identify tax expenditures.¹

Each proposed benchmark tax base has its own proponents and opponents, but only a few proposals are convincing enough and are applied in tax expenditure reports. Previously, the issue has been explored mainly by economics and legal tax experts. There is yet to be any accounting scholar to give opinion on this matter. The aim of this paper is to propose the use of accounting standards as an alternative benchmark tax base for corporate tax expenditure analysis, particularly for Malaysia, which to date has not published any formal or informal tax expenditure report.

First, this paper explores the concept of tax expenditures and the issues that revolve around it, which includes its benefits and shortcomings as compared to direct spending programmes, the measurement of tax expenditures and tax expenditure reporting. It then discusses the earlier proposed tax bases that have been offered by various scholars. This paper later develops arguments to support the use of accounting standards as the benchmark tax base, followed by a discussion about the sources of differences between accounting income and taxable income. Finally, this paper reveals the proposed benchmark for Malaysia’s corporate tax expenditure reporting and analysis.

2. Tax Expenditures

2.1 History and Background

The concept of tax expenditure was brought into light by the late Professor Stanley S. Surrey; a tax expert, a tax enthusiast and a tax reformist who had spent most of his life in the field of taxation. His contribution to tax policy started in 1930s, where he started to publish tax articles. He commenced as an attorney at the Office of the Tax Legislative Council in the U.S. Treasury Department, and later joined Berkeley Law as a professor in 1947. In 1950, he joined Harvard Law School. He left his academic position in 1961 to serve as the Assistant Secretary of the U.S. Treasury for Tax Policy. In 1969, he quit the public service and returned to Harvard Law School as a professor until his retirement. His vigorous works on the area of tax expenditure continued until his death in 1984.²

It was during his tenure as the Assistant Secretary with the U.S. Treasury that Surrey posited the idea of tax expenditure, and turned it into application. The issue arose after the U.S.

government, in its struggle to increase tax collection and to reduce expenditures, failed to consider tax expenditures due to the lack of awareness that tax expenditures are substitute to direct spending and the absence of any kind of data or analysis on that matter. The idea was first conveyed by Surrey on November 15, 1967, before the Money Marketeers, a New York financial group, entitled “The United States Income Tax System – the Need for a Full Accounting”, followed by many other books and journal articles authored by Surrey and his associates.

Since 1950s, tax scholars have expressed their concern about the rising number of tax incentives which could have negative impact to the tax system. In 1960s, the U.S. Treasury supported this notion, and contended that direct spending is a better measure to achieve the same objectives these tax incentives are trying to achieve. While both tax incentives and direct spending programme can be used to achieve certain policy, there is lack of comprehensive analysis over tax incentives and how much the use of these incentives costs the government. Therefore the Treasury, led by Surrey himself, started to compile a list of tax expenditures together with an estimate of the revenue forgone (which is equivalent to the amount spent under direct

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government spending). The outcome of this study was published in the 1968 Secretary of the Treasury’s Annual Report, and was the first tax expenditure budget produced.

There are a number of motivating factors for Surrey to uphold the idea of tax expenditure. First is his persistent effort to promote tax fairness. He believed that everybody has to be taxed based on their ability to pay. Tax expenditures provide incentives only to certain groups or activities, thus affect tax fairness. Moreover, due to lack of analysis, some tax expenditures provide most benefits to the higher bracket taxpayers, who obviously not the needy group.

The second factor is to enhance transparency. While direct spending programmes are subjected to detailed scrutiny, tax incentives, though are actually alternatives to direct spending, were implemented without have to go through the same process. In addition, since the provisions of tax incentives are embedded as part of tax law, the public were not aware of their existence. Surrey also highlighted how the tax office, apart from their well-known function as the revenue-raising agency, is also a medium used by the government to spend money through tax incentives. He believed the public deserve to be informed about these facts. Tax expenditure report pioneered by Surrey has become a mechanism for the public to assess these incentives.

The third factor why Surrey promoted this concept is to help government improves its tax and budgetary policies. By acknowledging the existence of tax expenditures within the tax system of a country, and with adequate analysis on these tax expenditures, government should be able to

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8 Stanley S. Surrey and Paul R. McDaniel, Tax Expenditures, above n 5, 2-3; Stanley S. Surrey and William F. Hellmuth, above n 4, 529-530.
14 Stanley S. Surrey and Paul R. McDaniel, Tax Expenditures, above n 5, 1.
formulate better policies.\(^\text{15}\) Information provided by this analysis should assist the government to better manage its fund.

### 2.2 The General Concept of Tax Expenditure as Posited by Stanley S. Surrey

Under the tax expenditure concept, income tax system consists of two elements – the structural provisions and the special preference provisions.\(^\text{16}\) The structural provisions are the primary rules that exist within a normal income tax system. They are considered necessary to implement a fair, good tax system. Each country has its own unique tax system, thus structural provisions of each country may differ. These structural provisions are the benchmark tax. Any tax rules that deviate from this benchmark are tax expenditures. Tax expenditures are the special preference provisions, give preference only to certain industry, activity, or class of persons, generally to achieve certain social and economic goals.\(^\text{17}\) These provisions are often known as tax incentives or tax subsidies, and can be in the form of exempted income, deductions, deferral of tax liabilities, tax credits or special tax rates.

Therefore, tax expenditures can be defined as tax rules that deviate from the benchmark tax. The first step in tax expenditure analysis is to distinguish between the benchmark element and the tax expenditure element.\(^\text{18}\) Surrey pointed out six components of the benchmark - the tax base, i.e. the definition of net income, the tax rate, the taxable unit, the taxable period, application to international transactions and tax administration procedures.\(^\text{19}\) These components are discussed below. Since personal income tax and corporate income tax has different nature and some matters are exclusive for one group, it is more appropriate to have separate benchmark for each group.\(^\text{20}\) This paper focused more on the benchmark for corporate income tax.

\(^\text{15}\) Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures*, above n 5, 2; Daniel N. Shaviro, above n 3, 201.
a. The tax base (the definition of net income)

Because income tax is imposed on net income, it is essential to decide the most appropriate way to determine net income. Surrey suggested Schanz-Haig-Simons (S-H-S) economic concept of income as the appropriate basis.\textsuperscript{21} The concept was developed by a Georg von Schanz, adopted by Robert Murray Haig and later refined by Henry Simons.\textsuperscript{22} Under S-H-S, income is the increase in net economic wealth between two points of time plus consumption during that period. However, the S-H-S income covers only basic aspects and discusses only few details, and does not discuss some issues in today’s world. Furthermore, items such as self-performed services, gift and bequests, imputed income from personal assets,\textsuperscript{23} and the unrealised increases in the value of assets (accrued capital gain), which fall within the definition of income under the S-H-S, are traditionally excluded from the definition of income for tax purpose. Therefore, to apply the S-H-S income as the tax base, the concept has to be tempered with “the generally accepted structure of income tax, based on ability to pay”.\textsuperscript{24}

More adjustments are required to apply S-H-S income to corporate income tax. The consumption aspect is irrelevant.\textsuperscript{25} Income refers to the increase in net worth of the company, which generally is the difference between total assets and total liabilities in the balance sheet. It can similarly be ascertained by deducting from gross income all expenditure incurred in the production of that gross income, with capital expenditures being allocated over useful life in accordance with accounting principles.\textsuperscript{26} Nevertheless, because several accounting principles, such as the matching and prudence principles, do not coincide with tax rules, taxable income cannot be taken straight away from the balance sheet or the income statement.\textsuperscript{27}


\textsuperscript{23} Imputed income is the value of the benefits that a person received from the use of his own assets, the services provided to himself and the consumption of self-produced goods/services. Most common example is imputed rent, which is the rental value of owner-occupied property.


\textsuperscript{25} Paul R. McDaniel and Stanley S. Surrey, \textit{International Aspects of Tax Expenditures: A Comparative Study}, above n 5, 43.


\textsuperscript{27} Paul R. McDaniel and Stanley S. Surrey, \textit{International Aspects of Tax Expenditures: A Comparative Study}, above n 5, 43.
In practice, it is apparent that S-H-S income is the starting point for most countries’ formulation in setting the benchmark tax base, though no one uses it. Rather, they assume it should be the benchmark but then provide a range of rationalisations why their national benchmarks should deviate (sometimes significantly) from this theoretical model.

b. The tax rates

There is no normative rate schedule to be adopted as benchmark.28 The rate schedules (including a possible zero rate or tax-free threshold for individuals) are determined based on the government’s fiscal policy and political goals. Once the benchmark is set, any special rate different from the benchmark is regarded as tax expenditure.29 Some countries offer a lower tax rate for small and medium-sized businesses. In one view, whether this constitutes a tax expenditure depends on the country’s policy and the intention of the government when they first introduced this rate.30 Usually, if the special rate is given to provide incentive, or to assist certain industries or activities, it should be treated as a tax expenditure. Likewise, a rate higher than the benchmark suggests a negative tax expenditure.

c. The taxable unit

The determination of taxable unit is important during the classification of a tax expenditure. In the case of personal income tax, if the individual is chosen as the benchmark tax unit, any tax breaks relevant to taxpayer’s dependents (spouse, children and parents) are considered tax expenditures.

In the case of corporate income tax, if the tax unit is individual company, then any intra-group loss set-off is a tax expenditure. The corporate tax unit could also be more specific, for example SMEs versus large companies, or special tax treatment for special line of businesses such as insurance and banking. As a result of these specific tax units, any different tax treatments involving different tax units are considered part of benchmark and do not give rise to tax expenditures or negative tax expenditure.

The benchmark should also decide on whether company should be taxed in its own right separate from shareholders, or to integrate tax system for company and shareholders so that no double taxation is imposed on the same income. The common benchmark is to avoid double taxation. Still, there are many views on how they should be implemented. They are further discussed below:

a. **Classical system.** Classical system treats company and shareholders as two separate entities. This means corporate profit is taxed twice, first at company level, and later profit distributed as dividend is taxed at shareholder level. As a result to this view, any tax rules that reduce or eliminate tax on dividends at the shareholder level, or allow a deduction for dividends at the company level, are regarded as tax expenditures.

b. **Full integration system.** Also known as shareholder allocation system, under this view company profit is taxed at shareholder level; the company is actually an aggregate of individual shareholders. All profit, whether distributed or not, is taxed to shareholders at their respective tax rate. To ease tax collection, company deducts withholding tax and pay net dividend to shareholders. Under this view, any relief given to shareholders is a tax expenditure.

c. **Dividend imputation system.** Company pays tax based on corporate tax rate and dividends are distributed after-tax. Shareholders need to include the dividends in their taxable income. The dividends need to be grossed up (i.e. get the amount of pre-tax dividends) and taxed to shareholders based on their respective tax rate. To avoid double taxation, shareholders get refundable tax credit for the difference between the tax paid by the company and the tax charged to them. Therefore, effectively it is the shareholder who has to pay tax on the dividend; company is merely a collecting agent. The tax credit is not a tax expenditure because its purpose is to avoid double taxation, not to provide incentive.

d. **Dividend exclusion system.** This system is simple to administer, because tax is payable at company level and distributed to shareholders as exempt income. There is no issue of double taxation, and no tax credit is required. However, if shareholder’s tax rate is lower

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than company’s tax rate, this system would result in a negative tax expenditure for shareholders.

e. **Dividend deduction system.** Under this system, dividends distributed to shareholders are regarded as deductible expenses for company. Company pays tax on profit retained in the company, and shareholders pay tax on distributed profit. Since dividend is not an expense in accounting, the deduction of dividend could be a tax expenditure if accounting standards is the benchmark tax base.

d. **The taxable period**

Surrey suggested the application of accounting rules as the benchmark tax for several elements that are not covered by the S-H-S income, particularly regarding the adoption of accounting period. Tax has to be calculated over a specified period. As the S-H-S income does not specify the period, the standard practice for tax follows the accounting practice, to calculate income (and therefore tax) over a period of 12 months. Other elements that relate to the use of accounting period should also be included in the benchmark, such as the allocation of income and expenditure to appropriate period. Nevertheless, Surrey also pointed out that the use of the standard accounting rules should be tempered “by resort to practical concerns of tax collection and tax administration”. One example is the issue of deductibility of expenses to be incurred in future years, such as the provision for retirement benefits and provision for warranty services. Based on company’s experience, the retirement benefits and the warranty services are certainly to be incurred in forthcoming accounting periods. However, because they relate to services rendered and sales in the current period, the accounting’s matching principle requires estimates of the amount to be incurred to be set off in current period’s income statement. This practice is not allowed in tax, due to the concern that the amount recorded as expense is uncertain and contingent in nature. The tax treatment prefers deductions to be granted only when the actual payable amount is known.

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35 Courts from different countries have tackled the issues differently. In New Zealand’s case Commissioner of Inland Revenue v. Mitsubishi Motors New Zealand Limited, the Privy Council ruled out that the tax treatment for provision of warranty services must following the accounting practices. In the USA, the Court of Appeal in Chrysler Corp. v. CIR refused to give deduction for anticipated warranty claims on the basis that it is contingent in nature. See discussion on this matter in Salwa Hana Yussof, ‘Tax Disincentives
The different treatment in accounting and taxation resulted in deductions to be deferred to future period, which is a negative tax expenditure. However, if government takes the view that this deviation is due to the concerns over tax collection and tax administration, then the deviation does not constitute tax expenditure or negative tax expenditure.\textsuperscript{36}

e. The application of the tax to international transactions

Two main issues related to the international transactions. The first is to establish jurisdictional principles that define “resident” and “non-resident”, because the two groups receive different tax treatment.\textsuperscript{37} The second issue is the rule of double taxation when the same income is taxed in two or more countries. It is a norm to allow double tax relief to avoid the same income to be taxed twice.\textsuperscript{38}

f. Tax administration

The tax office should have a standard tax administration procedure. Procedure undertaken to administer tax may give rise to tax expenditure, if there is a special treatment for certain taxpayers that deviates from the standard procedure, undertook with the intention to provide incentive to taxpayers.\textsuperscript{39} For example, certain taxpayers are allowed to pay their taxes over longer periods of time than is generally allowed.\textsuperscript{40} If this special treatment resulted in a lower tax liability, then it constitutes a tax expenditure.

2.3 Tax Expenditures versus Direct Spending

It is an accepted notion that tax expenditures are ineffective, unfair and unreasonable compared to direct spending.\textsuperscript{41} Nevertheless, this is not always accurate. One should not take the term “tax expenditures” as a single item and then give the same impression to all of them. It is

\textsuperscript{36} Stanley S. Surrey and Paul R. McDaniel, \textit{Tax Expenditures}, above n 5, 188-190.
\textsuperscript{40} Paul R. McDaniel and Stanley S. Surrey, \textit{International Aspects of Tax Expenditures: A Comparative Study}, above n 5, 61.
undeniably true that most subsidies are better to be delivered through direct spending; however tax expenditures might have their own strength. As has been highlighted before, what necessary is an analysis to decide which one between direct spending and tax expenditure is the better method to achieve the set objectives. Another important point is tax expenditures must go through similar scrutiny as direct spending to make a fair comparison. This section discussed the arguments that oppose and support the use of tax expenditures.

Opponents of tax expenditures claim that the tax expenditure system is embedded with many limitations, thus make direct spending the favoured method. At the same time, direct spending itself has a better design which renders it superiority to tax expenditures. Those arguments are discussed below:

a. **Lack of transparency.** The main issue with tax expenditures is they escape the detailed scrutiny put on direct spending programme. Therefore tax expenditures have become hidden government spending, and commonly used by politicians to pursue their political goals. With less budgetary oversight, less available information, less review and evaluation on their implementation and effectiveness, tax expenditures can easily and quietly slip through the government expenses without much hassle.

b. **Benefit the rich.** Since tax expenditures can only be claimed by those who pay tax, they are often claimed by middle income and high income earners. Low income earners and loss-making companies may receive lesser benefit from tax expenditures, despite the fact that they are the needy groups. Either their income is lower than the tax threshold, or the

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incentive that they can claim is limited due to low income.\textsuperscript{49} On the other hand, the wealthy could get a very low effective tax rate after claiming all tax expenditures they are entitled to.\textsuperscript{50} This situation is widely known as the “upside-down” effect. This will not only impair tax fairness, but also upset the objective of the tax expenditures. Direct spending, on the other hand, is channelled directly to the needy groups.

c. \textit{Tax expenditures are indefinite and open-ended}. The usual practice for direct spending budget is to have a ceiling on how much can be spent within a certain budget period. Anything above the ceiling would require a tight examination. On the contrary, tax expenditures have no set limits.\textsuperscript{51} Moreover, if no expiry date was set when they were first enacted, they will remain in the tax system until the government decides that it should be repealed.\textsuperscript{52} Thus it is hard to control the flow of fund through tax expenditures.

d. \textit{Restrictive accounting period}. The tax system adopts the accounting period as the time interval, which is twelve months. Taxable income and deductions are calculated according to the accounting period. Consequently the design of tax expenditures is restricted to the annual accounting period.\textsuperscript{53} Tax expenditures are granted based on one year, and eligibility to receive the incentive is also assessed for a period of one year. In contrast, direct spending can be delivered for a period of less or more than one year, tailored to the recipient needs.

e. \textit{Complicate the tax system}. Taxation is already perceived as complicated by the general public. Adding spending programme to the tax system makes it even more difficult.\textsuperscript{54} Tax expenditures can take many forms, and there are different criteria to entitle to tax

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\textsuperscript{52} Thomas F. Pogue, ‘Tax Expenditures: Concept and Framework for Analysis’ (Office of Tax Policy, New Mexico Taxation and Revenue Department, April 2009) 14.  
\textsuperscript{53} Eric J. Toder, ‘Tax Cuts or Spending – Does it Make a Difference?’, above n 11, 365.  
expenditures. Often it requires the help of a tax expert for taxpayers to claim all tax expenditures they are entitled to, particularly for corporate taxpayers. Moreover, because tax expenditures can be used as tax avoidance tools, additional rules need to be introduced to avoid abuse of the incentives. This adds complexity to the system.\textsuperscript{55} The complexity also causes problems to the tax office staff, since they have more items to be audited.

\textbf{f. Narrow tax base, high tax rate.} Tax incentives caused tax base to become narrow and leads to reduction in government’s revenue.\textsuperscript{56} To cover the loss of revenue, the tax rate has to be increased. Often the cost has to be borne by those who are not entitled to claim tax expenditures.\textsuperscript{57} Elimination of tax expenditures should broaden the tax base and reduce the tax rate, and the government could collect the same amount of tax revenue with simpler tax system.\textsuperscript{58}

\textbf{g. Distort economic behaviour.} Tax expenditures upset the neutrality principle in tax.\textsuperscript{59} They change economic behaviour, sometimes in a way that is less desirable and leads to market distortion.\textsuperscript{60} Tax expenditures encourage involvement in certain activities, for example, by giving tax exemption to companies that operate in a particular area. This distorts economic choices because tax has become the deciding factor and thus affects perfect market competition.

\textbf{h. Administration and monitoring.} Direct spending is administered by specialised government agencies, which have more knowledge in that area.\textsuperscript{61} They understand the need of the recipients better than others. If the authority to allocate resources is given to them, they should be able to design a good spending programme that can really benefit the recipients. They can also monitor the programme continuously for each individual recipient, not only on the eligibility criteria, but also how the subsidy granted was spent and the success of the programme. In contrast, tax expenditures are administered by the tax office staff. Eligibility

\textsuperscript{55} Eric J. Toder, ‘Tax Cuts or Spending – Does it Make a Difference?’, above n 11, 362; Richard Krever, above n 54, 488.
\textsuperscript{61} Neil Brooks, above n 46, 249.
is assessed based on the information provided in the tax return, which is limited. With limited information, monitoring is almost impossible, and the success of the programme remains unknown. Nevertheless, there are several tax expenditures that require certification from specialised agencies (most of investment incentives in Malaysia require approval from the Malaysian Industrial Development Authority), thus enable these agencies to provide continues monitoring.

The opponents of tax expenditures also argue that the alleged benefits of tax expenditures are actually incorrect. The following paragraphs discussed this statement:

a. **Minimise cost.** Tax expenditures are said to save government’s money because they are delivered through government’s existing agency, which is the tax office. On the other hand, if an incentive is delivered through direct spending, the government needs to start a specialised department, and subsequently incurs additional costs. This belief is not always true. The cost to develop a different agency can be kept at the minimum level if the eligibility criteria required are as simple as information provided in income tax return. Besides, the government already has so many existing ministries and agencies that can be used to deliver a direct spending programme. They are more expert in their area, and should be able to perform work in a more efficient manner (hence lower cost) than the tax office staff. There is no need to start a new specialised department.

In addition, direct spending incurs higher costs because it has stricter eligibility criteria, and needs detailed procedures and monitoring. These increase costs, but they are important process that normally left out from tax expenditure programme.\(^\text{62}\) Thus, although tax expenditures would probably reduce government’s costs, it lacks of detailed scrutiny and supervision present in the direct spending. If these are incorporated into the tax expenditure programme, the cost should become higher.

Moreover, tax expenditures appear as lower in cost, but actually some costs have been transferred to taxpayers because filing tax return has become more complex.\(^\text{63}\) There are also hidden costs incurred by the tax office itself, which include the costs of planning, developing rules, issuing public rulings, collecting tax, tax audit and lawsuit by taxpayers.\(^\text{64}\)

\(^{62}\) Neil Brooks, above n 44, 246-247.

\(^{63}\) Julie Smith, above n 12, 21.

b. *Simple to operate.* Tax expenditures seem to be simple and less complicated to be operated as compared to direct spending programme. This could be true; however the complication of direct spending programme run through a government agency is more likely to be targeted more efficiently. The programme is complicated due to the enhanced scrutiny and monitoring process. On the other hand, although tax expenditures is simple, it has been criticised for benefiting the high income group.

c. *Encourage private sector contribution in government’s economic and social programmes.* One of the objectives of tax expenditures is to encourage private sector companies to support government programmes especially those that related to social goals. However, tax incentive is not always the motivating factor. Tax expenditures alone are not enough to attract private sector’s involvement. Other factors could have more effect such as government regulations and company’s quest to portray good image to the public as part of their marketing strategy.

Although direct spending is preferred in many cases, the programme itself is not always perfect. If tax expenditure programme is designed properly, it can be better than direct spending. The followings discuss the potential strength of tax expenditures:

a. *Simple, lack of bureaucracy.* Because eligibility to certain tax expenditures is based on information provided in the tax return, the incentive is easier to claim compared to the direct spending. This can reduce the opportunity for malpractices that always happen in direct spending programme, which include political favour, discrimination and favouritism, and corruption. Although some argued that stricter control is important for direct spending and tax expenditures, several tax expenditures especially the general ones could still be effective despite its simplicity.

b. *Increase tax compliance.* Taxpayers are required to claim benefits from the tax office, and to claim they need to report their income and submit income tax return. This in turn shall increase tax compliance, especially for individuals and small business enterprises.

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67 Julie Smith, above n 12, 23.

c. **Incentive by way of refundable tax credit.** The features of tax credit are most similar to direct spending (when compared with other types of tax expenditures).\(^69\) Unlike other types of tax expenditures, tax credit gives cash reimbursement if the incentive exceeds tax payable. Therefore, low income taxpayers can still benefit from the incentive. Other types of tax expenditures such as income exemption and tax deduction may not fully benefit these low income earners because when taxable income is already below minimum tax threshold, they do not have to pay tax but cannot utilise any of the tax incentives.

Despite the claim that both tax expenditures and direct spending could be used to achieve government objectives, outcomes from these two methods might differ.\(^70\) In addition, tax expenditures offer qualitative benefits that cannot be quantified in monetary terms. For example, when government offers income tax exemption for involving in certain favoured industry that is of national importance, companies in that industry will push themselves to make profits so that they can benefit from the income exemption. In contrast, if the government is going to give cash benefit, they may not struggle as hard as in the previous case because they know that regardless of their performance, they will still get the subsidy. The estimated cost of tax expenditures is unable to measure these kinds of costs.

### 2.4 Measurement of Tax Expenditures

The issue of measurement also sparks substantial debate. Measurement of tax expenditures in monetary terms is essential as it represents the amount that would be spent by the government should the incentive be implemented by way of direct spending programme, thus provides information on which among the two programmes is more cost-effective. There are three different measurement methods that can be applied.

a. **Revenue forgone method.** The most common measurement used is initial revenue loss method, also known as revenue forgone method. It measures the estimated reduction in tax revenue that resulted from the introduction of a tax expenditure, with other factors remain unchanged.\(^71\) According to Surrey, this is the same method used when estimating the

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revenue loss or gain when any change in tax law is proposed. However, others have criticised the use of this method, claiming that the revenue estimates in ordinary budget costing processes do not require adjustments for changes in behaviour because they involve direct outflow of money. On the other hand, failure to account the effect of any behavioural response and the effect of interaction with other parts of the tax system for tax expenditures is misleading. Tax expenditures do affect taxpayers' behaviour towards certain goods or products. In fact, this is the intention of the government when they introduced a tax expenditure. Similarly, removal of a tax expenditure can change taxpayers’ behaviour, as it may increase the use of other tax expenditures. Removal of a tax expenditure can also lead to higher income by some taxpayers and pushed them into higher tax brackets (in the case of tax system with progressive tax rates). Failing to take these two factors into account can caused inaccurate measurement, and leads to a wrong decision-making by policymakers. Surrey realised this problem but contended that in seeking balance between accuracy and reliability, this method is safer and preferred. Besides, imprecise estimates are still better than not to have estimates at all, in which government could be left clueless about their indirect spending. In addition, similar inaccuracy and lack of information problems exist in the annual direct spending budget; yet it is still highly trusted.

b. **Revenue gain method.** The second method, revenue gain method, is the measure of additional revenue collected by the government if a tax expenditure is repealed. This method is more complicated as it has to take into account taxpayer’s behavioural response and the need for a policy specification resulting from the removal of each tax expenditure examined. This

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74 Dirk-Jan Kraan, above n 71, 137.


78 Zhicheng Li Swift, Hana Polackova Brixi and Christian Valenduc, above n 51, 7.
method overcomes the criticisms put on the first method. However, it is more difficult to apply, and requires additional efforts and resources. Besides, the complexity of the calculation and the inclusion of the behavioural effect, which is hard to measure, make the measurement questionable.

c. **Outlay equivalent method.** The third method is outlay equivalent estimate, which represents the before-tax cost of a direct spending programme designed to have similar after-tax result of the tax expenditure.\(^{79}\) Since some direct spending programme is taxable in the hand of the recipient, to make a fair comparison, its tax expenditure measurement must be grossed up to show the before-tax result, and the recipient must be as well of after tax as under the existing tax expenditure programme.\(^{80}\) Failing to do so will result in tax expenditure measurement to be understated. Nevertheless, this method is applicable only to tax expenditures that have their equivalent direct spending programme taxable.

In terms of practicality, the revenue forgone method is widely used. Although some tax experts claim that this method produces inaccurate results, the accuracy of other methods is still questionable as the calculation is more complex. Thus, the first method is still adopted by many governments in their tax expenditure reporting.\(^{81}\) The use of revenue gain method and outlay equivalent method can be found in a few tax expenditure reports, but are available only for selected tax expenditures.\(^{82}\)

Furthermore, it is also argued that the cost of tax expenditures should not be added up. Since there is interaction between two or more tax expenditures, and also there is interaction between tax expenditure and other parts of the tax system such as the progressive tax rates, adding up the estimates could yield double counted and biased estimates.\(^{83}\) If they are added up, then there

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\(^{82}\) The Australian Tax Expenditures Statement discloses the revenue gain for selected 10 tax expenditures, and the U.S. presents outlay equivalent estimates in the notes.

should be accompanied with a note to warn readers about its possible misleading effect. Nevertheless, comparing the annual sum of tax expenditures over a period of time could provide some hints for analysis, since the bias from interaction effects would be less significant in this context.

Ideally, estimates of tax expenditures and direct spending should be comparable. However, up to this date, this is still not possible due to the difficulties discussed above. Besides, because the measurements are calculated differently, side-by-side comparison could be confusing and misleading. The problem of inaccurate estimates does not rest on tax expenditure analysis alone. Direct spending programme and other budget elements also have the same problem. Regardless of the fact that it is very hard to produce accurate estimates of the cost of tax expenditures, it still an important element in tax expenditure analysis and should no way be omitted from the report.

2.5 Tax Expenditure Reporting

Since the U.S. pioneered the publication of tax expenditure report (known in the U.S. as tax expenditure budget) in 1968, many developed countries have followed the same path. Some developing countries also produce tax expenditure reports. This section discusses the importance of tax expenditure reporting and the contents of the report, accompanied by brief overviews of reporting practice by three selected countries.

In order to decide what should be included in a tax expenditure report, one has to first determine the objectives or the importance of such report. The objectives should guide what the contents are. The main reason that triggered the development of tax expenditure concept is when the U.S. government failed to take tax expenditures into consideration when they tried to increase revenue and to cut spending. As such, the tax expenditure report is an important tool to improve efficiency in government’s resource allocation and fiscal policy, and to help government to have better control over its spending. The report should identify which tax provisions are equivalent to direct spending and hence require detailed scrutiny. It should also include information necessary to further analyse a tax expenditure. The information provided in the report and the analysis on tax expenditures, coupled with existing information from the direct spending budget,

85 Thomas L. Hungerford, above n 83, 7.
86 Stanley S. Surrey and William F. Hellmuth, above n 4, 530; Stanley S. Surrey, ‘Tax Expenditure Analysis: The Concept and Its Uses’, above n 5, 6-7; Lotfi Maktouf and Stanley S. Surrey, above n 5, 754.
the government can see the overall picture of the amount spent to achieve certain goals, the costs and benefits involved and its beneficiaries.\textsuperscript{88} The report could be more useful if it can be presented side-by-side with the direct spending budget; however due to the problem in measurement as discussed previously, this is currently impossible.

Tax expenditure report is also an important tool to improve transparency of a government.\textsuperscript{89} By making the information available to the public, the once “hidden cost”, or “backdoor spending” is now visible.\textsuperscript{90} Hence, the efficiency of tax expenditures, and the tax system as a whole, can be assessed by the public. Not only that tax expenditures are currently viewed as direct spending, they are also subject to the same detailed scrutiny (however, this depends to the government whether they want to further scrutinise the tax expenditures). This should also prevent the politicians to use tax expenditures to benefit their personal political goal rather than for the benefit of the country. The report also benefits the government by disclosing to the public its “indirect spending” i.e. the amount that has been spent through tax expenditures.

There is no standard format in the presentation of a tax expenditure report. The contents and the layout of the report vary between countries. The tax base and the method of measurement used to determine tax expenditures are also different, therefore prohibit cross-country comparisons. However these differences are sensible because the report should provide information and data essential to the country’s own government and policymakers.

Still, few guidelines are available. The International Monetary Fund (IMF) suggested that a tax expenditure report should display the public policy objective of each tax expenditure, how long will it be effective, to whom the incentive is intended and its estimated costs. The analysis of previous tax expenditures, particularly with regard to how they accomplished the intended objectives, should also be included.\textsuperscript{91} Other tax scholars proposed that a basic tax expenditure report should at least disclose the definition of tax expenditures, the list of the country’s tax expenditures and their estimated revenue forgone, and the benchmark tax components used alongside tax rules that have been agreed as the “generally accepted structure of income tax”. The list of the tax expenditures should be categorised based on the government budget function and data provided should be for a period of several years, preferably similar to the direct

\footnotesize{\textsuperscript{88} Stanley S. Surrey and Paul R. McDaniel, ‘The Tax Expenditure Concept and the Budget Reform Act of 1974’, above n 5, 692.}  
\footnotesize{\textsuperscript{89} Mark Burton, ‘Making the Australian Tax Expenditures Statement an Effective Policy Instrument – from Fiscal Report to Transparent Report’ (2005) 8(1) Journal of Australian Taxation 1, 16-28.}  
\footnotesize{\textsuperscript{90} Eric J. Toder, ‘Tax Expenditures and Tax Reform: Issues and Analysis’, above n 87, 2.}  
\footnotesize{\textsuperscript{91} IMF Fiscal Affairs Department, Manual on Fiscal Transparency (IMF, Washington D.C., 2007) 64-65.}
spending budget. Additional information such as the source and the duration of the tax expenditures may also be provided.\textsuperscript{92}

Most Organisation for Economic Co-operation and Development (OECD) countries, which are regarded as the high-income earners, have produced some kind of tax expenditure reports.\textsuperscript{93} Several developing countries and emerging economics have produced something related to tax expenditures or are working towards it.\textsuperscript{94} The following paragraphs illustrate tax expenditure reporting in four selected countries. The U.S. is selected because it is the first country to produce a tax expenditure report and include it as part of the annual budget document. Australia has a reader-friendly, comprehensive separate tax expenditure report, and New Zealand is a country that decides not to set any neutral tax benchmark to identify tax expenditure. Jordan represents a developing country that just started to engage in tax expenditure reporting; hence could be a good example to non-reporting countries, including Malaysia.

\textbf{a. The United States}

The preparation and publication of a tax expenditure report is made mandatory in the U.S. by the Congressional Budget Act of 1974.\textsuperscript{95} The definition of tax expenditures under the Budget Act is “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability”.\textsuperscript{96} Tax expenditure report in the U.S. covers only those arising out of income taxes. The U.S. is the only country that produces two sets of tax expenditure reports. One report is produced by the Office of Management and Budget (OMB), a component of the Executive Office of the President of the United States. The second report is prepared by the staff of the Joint Committee on Taxation (JCT), a committee of the U.S. Congress. The U.S. Congress prepares a separate


\textsuperscript{93} Dirk-Jan Kraan, above n 71, 130; Mark Burton and Miranda Stewart, above n 92, 32; OECD, Tax Expenditures in OECD Countries (OECD Publishing, 2010) 14.

\textsuperscript{94} For example India, South Africa, Chile and Brazil. For case studies regarding tax expenditure reporting in these countries, see Mark Burton and Miranda Stewart, above n 92, 32.


\textsuperscript{96} Budget of the United States Government, Office of Management and Budget, Executive Office of the President of the United States, Analytical Perspectives (Fiscal Year 2012) 239; Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014 (JCS-3-10, 15 December 2010) 3.
tax expenditure report because under the U.S. Constitution, the Congress and the President of the U.S. are two distinct “coequal branches”.

The OMB’s report is published as part of the president’s yearly budget, but in a separate section called Analytical Perspective. Tax expenditure estimates in this report come from U.S. Treasury’s Office of Tax Analysis. The OMB’s report provides estimates for a seven-year period – current budget year, two previous years and four future years. Two baseline concepts are used, one is the normal comprehensive income tax baseline, and the other is the reference tax law baseline, both with few adjustments. Items within the reference tax law baseline are also within the normal income tax baseline, but the reverse is not always true. The tax expenditures are measured using the revenue forgone method, and where available, the outlay equivalent estimates are shown in the notes. The present value estimates are disclosed for selected tax expenditures. Also included in the report are brief explanations on how the tax expenditures deviate from the baseline tax system (or in other word, why these tax treatments have been classified as tax expenditures).

The JCT also produces tax expenditure report annually. The JCT relies on estimates supplied by the Congressional Budget Office. Similar to the OMB’s report, the JCT’s report also use normal income tax baseline, the S-H-S income as the baseline. However, the JCT is using a broader definition, thus the list of tax expenditures produced is longer. In addition, the JCT includes negative tax expenditures in the report. Estimates are shown for a period of five years – the budget year and four years after – using the revenue forgone method.

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98 Budget of the United States Government, Analytical Perspectives (Fiscal Year 2012), above n 96, 239-276.
99 OECD, Tax Expenditures in OECD Countries, above n 93, 134.
100 Budget of the United States Government, Analytical Perspectives (Fiscal Year 2012), above n 96, 239.
101 Further discussion on reference tax law baseline can be found in Section 3 of this paper.
102 Budget of the United States Government, Analytical Perspectives (Fiscal Year 2012), above n 96, 239-240;
OECD, Tax Expenditures in OECD Countries, above n 93, 132-134.
b. Australia

Australia’s Treasury produces Tax Expenditure Statement annually as a separate government document; however an excerpt from the statement is included in the federal government’s budget. The statement presents tax expenditure estimates for a seven-year period, consists of estimates for the current period, three previous years and three forthcoming years. The tax expenditures are classified according to their budget functions. The current period’s tax expenditures are also compared side by side with the direct expenditures. The statement reports tax expenditures arising from various types of taxes including income tax, capital gain tax, goods and services tax, excise and customs duties, petroleum resource rent tax and other direct and indirect taxes.

The statement defines tax expenditure as “a provision of the tax law that provides a benefit to a specified activity or class of taxpayer that is concessional when compared to the ‘normal’ tax treatment that would apply”. Tax expenditure estimates are measured using revenue forgone method. In addition, estimates using revenue gain approach are provided for ten of the largest tax expenditures (ranking based on revenue forgone method). The tax expenditures from income tax are identified using the S-H-S income as the tax base. Other benchmark elements include the application of nominal rather than real income, the use of cash basis for individuals and accrual basis for businesses, and exclusion of imputed rent from the basis.

Additional information provided in the report includes the tax expenditure types, reliability of tax expenditure measurement, commencement and expiry date of the tax expenditures, their legislative references and brief explanations on how the tax expenditures work.

c. New Zealand

New Zealand started its tax expenditure reporting in 1984, but later it was stopped when the country had a major reform to its tax system of which many tax incentives were removed. Recently, starting 2010, a tax expenditure statement has been published as part of the annual budget. The term tax expenditure is defined by the statement as “individual features of the tax system that reduce an entity’s tax obligation in a way that is designed to give effect to

107 Mark Burton and Miranda Stewart, above n 92, 29-30.
policy other than to raise revenue in the most efficient and economically neutral way”.

The statement discloses tax expenditures arising from New Zealand’s Income Tax Act and Goods and Services Act. In addition, to improve transparency, appropriated spending through the tax system, which consists of tax credits not identified as tax expenditures, is also disclosed in the statement.

One distinguished character of New Zealand’s tax expenditure statement is its choice to diverge from the common practice of setting the normative tax benchmark. Instead, tax expenditures are identified based on a list of guiding criteria. Those that fulfil all of the following criteria are disclosed in the tax expenditure statement:

1. The concession is available to a targeted group or type of activity;
2. The provision represents a targeted reduction in a tax obligation relative to current tax practice;
3. The provision is not primarily administrative or motivated by a (domestic or international) double taxation objective;
4. The provision is significantly motivated by a non-revenue policy objective.

As a country that has one of the most broadly based, neutral and efficient tax systems among OECD countries, New Zealand has a short list of tax expenditures. Only 37 tax expenditures from income tax are listed in the tax expenditure statement for both individual and business taxpayers. Nevertheless, the statement also indicates that as a result of the absence of benchmark, it is possible that there are more undisclosed tax expenditures. Among item that would normally be included in tax expenditure report, but does not appear in the list of New Zealand’s tax expenditure is tax exemption on capital gains.

The tax expenditure statement discloses the source of legislation and brief description for each tax expenditure. Out of the 37 tax expenditures, only six are presented with tax expenditure estimates for a two-year period – the current year and the forthcoming year.

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108 New Zealand’s Treasury, above n 1, 2.
109 The term appropriated spending through the tax system is defined in New Zealand’s tax expenditure statement as “hybrid transfers that can be taken as a cash payment or via a reduction in tax”.
110 New Zealand’s Treasury, above n 1, 2.
111 New Zealand’s Treasury, above n 1, 3.
113 New Zealand’s Treasury, above n 1, 3.
d. Jordan

Jordan is in the middle of tax reform process. Included in this agenda is its attempt to increase tax revenue collection and to improve transparency and accountability by evaluating tax expenditures.\textsuperscript{114} The Jordan government works with DAI, a consulting agency appointed by the U.S. Agency for International Development (USAID) to develop a tax expenditure framework and identifying tax expenditures from income taxes, sales taxes, custom duty and real property taxes. As this is still at proposal stage, the report covers mainly the conceptual part of tax expenditures and recommendations for tax reform. The report also produces the list of tax expenditures, but only provides estimates for one year, based on historical data.

The report defines tax expenditures as the deviations from the normal or benchmark tax structure.\textsuperscript{115} It provides a separate benchmark tax structure between personal and corporate income taxes. For individual, the income tax base is gross income reduced by the allowable costs of earning income. For companies, the tax base is the balance sheet methods. Apart from the tax base and the tax rate, other features are generally similar for both groups, which include the taxation period follows calendar year, losses can be carried forward for five years, the use of nominal income instead of real income and that the double tax relief is part of the benchmark.\textsuperscript{116} Revenue forgone method is chosen as the measurement for tax expenditure estimates.\textsuperscript{117}

Reports from these three countries show that each country produces a unique tax expenditure report based on what information needed by the government and policymakers. Since most of debates regarding tax benchmark and tax expenditure measurement originate from the U.S., the U.S. report tries to overcome these critiques by employing two baseline concepts – comprehensive income tax and reference tax law, and providing two types of measurement – revenue forgone and outlay equivalent. Unfortunately, too much different methods can cause confusion to readers. The confusion becomes greater when the report is presented in a way that is not reader-friendly.

Perhaps because Australia’s Tax Expenditure Statement is produced as a separate report, it gives greater clarity to the users. The information is properly arranged and explained. Even though

\textsuperscript{115} Ibid, 3.
\textsuperscript{116} Ibid, 5.
\textsuperscript{117} Ibid, 21.
the report uses two methods of measurement, the second method is produced in its own section with adequate elucidation to clarify all concerns regarding this second method. The brief information about tax expenditures assists first-time users to understand the concept. Nevertheless, the report’s attempt to calculate the aggregate tax expenditures by their functional category and later to compare them with their counterparts from direct spending could cause misunderstanding and misinterpretation. Although readers are warned in advance about the possible mix-up, the data is has no informative value and could better be discontinued in the future.

New Zealand’s tax expenditure statement is short and brief. It is short because it has a small number of tax expenditures, and it is brief since the statement reveals not much information regarding identified tax expenditures. Apart from the absence of benchmark, the statement does not disclose the method of measurement chosen, the non-revenue policy objective, the targeted group and the duration the incentives is effective.

Jordan’s first tax expenditure report, even though very brief and does not contain adequate information, is an excellent effort towards a more comprehensive effort in the future. The most fundamental issue in identifying tax expenditures, the benchmark tax base, has been specified in this report. The Jordan government should now put more effort to produce tax expenditure report annually, and to provide tax expenditure estimates and projections for several years.

Comparing the above tax expenditure reports, as well as reports from other countries, most reporting countries have similar basic features. Most countries adopted revenue forgone method as the method of measuring tax expenditures, with only the U.S. offers outlay equivalent method as additional measurement disclosed in notes and Australia that offers revenue gain method for selected tax expenditures. Also, most countries use an income tax benchmark, although in the academic debate many tax and economic scholars favours the use of consumption tax benchmark. Yet, cross-country comparability is still impossible due to distinct specific features in the chosen benchmark. These include treatment for depreciation, double taxation of corporate dividends and other variances rooted from the distinct tax system of each country.119

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118 Based on the work by OECD, Tax Expenditures in OECD Countries, above n 93 and a publication by World Bank in Zhicheng Li Swift, Hana Polackova Brixi and Christian Valenduc, above n 51, 1.
119 OECD, Tax Expenditures in OECD Countries, above n 93, 70-72.
3. The Debate on the Most Appropriate Tax Base

Since its introduction, the tax expenditure analysis has received various criticisms. The earliest criticism received was from Professor Bittker, a professor at Yale Law School. He criticised about the ambiguities within the analysis, and effect of personal judgement to the concept.\textsuperscript{120} Subsequent critics of the tax expenditure concept always quoted his comments. Some criticise the whole concept, claiming it as misleading, ambiguous, deeply flawed and confusing, and is far from achieving its original objectives.\textsuperscript{121} Others have proposed new paradigm to view tax expenditures.\textsuperscript{122} Critics come not only from tax scholars but also from within the government. At one time, the U.S. government under the administration of the then newly-elected president George W. Bush accused that “tax expenditure is of questionable analytic value”.\textsuperscript{123}

However, the issue that attracts the most criticisms is the tax base. Deciding the most appropriate concept of income to be adopted as the tax base is fundamental in tax expenditure analysis. The choice of the tax base affects what should and should not be included in the list of tax expenditures. In fact, the discussion about the most appropriate tax base for a country’s tax system has started decades before. Unsurprisingly, there are substantial debate regarding this subject when the concept of tax expenditure was first introduced, dominated by tax scholars and tax experts from the U.S. The debate still continues until now. Surrey’s choice of tax base, the S-H-S income (modified to include generally accepted structure of income tax and business accounting practice)\textsuperscript{124} was highly criticised; however other proposed alternatives have received equal (if not more) critiques.

In general, there are two sets of debates. The first is the debate about the tax base for a country’s tax system; hence affect the tax base for tax expenditure analysis. The second debate is regarding

\textsuperscript{120}Boris I. Bittker, ‘Accounting for Federal “Tax Subsidies” in the National Budget’, above n 73, 244-261; Boris I. Bittker, above n 73, 538-542.
\textsuperscript{122}In David A Weisbach and Jacob Nussim, ‘The Integration of Tax and Spending Programs’ (2004) 113(5) The Yale Law Journal, 955, the writers proposed a new paradigm where the concept of tax expenditures is viewed as the problem of institutional design and not a tax policy issue.
\textsuperscript{123}Budget of the United States Government, Office of Management and Budget, Executive Office of the President of the United States, Analytical Perspectives (Fiscal Year 2002) 61.
the basis for analysing the tax expenditures (not the tax system as a whole). The following paragraphs review these debates.

The S-H-S concept of income, which is also referred to as the comprehensive income tax, is commonly used as the base for income tax. It is a common practice to exclude certain income described under the concept from taxation, such as imputed rental, imputable labour income and unrealised capital gains. Nevertheless, some scholars argue that the exclusions are actually tax preferences that can be enjoyed only by those who have such income, hence being unfair to those who do not.125

Since the early adoption of income tax, some economic scholars have proposed the government to adopt consumption tax rather than the income tax.126 Consumption tax taxed people on what they spend, not what they earned. As such, savings are not taxable under consumption tax (as opposed to S-H-S income that imposes tax on savings). In reality, most current tax systems are a hybrid system that has both income tax and consumption tax elements embedded in it.127 For example, savings in the retirement fund are not taxable until they are withdrawn. Another example is the capital gain, which is not taxable unless it has been realised (the S-H-S rule tax capital appreciation even though the asset has not been sold). Nevertheless, some experts argue that the inclusion of consumption elements in the tax system is for administrative necessity and practicability, and therefore should not be viewed as a hybrid system.128 When S-H-S income was chosen as the tax base in tax expenditure analysis, the proponents of consumption tax view this as an impediment on their effort to move to consumption tax, since the consumption elements in the tax system are normally identified as tax expenditures.129

A group of researcher examines the use of X tax, a new breed of consumption tax, as the tax base to identify and measure tax expenditures.130 X tax was developed by David F. Bradford as a


130 Robert Carroll, David Jouifaian and James Mackie, above n 127, 498.
proposal for the United States’ tax reform. It has the element of a consumption tax that promotes investment and savings, but also incorporates a structure similar to the current income tax system.\textsuperscript{131} X tax offers separate rules for business tax and individual tax. Business tax is applicable for all forms of businesses (company, partnership and sole proprietorship), where they are taxed at one single rate. Individual tax, also referred by Bradford as compensation tax, use progressive tax rate, with the maximum rate is equal to the business tax rate. It also supports the notion that all income has to be taxed only once, either in the hand of the contributor or in the hand of the recipient. Nevertheless, like other applied and proposed tax expenditure bases, it has its own ambiguities and shortfalls, and has several alternative treatments based on several of factors within the consumption tax itself.\textsuperscript{132}

There is also debate regarding the basis or the method to be used to analyse tax expenditures. Most of the disputes disagree with Surrey’s concept that requires setting the tax base to identify and analyse tax expenditures. Professor Michael J. McIntyre, who accused Surrey’s definition of tax expenditure as problematic, asserted that the list of tax expenditures produced by Surrey and his team in the U.S. Treasury has “no serious claim of legitimacy”.\textsuperscript{133} He proposed a new approach that ignores the need to identify a normal tax structure. McIntyre’s approach is to examine the purpose of each tax rule. If its purpose is to promote a spending goal, then it is a tax expenditure and should subject to a tax expenditure analysis.\textsuperscript{134} Although this approach may have overcome the critiques on Surrey’s choice of base, it sparks a different problem. It is tricky to determine the purpose of a tax rule. The proponents of tax incentives could have change their language and avert the spending goal, and instead defend their arguments using other goals that do not trigger a tax expenditure.\textsuperscript{135} As a result, many tax expenditures could easily escape the detailed scrutiny.

One constructive proposal was made by Seymour Fiekowsky, who, at the time he published the article,\textsuperscript{136} was the Assistant Director of Office of Tax Analysis, U.S. Treasury Department. He argued that the tax expenditure budget produced by the U.S. Treasury was fundamentally erroneous because it failed to distinguish tax rules that serve to achieve objectives of spending.

\begin{itemize}
\item \textsuperscript{131} For more details about the X tax system, see David F. Bradford, \textit{Untangling the Income Tax} (Harvard University Press, USA, 1986) and David F Bradford, \textit{The X Tax in the World Economy: Going Global with a Simple, Progressive Tax} (AEI Press, USA, 2004).
\item \textsuperscript{132} Robert Carroll, David Joulfaian and James Mackie, above n 127, 508-509.
\item \textsuperscript{133} Michael J. McIntyre, ‘A Solution to The Problem of Defining a Tax Expenditure’ (1980) 14 \textit{University of California Davis Law Review} 79, 80-81.
\item \textsuperscript{134} Ibid, 100.
\item \textsuperscript{135} J. Clifton Fleming, Jr. and Robert J. Peroni, ‘Can Tax Expenditure Analysis be Divorced from a Normative Tax Base?’, above n 129, 149-150.
\item \textsuperscript{136} Seymour Fiekowsky, above n 80.
\end{itemize}
programmes from those rules that are related to basic structure of tax law. According to Fiekowsky, only tax incentive that is inconsistent with the basic structure of the tax law, and can be substituted with a direct spending programme should be classified as tax expenditures. Tax rules that have no spending objectives, or cannot be replaced with a direct spending programme, such as accelerated depreciation and capital gain preference, are not tax expenditures but rather a tax policy or a tax structural issue. Consequently, the U.S. Treasury adopted Fiekowsky's proposal, named as the “reference tax law” baseline, and dropped Surrey’s S-H-S baseline, in its tax expenditure budget prepared for fiscal year 1983 and 1984. The reference tax law baseline identifies as tax expenditures those “special exceptions from a generally provided tax rule that serve programmatic functions in a way that is analogous to spending programs”. Generally, reference tax law is similar to tax law in application; thus generates lesser tax expenditures. However, starting 1985, the U.S. Treasury has returned to the S-H-S baseline but offers reference tax law as an alternative baseline.

Victor Thuronyi claimed that Fiekowsky’s idea adopted by the U.S. Treasury is deficient, as it fails to clarify the approach needed should a tax provision has multiple purposes. His proposed method is actually an expansion to Fiekowsky’s suggestion. Thuronyi’s method requires identification of tax provision that can be substituted with non-tax programme. These “substitutable tax provisions” are classified by identifying the significant purposes of a tax provision, and to identify a possible non-tax programme that can effectively achieve the same purposes. This part is similar to Fiekowsky’s approach. Thuronyi refined the idea by explaining the approach that should be taken if a tax provision has more than one purposes, and these purposes can be achieved by both tax system and non-tax programme. He proposed the use of judgement, to evaluate the advantages and disadvantages of the tax provision and its non-tax substitutes. However, this refinement is already part of tax expenditure analysis proposed by Surrey, which requires a tax expenditure with justified objective to go through cost-benefit analysis to determine the best method that can achieve that objective.

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137 Seymour Fiekowsky, above n 80, 213.
138 Seymour Fiekowsky, above n 80, 215.
140 Budget of the United States Government, Analytical Perspectives (Fiscal Year 2012), above n 96, 240.
141 Thomas L. Hungerford, above n 83, 2.
142 Joint Committee on Taxation, above n 139, 26.
144 Ibid, 1186-1188.
145 J. Clifton Fleming, Jr. and Robert J. Peroni, ‘Can Tax Expenditure Analysis be Divorced from a Normative Tax Base?’, above n 93, 152 (in footnote 71).
In 2008, the U.S. JCT proposed a “new paradigm” approach to its tax expenditure analysis to overcome the criticisms over the use of the normal tax base. The new paradigm divides tax rules into two categories. The first is “Tax Subsidies”, defined as “a tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law… and that collects less revenue than the general tax rule”. This category basically refers to Fiekowsky’s approach which specifies that a tax expenditure has to be inconsistent with the basic structure of the tax law, and is coherent with the U.S. Treasury’s reference tax law baseline. The second category, “Tax-Induced Structural Distortions” represents structural elements within the tax law that “materially affect economic decisions in a manner that imposes substantial efficiency costs”. Interestingly, in its tax expenditure estimates for fiscal year 2009-2013, the JCT reverted to normal income tax baseline approach. The committee asserted that practically, the application of either the new paradigm or the normal tax base approaches will generate similar list of tax expenditures, although the list produced by the normal tax base approach is more expansive.

Most of these debates took place in the U.S.; hence this explained why tax expenditure report in the U.S. offers different baselines and different measurements. Looking at the practical side, these arguments have minimum influence on country’s tax expenditure reporting (except for the U.S.). Every country that prepares a tax expenditure report has its own unique definition of benchmark income tax base. Many countries do not have a specific definition; they rather use a list of criteria to describe what should be included in the benchmark. Other countries, including Canada, Japan, France, Germany, Korea, the Netherlands, Spain and the UK, describe their benchmark without referring to any specific theory. All reporting countries use income tax as the tax base except for tax expenditures from consumption taxes such as Value-Added Tax and Goods and Services Tax. The income tax benchmark for each country, although many accept the S-H-S income as the base, still differs to follow the country’s own unique tax system, and this hinders cross-country comparability. Regardless of which tax base is chosen, the ultimate rule to charge tax based on fairness and ability-to-pay should always become the priority.

146 Joint Committee on Taxation, above n 139, 39-42.
147 Seymour Fiekowsky, above n 80, 215.
150 OECD, Tax Expenditures in OECD Countries, above n 93, 76-140.
4. Accounting Standards as an Alternative Benchmark for Corporate Tax Expenditures

An income tax is a tax on chargeable income, and the first step to arrive at chargeable income is to determine adjusted income. Adjusted income is derived by deducting from gross income all expenses and costs incurred to earn the gross income.\(^{151}\) This is the requirement by Malaysia’s *Income Tax Act 1967* s 33(1), which says that:

Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source, including –

In accounting, the International Financial Reporting Standards (IFRS) defined the term profit as “the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income”\(^ {152}\). Literally, adjusted income in tax does not significantly different from accounting profit. They are the results of income minus expenses. Yet, in almost all cases, accounting profit has to be adjusted to arrive at taxable income. Section 33(1) of the Act starts with the phrase “subject to this Act”, which means income is calculated not only by deducting all outgoings and expenses incurred, but also need to take into account all other provisions in the Act. The following paragraphs briefly discussed issues related to these two similar but different terms, and later argued why accounting standards could be a workable benchmark for corporate tax expenditure analysis.

The effort to promote accounting standards as the base in the calculation of corporate income tax is not new. It started many years ago, advocated mainly by the accounting community, but sometimes received supports from the legal community.\(^ {153}\) They argue that since accounting income is convincing enough for investors and creditors, it should also be convincing enough for tax assessment. Furthermore, the use of accounting income for tax purpose could simplify the


tax system and minimise compliance costs, therefore reduce tax avoidance.\textsuperscript{154} As expected, there are a lot of dissenting views, mostly come from the economics and legal experts.\textsuperscript{155} There are various reasons for this, which includes the different objectives between accounting and taxation, and the issue of timing and uncertainties in accounting provisions. There is also concern about the role of the accounting standards setters, the IFRS, which is a private organisation, to play the government role of determining what should and should not be taxed.

When the European Union (EU) wants to decide a Common Consolidated Corporate Tax Base (CCCTB) to be applied in all EU member states, the use of international accounting standards have been seriously considered.\textsuperscript{156} Many proposed that accounting standards are suitable as the starting point, but needs further adjustments and clarifications.\textsuperscript{157} This proposal requires EU member states to harmonise both tax and financial accounting rules; hence involve many obstacles since there are various tax and accounting systems among the member states. The requirement to harmonise financial accounting rules was finally removed. Member states can continue to use their national financial accounting rules, and are required to harmonise the calculation of tax base only.

Belgium has successfully used accounting standards as its tax expenditure benchmark.\textsuperscript{158} Accounting profit is considered as taxable profit, but as in the case when economic income is the benchmark, the two profits do not always match, due to availability of various tax incentives and non-deductibility of certain expenses for tax purpose.

The above paragraphs show that accounting income has been viewed by many scholars to have close relationship with taxable income. This study proposes the use of accounting standards as an alternative benchmark for the corporate income tax base in tax expenditure analysis. Since

\textsuperscript{154} Kevin Holmes, ‘Should Accountants Determine How Much Tax We Pay?’, above n 153, 325.
\textsuperscript{156} European Commission Taxation and Customs Union, Common Tax Base <http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm>. EU members consist of 27 countries and each country has its own tax system. The CCCTB, a single set of tax rules to be used in the calculation of corporate taxable income for all 27 members, is deemed as a systematic way to overcome the current problem of companies operating in more than one EU countries.
\textsuperscript{158} Christian Vaënduc, above n 81, 77.
individual income differs from corporate income, and the calculation of individual taxable income differs from the calculation of corporate taxable income, it is worthy to consider a different benchmark for corporate income tax. Accounting income calculated based on approved accounting standards is a reasonable and workable benchmark based on the reasons below:

a. “Off the shelf” benchmark. Tax expenditure reports may potentially be even more important in non-OECD economies in which the revenue costs and economic distortions from proliferations of tax concessions may be substantial. Malaysia is among many countries that have not started to publish tax expenditure report. Realising the importance of such report, it is a priority for Malaysia to start the process as soon as possible. The choice for a benchmark is a fundamental issue in the preparation of tax expenditure reports. The political considerations that have influenced the development of ad hoc benchmarks for tax expenditure reports in OECD economies leave each slightly different and arguably only suited for the jurisdiction for which it was created. This raises the question of how other economies should go about adopting a tax benchmark for identifying tax expenditures.

There are endless debates among western scholars about the most appropriate benchmark. This paper suggests it is not necessary for emerging economies to emulate the experience of OECD countries and devote considerable efforts to creation of customised benchmarks affected by political considerations. After all, those debates take place after the adoption of tax expenditure report and analysis. In this context, it may be sensible to move away from them and use an “off the shelf”, readily available benchmark, in the form of national accounting standards (or international standards where they have been adopted for national use). With only a small number of adjustments needed for areas where tax law could deviate from accounting principles to achieve necessary anti-avoidance objectives such as countering transfer pricing or income splitting, accounting standards can provide a neutral and fair benchmark. The use of a ready-made and already known and understood benchmark can accelerate significantly the process of adopting tax expenditure reports in non-OECD countries.

Of course it might be suggested that, introducing accounting standards as the benchmark does not solve the tax base debate but rather adds to the debate. One could argue that it would be most efficient to use S-H-S income (the starting point for almost all national benchmarks) as the benchmark and simply avoid the multiple deviations from that base that make their way into the national benchmarks. In a sense, however, this is what is being
proposed. With one exception, accounting income and S-H-S income largely overlap.\textsuperscript{159} Under both concepts, income is the increase in wealth, or to put it in accounting language, the increase in net assets (assets minus liabilities). The main difference between accounting and S-H-S concept of income is the treatment of unrealised capital gains. Accounting standards recognise most types of capital gains at the point of realisation while S-H-S recognises accruing gains on an annual basis. With this exception, adoption of accounting standards as the tax benchmark in effect is the same as using S-H-S income as the benchmark.

b. \textit{Most tax expenditures are unambiguous.} Regardless of what is the choice of the benchmark, the vast majority of tax expenditures fall into areas that are not controversial. Tax treatments such as accelerated depreciation and double deductions are undeniably tax expenditures under every benchmark. The never-ending benchmark argument is all about issues that sit on the edge of the concept, and affect only a small percentage of tax expenditures, such as the taxability of unrealised capital gain. No single benchmark can satisfy everybody; therefore the proposal to use accounting standards as the tax base may convince somebody.

c. \textit{IFRSs are internationally recognised.} The IFRSs are (and are going to be) adopted by most countries in the world. Accounting profit as in audited financial statements has been accepted worldwide as a reasonable and reliable measure of company’s performance. It is a practical and realistic way to calculate corporate income, unlike some theories of income that are impractical and need adjustments and assumptions before they can be applied in the real world. Besides, the use of accounting standards as the benchmark would promote harmonisation of tax expenditure reports, thus enable comparisons among reports from different countries. Currently, data on tax expenditures is not comparable between countries since each country uses a different tax benchmark. Furthermore, accounting standards use objective measurements to calculate the business profits for the period, which means that their preparation is supported by evidence and not influenced by subjective valuations and bias.\textsuperscript{160} Accounting standards are designed to provide relevant information to assist users in making decisions.\textsuperscript{161} Information disclosed must also be complete, neutral and free from material error.\textsuperscript{162} In addition, because accounting standards are regularly reviewed, they offer a contemporary approach to reflect the recent changes in a business environment that has become more complex. The process of developing accounting

\textsuperscript{159} Kevin Holmes, ‘Should Accountants Determine How Much Tax We Pay?’, above n 153, 319.
\textsuperscript{161} IFRS Foundation, above n 152, para QC1.
\textsuperscript{162} IFRS Foundation, above n 152, para QC12.
standards involved detailed and thorough procedures to ensure the financial statements prepared reflect company’s true performance. The government should take advantage of these detailed procedures. At the same time, companies can benefit from the reduction in compliance cost, as most financial statements information can also be used for tax purpose.  

**d. Taxable income is unique.** Neither economic income nor accounting income can fit taxable income perfectly. The S-H-S income requires modifications on certain parts before it can be adopted as the benchmark. Likewise, accounting and taxation have different underlying principles. Thus, income calculated based on accounting standards must be adjusted before it can be applied as the tax benchmark. Treatments that can affect tax collections and tax administration procedures, or that are parts of anti-tax avoidance measures may need to be added as part of the benchmark if accounting income is used. Since the accounting concept of income is narrower compared to the economic concept of income, it requires less modifications as the modifications required by the S-H-S income mentioned earlier, such as the exclusion of self-performed services and unrealised capital gain from the definition of income, are already incorporated in accounting rules. Hence, it is tricky to conclude which concept of income is more appropriate. But looking at the practicability of accounting income to measure company’s profits, accounting standards is a workable benchmark.

**e. Company is a separate legal entity.** Under the S-H-S, company is not a taxable entity. Rather, the income of company is taxable onto its shareholders, and company only acts as a collecting agent on behalf of the shareholders. Surrey disagreed with this view. He recognised companies as taxable entities, reflecting in part the U.S. bias in his view. This view also contradicts with the concept of legal personality in company law. Generally, under company or corporate law, company is a legal artificial person – it can sue and be sued, can incur liabilities, can own assets, and hence can be taxed. This is similar to the concept of separate legal entity in accounting.

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163 Kevin Holmes, ‘Should Accountants Determine How Much Tax We Pay?’ , above n 153, 325.
166 Kevin Holmes, ‘Should Accountants Determine How Much Tax We Pay?’ , above n 153, 324.
168 Companies Act 1965 (Malaysia) s 16(5).
f. *Accounting profit meets ability-to-pay principle.* Profit represents the increase in purchasing power of an entity, and therefore represents the entity’s ability-to-pay.\(^{169}\) The income statement is used to evaluate the company’s ability to generate cash and cash equivalents in the future.\(^{170}\) Information provided in financial statements are utilise by shareholders to know the company’s ability to pay dividends, trust by creditors to evaluate the company’s ability to pay debts, use by employees to assess the company’s ability to pay wages, and hence should provide enough information to measure the company’s ability to pay taxes.

5. **Sources of Differences between Accounting Income and Taxable Income**

As mentioned above, taxable income is unique, and accounting income could not perfectly fit taxable income. Although there are various attempts to harmonise these two incomes, total harmonisation is almost impossible. The court often notes that the method of keeping accounts offers a guide to interpretation of the tax law but is never conclusive in tax issues.\(^{171}\) As tax rules differ between countries, it is not feasible for accounting to follow tax rules. The reasons why accounting income and taxable income could not be aligned are discussed below:

a. **Different objectives and purposes.** Accounting and taxation have different objectives; therefore they need to be designed differently. Financial statements are prepared mainly to show company’s financial performance and position to shareholders, potential investors and creditors.\(^{172}\) Generally what they need to know is the current and future performance of the company; whether the company is stable enough to give high return on investment and to pay its debts.\(^{173}\) Thus accounting standards are designed to provide trusted and reliable information about the company’s performance, which would also be used to protect investors and creditors from company’s fraud. Far from the objective of accounting, tax is a source of revenue for the government. Tax revenue is used to pay government expenditure; more taxes need to be raised if spending is high. Government has the right to tax what they want and give exemption where they think appropriate. Nevertheless, the principles of fairness and ability-to-pay should be considered by the government when they want to set tax rules, especially in democratic countries where taxation is always used by political oppositions to criticise government.

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\(^{170}\) IFRS Foundation, above n 152, para 4.27.

\(^{171}\) Gold Coast Selection Trust Ltd v Humphrey 30 TC 209; BHD Sdn Bhd v DGIR (2008) MSTC 3682

\(^{172}\) IFRS Foundation, above n 152, para OB 2.

\(^{173}\) Ibid, para OB 16.
b. **Timing issues.** Among main items for reconciliation between accounting and tax profits are those affected by timing issues. They include different useful life use to calculate accounting and tax depreciation, different point of recognition for income and expenses, and different treatment for expenses incurred before commencement and after cessation of business. These are the results of accounting’s matching principle that necessitate expenses to be matched with income, and the certainty and income-producing requirements under tax principles.

c. **Tax incentives.** Apart from revenue raising function, taxation is also a means to support government’s economic and social objectives. Besides, tax is also used by politicians to promote their political image. Thus various kinds of incentives and disincentives are embedded in the tax system, and they are far from accounting’s concern.

d. **Setting body.** Accounting standard setting body is a private organisation. Tax rules are the result of decisions by legislators, judiciary and relevant government agencies. Surely they would not pass their control over taxation to a private body. At the same time, the government support the adoption of internationally recognised accounting standards as this would enhance confidence among foreign investors and attract more multinational companies.

Nevertheless, accounting bodies and the tax authority have been working closely to narrow any gaps, where possible, between accounting and tax treatments. In Malaysia, main accountants’ groups, the Malaysian Institute of Accountants, the Malaysian Institute of Certified Public Accountants and the Chartered Tax Institute of Malaysia are working together in the Joint Tax Working Group on Financial Reporting Standards to discuss tax implications resulted from the adoption of IFRS. The group then produces discussion papers which include proposals for tax changes to ease taxpayer’s compliance.

6. **Proposed Tax Expenditure Benchmark for Malaysia’s Corporate Income Tax**

If accounting standards are the benchmark tax base, tax treatments that deviate from accounting standards will be identified as tax expenditures and negative tax expenditures. Nevertheless, there are some unavoidable differences between the two systems as a result of structural features of the tax system. Therefore accounting standards need some modifications before they can be used to identify the tax benchmark. These structural features are considered as part of the

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benchmark tax base, thus they should not be classified as tax expenditures or negative tax expenditures. The proposed tax expenditure benchmark for corporate income tax is presented below.

### Benchmark Tax Structure for Malaysia’s Corporate Income Tax

- Tax base is company profit based on Malaysia’s approved accounting standards.
- Income is based on nominal value.
- Tax unit is a legal person i.e. individual company.
- Tax period is the company’s accounting period.
- Tax rate is 25%.
- All income is taxable. This includes foreign source income and capital gains.
- Any rules to reduce or eliminate double taxation, such as double tax relief, are part of benchmark.
- Anti-tax avoidance measures are part of benchmark.

The tax base chosen for corporate income tax benchmark is company’s profit calculated based on approved accounting standards. Therefore included in the tax base is all business income earned less all business expenses incurred to produce the income, including accounting depreciation and amortisation. However the application of accounting standards is tempered with anti-tax avoidance measures, which means tax treatments that are implemented to prevent tax avoidance, such as restricted deduction for charity donation, are part of benchmark and therefore not tax expenditures.

Each individual company is a tax unit and subject to income tax. The taxable period follows the accounting period - usually one year, but could be less or more under certain circumstances (such as the first period in business). A single rate, 25%, is used as the benchmark tax rate. The benchmark scope of charge is worldwide income, i.e. all income, whether derived from Malaysia or outside Malaysia, is chargeable to Malaysian tax.

### 7. Summary

Although there are so many critiques with regard to tax expenditure concept, most tax scholars agree that tax expenditure analysis and reporting are important government tools. As such, while many are still sceptical about the best tax base and questioned the reliability of tax
expenditure measurement, most governments in developed countries offer some kind of tax expenditure reporting and many other developing countries are doing the same. But this does not mean that discussions and suggestions about these issues should stop. There are so many rooms for improvement and so many aspects that need perfection.

Having a separate benchmark tax base for corporate income tax based on accounting standards has its own benefits. There may be some transactions that are debateable, but the issue of inherent differences between accounting and taxation could partly be solved with the inclusion of anti-tax avoidance measures as part of the benchmark. It is hope that with this new proposed benchmark companies are taxed based on their business performance. Any tax treatments that are not related to measuring corporate income, or business expenses that are not deductible due to rules that were developed more than a century ago, are highlighted and further scrutinised. If required, further actions should be taken to rectify the situation.