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Dear Graeme,

Review of TVM Research Project

You asked me to review a draft of documents being prepared for an experiment to be conducted in relation to the "Tax Value Method" (***TVM***) of expressing income tax law proposed in the final report of the Review of Business Taxation, *A Tax System Redesigned. More certain, equitable and durable. Report, July 1999.*

This letter records my comments and recommendations on the draft documents.

The experiment

You indicated the experiment is designed to test the proposition that an income tax law expressed in the form of the TVM could lead to more certainty in the calculation of taxable income than is enjoyed under the current income tax law.

The experiment involves 60 undergraduate volunteers, none of whom should have had tax, legal or accounting expertise or experience. The 60 volunteers are invited to attend a session where they are required to complete an income tax exam after receiving instructions in income tax law from a post graduate drama student.

One group of the volunteers attends a session at which they receive instruction in the principles of the TVM (***TVM group***). The instruction consists of the drama student presenting a script which outlines principles of the TVM (***TVM script***). The group receives a written copy of the TVM script to read as the drama student presents. The group also receives selected extracts of the draft TVM income tax law prepared by the TVM Legislative Team, but reading of these extracts is not part of the drama student's presentation.

The other group of volunteers attends a session at which they receive instruction in the principles of the current income tax law (***other group***). The instruction consists of the drama student presenting a script which outlines principles of the current income tax law (***other script***). The group receives a written copy of the script to read as the drama student presents. The group also receives selected extracts of the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997,* but reading of these extracts is not part of the drama student's presentation.

Having been so instructed, each group is asked to answer an identical set of income tax problems consisting of 20 short questions and 2 longer case studies (***the test problems***). The test problems each take the form of a description of certain transactions concerning a person and a request to calculate the taxable income arising from those transactions for the person. The TVM group are asked to calculate the taxable income applying the principles of TVM on which they have been instructed. The other group are asked to calculate the taxable income applying the principles of the current income tax law on which they have been instructed.

Each group is requested to answer each of the 20 short questions by completing a worksheet set out under the question. The worksheet for the TVM group requires a net figure to be calculated from the formula:

"***Receipts - Payments +[Closing tax value of assets - opening tax value of assets] - [Closing tax value of liabilities - opening tax value of liabilities]***".

The worksheet for the other group requires a net figure to be calculated from the formula:

"***Ordinary income + Statutory income (Incl. Net capital gains: proceeds - cost base) - Deductions - Specific Deductions***"

and space is also given to record capital payments not taken into account in the formula.

Four sample questions and answers with completed worksheets are also inserted into the materials for each group to provide guidance on the required structure of answers.

At the bottom of each worksheet, volunteers are asked to indicate: whether they have followed the required steps in answering the question; how confident they are that their answer is correct; and how confident they are that they correctly followed the steps required by the TVM or the current income tax law (as the case requires).

The answers given by the TVM group and the other group will be exposed to various statistical comparisons, designed to disclose any difference between the two groups in the level of confidence with which they calculate taxable income in respect of the test problems.

Matters on which report requested

I am asked to report on the following matters:

1. Whether the TVM script and the other script are similar in terms of:
   (a) Range of issues covered?
   (b) Depth of explanation and detail?
   (c) Degree of economy of exposition?
   (d) Level of abstraction and provision of examples?
   (e) Clarity of explanation?
2. Whether overall the two scripts are equivalent?
3. Whether overall the two sets of materials are appropriate and fair in terms of:
   (a) The material selected to be instructed?
   (b) The way in which the material was presented in the scripts?
   (c) The choice of the questions asked and the way in which the questions are presented?

Bias in the experiment documents

The matters on which I am asked to report appear to be directed to the question of "bias" in the scripts, test problems and associated materials (***the experiment documents***) provided to the TVM group and the other group.

The experiment documents will test whether, when presented with an identical set of test problems, the TVM group is able to calculate taxable income with greater consistency than the other group. The value of the experiment will depend on the extent to which any differences in levels of consistency between the two groups can be said to arise from the fact that one group was applying TVM principles while the other group was applying the principles of the current income tax law. The experiment will be less valuable if differences in levels of certainty might instead be attributable to some other factor.

The difficult question, on which my opinion is sought, is whether any differences in levels of consistency between the two groups might be attributable to the experiment documents themselves, rather than differences between the principles of the TVM and the principles of the current income tax law.

Difficulties in identifying bias in the experiment documents

This question of identifying this kind of bias in relation to the experiment documents is difficult for three main reasons.

First, the experiment documents ask the volunteers to apply the principles of TVM as set out in the TVM script and the principles of the current income tax law as set out in the other script. The volunteers are not tested on the matter of discerning for themselves the relevant principles applicable under the TVM legislation or the *Income Tax Assessment Act 1936* and *Income Tax Assessment Act 1997.* This means that the experiment does not address one aspect of TVM which might make it easier to apply with certainty than the current income tax law. The aspect I refer to is the fact that the TVM is intended to be a comprehensive and largely self-contained set of statutory rules for calculation of taxable income, with all relevant rules to be found in the TVM statute itself. This distinguishes it from the *Income Tax Assessment Act 1936* and *Income Tax Assessment Act 1997,* which operates on the basis that key concepts such as the rules for identifying revenue and capital receipts and outgoings are to be found not in the statute itself, but rather in the body of judicial decisions, administrative rulings and conventional practice, conveniently described as "precedent".

It is not practical to test the possible impact of this difference between the TVM and the current income tax law in the confines of the experiment.

However, this difference leads to the second main source of difficulty. This difference between the legal framework of the TVM and the legal framework of the current income tax law, necessarily leads to differences in the way the experiment documents provide instruction on the principles of these two different methods of calculating taxable income.

As noted above, the TVM is conceived as a comprehensive statement of detailed statutory rules for calculation of taxable income. The statutory rules have been deliberately expressed with a sufficient degree of abstraction to enable them to apply to the entire range of current and future transactions which any kind of taxpayer might conceivably undertake. These abstract statutory rules are then applied to identify the particular items which need to be taken into account in the calculation of taxable income of a particular person. The instruction sections of the experiment documents prepared for the TVM group - that is, the TVM script - therefore consist of an attempt to summarise such of these statutory rules as are needed to answer the test problems.

The current income tax law, by contrast, depends in large part on general concepts of "income" and "capital" which, as noted above, are not found in the income tax statute at all. Rather, they are concepts which have been developed from analysis of actual transactions on a case by case basis by the judicial decisions, administrative rulings and conventional practice which make up tax law "precedent". The question of whether a particular item is to be taken into account in the calculation of taxable income is determined largely by a process of reasoning by analogy with the cases which make up the precedent. That is, the method is to ask whether or not the particular item, or similar items, have previously been taken into account in the calculation of taxable income. The instruction sections of the experiment documents prepared for the other group - that is, the other script - therefore consist of an attempt to set out sufficiently similar analogies drawn from precedent to enable the test problems to be answered.

In my review of the drafts of the TVM script and the other script, I found that the fact that the current income tax law relies more heavily on reasoning by analogy from precedent, seemed to result in the other script being more readable and easily understood than the TVM script. This was mainly because the other script proceeded less by way of statement of abstract principle, and more by way of provision of concrete examples of the relevant concepts, than did the TVM script. Another factor was that the essence of the methodology of the current income tax law – namely to determine how specific cases are treated by reasoning by analogy from concrete examples of similar cases – appears to me to be intuitively easier to comprehend than the essence of the methodology of the TVM – which is to determine how specific cases are treated by asking where they fit within a comprehensive set of generalised and abstract statutory rules. I say that the methodology of the current law is intuitively easier to comprehend, because it is a normal human method of reasoning rather than one which requires legal training.

This difference between the draft of the TVM script and the draft of the other script could no doubt be regarded as a fair reflection of the essential difference between the methodology of the TVM and the methodology of the current income tax law, rather than as a bias in the experiment documents. Nevertheless, I think the better approach would be to reduce the extent to which the experiment documents bring out this difference, by including more concrete examples of the concepts in the TVM script. Further, the concrete examples in the TVM script should include some examples which are similar to some of the fact situations in the test problems, so that the TVM group would be able to reason by analogy by reference to the examples, in the same way as the other group, in answering the test problems.

The essential differences between the methodology of the TVM and the methodology of the current income tax law do, however, lead to a third source of difficulty in identifying bias in the experiment documents. This third source of difficulty is the fact – which cannot be avoided - that these differences in methodology necessarily mean some kinds of test problems will be more easily answered applying TVM principles, while other kinds of test problems will be more easily answered applying current income tax law principles.

While this proposition is easily stated, it is less easy to define with precision the types of test problems which will be answered with greater or lesser certainty by the TVM or the current income tax law. Indeed, to do so would be to a large extent to pre-judge the issue with which the experiment itself is concerned. It is also far from straightforward to determine how this should be reflected in the test problems in the experiment documents – for example, should the test problems contain problems of equal difficulty for both TVM and the current law, or should the test problems contain equal numbers of problems answered more easily by the one or the other regime?

Notwithstanding these theoretical difficulties, my review of the draft test problems left me with the impression that, on the whole, they would be more difficult to answer applying the principles of the TVM than the principles of the current income tax law. My two main reasons for forming this impression can be briefly stated:

- First, the TVM seems to me to be the simpler of the two regimes to apply when a transaction (or, at least, a non-private transaction) gives rise to a cash receipt or cash outgoing without the creation, alteration or extinction of any associated asset or liability. This is because the TVM operates in such a case to require nothing more than the recording of the receipt or the outgoing, whereas the current income tax law requires not just the recording of the receipt or outgoing, but also the additional and sometimes contentious step of characterising whether it is of a revenue or capital character. The draft test problems do not contain many examples of this kind of case, ie the case of a cash receipt or cash outgoing without associated issues concerning assets or liabilities.

- Second, the TVM seems to me to be the more complex of the two regimes to apply where a transaction involves a receipt or outgoing which creates, alters or extinguishes an asset or liability. This is because the TVM in such a case requires not just the recording of the receipt or outgoing, but also a number of additional steps, including identification of whether the transaction creates, alters or extinguishes an asset or liability of a kind which the TVM recognises, and, if it does, calculation of the tax value, or change in tax value, of that asset or liability, in accordance with the rules of the TVM. Further, where a transaction has both a recording or a receipt or outgoing and a recording of a change in assets or liabilities, the TVM may also require a third step of reconciling the two items to ensure there is no double-counting. Since the concept of asset and liability under the TVM are both referenced to legal concepts of property and rights, and the calculation of tax values adopts special statutory valuation rules rather than actual values, these are all steps which need to be learned by training rather than followed by intuition. The draft test problems contain many examples of this kind of case, ie cases involving not just receipts and outgoings, but associated issues concerning assets and liabilities.

This feature of the draft test problems could no doubt be regarded not as a bias in the experiment documents, but rather as a fair reflection of the fact that most (non-private) transactions involving cash receipts and cash outgoings will also involve changes in assets or liabilities as well. For example, even the simple payment of salary into a bank account seems to gives rise to changes in assets and liabilities under the TVM. Nevertheless, I think the better approach would be to reduce the extent to which the experiment documents bring out these relative features of the TVM and the current income tax law, by taking two steps. The first is to replace some of the test problems with cases which involve cash receipts or cash outgoings with no associated changes in assets or liabilities. The second is to replace some other test problems with cases which would make it more difficult to apply the principles of the current income tax law to the characterisation of a receipt or outgoing as of a revenue or capital nature.

Conclusion

Subject to the qualifications and comments made in the above discussion, and implementation of the changes I have suggested, I would report as follows:

- In my opinion, the TVM script and the other script are generally similar in terms of range of issues covered, depth of explanation and detail, degree of economy of exposition, level of abstraction and provision of examples; and clarity of explanation, and the differences between the scripts are primarily attributable to differences between the methodologies of the TVM and the current tax law rather than bias in the experiment documents.

- In my opinion, overall the two scripts are generally equivalent in terms of approach, and the differences between the scripts are primarily attributable to differences between the methodologies of the TVM and the current tax law rather than bias in the experiment documents.

- In my opinion, overall the two sets of materials are appropriate and fair in terms of the material selected to be instructed, the way in which the material is presented in the scripts, the choice of the questions asked and the way in which the questions are presented, and the differences between the two sets of materials are primarily attributable to differences between the methodologies of the TVM and the current tax law rather than bias in the experiment documents.

Yours sincerely,

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