

COMMENTS ON MATERIAL FOR TVM EXPERIMENT PROVIDED BY PROFESSOR GRAEME COOPER

My team has quickly reviewed the experiment materials forwarded by Professor Cooper. On the whole we thought the materials were well written and presented. However, we have significant concerns about the whole idea as now put forward.

General issues

Time frame

It seems the testing is to start next week. We have been given 3 working days to consider the materials, and it appears there are then 2 working days until the experiment starts. Realistically, it seems there is no time to make anything but minor changes to the material.

Usefulness of experiment results

It appears participants in the experiment will have one hour and fifty minutes for the test. Given this constraint, our view is that there is way too much material and way too many questions for any sensible results to be achieved. I myself, having a reasonable experience in both the current and TVM systems, found it difficult just to read and make some sense of the material in that kind of time frame. I fear that participants will be overwhelmed, leading to a strong likelihood of random results.

It would seem to be more sensible to limit the material in some way and restrict the questions requiring answers to perhaps one or 2 problems.

Bias in the questions

The questions, it seems, are biased towards tax effects for individuals, and in particular bank accounts of individuals. As far as we can make out, 30% of the questions involve bank accounts!

This doesn't seem sensible. First of all, why make a relatively trivial issue the major focus of the experiment?¹ Secondly, the TVM draft legislation is incomplete in its treatment of individuals, because of the need to draft other legislative elements in preference (e.g. CGT and STS). Individuals would ultimately be subject to cash basis treatment², rules for which have not yet been drafted for TVM.

The experiment might perhaps be more useful if it dealt with a broader cross section of issues that have at least been dealt with in the TVM draft.

¹ The interface between individuals and the tax system is not, and probably never will be, the legislation itself.

² ATSR recommendation 4.4.

Description of current law

It is arguable (strongly in my view) that the nature of the existing system is misdescribed in the explanatory material. The emphasis is that the existing concept of assessable income is about flows.³ While that is normally true of the ordinary income concept, it is not always true in that area,⁴ and it is certainly not true of assessable income in general.⁵ It would be more accurate to describe the existing system as a mix of flows and asset ideas.

TVM reflects some RBT policy recommendations not yet reflected in the existing system

In reflecting on any results that come out of this experiment, the Board and others will need to keep in mind that the TVM draft legislation has incorporated some key RBT recommendations that are not reflected in the current law. These include the TOFA recommendations. It should be noted that the TOFA recommendations add some complexity to TVM that is not present in the current law, because they embed at a core level the idea of using present, rather than nominal, values for many transactions involving finance.

Incomplete comparison between current system and TVM

The explanatory material for TVM explains several issues that are not dealt with at all in the explanatory material on the current law. This surely means that the results will not be comparable.

For example, the TVM explanation and legislative extracts discuss non-cash transactions, the effect of contingencies, bank accounts and accruals on financial instruments. That is OK. But the current law's treatment of the same issues is not mentioned at all in the explanatory materials or legislative extracts. This means that the current system appears less complex in these areas when, at least arguably, that is not the case.

Set out below is my understanding of the main provisions in the current law that are relevant to these issues (there are usually many other peripheral provisions):

Non-cash transactions

- section 21 of the 1936 Act (dealing with converting non-cash consideration into money value);
- section 21A of the 1936 Act (dealing with non-cash business benefits);
- paragraph 26(e) of the 1936 Act (dealing with non-cash remuneration for services);

³ e.g. the implication is that only receipts and payments are relevant. Perhaps it is arguable that this is true over time, it is certainly not correct in a temporal sense.

⁴ e.g. we currently have the gain concept of ordinary income as well as the flow concept.

⁵ The trading stock rules, whereby an increase in stock value is assessable income, are a very obvious example.

- section 51AK of the ITAA 1936 (about agreements for the provision of non-deductible non-cash business benefits);
- section 40-185 of the 1997 Act (dealing with the cost of depreciating assets);
- section 40-305 of the 1997 Act (dealing with the termination value of depreciating assets);
- numerous provisions in Divisions 104, 110, 112 and 116 of the 1997 Act (dealing with the amount of capital gains and losses on CGT assets, their cost bases and the capital proceeds on their disposal);
- Subdivision 245-C (dealing with debt forgiveness) to the extent it reduces the gross forgiven amount by any non-cash consideration.

Contingencies

- ‘derived’ concept in section 6-5 of the ITAA 1997;
- ‘incurred’ concept in section 8-1 of the ITAA 1997;
- various cost and termination value/proceeds rules in Division 40 and Part 3-1 of the ITAA 1997;
- debt/equity rules in Division 974 of the ITAA 1997.

Bank accounts

- the ‘revenue asset’ concept
- provisions dealing with deferred interest securities (Division 16E) and traditional securities (sections 26BB and 70B) in the ITAA 1936
- cost-base and other relevant CGT rules in Part 3-1 of the ITAA 1997.

Accruals on financial instruments

- Division 16E of the ITAA 1936.

Comments on matters of detail

The Attachment sets out a number of comments on detail issues that we have picked in the time available to us for review.

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SPECIFIC COMMENTS ON TVM EXPERIMENT

1. The Tax Value Method of Computing Taxable Income

#	Reference	Comment
1.1	-	The provisions used refer to subsections, sections, etc. Should these be explained in the presentation?
1.2	-	It would be useful to also present the net income formula as: Net Income = [Receipts – Payments] + [Closing tax value of assets – Opening tax value of assets] – [Closing tax value of liabilities – Opening tax value of liabilities]
1.3	9 th para, Part 3	‘Tax value’ as a concept does not change meaning for different kinds of assets and liabilities. How tax value is measured can however be different for different kinds of assets and liabilities.
1.4	12 th para, Part 3	Should be “the (<i>non-private</i>) cash inflows less (non-private) cash outflows”.
1.5	16 th para, Part 3	The script says that Item 6 (of section 10-40) assets are any other assets as well as investment assets. Section 78-10 defines investment asset by way of exclusion and as such, it includes “any other asset”.
1.6	18 th para, Part 3	Should be “... is ignored if the asset is a <i>fully</i> private asset. Similarly, a liability owed by a person is ignored if it is a <i>fully</i> private liability.”
1.7	20 th para, Part 3	The reference to “this rule” appears to be referring to the special rule for land (as mentioned in the previous paragraph) when it should be referring to the private or domestic rules more generally.
1.8	21 th para, Part 3	The statement that “only assets that are property can be held” is incorrect. Legal and equitable rights and purchased secrets can also be held: see section 10-20. In addition, it is likely that ‘property’ as a legal concept might not be well understood by the participants, even with the inclusion of the mousetrap example. It needs to be discussed further.
1.9	27 th para, Part 3	The formatting in the calculation is awry.

1.10	3 rd para, Part 5	Not all of the assets listed will be investment assets. “Other financial investments” may be financial assets.
1.11	4 th para, Part 5	<p>In calculating their taxable income, individuals do not need to be concerned about their bank accounts per se (even though they are not private assets).</p> <p>The balance of their bank accounts is irrelevant when they actually calculate their taxable income. Instead, individuals only need to be aware that certain amounts that flow into or from their account may affect their taxable income.</p>
1.12	12 th para, Part 5	<p>The script presumes that an employee’s right to get paid wages accruing at the end of the income year is a financial asset. While meeting the definition of a financial asset, paragraph 17.143 of the EM states that “TVM will provide for individuals to use cash accounting for certain types of transactions (this is in accordance with recommendation 4.4 in ATSR which has not yet been drafted)”. Page 15 of the Prototype 4 demonstration legislation also notes this.</p> <p>An employee’s right to get paid wages accruing at the end of the income year does not represent one of the assets that recommendation 4.4 requires individuals to account for.</p>
1.13	13 th para, Part 5	Generally, an Item 2 financial asset will have a tax value equal to its face value other than zero even though the amount is not yet due and payable. In the example provided, the supplier would recognise a financial asset with a tax value equal to the amount they have the right to receive, which is \$1,200.
1.14	15 th para, Part 5	The final sentence should read “...reduced by any payments of <i>principal or interest ...</i> ”.
1.15	20 th para, Part 5	The reference should be to “depreciating assets” rather than “depreciable assets”.
1.16	21 st para, Part 5	The first sentence could be augmented to remind participants that Item 6 assets are investment assets.
1.17	2 nd para, Part 7	<i>Most</i> assets (rather than <i>some</i>) will have a tax value that is or starts from the cost of the asset.
1.18	8 th para, Part 9	Typo in first sentence.
1.19	10 th para, Part 9	It would be useful to have an example here explaining the impact zero tax value assets have on net income (e.g. how office supplies immediately reduce net income). The example could expand on the 12 th paragraph in Part 3.

2. TVM provisions

#	Reference	Comment
2.1	-	Why are 17.5 pages of TVM law included but only 11.5 pages of current law included?
2.2	s28-50	Why is this provision here? It only modifies the scope of provisions that aren't included.

3. The Receipts and Payment Method of Computing Taxable Income

#	Reference	Comment
3.1	-	The provisions used refer to subsections, sections, etc. Should these be explained in the presentation?
3.2	5 th para, Part 1	The implication here is that something must be received or paid to be assessable income or a deduction. There should either be an explanation of the concepts of 'derived' and 'incurred' or the reference to receipts and payments needs to be removed.
3.3	2 nd para, Part 3	The conclusion that ordinary income includes profits from carrying on a business is misleading. Ordinary income usually includes gross receipts. Profits are usually only brought to account when legitimate expenses are not deductible.
3.4	6 th para, Part 7	It's more usual to call a retailer's stock "trading stock" in a tax context than "inventory". The rest of the presentation uses trading stock.
3.5	3 rd para, Part 8	It is not true that wages paid to staff produce no enduring advantage for a business and are always deductible. See, for example, <i>Goodman Fielder Wattie Ltd v FCT</i> 91 ATC 4438 at pp. 4453-4; <i>Steele v DFCT</i> 99 ATC 4242 at p. 4257.
3.6	4 th para, Part 9	In the second dot point, there is strictly no receipt.
3.7	5 th para, Part 9	Does a bank derive interest only when payable, as this para says, or on a daily basis as TR93/27 says? Same point arises in the 9 th para of Part 9.

3.8	8 th para, Part 9	I think the general view is that payment is not necessary for a loss or outgoing to be incurred; there must simply be a definitive commitment /present liability, etc. and that this is no different for individuals than it is for corporations.
3.9	8 th para, Part 10	In explaining the cost of an asset under the current law, the script overlooks the rules associated with non-cash benefits. This is not consistent with the TVM script, which does include an explanation of non-cash transaction rules (see Part 7). Furthermore, the “cost of an asset” refers to a CGT asset. The script does not explain how the cost of a depreciating asset is determined.
3.10	9 th para, Part 10	Is it worth mentioning that the value of assets received included rights to services?
3.11	10 th para, Part 10	The last sentence should read “...to various receipts that would <i>not</i> be ordinary income”.
3.12	17 th para, Part 10	The statement made in this paragraph about depreciating assets is incorrect. The sale of depreciating assets does not fall within ordinary income. Furthermore, CGT can apply to depreciating assets (see CGT Event K7).
3.13	1 st para, Part 11	Should this read “...look at <i>a</i> few rules”?
3.14	5 th para, Part 11	The “its” in the first sentence should probably be removed.
3.15	7 th para, Part 11	The example of the truck’s depreciation is only correct if the truckie chooses the straight-line method. The same example should probably also be included in the TVM presentation.

4. Questions

3 of the comments about the legislation refer to tax policy and not certainty. Those are “appears fair”, “seems out of touch”, and “appears arbitrary”.

Also, the Collins English Dictionary defines ‘economical’ as “using the minimum required; not wasteful of time, effort, resources etc ...”. As such, it is only indirectly related to certainty.

The questionnaire also uses contrasting statements. These include:

- is simple – is complex
- is vague – is precise
- uses general principles (or sets out a vision) – uses many detailed rules (or is elaborate)
- is well defined – is open to interpretation

Are the opposites used as disqualifiers (for example, if the participant says that the legislation is both simple and complex, both responses are ignored)? If so, is the whole response treated differently also?

5. Examples

#	Reference	Comment
5.1	Example A	Might be more helpful to say “ <i>Office supplies</i> have a tax value of zero”.
5.2	Example B	Given the nature of the legal services, the \$4,000 probably wouldn’t be built into the cost of the land (as they would be if they were conveyancing fees).
5.3	Example C	If the example is to show the bank account (noting our concerns on the emphasis of bank accounts for individuals), can the solution be separated so that the participants are aware that the changes in tax value of the bank account do not affect taxable income?

6. Problems

#	Reference	Comment
6.1	Questions 1, 2, 3, 4, 11 and 12	All of these questions include an individual’s bank account in the facts. The bank account is a subsidiary aspect to the questions, and based on the script, will not be an issue that is drawn to the attention of participants applying the current law. As such, the TVM results from these questions will reflect both

		the question at hand and the treatment of bank accounts whereas the current law results will only reflect the question at hand. The outcome thus is not an effective comparison.
6.2	Question 4	The TVM script needs to be updated for comment 1.12 above, otherwise results from this question will be erroneous. This is because individuals are taxed only on wages received.
6.3	Question 5	This question involves a one-sided non-cash transaction. This is not explained in the script for either the current system or TVM.
6.4	Question 8	To calculate the amount of decline in tax value of the depreciating liability, this question needs to explain the year in which the agreement was made. It also needs to be made clear whether the year in which the agreement is made is the year that the participants must calculate Motorway's tax position.
6.5	Question 10	The script does not sufficiently describe the current law in regard to the issues raised by this question. For instance, there is no discussion of the treatment of bad debts or traditional securities in the current law. Notwithstanding that, this question applies to a deposit, which is both a bad debt and a traditional security.
6.6	Questions 11 and 12 (and also 3)	<p>Your peer review letter explained that you saw "little purpose in testing areas where there is little explicit change to be made by TVM". One area you mentioned was determining whether payments are of a private or domestic nature.</p> <p>However, that is what questions 11 and 12 require the participant to determine. Similarly, question 3 involves determining whether a receipt is of a private or domestic nature. For each of these questions, the script does not provide any guidance on what the outcome should be.</p>
6.7	Question 13	This question is not clear. Whether the purchaser 'holds' the goods being delivered depends on the conditions of sale, such as when legal title in the goods transfers. This should be explained in simple terms.
6.8	Question 14	This question should make it clear which year is the current year and that the question about tax position relates only to the obligation to replant the trees and not to the sale of timber.
6.9	Question 15	An issue here is that TVM does not yet implement the \$1,000 de minimus exception present in the current prepayment rules. However, it would be implemented if TVM proceeds. In the interim, a more reasonable comparison might be \$1,300 per month.
6.10	Question 20	The second 30 June date is not attached to a particular year.

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