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Turning Losers into Winners

A Simpler Approach to Policy and Legislation

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1. Introduction

The theme for this conference is “Sharing the Burden – Tax Reform’s Shifting Winners and Losers”.

That there is a focus on winners and losers is unsurprising – it is always thus and politicians and journalists often[1] like to frame the debate in this way. It seems to me that it is often easier to focus on just readers or voters rather than on the bigger picture of the system as a whole and its impact on the country and the various client segments.

This paper intends to focus on one area where everyone is currently a loser and how we might be able to turn everyone into a winner. That is in the area of law design and drafting.

While the paper will examine a number of reasons that give rise to complexity, I would posit that the main driver is a desire for certainty built on a level of distrust.

That desire for certainty can be illustrated in the classic error of the English-speaking traveller who will think “Perhaps if I speak louder and longer in English, this non-English speaker will ultimately understand”. We all know this to be nonsense and yet we apply the same principles in trying to deal with the uncertainty that taxpayers and administrators face – that if we use more words surely everyone will understand this tax law.

This is not new to many academics – quite a lot of study has been done on this[2]. So why does the problem persist? This paper will explore this issue through the lens of a tax law design framework using specific examples, identify some of the barriers to addressing this problem and suggest a new and coordinated approach.

2. How did we get here?

We live in a fast-changing and unpredictable world: there is ever increasing global trade, technological change, economic and political changes.

We also live in a world of changing social mores – expectations, standards and values are constantly moving.

Over the second half of the 20th century, governments responded to an increasingly complex world with increasingly complex legislation. Some of this was driven by avoidance practices from the 1960s and 70s and some by the courts of the times reflecting a more demanding expectation of the legislature.

The result was not only increased anti-avoidance rules (and that trend has continued) but more detailed and prescriptive legislation. This led to very detailed law that sought to cover every kind of situation that might conceivably need to be dealt with.

That means that the detailed rules have two fundamental flaws:

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[1] Although not exclusively – see later discussion around particular reviews.

[2] In fact, this has been an area of a number of studies and papers over many years including the fairly recent significant work “Tax Simplification”, Chris Evans, Richard Krever and Peter Mellor (Editors), Wolters Kluwer Law & Business, 2015.

> Firstly, it assumes the world is static and therefore because the legislation can deal with every situation that exists at the time of drafting, it must therefore be able to deal with every situation that will arise in the future. That is patently wrong.
>
> Secondly, it suffers from hubris. It is folly to think that one can be confident and all-knowing of the detail of every current situation in a way that really does cover the field and doesn't leave gaps.

All this reflects an attempt from an administrator's and legislator's point of view to ensure that the law covers all it should. As will be evident later, this is a flawed approach and is the very reason for the current predicament.

3. Growth in volume of tax law

While the size of the tax law is said, by some, not to necessarily be an indicator of complexity, I believe there is a point at which the size of the legislation is at least so daunting to be confronting, even overwhelming, to the educated professional (let alone the average citizen). Moreover, I do think that size is an indicator of poor policy design and indicates piecemeal, not holistic thinking.

I do not lay the blame at the door of any one group in particular. Every single player in the system is responsible in some way – I will come back to this later.

As to size, I should note that in 1980, when I started in tax, the size of the tax laws (including the Taxation Administration Act and the International Agreements Act and DTAs) was around 1,000 pages.

In contrast, the size of the tax laws in 2006–7 – after the reduction of 4,100 pages by the Board of Tax work – was estimated at over 6,000 pages. Of course since then there has been considerably more legislation introduced (think so-called "Simpler Super", TOFA, R&D – to name only a few) and little has been repealed.

4. Reasons for complexity

The reasons for, and consequences of, complexity have been explored by many academics over a long period. Indeed, a significant tome was published in 2015 covering the work of a number of academics that have researched this area. I will mention some of them although I commend those interested to the wealth of work available.

4.1 Taylor

In his much-quoted work in 2006, Professor John Taylor gave 13 "Causes of Complexity". In coming to these 13, Professor Taylor made good use of the work of those who had gone before.

1. Detailed operational rules obscure fundamental policy.
2. Complex anti-overlap provisions – but it goes further – look at "primacy" provisions and interplay between various regimes.

3. Rules rendered unnecessary by subsequent developments – I would add rules neutered by subsequent provisions; consider MIT rules and infrastructure or Everett assignments and CGT discount/small business concessions.
4. Administration not enforcing literal meaning because practically difficult, unfair outcomes and/or contrary to policy.
5. Duplication of interpretative/computational rules – but if one takes the 1st point into account then there would be no need to fix this problem as there wouldn't be attempts to define the life out of everything or include operational rules at all.
6. Designing for the minority – exceptional circumstances driving the design of the rules in the first place or by subsequent amendment.
7. Poor targeting.
8. Interplay of different regimes (e.g. individual and business taxation).
9. Anti-avoidance rules – and lots of them!
10. Method statements – arguably another manifestation of the 1st point above.
11. Structure of legislation requires lots of work to find out that rules actually don't apply to you in the first place.
12. Inconsistent policy choices – often dependant on entity – fringe benefits v non-cash business benefits; tax preferences flowing through vehicles.
13. Interaction/inconsistency between domestic law and Double Tax Agreements (DTAs).

I agree with Professor Taylor and would suggest that many other researchers have as well – although sometimes expressing themselves in other terms.

4.2 Office of Tax Simplification

The OTS has also developed a complexity index based around 10 factors, including:

1. the use of exemptions
2. the number and frequency of changes to the law
3. readability
4. the number of pages
5. complexity of guidance and return information required
6. compliance burden
7. taxpayer ability
8. tax thresholds

The OTS suggests approaches such as layered legislation and addressing the proliferation of definitions.

4.3 Others

Other commentators have focussed on particular types of reasons – Professor Judith Freedman, for example, has recently examined the institutional framework for tax policy-making as a contributor to complexity.

Others have sought to measure the cost that complexity of the tax laws imposes on the citizen.

All of these are appropriate and useful.

However, despite the great work in identifying the philosophical shortcomings of the tax laws and identifying the various reasons, I have not seen many excursions into taking particular pieces of legislation and considering what could be done differently or better. That is not to say that they don't exist. Rather, it seems to me an area ripe for further study. I would like to provoke thought about potential opportunities with some observations of particular parts of the law.

4.4 Examples

FBT

There have been, once again this week, calls from business to address the complexity and compliance costs associated with the Australian version of FBT.[3] This is not the first time and, I am sure, will not be the last. Why does FBT cause such angst amongst business? Why, anecdotally, does large business spend so much time complying and small business is said to ignore it? This latter phenomenon, if true, is itself indicative of the complexities and non-intuitive way in which FBT applies.

FBT suffers from some of the same problems that CGT does and reflects the issues enumerated by Professor Taylor, among others. Fundamentally, it tries to cover (a) everything and (b) in detail. It contains detailed operational rules.

The structure of FBT is a reflection of the way in which tax law drafting was approached in the 1980s – draft broadly to include everything and then carve out. As a result, the definition of "fringe benefit"[4] has to specifically state that it does not include salary and wages or superannuation or termination payments. The FBT law is littered with exclusions for things that the ordinary person doesn't think is a fringe benefit in the first place. For example, we have s.58A to exclude a fare you pay for someone to attend an interview for a job; s.58B when you pay for the cost of moving an employee to another location. However, my favourite exemption is for the use of toilets and bathrooms[5].

You know that there is something wrong with a piece of law that when dealing with car fringe benefits there is a section designed to say that, in order for there to be a car fringe benefit, then an employee must be provided with a car[6]. It would be reasonable to describe this as stating the bleeding obvious.

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[3] "Staff Share Plans would ease wage angst", Joanna Mather, AFR 15 January 2018, p8.

[4] S.136.

[5] Subss.47(3) and (4).

[6]

7(1) [Car applied to, available for employee's private use]

Where:

(a) *at any time on a day, in respect of the employment of an employee, a car held by a person (in this subsection referred to as the* ***provider****):*

(i) *is applied to a private use by the employee or an associate of the employee; or*

(ii) *is taken to be available for the private use of the employee or an associate of the employee; and*

(b) *either of the following conditions is satisfied:*

(i) *the provider is the employer, or an associate of the employer, of the employee;*

(ii) *the car is so applied or available, as the case may be, under an arrangement between:*

(A) *the provider or another person; and*

Capital gains tax

Capital gains tax was designed to bring into the tax base profits of a capital nature which until that point had not been subject to tax. A laudable objective.

However, I find it difficult to fathom or justify a system that takes almost 200 pages[7] of events regarding assets, their cost base and proceeds to say "If you make a capital gain, include it in your income" (to use 1997 Act vernacular). Condensing those 200 pages to a single sentence is, to me, the type of choice we have. I should also point out that that single sentence paraphrases subsection 100-10(1).

Perhaps the most damning indictment of the Australian CGT law, as it currently stands, is that it falls far short of its ideal of being a comprehensive tax on capital gains. Further, the current structure of the CGT rules dooms us to a continuing tinkering and potentially results in an even larger set of rules into the future; in other words that the current rules are not future-proof.

RATS

The Draft White Paper "Reform of the Australian Tax System"[8] (commonly referred to by its acronym "RATS") released in June 1985 set out in Chapter 7 the issues associated with the taxation of gains on capital. It addressed some of the different models and experience of other jurisdictions including, but not limited to, the issues of "lock-in", "bunching" and timing.

Interestingly (and in the writer's view, quite correctly), it also notes the principle of symmetrical treatment between capital gains and losses, the consequence of which would mean that losses should be deductible as realised in the same way that gains would be assessed as realised. Noting the "incentive and opportunity to bring forward or otherwise arrange the timing of losses so as to provide maximum tax advantage"[9], the paper discusses options for addressing such a challenge noting that "(n)one of these approaches is particularly appealing on theoretical grounds"[10]. The paper does not discuss the way in which ordinary gains, income and deductions can be similarly "managed".

In the then inflationary environment, there was some focus on taxing "real" gains and the differing models of indexation and discount (of either gain or rate) that can be adopted. Noting the potential harshness of discount methods compared to indexation in differing inflationary conditions[11], it was nonetheless observed that, at that time, there was little difference in overall revenue to an indexation system and a flat rate of 25% or a 50% partial inclusion tax[12].

***(B)** the employer, or an associate of the employer, of the employee;*
that application or availability of the car shall be taken to constitute a benefit provided on that day by the provider to the employee or associate in respect of the employment of the employee.

[7] CCH version of ITAA 1997, 2017 Edition. It is the author's view that the other 250 plus pages of capital gains tax legislation is also ripe for simplification.
[8] Australia, Keating, PJ & Department of the Treasury 1985, *Reform of the Australian tax system: draft white paper, June 1985.* Australian Government Publishing Service Canberra.
[9] Ibid, paragraph 7.14.
[10] Ibid, paragraph 7.15.
[11] Ibid, paragraph 7.19.
[12] Ibid, paragraph 7.42.

Overall, the proposal contained in RATS in relation to taxing capital gains was simply that it be applied on a realisation basis with losses offset against gains (or carried forward), an inflation adjustment mechanism and limited exemptions[13]. It mentioned nothing of the way in which the gains or losses should be identified or calculated. In a sense, that was the closest we got to a broad overarching policy statement of CGT. It is perhaps the absence of an adequately principled policy statement that set CGT on the more detailed path it followed. It is a salutary lesson that the intent of policy must be clear for legislation to be clear.

CGT – the 1986 version

The translation of the above principles, as expressed in RATS, into the law seemed to take a completely different approach. The detail regarding capital gains tax contained in the Treasurer's announcement to Parliament was otherwise relatively consistent with the RATS document[14].

Nowhere did the announcement to Parliament foreshadow the detail that was to come in the Bill that was introduced and became law on 24 June the following year.[15]

That Act of over 100 pages introduced the tax world to the delights of "asset" (inclusively defined, of course, in new section 160A[16]), "disposals" to which the Part applied and which it was determined

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[13] Ibid, paragraph 7.43.

[14] The text of the announcement insofar as it relates to CGT was:

"CAPITAL GAINS TAX

There has been a long debate in this country about the role of capital gains taxation – a debate which unfortunately has too often been characterised by misinformation and hysteria rather than rational discussion. The Government believes that in inviting discussion about capital gains taxation in the draft White Paper the Australian community was finally offered an opportunity to consider the question of capital gains taxation in a more reasoned atmosphere. The Government has decided to introduce a capital gains tax but, in the light of the public debate, to incorporate several major modifications to the proposal outlined in the White Paper in June.

These changes address the concerns which have been expressed and will substantially reduce the impact of the tax and allow the community a lengthy period in which to adjust to its application. In particular, it has been decided that the tax will in every sense be prospective. That means it will apply only to gains on assets purchased or acquired after today. All assets already owned by taxpayers will be exempt from the tax when sold by them, both in respect (sic) of gains accrued until now and all future gains. The Government has decided that the deemed realisation at death proposal, outlined in the draft White Paper, will not apply. Liability for tax in the case of death will be rolled over to successors, and will only be assessed on any subsequent disposal. Therefore the capital gains tax will not apply in the case of death.

Other main features of the tax include:

it will apply only when the asset is sold or transferred by gift;

it will apply only to real capital gains calculated by fully indexing the cost of the asset for inflation;

a complete exemption will apply to gains on the taxpayer's principal residence and reasonable curtilage, on all motor vehicles, on other personal-use items such as furniture up to a sale value of $5,000, and on gains with respect to superannuation and the proceeds of life insurance policies;

there will be provision for nominal losses to be offset against gains;

the tax will be levied, on real gains, at ordinary rates of personal and company income tax.

The existing capital gains section 25A of the income tax law will not apply in respect of assets acquired after today, but will continue to apply for assets acquired before midnight tonight. The existing section 26AAA will continue to apply for all relevant assets. Because of the wholly prospective nature of the tax, revenue is expected to build up gradually over a lengthy period, as newly-acquired assets are disposed of.

As an illustration of the fact that this tax will affect only a tiny section of the population, its expected revenue yield, in the fifth year of operation is estimated to be only $25m. The tax will mean that for assets acquired after midnight tonight, taxpayers will simply need to keep their records of purchase price, spending on improvements and sale price. Valuation of assets already held will not be necessary as all are exempt from the new provisions.

…."

[15] *Income Tax Assessment Amendment (Capital Gains) Act 1986.*

[16] *Income Tax Assessment Act 1936* ("the 1936 Act" or "ITAA36").

necessary to define, together with the concept of "acquisition", in section 160M. Section 160M, *inter alia*, introduced concepts of disposals of assets that did not exist (subsection 160M(6)) and an act or event in relation to an asset whereby a person receives money (subsection 160M(7)) (together "the terrible twins").

It is interesting to observe that it took over 100 pages to describe what the then Treasurer had expressed[17] in a few paragraphs. Despite the number of pagers, gaps were created by the approach taken. By comparison, despite its 155-page length, the Explanatory Memorandum accompanying the Bill managed to describe the main features of the law in a little over two pages[18].

Part of the reason lay not only in the decision to identify and define concepts such as "asset" and "disposal" but to also introduce concepts related to the time of an acquisition (section 160U) – which did not always follow ordinary concepts – as well as a calculation of the gain or loss (section 160Z) and how to determine the component parts of consideration (section 160ZD) and cost base (section 160ZH).

Having started down this path it then became *necessary* to make appropriate adjustments for the exceptions or modifications to the now defined concepts. Thus emerged adjustments for deductions for that part of the cost base already deducted (at least in part: section 160ZK) as well as capital returns (sections 160ZL and 160ZM); whole divisions were determined necessary for Leases (Division 5), Trusts (Division 6), bonus units and shares (Divisions 7 and 8) as well as share rights, convertible notes and options (Divisions 10 – 13) and more.

The 1997 rewrite

The key difference in approach taken when rewriting the CGT provisions into the 1997 Act was that the central concepts of the CGT provisions as expressed in the 1936 Act were augmented (some argue replaced but even cursory examination will see that the previous concepts of "asset" and "disposal" continue to subsist in the 1997 Act) by the inclusion of a new concept of "CGT event". This resulted in an increase in the number of pages and added further layers of complexity.

Of course, the re-write exacerbated what was already a fundamental problem with the CGT provisions: that of trying to specify all aspects of how the law should operate. The fact that the original law presented some issues that were actually rectified in the new law should have been a warning that there was a fundamental design flaw in the approach taken[19]. This became evident in the number of "CGT events" that were added to the original, albeit mostly – but not wholly – as a result of other changes to the law (for example the introduction of consolidation). Nonetheless, a design that requires a special CGT event to reverse a previous rollover[20] surely must cause even the casual reader to question whether the right design and drafting approach has been adopted.

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[17] See footnote 14.

[18] Explanatory Memorandum to the Income Tax Assessment Amendment (Capital Gains) Bill 1986 pp1-3. Income Tax (Rates) Amendment (Capital Gains) Bill 1986.
It should be acknowledged that this was prior to addressing exceptions and special rules which, for the purposes of this paper, are not presently germane.

[19] Corrections such as allowing for an adjustment to a capital gain or loss if the vendor repays part of the consideration (s. 116-50, ITAA97).

[20] CGT event J1, ITAA97.

The experience

The cases and the rulings that have followed have had to grapple, not with whether a taxpayer made a gain or not, but how the rules applied to bring that gain to account. *Hepples*[21] was an early expose on what was wrong with the detailed approach when the majority of judges agreed that there was a capital gain but there was no majority on which provision applied. *Allina*[22] showed the problems of writing in the mechanics of calculating a gain.

And the ATO has issued over 1,000 public Tax Rulings of various kinds that deal with capital gains in some respect. While about two thirds of those 1,000 are Class Rulings (in the sense that CGT is a significant part of the ruling) there are still around 400 rulings that provide some guidance on the CGT rules. This seems an extraordinary number of public rulings on a single topic. In addition to these public rulings are some 163 ATO Interpretative Decisions (ATOID) on the topic.

Contrast this with a search of the ATO legal database for rulings on "profit making" which yields 14 rulings and 3 ATO IDs. One might be surprised by this – surely the concept of "profit making" undertaking or scheme has been an issue in the tax world since time immemorial?

And yet, the profession and regulators still grapple with how best to deal with things like Earnouts[23] within the framework of the current prescriptive rules and yet most of those players agree on what the solution should be.

Finally, the experience has also shown the need to continually tinker with the CGT rules. Sometimes it is because of the need to address new provisions inserted elsewhere in the Acts (consolidation being the most obvious one). At other times it is because there has been an oversight in the way a provision was drafted and the need to address unintended consequences. Sometimes it is because the interaction between the CGT rules and other provisions of the Acts has been unsatisfactory and both have been changed (think of trusts). Then there are the situations where a hole just has to be plugged.

The great oversight – liabilities

How did this ever happen?

It is perhaps easier in hindsight to identify the flaws in a particular approach. To address the absence of a capital gains tax in Australia prior to 1985, drafters no doubt looked to overseas experience. The most obvious starting point was the UK. While short term gains had been the subject of taxation in the UK for a number of years, it was the Finance Act 1965 that saw the introduction of a broad capital gains tax. Under that Act, tax on "chargeable gains" was imposed[24] (note the introduction of a new concept). The tax on "chargeable gains" was, inter alia, on the "disposal" of "assets". Sound familiar?

Thus our tax on capital gains was to be doomed by its parentage. The similarities between the original Part IIIA of ITAA36 and the UK provisions are uncanny, even if unsurprising. If any lesson is

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[21] *Hepples v. FCT* (1991) 102 ALR 497.

[22] *Allina Pty Ltd v FCT* (1991) 28 FCR 203; 91 ATC 4195.

[23] See Draft Taxation Ruling TR 2007/D10 *Income tax: capital gains: capital gains tax consequences of earnout arrangements*.

[24] Sections 19 and 20 of the Finance Act 1965.

to be learned from other jurisdictions, it is that one must consider and challenge whether their approaches should be adopted, understand their experience and what lessons can be learned before adapting their law to our environment.

The justification for certain liability provisions

As has been noted previously, the path of drafting the law based around concepts of CGT events in relation to assets not only limits the different ways in which a capital gain or loss may arise but also addresses only half of the balance sheet. That there could be gains and losses arising on the discharge or compromise of liabilities had long been recognised[25]. Whether such a gain or loss should be brought to account was, prior to the introduction of CGT in Australia, determined on whether the underlying liability was on revenue or capital account[26]. What became quickly apparent is that the structure of the CGT provisions meant that it was possible (even likely) to have scenarios where there could be no relevant disposal of an asset on which a gain or loss could be said to arise[27].

As a result the tax laws were substantially deficient when dealing with gains and losses on liabilities on capital account.

Division 3B/Division 775

Division 3B was introduced into the 1936 Act in 1987. In the second reading speech introducing the Bill[28], it was said that the purpose was to allow deductions and treat as assessable income losses and gains on foreign exchange. At a time of high interest rates and Swiss Franc loans, it was relatively easy to make a case that there was a similarity between foreign exchange gains and losses and interest on loans (superficially attractive despite being internally inconsistent) and therefore should be taxed on the same basis as interest.

Perhaps most importantly, despite the earlier announcement of the introduction of a capital gains tax on 19 September 1985, the then Treasurer announced on 18 February 1986 (before the introduction of the Income Tax Amendment (Capital Gains Tax) Bill 1986) that there would be specific rules to deal with exchange gains and losses on “borrowings and loans”. What one can immediately glean is that there is something more at play here – an acknowledgement that the CGT rules, as announced, were not going to cover gains (and losses) on liabilities. This may have been a lost opportunity to re-think the design of the CGT rules before their introduction to parliament.

The so-called solution or “patch”

To overcome the “gap” in the law regarding gains and losses (although the latter were not usually the focus of amendments) of a capital nature on liabilities, various specific solutions were implemented in addition to Division 3B (and subsequently Division 775).

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[25] See, for example, *British Mexican Petroleum Co Ltd v Jackson (1932)* 16 TC 570 where the House of Lords found the amount of the profit on discharge of a liability was not included in income and compare to *International Nickel Australia Ltd* (1977) 137 CLR 347 and similar cases where the gain was held to be on revenue account usually on the basis that the underlying application of borrowings etc. had a revenue flavour.

[26] Compare *Hunter Douglas Ltd v FC of T* (1982) 82 ATC 4550.

[27] See *FCT v Unilever Australia Securities Ltd* (1995) 127 ALR 437; 95 ATC 4117 per Beaumont J at ATC 4135-6.

[28] Taxation Law Amendment Bill (No.5) 1986.

Commercial Debt Forgiveness

The Commercial Debt Forgiveness (CDF) rules were inserted into the ITAA36 via former Schedule 2C (now Div 245 ITAA97).

CCH Federal Tax Reporter describes the reasoning behind the introduction succinctly:

> "(these are) special rules to remedy the effective duplication of tax deductions that would otherwise arise from the forgiveness of "commercial debt". Duplication could occur because, while a creditor could be entitled to a tax deduction or a capital loss when a debt was forgiven, the debtor, though relieved of the liability to repay the debt, was not assessed on any gain and could continue to claim deductions for accumulated revenue and capital losses and other undeducted expenditure…"[29]

One suspects this reasoning may have been influenced by the relevant Explanatory Memorandum: while one can identify an asymmetry, describing it as a duplication of deductions ignores the absence of a mechanism to tax the gain to the forgiven debtor.

Of course, in retrospect, the CDF rules are justified on the basis of not seeking tax from an entity in relation to a compromised obligation at the very time that it is in financial distress. This argument ignores the fact that if the obligation has been compromised/forgiven, it is because of the entity's inability to pay the debt because the money or assets have been lost. If the money or asset has been lost (or lost significant value) then it is also highly likely that the entity has tax losses to offset the gain that might be assessed under a comprehensive CGT regime. Such an outcome would be the same as the tortuous method that is adopted under the CDF rules.

Defeasance gains

The defeasance gains (they are seldom losses) that escaped tax as alluded to above, were not the universal outcome. Thus in *FCT v. Orica* (1998) HCA 33, the High Court held that the CGT rules could apply to the gain arising on defeasance because of the satisfaction of the rights that Orica held under the defeasance arrangements as against the Melbourne and Metropolitan Board of Works; this seemed to be in contrast to the logic in *FCT v. Unilever Australia Securities Ltd* 95 ATC 4117, although in that case the comments were *obiter dicta*.
The fact there seems to have been the potential for different outcomes for what are, in essence, the same economic transactions is part of the issue of the prescriptiveness of the existing (and predecessor) CGT provisions.

Limited Recourse Debt Rules – Division 243

Limited recourse debt rules are designed to limit the amount of deduction that a taxpayer can claim in respect of an asset (usually in the form of capital allowances) where, by virtue of the limited recourse loan, the taxpayer ultimately doesn't have to meet a shortfall in the value of the asset and the amount of the loan. The need to include a specific rule is arguably a response to the absence of any CGT rules to bring to account the gain that is inherent in the extinguishment of what might have otherwise been the obligation but for the limited recourse nature of the loan.

[29] CCH Federal Tax Reporter at [798-740].

Consolidation rules

The introduction of the consolidation regime that detailed calculations of joining amounts and resetting of cost bases by reference to assets and liabilities of group entities meant that the CGT provisions suddenly had to deal with liabilities being taken into account in cost setting. Rather than question the fundamental structure of the CGT rules, it was thought sufficient to simply add (and continue to add) a range of additional CGT events to address the mismatch in regimes. Thus there are a range of events to cover situations such as discharging liabilities for a different amount to that that subsisted at the consolidation time and negative leaving cost bases.

These represent more examples of specific provisions being inadequate to address new situations and law and thereby giving rise to the need to continually tinker with the rules.

Gains on Financial Arrangement liabilities – Division 230

To borrow from JRR Tolkien, the Taxation of Financial Arrangements (TOFA) provisions contained in Division 230 might be described as "one rule to solve them all". By this I mean that some of the previously mentioned shortcomings that exist in the tax law by virtue of the structure of overlooking liabilities are dealt with by Div 230 dealing with both rights and obligations.

TOFA

Considering the shortcomings of CGT provides a natural segue to TOFA. In particular, Division 230 has been criticised for its reach and complexity and one wonders whether it would really have been necessary at all had there been a comprehensive CGT.

In its complete sense, TOFA includes debt-equity rules, forex rules as well as the broader TOFA rules contained in Division 230.

The debt-equity rules in Division 974 were designed to overcome the problem of the economic substance of instruments not matching the legal form and the tax rules giving outcomes based on legal form rather than economic substance. To address such a problem was a joy for the economic purists. Such problems are also reflected in the recent Base Erosion and Profit Shifting (BEPS) work done by the Organisation for Economic Cooperation and Development (OECD).

To overcome what was seen as taxpayers and their advisers choosing whatever *legal* structure suited them to achieve the desired tax treatment while still achieving the commercial outcomes, rules such as Division 974 were developed – as were the anti-hybrid rules in response to BEPS.

Of course, what Division 974 does is it allows taxpayers and their advisers to choose the *economic* structure suited to achieve the desired tax outcome while still achieving their commercial outcomes.

Have we really advanced the cause of a coherent tax system? The ATO had already been clear that the legal form was not a panacea and that what might be described as a debt may, at law, not be a debt after all[30].

There are some truly challenging provisions in Division 230. The objects provision[31] claims that it seeks to align commercial and tax outcomes by, among other things, recognising gains and losses on

[30] see TR 2002/15.

revenue rather than capital account. The keen tax savvy reader will immediately recognise the inherent contradiction in such a claim. The commercial outcome may often be on capital account and yet Division 230 will ensure the tax outcome is on revenue account – thereby adding to the litany of mismatches that occur in tax. Without any sense of irony, the section goes on to argue that one of the objects of the Division is to minimise compliance costs.

TOFA also represents a prime example of Taylor problem 2 of complex overlapping provisions. It is perhaps my favourite example of the battling primacy of provisions: Division 230 claims essential priority as the taxing provision for those things to which it applies to the exclusion of any other provision of the Act[32]. The Foreign Currency Gains and Losses Rules in Division 775 claim a similar priority[33] – which is interesting given what is in Division 775 can clearly be in Division 230.

Of course, those prioritisation rules stand side by side with the general prioritisation rules in s.6-25. Why?

Consolidation

The Consolidation provisions in Part 3-90 have proved to be a lesson in what not to do. Firstly, they represent a unique approach to dealing with wholly owned groups of companies – one that has not, for obvious reasons, been replicated by any other jurisdiction.

They present many of the very problems that researchers have identified as problematic. At the most fundamental, there is the complete mismatch between a set of rules designed to overcome the problem of duality of cost base, gains and losses in an overall framework that continues to recognise that duality. That asymmetry represents the perfect planning opportunity. Thus, cost base uplifts for some are not recognised for counter-parties. Single economic groups can have, through fairly simple means, multiple consolidated groups should it suit their purpose. Indeed, it is specifically provided for in the case of Multiple Entry Consolidated Groups.

The rules are the epitome of detailed mechanical provisions being the hallmark of the operation.

The response to various problems presented by the Consolidation rules has been to write more rules – including adding to the burden of CGT events! The administration has also been called on to try and make the unique and unnecessarily cumbersome rules work with various guidance and rulings. Perhaps the early creation of the Consolidation Reference Manual of over 1,000 pages should have been a signal that there was something amiss.

Loss Rules – when the cure is worse than the disease

That there were issues with the current and prior loss carry forward rules in the 1936 Act is unquestionable. To replace around 20 pages of difficult legislation with the 90 pages in Divisions 165 and 166 did not prove to be the answer – or if it was, perhaps the wrong question was being asked. As many would be aware, those newer provision have themselves been amended on various occasions to overcome what is perceived to be the difficult operation of the tracing rules.

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[31] S.230-10.

[32] S.230-20.

[33] Ss.775-15(4) and 775-30(4).

It would be fair to observe that the rules have moved to a new phase by the replacement of the same business test with the similar business test. How much of a difference that change makes to the underlying compliance burden is yet to be seen but it does feel a little like exchanging one set of rules for another for, perhaps, little advancement.

What one should ask is whether the whole concept of continuity of ownership and similar business tests is really all that relevant in the first place? Insufficient attention is paid to the history of the insertion of certain rules and the said justification. Is the original reason for the rules still valid? Can the same objective be achieved in a simpler and more effective, low compliance cost way? When those questions are asked of the loss rules, in my opinion, it will become apparent that the existing framework should be revisited and that there is a simple solution that will achieve the real original intended and desired outcome.

5. Cost of compliance and administration

In its March 2015 report "Stocktake of Regulation", Treasury estimated that in its portfolio (which includes the ATO) there are over 47,000 pieces of regulation. That includes, but is not limited to, Acts, legislative instruments, treaties, guidance notes, forms and codes of practice. The ATO's share of this was 24,480.

The actual cost to the Australian economy of that regulation was estimated in that report to be approximately $40 billion. That is an annual cost – each and every year. To put that in context, the ATO's budget for administering the tax system is around $3.2 billion. This is in contrast to the estimated cost of compliance of *non-tax* regulation at around $7 billion.

Early studies from the 1990s[34] suggested relatively lower overall costs of compliance, although these were based on relatively narrow data sets and the absence of GST and before the pervasiveness of Self-Managed Super Funds (SMSFs).

Whatever the costs, compliance is a deadweight cost on the economy and reduction in the costs of compliance translates as productivity gains: that is, time saved on compliance can be devoted to more productive tasks.

6. Interrelationship with sustainability of the Tax System

6.1 Does complexity add to planning opportunities?

There are many examples of how complexity adds to tax planning – by which I mean taxpayers taking advantage of the law including in ways that were not originally contemplated. While it has been argued by some that complexity in law is necessary to battle tax planning, I would argue the inverse is true: it is complexity of law that gives rise to more tax planning opportunities rather than addresses that tax planning. Perhaps the greatest myth in tax law development has been, in my

[34] Including the Productivity Commission Report 1996.

opinion, that a complex world and complex business and transactions requires complex tax laws to deal with it. There is no basis for such claims and the sooner they are given short shrift the better.

One tax planning opportunity is ensuring the most attractive tax rate is used to the greatest extent possible. This is only viable in a system with different rates of tax for different vehicles and different kinds of income. Thus, those able to do so, will arrange their affairs to maximise the use of superannuation rates of tax, tax-free thresholds, and company tax rates rather than pay marginal rates of personal tax greater than 30%.

Similarly, deferral is one of the more straightforward tax planning techniques. It is axiomatic that the longer the deferral the more valuable it is. Those in business – particularly those unlisted or closely held – have the incentive to arrange their affairs to take advantage of deferral of taxing point – or of taxing point at full rates. In fact, add deferral to differential tax rates and the opportunities for tax planning open up considerably.

Among the techniques that have been in the news lately is income splitting. Recently, Everett assignments were singled out as a particular income splitting technique available to professionals. However, it is no more of an income splitting technique than is used by most small businesses – partnerships, trusts and companies. To address one only could only be described as a "whack-a-mole" response – reminiscing that game where one hits one problem that pops up only to find another, somewhere else, immediately takes its place. To attack one of these techniques only means that others will be adopted (if they haven't already). To use general anti-avoidance rules as a response to such planning may risk the whole edifice falling down. If one kind of partnership is a tax avoidance arrangement, does it call into question every partnership in the country run by small businesses?

Why are any of these problematic? Because they often represent some fundamental design flaws – where different parts of the law come into play with other parts of the law and that interaction is found wanting – or more correctly that interaction opens tax planning opportunities.

The impact of avoidance on complexity (and vice-versa) was something that the UK's Office of Tax Simplification started considering but has not completed due to resource constraints.

7. What are the current barriers?

Every player in the development of tax law must take some responsibility for the current state of the law. It is not just a question of those who have sought a concession here or a particular treatment there: we have all had a role in failing to address the fundamental issues and agree to a clear statement of the outcomes that are sought to be achieved by the relevant legislation.

7.1 Parliament

Parliamentary processes are not designed to write law. Rather, parliamentarians consider and pass bills presented to them. The preparation of those laws has been through a considerable gestation period, conceptual development, debate, drafting instructions, drafting, consultation, ministerial, cabinet and party room approval processes before being introduced to parliament. There may have even been some negotiation between the government and other parties to ensure the smooth passage of the bill.

7.2 Government

Governments of the day set policy and reasonably expect and rely on public servants to deliver that policy. The reality is that as much as "frank and fearless" is a hallmark of good public service advice, it will not always persuade politicians who have to deal with competing interests and sectional interest lobbying. Such lobbying is not necessarily purely self-interested. However, it would be fair to say that such lobbying often deals with the matter before it without appreciating the bigger picture or longer term game. Nor will there always be recognition of what the current proposed change means in the context of existing law. A simple change today may have large implications down the track when it is realised how it overlays an existing framework. The emergence of stapled structures that undermine the corporate tax base was, in part, a response to withholding tax concessions and is a case in point.

Often the process of developing the law is rushed which often means the solution can be tactical rather than strategic and whole of system focussed. Election cycles contribute to the way policy and legislative solutions are developed. The media contributes as it is often looking for a negative angle because that makes a story. The media often looks for "losers" in any announcement and this is something that politicians are also acutely aware of.

Governments have fallen into the trap of thinking that articulation of policy requires details of the operation and mechanics of the law to be set out in the policy announcement. While this may be to assuage concerns of affected parties, more often it just leads to more questions. This temptation to nail down all the details must be resisted. Good policy would simply articulate the *outcome* that the policy is designed to achieve – not the detailed mechanics of how that outcome is achieved.

7.3 Treasury and the ATO

Treasury and the ATO must work within the parameters set by government. To the extent it is possible to influence those parameters in advising government, it should be about outcome and impact but not to have the government adopt the nascent thinking of how the law may work in practice. That is a detail for administration and compliance – not, I would argue, for the law itself to deal with.

One of the valuable contributions the ATO can make is to inform policy development of the operation of the existing law in practice. The experience of the ATO can also help inform how future law may actually operate. However, one key experience of administering the law that seems to have failed to capture the attention of policymakers is that the more detail that is put into the law the more difficult it is to give effect to policy. Detail constrains the administration and compliance of the law.

A simple example: taxpayers should know what the assessment of their tax liabilities is. To achieve that, the law currently requires that the Commissioner make an assessment of the taxable income and tax liability, produce a notice of assessment and send that notice to the taxpayer. Readers would immediately see that this is somewhat archaic in the modern world.

I have shown above the detail of various provisions of the Act. The shortcomings of those examples are obvious – they produce strange results that can give rise to inappropriate tax outcomes including

opportunities for tax planning as well as prevent sensible administration to deal with normal transactions.[35]

7.4 Masking complexity

Finally, there is an aspect of administrators "papering over" complexity in the law. For example, administrative advice and guidance can be one means of removing – or masking – complexity in law[36]. In the last few years the ATO has been reinventing the way advice and guidance is produced – with a view to providing guidance that actually guides. This is being achieved through taking a layered approach, including web-based guidance, factsheets, rulings, and more detailed explanations that users can access depending on their needs.

New ATO guidance products have been introduced, including Practical Compliance Guidelines (PCGs), Law Companion Rulings (LCRs) to complement Binding Rulings (both public and private), factsheets and web guidance on ato.gov.au as well as finding new ways of using existing guidance such as Taxpayer Alerts (TAs).

PCGs are meant to fill a gap that previously existed about where we can guide people where it is safe to play or "swim between the flags" and where it is not.

LCRs are a form of public ruling designed to give early guidance on new law that ensures the way the ATO will administer new law is in the public domain as early as possible. By drafting these at the time the legislation is being developed can have the added advantage of finding ways to simplify the law – usually by taking unnecessary mechanics out of the law.

TAs are now issued to warn of concerns about new or emerging higher risk tax or superannuation arrangements or issues that are under risk assessment. By sharing concerns early, the ATO seeks to help taxpayers make informed decisions and not to unknowingly take on tax positions that might give rise to future disputes or adjustments.

On the one hand, these approaches address some complexities in the law – as does the Commissioner's Remedial Power. But they should not supplant the need to address the underlying problem of the complexity of the law itself.

7.5 The tax profession

The tax profession has also played its part in adding to the complexity of the law. A desire for certainty – however illusory that has turned out to be time and again – has meant the profession has often demanded more detail so that it "knows the rules". The ATO has been complicit in this because, as administrator, it too has wanted to "nail down" the rules sufficiently to prevent opportunities for avoidance or tax planning.

[35] See "The Experience" on p.9 above.

[36] Having said that, there are examples of guidance from the past that probably has been unnecessarily complex. Sometimes they have read like masters dissertations – and not very good ones at that!

8. Efforts to reduce complexity

There have been various efforts to reduce the volume and complexity of the tax laws. James, Sawyer and Wallschutzky[37] argue that these attempts (both in Australia and elsewhere) have not been very successful.

The work of the Tax Law Improvement Project (TLIP) project in the early 1990s was the first obvious attempt at addressing the complexity of the Income Tax Assessment Act 1996. It followed from a recommendation of the Joint Committee of Public Accounts in its report of November 1993[38] recommending the setting up of a broadly based Task Force to rewrite the income tax law. The object was not so much to simplify but to take a new approach to the development of tax laws.

As alluded to previously, the work of the Board of Tax over 2005–06 resulted in the repeal of approximately 4,100 pages of the Income Tax Assessment Acts. This was a significant reduction in the then size of the tax laws. Unfortunately, while it was successful in itself, the achievement has been somewhat undermined by the ongoing subsequent additions to the law.

Principles-based drafting of tax laws was spoken about a lot in the early 2000s. Various papers were written on the topic including that of Greg Pinder of Treasury in 2005[39]. The paper notes that the government in 1998 made a commitment to use general principles in the tax code in preference to long and detailed provisions.

9. Why have attempts to date been of limited success?

9.1 TLIP project

As noted above, the TLIP project arose from a JCPAA recommendation. Ironically, the reason for the recommendation was that the Income Tax Assessment Act 1936 had become "cumbersome and idiosyncratic"[40]. One wonders what those committee members might make of the current Acts which are more than twice the size and filled with more arcane provisions than at that time[41].

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[37] "Tax Simplification: A review of initiatives in Australia, New Zealand and the United Kingdom"; eJounal of Tax Research (2015) vol.13, No. 1, pp280-302.

[38] Joint Committee of Public Accounts 1993, An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office, Australian Government Publishing Service, Canberra.

[39] "The coherent principles approach to tax law design", Economic Roundup, Treasury, Autumn 2005, pp75ff https://static.treasury.gov.au/uploads/sites/1/2017/06/07_coherent_principles.pdf

[40] At paragraph 5.1 quoting *Butterworths Australian Tax Legislation 1992, vol. 1, Income Tax Assessment Act,* Butterworths Pty Ltd, 1992, p. vi.

[41] The premise of much of the Committee's logic is, with respect, flawed. Much of the complexity in the then law was blamed on, broadly, two "interrelated factors": complexity of commercial life and responses to avoidance. A former Commissioner's submission is also quoted with some more detailed observations (which, respectfully, fall into similar traps as the Committee). Whether the commercial world is more complex or international or somehow different to the way it was in the past may or may not be correct – that is beside the point. Good law is able to respond to changing circumstances without the need for constant tinkering; well-expressed principles have stood the test of time (sometimes in spite of an attempt to re-write them (see ss.6-5 and 8-1 of ITAA97)).

The object of the TLIP was to re-write all of the Income Tax Assessment Act 1936 in a new and approachable way. This lofty principle stumbled at early outings as is evident in the re-write of the CGT provisions.

Moreover, the project was doomed from the start for a number of reasons.

Firstly, the approach taken meant that it was assumed that the “user” of law is the individual. This is no more so true than in relation to road rules – how many drivers on Australian roads have actually read the law and regulations? More likely they rely on the test they passed to be licenced in the first place and hope there is a government or motorist body that will tell them of any changes. In reality, it will be the BBQ conversation that really informs their knowledge of the road rule changes. Why do we suppose tax to be any different? I drive many more times per year than I lodge a tax return or file a BAS.

The second handcuff put on TLIP was that no policy changes were to be made. While I do not advocate policy changes per se when looking at simplification, it is inevitable that some small changes are necessary if true progress is to be made.

The proof that not all provisions needed to be rewritten can be seen in some of the so-called “core” provisions of the 1997 Act, the most obvious example of which is the 1936 Act provisions of ss25 and 51 being rewritten into ss6-5 and 8-1. The table below compares those sections:

1936 provision	1997 equivalent
S.25(1) The assessable income of a taxpayer shall include – (a) where the taxpayer is a resident – the gross income derived directly or indirectly from all sources whether in or out of Australia; and (b) where the taxpayer is a non-resident – the gross income derived directly or indirectly from all sources in Australia, which is not exempt income	6-5(2) If you are an Australian resident, your assessable income includes the *ordinary income you *derived directly or indirectly from all sources, whether in or out of Australia, during the income year. 6-5(3) If you are a foreign resident, your assessable income includes: (a) the *ordinary income you *derived directly or indirectly from all *Australian sources during the income year; and (b) other *ordinary income that a provision includes in your assessable income for the income year on some basis other than having an *Australian source.
s.51(1) All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable as deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.	8-1(1) You can deduct from your assessable income any loss or outgoing to the extent that: (a) it is incurred in gaining or producing your assessable income; or (b) it is necessarily incurred in carrying on a *business for the purpose of gaining or producing your assessable income. [Note omitted] 8-1(2) However, you cannot deduct a loss or outgoing under this section to the extent that: (a) it is a loss or outgoing of capital, or of a capital nature; or

	(b) it is a loss or outgoing of a private or domestic nature; or (c) it is incurred in relation to gaining or producing your *exempt income or your *non-assessable non-exempt income; or (d) a provision of this Act prevents you from deducting it.

The language is a little different but not much. What does that tell us? That there are fundamental and wide-ranging concepts that can be expressed in relatively straightforward language. Without seeking to re-analyse all of the impacts of these two foundation provisions, consider the language used – it is essentially the same in both versions. It importantly makes no mention of how to make any calculation – it is devoid of any operational rules (see Taylor). Further, there is no definition – either in the section or in s.6 – of the concepts of "income" (simpliciter) or of "loss or outgoing".

Some of the failings (in terms of the criteria that Taylor and others have enunciated) in the way the 1997 Act is written become obvious on cursory examination. For example, as soon as one sees a method statement one knows that the drafter has overstepped the mark by straying into mechanical operational rules and away from outcomes-focussed principles.

9.2 Principles-based drafting

The phrase "coherent principles approach" was coined to describe this process. Certain examples were referred to in Pinder's[42] paper – one might argue how successful those examples were in reflecting a principled approach. Nonetheless, Pinder goes on to, quite correctly in my view, describe "(a) principle is a statement about an intended outcome in a general field…. A principle…

- is an operative legislative rule
- specifies the outcome, rather than the mechanism that achieves it; and
- expresses the outcome at the highest possible level rather than itemising a list of outcomes for every conceivable case."[43]

Unfortunately, even the examples pointed to express some level beyond simple principle and outcome and describe mechanisms to achieve the outcome.

Moreover, the mistake with principles-based drafting is to accept that one has the right principle in the first place. In some cases, it is quite clear that the mechanism chosen to achieve a particular outcome is the wrong one. For example, Pinder says the drafting in Division 320 follows the principles-based approach. Having been party to the development of those rules, I acknowledge part responsibility for picking the wrong mechanism to achieve the desired policy outcome.

Principles-based drafting has some way to go in its development and maturity. Examples to date – while a vast improvement on other approaches – fail to get to the true principle and are still hampered by some level of verbosity in drafting.

[42] Op cit.
[43] Ibid, p77.

9.3 Trust

Lack of trust, desire for certainty and fairness or a fair go – is, to my mind, the greatest underlying reason for the current state of the law.

As mentioned previously, in recent decades there has been a demand from users of all kinds that the law be clear in what it covers so there is no danger of "unintended consequences". The truth that is now apparent is that such detail simply leaves new gaps or areas of uncertainty. Moreover, it often meant that the law operates in a way that is contrary to normal business and commercial practices, thus adding to the compliance burden.

At its core, the two sides of this approach reflected a complete lack of trust: a lack of trust in taxpayers and their advisers, a lack of trust in the administrators and a lack of trust in the judiciary.

In Australia, that era I would like to think has come to its necessary end. While trust has not yet been fully restored, I would venture to say that it is re-emerging. Where there is trust there can be a new and principled approach to the way law is drafted. This should mean simpler law. It should mean law that is adaptable to changing circumstances and new and emerging ways of doing business.

10. What is the most appropriate framework for the design of tax laws?

If simpler law means changing the impact of tax for some, does that mean there may be losers? I would argue it is, at best, a remote possibility: gaps in existing law are often filled by additional provisions. Law that is simpler also likely to build trust in the system – there are fewer "loopholes".

10.1 How do we ensure "tax just happens"?

How to build confidence in the system – that the system works to ensure everyone is doing the right thing and that it is easy to do the right thing and hard not to? The ATO vision and purpose is directed towards this aim. However, it would be made considerably easier if the law itself supported that outcome.

In my opinion, a simply expressed principle can cut a swathe through a significant amount of unnecessary and confusing clutter, saving enormous compliance and administration costs, taking a dead weight off the productivity of the Australian economy and, moreover, making the tax practitioner's life that much more pleasant.

For example, the various concepts of CGT events, disposal, asset, cost base and proceeds (and possibly others) can be replaced by stating what it is that is to be subject to tax in a truly principled way. Where might we look for inspiration for such a solution? In my view, sections 6-5 and 8-1 (and their predecessors, section 25 and subsection 51(1)) provide the model. If one was to express the relevant principle in the terms of those sections, it would look something like this: "Include in your assessable income any net capital gain that you make. A net capital gain is capital gains less capital losses."

The defenders will lament the apparent lack of clarity around timing, cost and proceeds but most will find that these issues have not been the subject of real argument when the concept of the timing and amount of gain or loss has had to be determined under ordinary income principles[44].

The most obvious advantage of a broad, principled-based approach is the flexibility that it provides in dealing with the ever-changing world and emerging practices. In the case of CGT, not only would it cover assets *and* liabilities, enable the abolition of large chunks of "patch" provisions, reduce the size of the tax law and save compliance costs, it would also enable the law to meet with dexterity and flexibility that changing economic landscape. In other cases, it would involve a re-think of the underlying basis and approach to the relevant rule and development of better solutions: Consolidation and Fringe Benefits Tax are but two examples of this.

Such an approach would have the advantage of the flexibility inherent and evident in provisions such as the core income and deduction rules. Importantly, it would give the ATO as administrator the flexibility to deal with difficult and emerging issues.

11. Conclusion

We all have a role to play in improving the usability of the tax and super system that we are handing down to our children, grandchildren and the young people in our lives that we care about. To persist with the current approach and adding further layers of complexity to an already overburdened legislative framework will bring us closer to the point of collapse. There is probably no more urgent a time than right now to make such a change.

To turn 'everyone into a winner', I believe a systemic approach is required as argued for by James, Sawyer and Wallschutzky[45], who also advocate for the establishment of a permanent body to oversee the development of tax policy including simplification.

[44] Refer, for example, the cases referred to at footnote 25.
[45] Op cit, p.300.