



A U S T R A L A S I A N
TAX TEACHERS ASSOCIATION

JOURNAL
OF THE
AUSTRALASIAN
TAX TEACHERS ASSOCIATION

2005
Vol.1 No.2

Edited by
Paul Kenny & Margaret McKerchar

Postal Address:
Atax, Faculty of
Law, UNSW, NSW 2052
Australia
Phone: +61 2 9385
9362
Email:
m.mckerchar@unsw.ed
u.au

The Journal of the Australasian Tax Teachers Association (JATTA) is a double blind peer review refereed journal. It is normally published annually and subsequent to the Association's annual conference.

The Australasian Tax Teachers Association (ATTA) is a non-profit organisation established in 1987 with the goal of improving the standard of tax teaching in educational institutions across Australasia. Our members include tax academics, writers and administrators from Australia and New Zealand. For more information about ATTA refer to our website (hosted by the University of New South Wales) at www.atax.unsw.edu.au/atta

Direct enquiries regarding the Journal to:

Associate Professor Margaret McKerchar
Australian Tax Studies Program (Atax)
Faculty of Law
The University of New South Wales
NSW 2052
Australia

**Editorial Board of the Journal of the Australasian Tax Teachers Association
(2005-2007):**

Associate Professor Dale Pinto (Curtin University)(Chair)
Miranda Stewart (University of Melbourne)
Adrian Sawyer (University of Canterbury, NZ)
Associate Professor Natalie Stoianoff (University of Wollongong)
Associate Professor Andrew Smith (Victoria University, NZ)
Associate Professor Margaret McKerchar (University of New South Wales)

ISSN: 1832-911X

Volume 1 Number 2 published June 2005

Copyright © 2005 Australasian Tax Teachers Association

TABLE OF CONTENTS

FOREWORD	iv
TAX REFORM: A TOWER OF BABEL; DISTINGUISHING TAX REFORM FROM TAX CHANGE <i>Graham Hill</i>	1
ADMINISTRATION AND TAX REFORM <i>Michael D'Ascenzo</i>	25
AUSTRALIA'S CAPITAL GAINS TAX DISCOUNT: MORE CERTAIN, EQUITABLE AND DURABLE? <i>Paul Kenny</i>	38
MUCH ADO ABOUT NOTHING: RALPH'S CONSIDERATION OF SMALL BUSINESS <i>Michael Dirkis and Brett Bondfield</i>	110
TRANS-TASMAN TRIANGULAR TAXATION RELIEF: AN EXERCISE IN POLITICAL FUTILITY <i>David Dunbar</i>	142
JURISDICTION TO TAX AND THE CASE FOR THRESHOLD REFORM <i>Kerrie Sadiq</i>	162
DIVIDEND IMPUTATION AND DISTRIBUTIONS OF NON PORTFOLIO FOREIGN SOURCE INCOME: AN EVALUATION OF SOME ALTERNATIVE APPROACHES <i>C John Taylor</i>	192
THE RESIDENT/NON-RESIDENT DICHOTOMY IN NEW ZEALAND'S TAX REGIME: PROPOSALS FOR SOME INTERMEDIATE STEPS? <i>Andrew Smith</i>	223
THE GST RECURRENT COMPLIANCE COSTS/BENEFITS OF SMALL BUSINESS IN AUSTRALIA: A CASE STUDY APPROACH <i>Binh Tran-Nam and John Glover</i>	237
HOW SIMPLE CAN TAX LAW BE?: THE INSTRUCTIVE CASE OF HONG KONG <i>Michael Littlewood</i>	259
PART IVA AND TAX REFORM <i>Tom Delany</i>	293
AN HISTORICAL ANALYSIS OF FAMILY PAYMENTS IN AUSTRALIA: ARE THEY FAIR OR SIMPLE? <i>Helen Hodgson</i>	318
STOCK-IN-TRADE VALUATION FOR UK TAXATION PURPOSES 1925-71: HAS IT ALL BEEN THE ACCOUNTANTS' WAY? <i>David M Smith</i>	342
TAX REFORM AND THE USE OF OVERSEAS TAX MATERIALS IN AUSTRALIA <i>Colin Fong</i>	414
REMINISCING THE TAXATION PRIORITIES IN INSOLVENCY <i>Christopher F Symes</i>	435
NOT ANOTHER TAX <i>Elfriede Sangkuhl</i>	450
ENTITY TAXATION: THE INCONSISTENCY BETWEEN STATED POLICY AND ACTUAL APPLICATION <i>Brett Fredudenberg</i>	458
AN APPRAISAL OF RESEARCH-LED TEACHING IN THE CONTEXT OF TAXATION: CAN BOTH TEACHER AND STUDENT BENEFIT? <i>Margaret McKerchar</i>	491

FOREWORD

The papers included in this edition of the *Journal of the Australasian Tax Teachers Association (JATTA)* are based on presentations made at the 16th Annual Conference of the Australasian Tax Teachers Association (ATTA) held on Thursday 29 January to Saturday 31 January 2004 at Flinders University, Adelaide.

The Vice-Chancellor of Flinders University, Professor Anne Edwards opened the conference and welcomed delegates. Plenary presentations were given on the opening day of the conference by the Hon. Justice Graham Hill, (Patron of ATTA), Michael D'Ascenzo, Second Commissioner of Taxation, and Professor Alice McCleary, Deputy Chancellor, the University of South Australia. On the second day of the conference the plenary speakers were Associate Professor Owen Covick, Deputy Head Faculty of Social Sciences of Flinders University and Jim Gordon, of the Inland Revenue New Zealand.

The conference theme 'Tax Reform = Fairer, Efficient, Simpler???' generated considerable interest from tax academics, policy makers and practitioners across both Australia and New Zealand. The papers in this edition of *JATTA* demonstrate the significance of tax reform to our social and economic wellbeing and the enormous and ongoing challenge that it presents. It is hoped that these papers will make a valuable contribution to the literature and stimulate the engagement and contribution of others, including students, to improving our respective tax systems.

Finally, the efforts of many made the 16th Annual Conference the great success that it was and have culminated in the publication of this edition of peer reviewed papers. Sincere thanks to all those involved. With your ongoing support, ATTA will undoubtedly continue to thrive as a valued organisation.

Paul Kenny (Flinders University)
Margaret McKerchar (Atax, UNSW)

30 June 2005

TAX REFORM: A TOWER OF BABEL; DISTINGUISHING TAX REFORM FROM TAX CHANGE

GRAHAM HILL

Justice of the Federal Court of Australia, Sydney.

I TAX REFORM: WHAT IS IT?

For many years now the subject of tax reform has rarely been far from the front pages of the nation's newspapers. It is not to be assumed, however, that this reflects an all-consuming interest in tax reform on the part of those who buy these newspapers. Rather it reflects politicians' perceptions that the subject is one with a high electoral profile which can be turned to advantage in the everyday cut and thrust of Australian political life, especially having regard to the amount of space newspapers afford our politicians. Whether the politicians are right is not a question I am qualified to judge. Presumably, however, political surveys must give some support to these perceptions, or perhaps even guide them.

Tax reform has not always been a topic for media coverage—this is a modern phenomenon. Nor, presumably, was it given great popular emphasis in political platforms of the past, although governments in Australia have appointed a plethora of Royal Commissions or bodies of inquiry over the first 100 years of federation.

The central role that taxation plays today in the political process probably dates from the late 1970s when the bottom of the harbour schemes attracted public attention. It was given an even higher profile by the Taxation Summit of 1985. Since then, governments of both political persuasions have made tax reform a political issue. The continuing emphasis upon tax reform, and the media concentration upon it, assumes that there is a common understanding about what tax reform means, even if there is no complete agreement about how it is to be achieved.

The word 'reform' is defined in the Macquarie Dictionary (Third Edition) as 'improve by alteration, substitution, abolition etc'. Unfortunately we can discard the alternative meaning given by the same source: 'put an end to (abuses, disorders etc)' or 'abandon evil conduct or error'. The word does not simply mean 'change'. Because the word carries within it the subjective concept inherent in 'improvement', opinions may differ as to what constitutes reform on the one hand, as against mere alteration in the law on the other.

It is not a particularly insightful comment to make the point that tax reform being subjective can have no fixed meaning. The more important point is that because the concept of reform is subjective the word will have different meanings or will signal different messages to different audiences or users.

Lawyers and accountants, particularly those who teach law, would acknowledge a difference in meaning between reform of the tax system and reform of a particular tax. Reform of the tax system is necessarily wider than reform of a particular tax, because it directs attention to the significance of a particular tax within the tax system as a whole, as well as to the need to remedy defects in a particular tax. Indeed, a proposal for reform of the tax system as a whole might render irrelevant any defect that may exist in a tax which is to be repealed. While a particular section of the death duty legislation may have warranted discussion in the early 1980s, if the subject matter of debate then was the reform of death duty, that question would have been quite insignificant if the subject matter of the debate at that time was whether death duty should be abolished and replaced by some other form of tax.

An assessment of the tax system generally involves the application of three criteria, namely that the system involves equity and simplicity, and that it promotes economic efficiency.¹ The same criteria may be applied to the assessment of a particular tax on its own. These criteria are often, and probably almost always, incompatible with each other.

Equity involves both horizontal and vertical equity. The former is concerned with ensuring that those having equal ability to pay tax bear equal burdens of tax. The latter is concerned rather with ensuring that a greater ability to pay attracts a greater tax burden. Both imply fairness. There can be little dispute that change will not be reform if it produces unfairness.

Simplicity may be less significant than fairness. It is generally the case that the more fairness there is in the tax system the less simple it will be. A flat-rate income tax permitting no deductions might be simple yet unfair. The Australian income tax system clearly is not simple. But this does not mean that simplicity should be discarded. Indeed, it should be encouraged, for complexity increases both the costs of administration and the costs of compliance. Change that is designed to produce simplicity without affecting either fairness or efficiency (for example, the work of the Tax Law Improvement Project) may still involve reform.

Efficiency of a tax system is said to exist where the tax system is neutral, that is to say, in relation to an individual when the choices available to the individual are not skewed by the tax system. Efficiency is but one public policy end. Other matters of public policy may suggest that efficiency should not be promoted. For example, health considerations may dictate that there be a high rate of excise on cigarettes to discourage smoking and thus encourage other kinds of expenditure. Almost invariably political considerations will take priority over efficiency. The exemption of the family home from capital gains tax creates fiscal inefficiency but any government that sought to abolish it would not remain long in office.

It is questionable whether the three criteria can play a role in defining when change is reform. If there *is* a role for them in the definition process, it can only be if agreement can be reached as to the weight that is to be given to each. A change that created both simplicity and unfairness might or might not properly be regarded as involving real

¹ The Asprey Committee Report of 31 January 1975 discussed below contains in Chapter 3 a useful discussion of the criteria for assessing tax systems and particular taxes.

reform. Whether it should be so regarded will depend upon the weight to be given to simplicity and the weight to be given to equity in relation to the particular change. This is a matter to which I will return later in the paper. It suffices to say here that the subjective element that differentiates reform from mere change is to be found in the application of these criteria and, furthermore, the weight to be given to each of them.

There is a question whether tax reform has a common or accepted meaning even if the subjective element is put to one side. If the expression means different things to different people then any debate about tax reform would be rather useless. Hence the reference to the Tower of Babel in the title of this paper. For this purpose I propose to approach the question in two ways. The first is to examine how those involved in the tax reform process see tax reform. The second is to see what governments have meant by tax reform when they have appointed committees to advise them on tax reform.

The first approach may be assisted by considering the way newspapers report or editorialise upon tax reform. On the assumption that newspapers reflect public opinion, and do not create it (an assumption that is clearly only partly correct), the public perception of tax reform will be reflected in the way that newspapers deal with tax reform. Newspaper reports may also provide some insight into how those who participate in the tax reform process view that process. It is for this reason that I have, from time to time, referred to reports from the *Sydney Morning Herald* (SMH) on tax reform. I have restricted my research to that newspaper because it is generally accepted as a quality newspaper of record and would most likely be the only newspaper in the Commonwealth which would, in the period since federation, have continuously reported on tax matters.

II TAX REFORM: WHAT IT MEANS TO PARTICIPANTS IN THE PROCESS, THE PUBLIC AND THE POLITICIANS

To the man or woman in the street and the politician shortly to face the electorate, tax reform generally means lowering the tax thresholds or the tax rates, or increasing deductions or rebates. Other changes are irrelevant unless they promote a lessening of the tax burden. The emphasis upon the self-interest of the taxpayer is nowhere better demonstrated than in the famous Liberal–Country Party electoral campaign which centred upon ‘the fist full of dollars’ or the ‘L-A-W tax cuts’ promised by the then Prime Minister, Mr Keating. But it is hard to see the normal citizen as in any real way a participant in taxation reform. Rather he or she is the target of rhetoric in support of, or opposed to, what is said to be tax reform as part of the political process.

Politicians, on the other hand, are in a different position. Reform is a useful political mantra. To appear concerned to promote reform is a political positive. It may be satisfied by politicians who form part of the government for a while by the setting up of inquiries to report on tax reform. That gives, at least, the appearance of action. At some stage there may be a need to legislate for change. That change will be proclaimed by the government to be reform even if the label is not accepted by the opposition. Oppositions likewise may make tax reform a political issue. The Democrats have fulminated about tax avoidance. They have pushed the view that Part IVA is defective, a view that is, to say the least, questionable. They constantly remind

both the government and the public that trusts are a vehicle of tax avoidance, and that what they would label 'reform' is necessary to change that.

The Whitlam government put tax reform on the political agenda in 1975 when it tabled the Asprey Committee report² although the Committee itself was established by the former Liberal government in 1972. By this time the effect of inflation and bracket creep was being clearly felt by workers and the case for tax reform as enunciated by the Asprey Committee in its final report was becoming obvious. The events of 11 November 1975 not only ended the fortunes of the Whitlam government, but also ensured that the implementation of the Asprey recommendations would, with a minor exception, be substantially delayed.

Tax avoidance exploded as an issue for the Fraser government with the bottom of the harbour schemes and the sale of packaged tax avoidance schemes. The government was ultimately forced into acting against the former with the *Taxation (Unpaid Company Tax) Assessment Act 1982* (Cth) and against the latter with the introduction of Part IVA by the then Treasurer, Mr Howard. This legislative activity, including a plethora of specific anti-avoidance measures, was clearly accepted as tax reform by the community.

The Hawke and subsequent Keating Labour government thereafter made tax reform a major political issue. No more clearly was this demonstrated than with the Taxation Summit of 1985 which led to the introduction of a tax on capital gains³ and to fringe benefits tax, although not to Mr Keating's favoured GST. The Keating government commissioned the Tax Law Improvement Project which promised more than it ultimately delivered when the *Income Tax Assessment Act 1997* (Cth) was unfolded. But at least simplicity of a kind was put on the agenda of tax reform even if it could be argued that simplicity meant not merely simplicity of language but simplicity of concept. Tax became a vehicle for the government's social policies; a collection mechanism for child support and HECS payments, as well as fulfilling a function of social security through rebates and other tax relief to the poorer sections of society. The Howard government has pushed the barrow of tax reform to the point where it has almost become identified with tax reform more than with any other issue. That identification evidenced by the avalanche of tax legislation enacted since it took office.

There are, however, identifiable participants in tax reform besides the politicians and the public generally. They have, in various guises, had input into the process since federation, although the weight of each may have altered in regard to shifting political circumstances over time. By identifying these participants it is possible to list factors that are present in the way tax reform is addressed in Australia.

² 'Taxation Review Committee', *Full Report* (31 January 1975).

³ The Asprey Committee had recommended deferring the introduction of a capital gains tax. The government had announced the introduction of a capital gains tax as and from 17 September 1974 but subsequently decided to postpone introduction of that tax. It was not revived until after the tax summit.

III PARTICIPANTS IN TAX REFORM: SEPARATE AGENDAS

There are many recognisable participants in the tax reform process. Some of them are identified in the short discussion that follows, although the list is not intended to be complete. Given that advocates for change often wish to be cloaked with anonymity, a complete list would be impossible. Further, participation in the tax reform process has changed over time. But there are some important and recognisable categories of persons who may readily be identified as participants. Their agendas and what they would nominate as tax reform are often in opposition.

Among the most significant categories of participants in tax reform, at least in recent times, is the welfare lobby. This includes the churches, particularly those engaged in providing social services, for example, the Salvation Army, the Catholic Church's Social Welfare organisation, and the Uniting Church as well as the other mainstream churches. It also includes the Australian Council of Social Services (ACOSS), a body which has played a significant role in the tax reform process; the Council of the Aging and like bodies. To many of these organisations tax reform may be seen to be directed more at social security or welfare benefits to the disadvantaged, or at incentives which may be aimed at improving their situation within the community, than at other areas that could be considered reform. The welfare lobby was instrumental in the axing of Option C advocated by the then Treasurer, Mr Keating, at the Taxation Summit of 1985.⁴ These bodies would probably see other measures—for example, measures designed to simplify appeals—as not constituting real tax reform but rather a distraction from tax reform, unless, measurably, they operated to reduce the tax burden on the poor, or improved the social security position of their constituents.

It is questionable whether social security benefits have any place in the tax system at all. On the one hand it may be said that social security benefits are just the opposite side of revenue raising, with the consequence that the two are intertwined. On the other hand, it may be said that taxation should be concerned with raising money and not with how the money raised is spent. It is impossible to divorce the raising of revenue from the spending of that money, if only because an estimate must necessarily be made as to what outlays the government may have, and the revenue required to meet those outlays, before decisions can be made as to how the necessary revenue is to be raised. In any event social security benefits can be, and are, provided through the taxation system itself as well as from outside that system. The family tax allowance is an example. There are many who say that incentives (tax expenditure) should arise outside the taxation system, rather than be hidden from scrutiny within it. All these issues form part of the tax reform debate and mean that tax reform can encompass consideration of social benefits.

The welfare lobby is but one of the many special interest groups that demand a say in tax reform. Some feminists point to women being disadvantaged by the present tax system and advocate reform to remove that disadvantage.⁵ The debate has in more recent times, and partly through the work of Ms Pru Goward, extended to a review of

⁴ A report of the Tax Summit is to be found in *20 Taxation in Australia*, 82.

⁵ Claire Young, 'Taxing Times for Women: Feminism Confronts Tax Policy' (1999) 21 *Sydney Law Review* 487; and see Professor Apps' interesting article 'Tax Reform, Ideology and Gender' in the same edition of that journal at 437.

family tax benefits with particular emphasis on the effect of the taxation system upon the choice of mothers with infant children to work or stay at home. Newspapers suggest that the present government will in early 2004 publish a detailed policy statement on these issues.

In addition, the Trade Union movement has the particular interest of its membership in mind and approaches tax reform, at least to some extent, by reference to the impact it might have upon employment, either generally, or in particular industries. To be fair to the Australian Council of Trade Unions, the submissions it makes on taxation reform are much more far-reaching than that.

At the other end of the political spectrum is what is popularly referred to as the 'big end of town'—represented, for example, by the Australian Chamber of Commerce and the Corporate Tax Association—with a particular interest in the reform of corporate taxation, incentives to business in general, or to specific industries in particular. Like the Trade Union movement, these bodies have a wider view of tax reform than the mere promotion of their members' interests although the ultimate focus will necessarily be on business taxation. Often big business views of tax reform may be opposed by those representing small to medium business, and particularly those representing primary industries, for example, the Farmers' federation. The tax legislation in Australia, both federal and state, is replete with concessions to primary producers.

There are, additionally, lobby groups (sometimes ad hoc, at other times more organised), which are concerned to advance the claims of particular industries for special taxation treatment and who would define tax reform as the taking of such steps as were necessary to satisfy such claims. One need only mention the Australian film industry as an example. Professional actors and others interested in the arts fall within this category, although because they are ad hoc and generally galvanised into action by elections or at budget time, they would be unlikely to participate directly in the reform process.

Purporting, at least sometimes, to stand on loftier ground outside mere economic self-interest, are economists whose contribution to the debate may cover theoretical issues or proposals as well as those invariably suggested by their own underlying political philosophy. Indeed, it may be difficult to separate economic theory from the underlying political philosophy that influences it. One may expect economists to take a much wider view of what constitutes tax reform than those who are self-interested, while nevertheless being constrained by their political philosophy. Economists might well see the idea of taxing imputed rent from home ownership as tax reform whether or not this was politically possible. Other participants in the reform process would regard such a proposal, on the other hand, as mere change at the least. By virtue of their training, it might be expected that economists would tend to emphasise economic efficiency over the other criteria for judging tax reform.

Tax teachers, lawyers and accountants (perhaps even judges, although judicial participation would raise a constitutional question as to whether participation in the legislative process is compatible with the conferral of Commonwealth judicial power in Chapter III of the Constitution) must be included in any list of participants in tax reform, although their voices may not be heard among the Babel originating from those motivated by self-interest. Academic and other informed criticism from experts in

taxation law may give rise to change in the law. Their influence will be greater through submissions made by professional bodies such as the Law Council of Australia, the accounting bodies or the Taxation Institute of Australia, and operate more at the level of detail in draft legislation than in the larger tax policy issues. This is reflected in the liaison meetings with the Australian Taxation Office (ATO) and Treasury and in membership of ruling panels.

Last, but not the least significant, are officers from Treasury and the ATO itself. The influence of Treasury and of the ATO will by its nature not be visible save in so far as officers have in the past staffed Committees of Inquiry and can be expected to do so in the future. Since Treasury operates to advise the government of the day, and is charged with guarding the revenue and promoting the economic health of the country, tax reform would most likely be seen by Treasury or ATO officials as steps required to make the tax system more efficient. Compliance or administration would constitute reform so long as it brings about an increase in tax revenue or produces an economic benefit to society.

While each of these groups have been involved in tax reform in Australia, the focus they bring is so different that debate among them may do little to bring about real reform. They have conflicting views about what changes constitute tax reform. However, once the participants in the process are identified, it is possible to deduce what tax reform would mean to them considered as a whole, rather than individually. It would extend to some or all of the following:

- Reducing or increasing tax rates, deductions or rebates
- Adjusting the progressivity of tax rates
- Increasing social security benefits
- Providing industry incentives
- Plugging loopholes
- Encouraging social policy objectives (including reducing unemployment)
- Increasing economic efficiency

Of necessity, there will be considerable overlap of these matters. For example, while tax reform will clearly focus on reducing or increasing tax rates so too will steps aimed at making the tax rates more progressive. A focus on tax rates inevitably requires consideration of deductions or rebates as well as tax thresholds. The question of tax rates likewise will require an analysis of the tax base and the mix of taxes to be employed. All of these matters, therefore, must be included in the general rubric of tax reform.

What governments regard as tax reform might perhaps be gauged by classifying what they ultimately do through legislation. That would be misleading. On this basis, allowing a deduction for child care expenses could not be classified as tax reform because, however desirable, it has not been legislated for. Another, and perhaps less cynical, way of classifying what governments see as tax reform is to consider the many commissions or bodies that have been set up since Federation to advise the government on tax reform and the terms of reference under which they have operated. These commissions were necessarily concerned with the issues of the time, many of which have ceased to interest us. So, for example, the earliest commissions had as their major

objective uniformity between Federal and state taxes. However, all to some extent were concerned with general tax reform even though their focus differed. It is proposed, therefore, to consider the various commissions established since Federation in chronological order to see what conclusions can be drawn as to whether there is some consensus about what tax reform is.

In the interests of space I have omitted reference to a number of commissions that have peripherally touched on taxation, for example, the Campbell Commission⁶ which reported on the Australian Financial System and the Mathews Report on inflation.⁷ I have omitted the latter, not because it was insignificant, for indeed, at the time when inflation was almost out of control, inflation indexation was a very important issue for taxation. However, the issue it touched upon was too narrow and specific to its times to be included in a generally accepted consensus about tax reform. I have also not dealt specifically with the Report on Rates of Depreciation, issued in 1955 by what was then identified as the Hulme Committee,⁸ because of the narrowness of the issue with which it was concerned. This report received editorial approval,⁹ with the *SMH* pointing out that if Australia was to hold its own in an increasingly competitive world, the Treasurer would need to give full weight to its recommendations. The Committee was absolutely excluded by its terms of reference from giving consideration to initial depreciation allowances, but bravely recommended that depreciation on industrial and commercial buildings should be allowed.

Likewise, I have chosen not to discuss the countless amending acts which have changed the face of income taxation by countering loopholes, and generally by legislating changes in the way the tax system operates, even though this form of legislation is tax reform in action. Finally, I have arbitrarily stopped at 1999 with the publication in 1998 of *Tax Reform: Not a New Tax a New Tax System*¹⁰ and the Ralph Report.¹¹

IV THE FIRST ROYAL COMMISSION: THE KERR COMMISSION 1920

The Commonwealth, faced with the wartime expenditure brought on by the First World War, entered the field of income tax in competition with the states in 1915. Although the initial draft of the 1915 legislation is said to have been prepared with the view to conforming as much as possible with the state laws,¹² the first Commonwealth Income Tax Assessment Bill bore slight evidence of any conformity. Thereafter, several conferences directed at uniformity were held between state and Commonwealth

⁶ Australian Financial System Inquiry (known as the Campbell Committee), *Final Report of the Financial System Inquiry*, (1981).

⁷ Committee of Inquiry into Inflation and Taxation (R K Mathews, Chairman), *Inflation and Taxation: Report of the Committee of Inquiry into Inflation and Taxation*, (1975).

⁸ Commonwealth Committee on Rates of Depreciation, Chief Minister's Department, (7 June 1955). This Committee was really no more than an extension of the Spooner Committee appointed in 1950 which is discussed later in the paper.

⁹ *SMH*, 9 June 1955.

¹⁰ *Tax Reform: Not a New Tax a New Tax System*, circulated by the Treasurer, the Honourable Peter Costello, August 1998.

¹¹ Ralph Committee Report, *A Tax System Redesigned*, July 1999.

¹² Ferguson Committee, Ewing, *Report of the Ferguson Committee: Taxes and their Incidence*, para 286.

officials in the years 1916 to 1921. One of these¹³ considered a uniform Income Tax Bill which was not adopted by any of the states and only partly by the Commonwealth.

The first Commonwealth Royal Commission into tax reform was instigated by the then Prime Minister, the Honourable Mr W M Hughes, in September 1920. According to the Letters Patent under which it was appointed, the Commission was to inquire into and report upon the incidence of Commonwealth taxation and any amendments necessary to place the system of taxation:

upon a sound and equitable basis, having regard generally to the public interest, and particularly to –

1. The equitable distribution of the burdens of taxation;
2. The harmonisation of Commonwealth and state taxation;
3. The giving to primary producers of special consideration as regards the assessment of income tax, particularly in relation to losses resulting from adverse weather conditions; and
4. The simplification of the duties of taxpayers in relation to returns and in relation to objections and appeals.

The Commission, named after its Chairman, Mr Warren Kerr, reported in 1922. It held 118 public sittings and heard evidence from 191 witnesses. Notwithstanding the breadth of its terms of reference, its first report dealt with only seven topics: special concessions to primary producers; the taxation of profits on the sale of mining leases; bonus shares; the establishment of a Board of Review; double taxation as between Australia and the United Kingdom where residents of the United Kingdom derived income in Australia; the taxation of lessees' interests in Crown leaseholds; and the general exemption and allowances for children. The greatest emphasis in the report was upon granting special consideration for primary producers to average their incomes.

Witness support for a Tribunal being established to hear tax appeals was unanimous.

The Committee noted that in its recommendations it held 'tenaciously' to the principle of equity formulated by Adam Smith which it described as 'classical both in precept and in practice', namely:

- 1 The subjects of every State ought to contribute towards the support of the Government as nearly as possible in proportion to their respective abilities, i.e., in proportion to the revenue which they respectively enjoy under the protection of the State.
- 2 The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid ought to be clear and plain to the contributor and to every other person.

¹³ Considered by a conference of taxation officers held in March 1917. Ibid 287.

- 3 Every tax ought to be so levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it.
- 4 Every tax ought to be so contributed as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State.

The Committee also accepted for the purposes of its recommendations another principle attributed to a Professor Bastable, which was expressed as follows:

The successful administration is the final object (of any system of Taxation), and therefore convenience or even equity may have to yield to productiveness.

The Committee split on the question of averaging income. The majority recommended a system of averaging with individual taxation being imposed on the net taxable income of the twelve months immediately preceding the year of assessment, taxed at the rate applicable for the year of assessment to the average net taxable income of the taxpayer for all the years for which the taxpayer has lodged returns, not exceeding the five years preceding the year of assessment. The majority expressed the view that averaging should not be limited to primary producers as such, but should be applicable to all taxpayers. A minority of the Committee, comprising the chairman and two other members, strongly disapproved of applying a system of averaging. Instead, they recommended a modification to the normal carry forward of losses provision. It is interesting that the minority made the point that the effect on revenue should not be the dominant factor in appraising a system of taxation designed to create a more equitable distribution of the burden of taxation, while nevertheless treating the effect on revenue as an element that should not be ignored.

V THE FERGUSON COMMITTEE 1932

In the October 1932 budget speech, the Government announced the establishment of a further Royal Commission to inquire into and report upon
the simplification and standardization of the taxation laws of the Commonwealth and of the States in so far as they relate to substantially the same subject-matters of taxation, as, for instance, income tax, land tax, and death duties; and, in particular to make recommendations for the purpose of obtaining uniformity in legislative provisions, including provisions relating to procedure and forms of returns.

The Committee's deliberations attracted considerable publicity.

By 1931 taxation had become a political issue as may be seen from the reporting by the *SMH* on 21 January 1931 of the establishment of a taxpayers' party of protest against extravagance by NSW state politician, Mr Drummond. In announcing the establishment of this party, Mr Drummond pointed out that it had by then become abundantly clear to the average citizen that all government revenue came from citizens. Hence citizens should insist upon 'sane government, hard work and thrift'.¹⁴

¹⁴ *SMH*, 21 January 1931.

There was also to be found in the newspapers of the time some more informed technical criticism of taxation legislation, for example, from Mr McGrath, later to edit a series of reports on income tax cases.¹⁵

The Commission was established against the background of the depression, the deterioration of the credit position of Australia overseas—reflected in the dismissal of the Lang government in NSW—and the fall in commodity prices. Even the government of the day admitted that the people of Australia bore a heavy taxation load.¹⁶ However, it was the complexity of the tax system and the lack of uniformity that provided the impetus to appoint a Commission to examine both Federal and state taxation laws.

In an opening address to the Ferguson Commission, counsel assisting the Commission, Mr Roper, is reported to have said¹⁷ that there had been brought to the knowledge of the Federal Government ‘considerable public feeling with regard to the complexity of the Federal and State Acts, and of their operations upon the individual taxpayer.’ Thus complexity would be the subject of the Commission’s focus. In all, the Commission examined some 136 witnesses and conducted interviews with the Commissioners of Taxation for both Commonwealth and state.

The first witness to appear before the Commission was Mr McKellar White, then President of the Taxpayers’ Association of New South Wales, a body influential in the tax reform process over a long period of time. One of the issues raised by the Commission was whether the concept of taxation at source could be extended beyond dividends. Mr McKellar White was strongly opposed to this because, he said, taxation should not be imposed by reference to gross income. Outgoings were allowed by way of deduction. The taxation of dividends should, he thought, be in no different position.¹⁸

A Mr Bogan representing the Commonwealth Institute of Accountants emphasised the complexities which existed in the then system and which placed much work in the way of accountants. He was reported on 2 December 1932 as stating that ‘[h]opelessness and helplessness were the feelings engendered by the present system’.¹⁹ He said that the incentive to earn profits was being stultified by excessive taxation and complained of the methods adopted by tax officers of the Investigation Department many of whose inquiries were, he said, found to be unnecessary. These comments have a contemporary feel about them. Another witness, a taxation consultant and former tax assessor claimed that the burden of taxation on commerce had reached breaking point. The then Professor of Mathematics at Sydney University, Mr Carslaw, made a personal submission in which he emphasised the complexity of the income tax system. The Federal government was, he said, the ‘chief offender’.²⁰

¹⁵ SMH, 1 December 1931.

¹⁶ Budget Speech, Hansard 1, September 1932.

¹⁷ SMH, 22 November 1932.

¹⁸ SMH, 22 November 1931.

¹⁹ SMH, 2 December 1932.

²⁰ SMH, 3 December 1932.

By 1932 the Board of Review that had been so enthusiastically recommended by the Kerr Commission was not so favourably seen by the profession. A solicitor and member of the taxation committee of the Sydney Chamber of Commerce, Mr Maund, suggested that the Board was a 'farce' and that '[o]ne gentleman sits on his own cases.' In a 'trenchant criticism', Mr Maund said that, 'the tax collectors were setting up the worst kind of "new autocracy"'. He recommended that it would be preferable for cases to be heard by 'an inexpensive Court'.²¹

The Commission reported in stages, handing down its first report in December 1933 and its fourth and last report in November 1934. The first report dealt with the taxation of companies and dividends, the allocation of the statutory exemption and concessional deductions, the provisions dealing with insufficient distributions of private companies, and the complications created by the then extant Special Property Tax. The second report concentrated upon the principles underlying the assessment and collection of income tax. Its most significant recommendation was for the preparation of a uniform assessment act to give effect to a reconciliation reached by agreement between the Commonwealth and the states about the differences in their legislation. The Commission was of the view that the Commonwealth legislation should be taken as the base for uniform legislation. Necessarily, the Commission was required to consider the then vexing problem of apportioning profits where a trade was carried on in more than one state. The third report was largely concerned with the discrimination that was made by some states against residents of other states. The Commission had little difficulty in rejecting the idea that the allowance of deductions should be determined by the custom of accountants. The recommendations of the Committee formed the framework for the *Income Tax Assessment Act 1936* (Cth) (ITAA36). The fourth and final report was concerned with estate duty and land tax.

VI THE SPOONER COMMITTEE 1950

The emphasis after the ITAA36 continued to be upon simplicity. In 1950 the government established another committee to undertake a comprehensive review of ITAA36 under the chair of the Honourable Mr Spooner, a Sydney Chartered accountant. The Spooner Committee included the late Mr Gunn, author of the work later to become the Law Book Company's Tax Service and Dr Hannan, a Sydney barrister and author of the first Australian income tax text. Dr Hannan died before the Committee reported and his place was taken by Mr Gordon Wallace, later to become a Judge of the New South Wales Court of Appeal. The terms of reference were as follows:

The functions of the Committee will be to examine and inquire into such matters as are, from time to time, referred to the Committee by the Treasurer of the Commonwealth in connexion with income tax and other taxation laws of the Commonwealth, and to report to the Treasurer upon those matters. In respect of those matters, the Committee will recommend any changes in law or procedure which it considers necessary to achieve the following objects:-

²¹ SMH, 24 November 1932.

- (1) making the laws as simple and intelligible to the taxpayer as the nature of the legislation admits;
- (2) simplifying the duties of taxpayers under those laws, especially in preparation of returns;
- (3) removing anomalies in those laws; and
- (4) providing an adequate and equitable basis of taxation.

The Committee became a standing committee on income tax to which references were made by the Treasurer over a period of some five years. Annexed to this paper is a list of the references to the Committee. Consequently the Committee, unlike other committees, did not issue a single report, but rather a series of reports, ordinarily one report for each reference. The references were narrow and generally required consideration of particular sections of ITAA36. The first reference required the Committee to report upon the advantages or disadvantages of substituting for the then schedule of rates graduated in steps of one pound of taxable income—a schedule of rates graduated in steps of, say L 100 of taxable income or some other gradation. The Committee took the view that this system was too complex and that it should be replaced by a stepped scale of rates. It recommended abolition of the differential rates between property and other income while adding that if differentiation should be regarded as necessary, it should be achieved by the imposition of a surtax. Reference No. 3 required the Committee to report on the assessability of amounts received in relation to employment and retirement from employment (ss 26(d) and (e)). Reference No 6 concerned the assessment or exemption of incomes derived from primary production and related to averaging and concessions for primary producers. Reference No 29 concerned the PAYE system of tax collection by instalments. Reference No 22 concerned contributions to pension funds. There were 53 references in all, which gave rise to 37 reports.

The newspapers awaited the first of the Committee's reports dealing with rates, with the editorial line 'Taxpayers Looking for a New Deal'.²² One of the issues regarded as urgent by the profession, as reported in the *SMH*, was the system of review of objection decisions. The Tax Boards of Review were by then three years in arrears—proof, so the *SMH* said, that 'the whole taxation system has become bogged (down)'. The paper awaited, it said, a cut in the tax rates. The level of rates represented 'a severe deterrent to effort or initiative'. The paper called also for more honesty in the budget predictions for tax revenue receipts. It complained that Mr Chifley had indulged in 'consistent evasion' in the revenue papers, on one occasion underestimating revenue by no less than 61 million pounds.

VII THE LIGERTWOOD COMMITTEE 1961

On 3 December 1959 the Commonwealth Government appointed yet another committee to inquire into the taxation laws. The terms of reference were, however, somewhat more limited than those applied to earlier committees. The enquiry was (as well as relating to any matters that might be specifically referred to the committee) to consider the existing income tax laws and their operation:

²² *SMH*, 8 May 1950.

for the purpose of ascertaining any anomalies, inconsistencies, unnecessary complexities and other similar defects that exist in, or arise out of the operation of those laws, and to formulate proposals for remedying those anomalies, inconsistencies, complexities and other defects and for simplifying those laws.

The Ligertwood Committee was required to have regard for the cost to revenue of its recommendations. Later the terms of reference were extended so as to permit the Committee to inquire into the whole of the laws relating to income tax, subject to some specified exceptions such as depreciation, which had been the subject of the earlier Spooner/Hulme reports and zone allowances.

The Committee received 519 written submissions and also heard oral evidence from many of the submission writers. Most of the report is concerned with amendments to counter tax avoidance. In addition, the Committee made recommendations for taxation relief where to do so appeared equitable subject to questions of policy, which were left to the government.

After the report was tabled, the Government adopted all the recommendations made to counter avoidance, but virtually none of the concessions (other than a deduction for dental expenses and a deduction for underground water pipes for primary producers). The then Treasurer, Mr Holt, advised Parliament that the recommendations on liberalising deductions 'would deplete revenue and might cause anomalies in the future'. They would, he said, be treated as 'taxation policy issues' and be considered 'at the appropriate time'.²³ The then Leader of the Opposition, Mr Calwell criticised the government for 'showing little concern about any real reform of our taxation laws except where suggested reform can benefit Commonwealth revenue'. The *SMH* in its editorial on 19 August 1961 headed, 'The Tax Stick Used and The Carrot Ignored' took up the criticism. It noted that the Treasurer was hungry for more revenue and that the recommendations made in the Report, comprising amendments to the legislation to counter avoidance as well as suggesting some liberalisation, were intended to be acted upon as a whole. Likewise the Taxpayers' Association of NSW expressed its regret at the Government's intention to defer indefinitely the Committee's recommendations for taxpayer relief while implementing the recommendations designed to plug loopholes.²⁴

VIII THE APSREY COMMITTEE 1972

Nineteen seventy-two saw the appointment of what became known as the Asprey Committee. Unlike the Ligertwood Committee inquiry, this was to be a full-scale inquiry into the operation of the taxation system and was designed to 'put the Government in a position to have an overall look at tax policy'.²⁵

The terms of reference of the enquiry were as follows:

1. The functions of the Committee of Inquiry are –

²³ *SMH*, 18 August 1961.

²⁴ *SMH*, 19 August 1961.

²⁵ See the Preface to the Committee's Report.

- (a) to examine and inquire into the structure and operation of the present Commonwealth taxation system;
 - (b) to formulate proposals for improving the Commonwealth taxation system, either by way of making changes in the present system, abolishing any existing form of taxation or introducing new forms of taxation; and
 - (c) to report to the Treasurer of the Commonwealth accordingly;
2. The Committee of Inquiry shall, in carrying out its functions, do so in the light of the need to ensure a flow of revenue sufficient to meet the revenue requirements of the Commonwealth and have regard to –
- (a) the effects of the present Commonwealth taxation system, and of any proposals formulated by the Committee, upon the social, economic and business organisation of the community and upon the economic and efficient use of the resources of Australia; and
 - (b) the desirability of the Commonwealth taxation system being such that, so far as is practicable, there is a fair distribution of the burden of taxation, and revenue is raised by means that are not unduly complex and do not involve the public or the administration in undue difficulty, inconvenience or expense.

The Committee received 605 written submissions and also commissioned studies from experts. It took into account reports from other countries, particularly the Carter Commission in Canada, the Ross Committee in New Zealand, various commissions in South Africa, Green and White Papers from the United Kingdom and evidence given at Congressional hearings on tax reform in the United States. The final report, when printed in 1975, was produced against the standard criteria for assessment of taxes (see above). The Committee noted, however, that flexibility in the taxation system was important, so that rates could be quickly raised or lowered where this was needed, and that taxation should contribute to economic growth.

The report contains a detailed criticism of the income tax legislation then in force and the problems contained within it. It took almost twenty years before the legislature had adopted virtually all the recommendations contained in the report. The recommendations include the introduction of a broad-based goods and services tax (BBCT) in place of the then wholesale sales tax. The Report suggested an initial rate for the BBCT of five per cent which could thereafter be increased with downward adjustments to income tax. The Committee considered, but did not recommend the introduction of a wealth tax. As earlier noted, it recommended deferral of the proposal to introduce a capital gains tax.

Given that Professor Parsons played a large role in the preparation of the report, it is not surprising that the report is probably the most technically competent of all reports that have been issued in the name of tax reform.

The *SMH* editorialised on 4 March 1975 that the Asprey Report was eagerly awaited, particularly because it was expected that it would be recommending that Commonwealth estate duty not be levied on homes passing to widows. In fact when the final report was published it recommended that a previous exemption of duty on

homes up to a certain value passing to widows be repealed and replaced with a fixed money exemption for property passing to a surviving spouse, or gifted to that spouse, a consequence of a recommendation that estate and gift duty be integrated.

IX THE POPULARISATION OF TAX: THE TAX SUMMIT JULY 1985

Probably nothing was calculated to raise awareness of tax reform more than the calling of a 'Tax Summit' in 1985 by then Prime Minister, Mr Hawke. In place of the advisory Commissions which had been the instruments of reform in the past, there was prepared by Treasury a Draft White Paper entitled 'Reform of the Australian Tax System'. The White Paper contained a discussion of some of the problems of the personal income tax system. These included the tax unit, the absence of a tax on capital gains and fringe benefits, concessional rebates, the rate scale, the need for a foreign tax credit system and provisions to deal with the question of inflation. Discussions followed, firstly on broadening the tax base to encompass a broad based consumption tax (for example, a GST), secondly on the possibility of a wealth tax and finally on issues of business tax including imputation, inflation adjustments, and the taxation of foreign source income. The White Paper concluded with three options, the last of which, Option C, consisted of broadening the tax base by legislating for: capital gains to be taxed; fringe benefits to be taxed; imputation to be introduced; concessional expenditure rebates to be abolished; and particularly for the enactment of a goods and services tax at an initial rate of 12.5 per cent.

Ultimately Option C did not gain approval.

The newspapers at the time were replete with commentary, much unfavourable in regards to both Option C, and particularly the introduction of what was referred to as a broad based consumption tax.²⁶ Tax started to occupy the Letters to the Editor page.²⁷ After the summit concluded the broad based consumption tax vanished from view, at least for a time. Most other proposals from Option C were adopted.

X AN INQUIRY INTO THE AUSTRALIAN TAXATION OFFICE: JOINT COMMITTEE ON PUBLIC ACCOUNTS 1991

Many aspects of tax administration have from time to time been the subject of review by Parliament. In 1991 the Joint Committee of Public Accounts conducted a wide-ranging review of the administration and operation of the ATO. The terms of reference for this inquiry required the Committee to

inquire into and report on the administrative procedures adopted by the ATO in the collection of taxation revenues under ITAA36 with particular reference to:

- the administrative and operational structures of the ATO and the application of common standards of practice across Australia;
- the efficiency and effectiveness of self assessment;

²⁶ Mungo MacCallum, SMH, 9 June 1985. See also Peter Robinson in the paper of the same day.

²⁷ See, for example, SMH, 12 June 1985.

- the authority and application of taxation Rulings;
- the use of information technology within the ATO; and
- the resources of the ATO and their allocation.

This inquiry received some 120 submissions, one from the then Chairman of ATTA. It reported in November 1993. Among a number of significant recommendations—such as the establishment of a Small Taxation Claims Tribunal, a Taxation Ombudsman and the formulation of a taxpayers’ Charter of Rights—was a recommendation that ITAA36 be redrafted using simplified language and that a broadly based task force be established for this purpose. The then Treasurer, Mr Dawkins, responded by announcing on 17 December 1993 the establishment of a taskforce to rewrite ITAA36 and related Acts so as to make them more understandable. Legislation to fund the task force was introduced into Parliament on 8 December 1994.

The Tax Law Improvement Project was said to be about reducing the costs to taxpayers brought about by the complexity of expression and presentation of the existing law. Its aim was to completely rewrite the income tax legislation and thereby to develop a better structure and arrangement of the law. The rewrite was to promote an understandable expression of the law. Some small changes of policy were later introduced so as to make the tax rules ‘more commercial’.

The *Income Tax Assessment Act 1997* (Cth) was the tangible outcome of the project. While the rewrite was generally simpler than ITAA36 provisions it replaced, the legislative statement that the 1997 Act was not intended to change the meaning of the comparable provision of ITAA36, had the result that it was (and still is) often necessary to consult both Acts. As a result, the apparent plus for simplicity was converted into a negative of complexity.

XI THE NEW TAX SYSTEM: AUGUST 1998

The period from the Tax Summit until 1998 was the age of tax change. At no other time since federation was parliament so occupied with amendments to the taxation law. It may be argued that the legislative activity was a reaction to public interest in tax. It’s more likely, however, that public interest was fostered by the newspapers’ constant publicity given to taxation, and their publication of political comment on taxation.

Whatever was cause and whatever effect, by the 1990s taxation had become political. The document ‘Tax Reform: Not a New Tax a New Tax System’ (ANTS), published in August 1998, was not a technical document. It was a political document and did not purport to be otherwise.

The ANTS document was produced on the premise that Australia’s existing tax system condemned Australia to a future of high tax, (particularly high income tax), evasion and avoidance, unfairness, complexity and penalisation of exports. Change was, it was said, ‘a clear national priority’. The existing system was ‘out of date’ (this was a reference to wholesale sales tax); ‘unfair’ (this was a reference to tax rates and thresholds); penalised exports and discouraged investment (a reference to the wholesale sales tax but as well to the distortion of business decisions by tax considerations);

‘ineffective’ (a reference to the supposed decline in indirect tax revenue); and ‘complex’ (this appears to be a reference to the growth in tax legislation as a result of changes in tax policy over the preceding 15 years). The implication was that these defects in the existing system were to change as a result of government policy.

Of the five principles of taxation reform which had been announced by the Prime Minister on 13 August 1997, the first was that there be no increase in the overall tax burden, and the second was that there were to be major reductions in personal income tax. These goals were to be achieved by a number of measures. The first was the introduction of a GST, the revenue from which was to go to the states, thus helping to solve the problem brought about by the High Court holding that tobacco and petrol licensing was outside the legislative competence of the states because they were duties of excise.²⁸ The GST was to replace a number of state stamp duty taxes as well as sales tax. Secondly, there was to be a reduction in personal income tax and increased family and social security benefits. Thirdly, tax avoidance, particularly through trusts, was to be targeted. Finally, the design of tax laws was to be ‘improved and streamlined’.

Space does not permit a detailed outline of the various proposals contained in the document. However, it is important to note that the document repeatedly emphasises the need for tax laws to be clearer, and the rights and obligations of taxpayers more certain. As spelled out in more detail in the document the tax laws were to be brought together into a code to be designed from the taxpayer’s perspective—integrated, easily understood and difficult to avoid, and written with general principles in mind. The Tax Law Improvement Project was to be subsumed into the larger goal of codification. Five years on the prospect of a simpler tax system seems just as unattainable as it did in 1998.

The document contemplated that consultation would take place with business on the proposed reforms of business entities and business. This took the form of establishing a Review Committee under the chair of Mr John Ralph AO, a prominent company director, assisted by Mr Allert, a chartered accountant and company director, and Mr Bob Joss, formerly Managing Director and CEO of Westpac Banking Corporation and thereafter to become Dean of the Graduate School of Business at Stanford University as from September 1999. The terms of reference of this Committee were announced by the Treasurer on 14 August 1998. They required the Committee to

assess the design and the administration of the tax regimes affecting business and to make recommendations on the fundamental design of the business tax system, the processes of ongoing policy making, drafting of legislation and the administration of business taxation.

The Committee was to be guided by the strategy identified in ANTS and it was required that its recommendations be:

consistent with the aims of improving the competitiveness and efficiency of Australian business, providing a secure source of revenue, enhancing the stability of taxation arrangements, improving simplicity and transparency and reducing the costs of compliance. The Review will adopt a comprehensive

²⁸ *Ha v New South Wales* (1997) 189 CLR 465.

approach to reform driven by clear, sound principles involving a move towards greater commercial reality.

The Review Committee formulated for itself the outcomes it sought to achieve in the following terms:

- A structure that is robust and based upon explicit principles so that the architecture of business tax legislation is durable and capable of future modification without doing damage to the framework on which it is based.
- An integrated design process, reflected in the accountabilities of a Charter of Business Taxation, that ensures that business tax policy, the legislation to give effect to that policy and the systems to administer it are compatible and integrated.
- An ongoing process of external involvement, including a Board of Taxation with specific accountabilities towards ensuring the integrity of the processes are maintained, to build upon the more constructive relationships that have been established during the review process.
- A more neutral system where similar activities, investments and entities are taxed similarly – and where taxpayers feel they are treated equitably, with the burden being shared fairly across the community.
- A tax system which is easier to understand and comply with, and makes fewer demands on the time of ordinary taxpayers.
- A far simpler system for small businesses, with a more concessional approach to writing off their capital expenditure and a reduced record-keeping load.
- A flow-through basis of taxation which puts individuals, who pool their resources to invest collectively and obtain the benefits of diversification, on an equal footing with wealthier individuals who can invest directly.
- A more competitive capital gains regime to encourage investment particularly to attract highly mobile international capital for which there is strong and increasing competition, to encourage entrepreneurs to start their businesses in Australia, and to achieve a better functioning capital market.

In summary, to quote Mr Ralph,²⁹ the task was to ‘adopt and implement a more certain, equitable and durable taxation system’. The Review Committee’s stated objectives that the Committee accepted involved trading one objective off against another, including ‘optimising economic growth; promoting equity; and promoting simplicity and certainty’.³⁰ One may question whether recommendations such as consolidation (now implemented) or the tax value basis of calculating taxable income (now discarded) produce or, in the case of the tax value method, would have produced, either simplicity or certainty. It is not the purpose of this paper to assess the Committee’s recommendations.

²⁹ *A Tax System Redesigned*, 2.

³⁰ *A Tax System Redesigned*, 13.

The Committee went about its work by publishing and circulating discussion papers, conducting public seminars, and receiving and considering written submissions.³¹ It complemented its program by conducting focus group discussions on particular issues involving, inter alia, business representatives, academics, tax advisers and practitioners.

XII SO, HOW SHOULD WE DEFINE TAX REFORM?

There is a thread which runs through the terms of reference of each of the Committees to which reference has been made. Not surprisingly it does not differ greatly from the aggregate of views of the participants in the reform process to which reference was earlier made, notwithstanding that those views conflict with each other. What a perusal of the *SMH* over more than 80 years shows is that the establishment of Committees to advise on tax reform has not, in the past, been a consequence of public pressure on the government except in the area of tax rates. To the extent that tax reform was a matter of public interest, at least prior to the Tax Summit, that interest was largely focused on matters of administration and, in the late 1970s and onward, tax avoidance.

To define what is meant by tax reform it is first necessary to draw the distinction between reform of the whole system and reform of a particular tax, although the former may involve steps to reform a particular tax as well.

Reform of the system as a whole will involve a change of one or more of the following kinds:

- Tax mix—existing taxes
- Tax mix—the imposition of new taxes
- Existing taxes—tax rates including deductions and rebates having regard to the tax mix and to promote an equitable distribution of tax burdens
- Existing taxes—change in tax rates including deductions and rebates to promote an equitable distribution of tax burdens
- Existing taxes—change in the tax base (for example extension of income tax to include capital gains).
- Existing taxes—promoting neutrality of the tax system, eg, entity taxation
- Existing taxes—substantive amendments such as plugging loopholes or removing anomalies, inconsistencies or complexities
- Existing taxes—procedural or administrative changes to promote simplicity in compliance or administration
- Existing taxes—simplifying language to improve intelligibility
- Existing taxes—tax expenditure elimination (or introduction of new concessions designed to promote government economic policy)

If what is under consideration is reform of a particular tax rather than the whole system then the change will necessarily exclude the first three matters.

As already noted, tax reform involves more than merely adopting one or other of the above proposals simply to effect change. That is where the three criteria of equity, simplicity and efficiency have their place in defining tax reform. Strangely, while there

³¹ According to the Report some 300 submissions were received, 12.

is general agreement about these criteria, they are, once stated, then largely ignored. My thesis is that they should be given a real place in the definition of tax reform by being used to distinguish change from reform. The suggestion is that before a proposal can be classified as reform there be a requirement that the proposal be judged against the criteria. It may be necessary that other criteria be taken into account as well. That should be the subject of further discussion. For example, there is much to be said for the view that the criterion of efficiency be replaced by a broader criterion of economic benefit or advantage. The debate itself is worth having, whether or not there is ultimate agreement. However, it must be realised that if the criteria to be used is too vague, the advantage which the adoption of criteria would bring to assessing whether there is really tax reform could be lost.

It has become conventional to require environmental impact studies whenever development is considered, victim impact studies before sentencing, or cost estimates to be prepared before new legislative proposals come before Parliament. There is already an administrative requirement that Explanatory Memoranda include a financial impact statement describing both the direct and indirect financial impact for the Commonwealth of the Bill which the Explanatory Memorandum explains.³² Before changes are accepted as tax reform they might likewise be required to be rated by reference to the three criteria of equity, simplicity and efficiency/economic advantage. Only where the rating was positive and so reflected improvement rather than change could a proposal be assessed as tax reform. While both the rating and the content of the criteria are necessarily subjective a requirement to rate by reference to criteria would introduce some objectivity to the labelling of change as reform and in any event promote a more informed discussion of what really is tax reform and of the proposal being rated.

A possible methodology of rating might be to take the particular change proposed (for example, removal of an anomaly) and to rate the proposal on a scale from one to ten on each of the three criteria. So, for example, the recommendation might rate nine for equity. However, the recommendation might create complexity so that it might rate only three on simplicity where five would be neither complex nor simple. So far as efficiency/economic advantage is concerned the recommendation might be neutral (ie it would be rated five on a scale of 1–10). Unless there was a need to adopt some special weighting of the criteria the recommendation would rate overall 17 out of a possible 30. So long as the recommendation rated more than 15 it could be said then to involve a change which is an improvement and therefore reform.

The above proposal for rating changes in tax policy or law before those changes can be labelled as reform can easily be criticised not only because it reintroduces subjectivity in a different guise, but also because it places equal weight upon each of the three criteria. If it is thought that more weight should be given to one of the three criteria rather than the other two this could be done. Again, the debate about what weight should be given to a particular criterion is a debate that is worth having in its own right. So long as the criteria against which a proposal is to be rated and the weight to be given to the criteria are known it will be possible for a judgment to be made whether what is proposed is really reform or whether it is mere change even if there is not universal

³² See Legislation Handbook, Department of Prime Minister & Cabinet, Commonwealth of Australia, (1999), Chapter 8.

agreement either as to the criteria to be adopted or as to the weight to be given to any criterion. At the least the requirement to rate changes by reference to a set of criteria would permit a more informed discussion of tax reform than at present is possible.

The alternative is to continue to accept, uncritically, that a proposal constitutes tax reform merely because the proponent of it says so.

Schedule 1: Commonwealth Committee on Taxation (Spooner) 1951 – 53

Reference No	Date	Name	Year and Page of the Parliamentary Papers (General)
	10/10/51	Income Tax – Concessions to industry ³³	51-53: 465
1	10/10/51	Income Tax Rates Schedule	51-53: 485
2	12/08/52	Accessibility of amounts received in relation to employment and to retirement from employment.	51-53: 375
2	12/08/52	Income Tax – Forms of return and notices of assessment	51-53: 471
4	10/10/51	Exemption of Country Entertainments from entertainments tax	51-53: 425
5	20/11/51	Taxation of Mining Industries	51-53: 513
6	12/08/52	Assessment or exemption of incomes derived primary production	51-53: 387
7	10/10/51	Income Tax – Concessional allowances for dependants	51-53: 437
8	10/10/51	Income Tax – Concessional allowances for medical, dental, optical and funeral expenses.	51-53: 455
9	10/10/51	Income Tax – Concessional allowances for life insurance premiums, superannuation fund contributions, friendly society dues and like payments	51-53: 449
10	10/10/51	Income Tax – Concessional allowances for education expenses	51-53: 445
11	10/10/51	Income Tax – Scholarships and similar payment for educational purposes	51-53: 477
12	10/10/51	Income Tax – Concessional allowances in respect of gifts to certain funds and institutions in Australia	51-53: 461
13	10/10/51	Income Tax – Taxation of superannuation allowances and pensions, and income of aged persons	51-53: 481
15	12/08/52	Taxation of Income of Companies – Private and Non Private – and of shareholders; together with supplement – private companies	51-53: 613
17	12/08/52	Leases dated 16 Jan 1952 (prelim report) and 22 July 1952 (final)	51-53: 502
20	12/08/52	Trading Stock (Provisions other than those relating to live-stock); together with supplementary report	51-53: 637
22	12/08/52	Contributions to pension funds	51-53: 407

³³ The Committee had received no reference for this report.

Reference No	Date	Name	Year and Page of the Parliamentary Papers (General)
25	12/08/52	Exemption of income of certain bodies and funds	51-53: 429
27	20/10/53	Provisional Tax	51-53: 543
29	20/10/53	Collection by instalments	51-53: 405
31	20/10/53	Returns and Assessments	51-53: 547
34	20/10/53	Penal Provisions and Prosecutions	51-53: 541
41	20/10/53	Taxation of Abnormal Income Receipts	51-53: 559
42	12/08/52	Deductions in respect of retiring allowances and pensions paid to employees, former employees and their dependants	51-53: 415
44	20/10/53	Sales Tax: Freight Charges	51-53: 549
45	20/10/53	Pay Roll Tax: Local Governing Bodies	51-53: 539
46	20/10/53	Entertainments Tax: Conditional Exemption	51-53: 421
49	12/12/50	Taxation of Excess Profits – The Committee’s report to the Treasurer	51-53: 567
49	23/02/51	Taxation of Excess Profits – The Committee’s Second Report to the Treasurer	51-53: 581
49	23/05/51	Taxation of Excess Profits – The Committee’s Third Report to the Treasurer	51-53: 597
49	07/06/51	Taxation of Excess Profits – The Committee’s Fourth Report to the Treasurer	51-53: 605
49	10/10/51	Taxation of Excess Profits – Reports no 1, 2, 3 and 4.	51-53: 565
50	12/08/52	Taxation of Income of Friendly Society Dispensaries	51-53: 631
52	20/10/53	Pay Roll Tax: Exemptions and Anomalies	51-53: 535
53	20/10/53	Sales Tax Exemptions: Private Hospitals and Similar institutions	51-53: 551
several	12/08/52	Self Assessment	51-53: 554

ADMINISTRATION AND TAX REFORM

MICHAEL D'ASCENZO

Second Commissioner of Taxation, Australian Taxation Office

INTRODUCTION

A starting point for recent tax reform is the government's 1998 blueprint for reform: 'Tax Reform –Not a New Tax, a New Tax System' (ANTS).¹

This paper highlights the administrative challenge of introducing the ANTS measures for the period August 1998 to July 2001.

In ANTS the government expressed its view 'that a modern tax system is one of the keys to Australia's future economic growth and dynamism'.² In the government's opinion at that time, '[t]he existing tax system is out of date, unfair, internationally uncompetitive, ineffective and unnecessarily complex'.³ The solution proffered was a new tax system because 'systemic problems require systemic solutions'.⁴

The reforms were intended to fall into four broad categories:

1. Incentive—personal income tax and social security
2. Security—indirect tax and state finances
3. Consistency— Review of Business Taxation (RBT)
4. Simplicity— tax administration

A Incentive

Under the heading of 'Incentive' came a new income tax scale (with reductions in personal income tax and the progressive move of the company tax rate from 36 per cent to 30 per cent); complemented by a families assistance package, a health insurance rebate, and extra assistance to social security recipients.

¹ 'Tax Reform: Not a New Tax, a New Tax System', The Howard Government's Plan for a New Tax System, August 1998.

² Ibid 3.

³ Ibid 5.

⁴ Ibid 112.

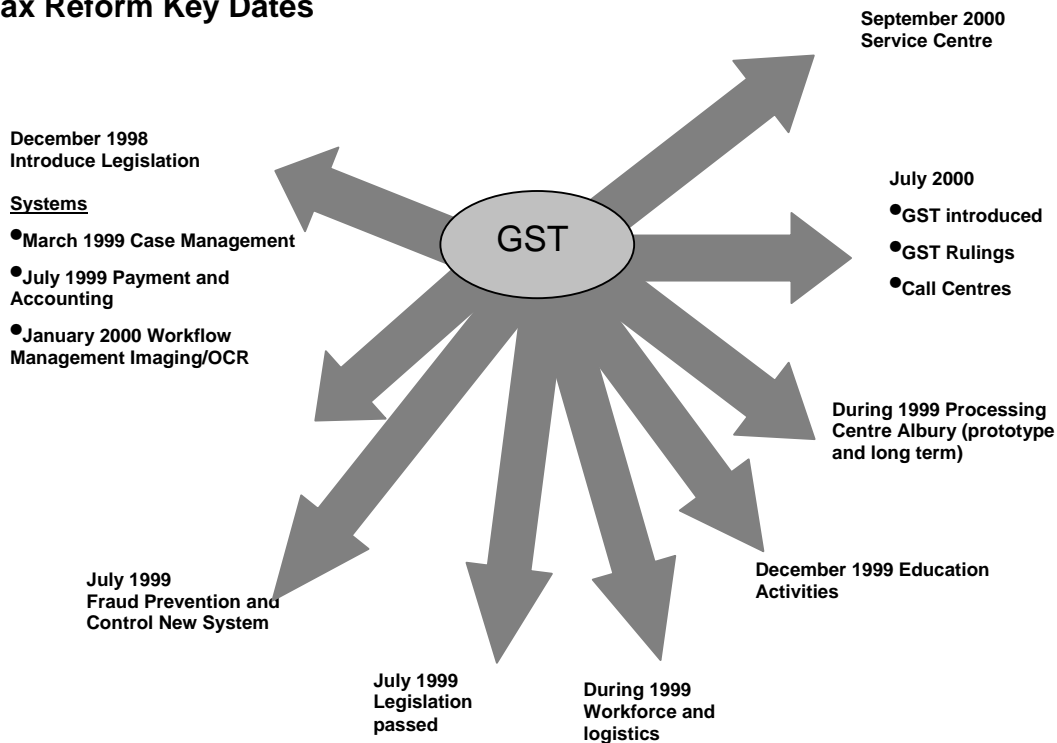
There were also changes to the Fringe Benefits Tax (FBT) system, for example, limiting FBT exemption for public benevolent institutions to \$17 000 of the grossed-up value per employee.

B Indirect Taxes and State Finances

The proposals around ‘Indirect Taxes and State Finances’ centred around the introduction of a Goods and Services Tax (GST), with a start date of 1 July 2000.

The diagram below shows how in November 1998 the ATO saw the administrative challenge of implementing the GST.

Tax Reform Key Dates



Other proposals under the banner of ‘Indirect Taxes and State Finances’ included the abolition of the Wholesale Sales Tax, the introduction of Luxury Car and Wine Equalisation taxes and changes to tobacco excise to ensure no reduction in the prices of these goods. A new comprehensive diesel fuel credit was also proposed.

C Tax Administration

The 'Tax Administration' proposals included the:

- introduction of a new business registration system based on the Australia Business Number (ABN);
- implementation of the Pay As You Go (PAYG) system to replace the existing company instalment system (COIN), provisional tax, Pay As You Earn (PAYE), Prescribed Payments System (PPS), Reportable Payments System (RPS) and a number of smaller withholding tax arrangements (for example, payments of interest, dividends and royalties to non-residents);
- registration of charitable organisations;
- binding oral advice — for taxpayers with simple affairs; and
- the reduction of the period for review and adjustment of assessments — for taxpayers with simple affairs.

A significant driver of the tax administration changes was the intention to rationalise and simplify the way in which taxpayers made provision for tax as they earned income, including changes to the tax withholding arrangements.

Prior to PAYG there were five payment and reporting systems with their own rules administered by the ATO.

The two arms of the new PAYG arrangements are:

- (a) The PAYG instalment system which replaced both the provisional tax and company instalment system with a comprehensive PAYG system;⁵ and
- (b) The PAYG withholding system which replaced the PAYE, the PPS and the RPS.

Integral to rationalising the various taxes and reporting systems is the way taxpayers pay their tax. The policy intent was to ease the tax compliance costs for small business by introducing a single BAS statement with one payment for each quarter for a large number of taxpayers.⁶

The BAS also provided the opportunity to integrate other functions such as compliance activities with the more regular flow of information provided by the BAS reporting process. For example, as the Treasurer has recently commented:

What the GST did is that the Australian Business Number and the reporting of these transactions for goods and services [tax] gave you a tool that you could take back into the income tax area. Some business would report that it had big transactions – purchases, for example, from one of its suppliers – and you go back into the income tax area and look for that supplier's income and it does not

⁵ 'Individuals who pay provisional tax will benefit from these changes ... Companies will have to pay tax earlier, but the impact of the earlier payments will be more than offset by GST cash flow benefits for all but larger companies'. Ibid 136.

⁶ The BAS was designed on the assumption that most taxpayers keep a full set of accounts—and the timeframes limited the initial scope for further segmentation. In response to community concerns, the government announced in February 2001 the BAS simplification measures. They allowed for simplified reporting arrangements and an instalment system accompanied with an end of year settlement. These changes required significant systems and form redesign, and a marketing strategy for the new measure.

match. I think matching of the indirect tax with the income tax, which is happening now and will happen progressively [even more], will give us more tools to handle the black economy.⁷

However, while the reform package for a single account related to business tax obligations, the design and differing platforms of ATO systems made the separation of business and non-business accounting functions and the implementation of a 'running balance' account extremely difficult. The latter was made more complicated because taxpayers could choose to have different accounts for different revenue products. There were also the associated difficulties of allocating payments and credits to the taxpayer's different accounts.

In addition, specific rebates and benefits provided under the tax system further complicated the notion of a single running account which automatically offset credits and rebates against outstanding debts.

The policy intent was as follows:

Businesses that register for GST (whether company, sole trader or other) will pay their income tax in four quarterly instalments, at the time they remit their GST payments (or claim their GST refunds). They will be able to offset credits of GST against instalments of income tax or other payments (such as remittances of withholding tax instalments) that are made at that time.

However, the same policy intent did not necessarily apply to the off-set of family tax benefits or diesel fuel rebates.

D The Way We Were: 1998

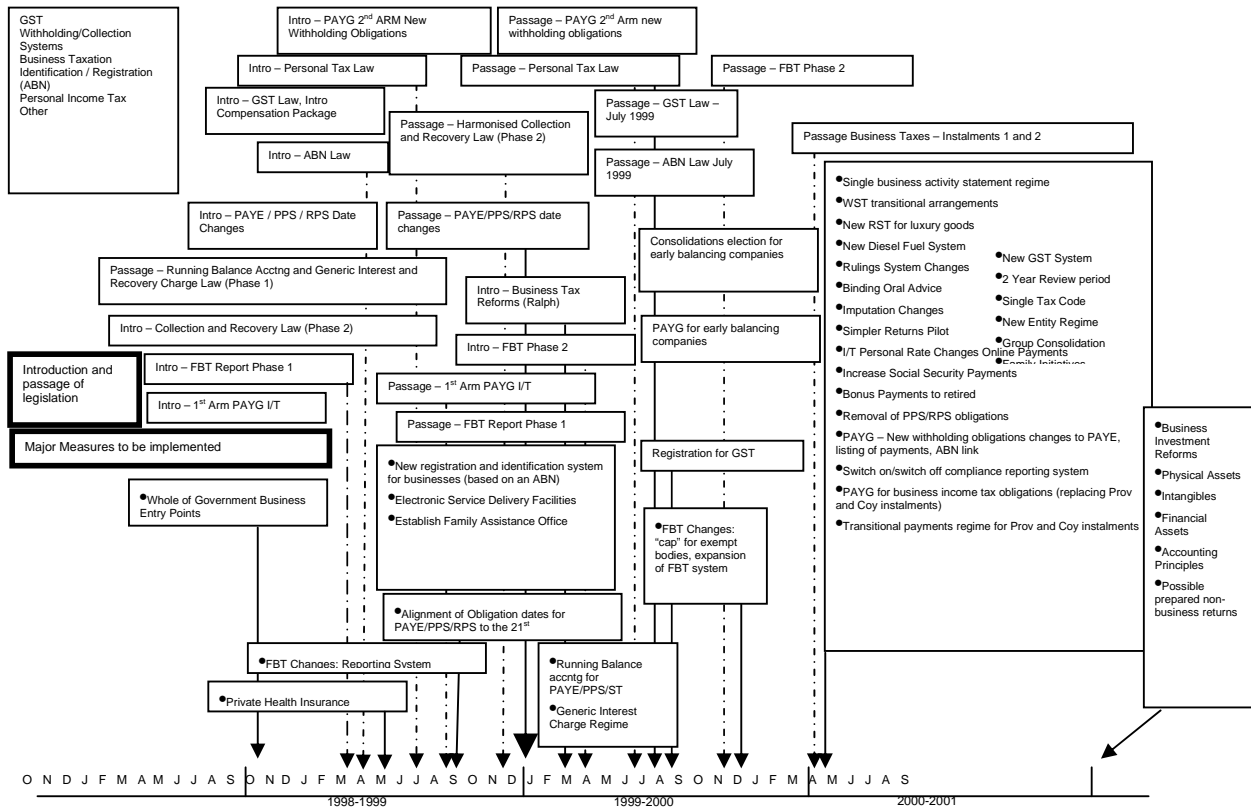
Even without the looming legislative changes associated with business tax reform the ATO (as well as businesses and tax agents) were involved in a major change program. The implementation challenge was acknowledged:

A reform package of the scope contemplated by the Government requires considerable time to implement. Legislation needs to be drafted and enacted. There is a need to develop, in some cases, new computer and other administrative systems. Taxpayers need to be informed about their obligations under the new system and given time to adjust.

Nevertheless, the timeframe for implementation of the massive changes contemplated in the first tranche of ANTS was ambitious. Below is the timeline developed for this implementation:⁸

⁷ Peter Costello, Federal Treasurer, *Business Review Weekly*, 9–15 October 2003, 38.

⁸ ATO November 1998.



Notably, some earning legislation for the implementation of ANTS was enacted a few days before the start of the system.

E The New ATO

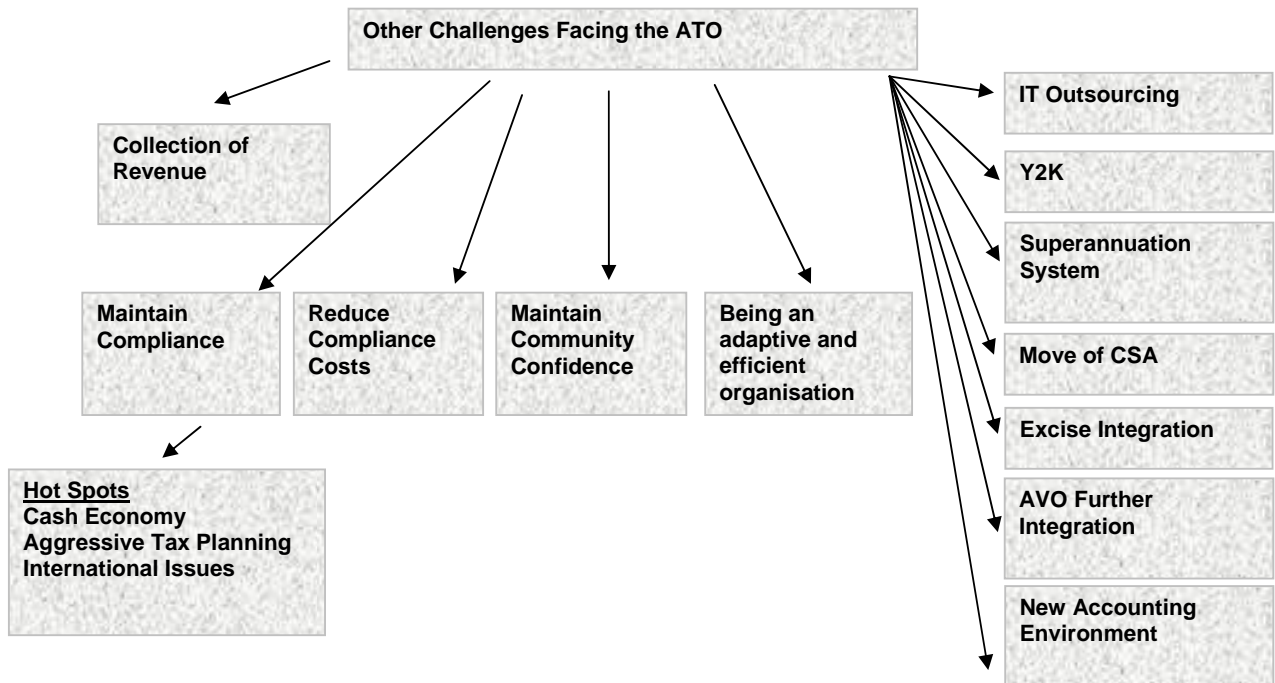
In 1991 the then tax Commissioner gave a presentation which he entitled ‘we eat change for breakfast’. The historical context was dramatic. We had moved to self-assessment and were in the midst of our modernisation and redevelopment program that involved re-equipment in excess of \$1 billion. There was also significant focus on federal public sector management reform.⁹

The winds of change did not abate and indeed the federal government’s ANTS agenda was described by the current Commissioner as ‘the biggest change to taxation in Australia’s history’. The Commissioner went on to say that ‘[t]o meet the challenges before us, we are designing and creating a new Tax Office’.¹⁰

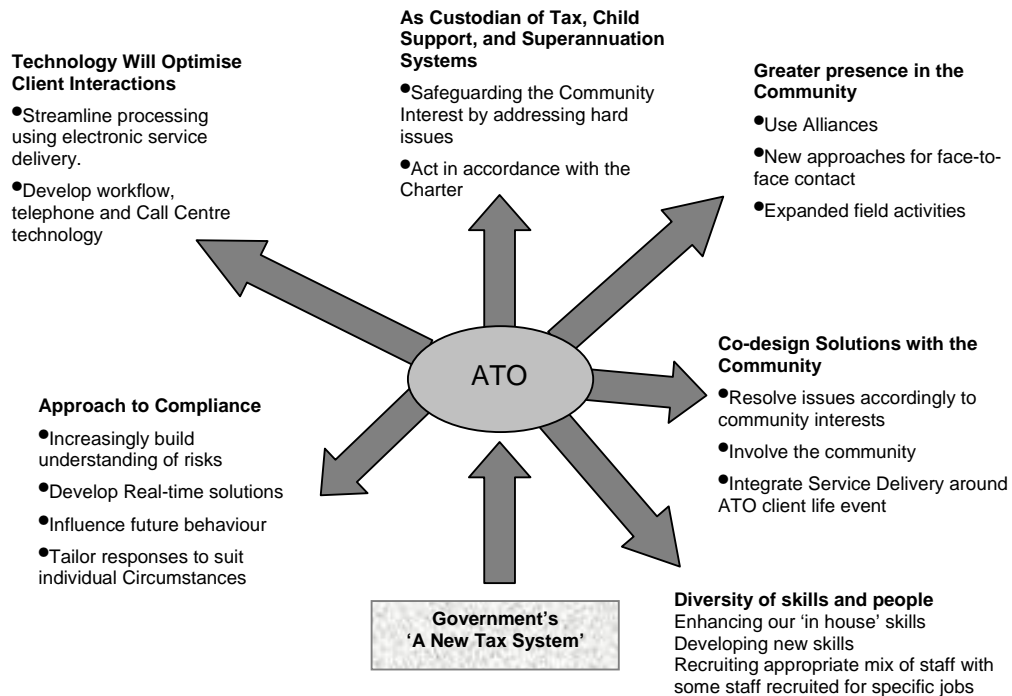
The ATO also faced other challenges in 1998 – 99:

⁹ See M Codd, ‘Federal Public Sector Management Reform’, AGPS 1991.

¹⁰ M Carmody, May 1999.



The chart below illustrates how the ATO sought to integrate tax reform with the ATO's then newly developed strategic directions:¹¹



These strategic directions are generally still current.

¹¹ ATO, November 1998.

F Implementation of ANTS

The intensity of activity required to implement the New Tax System changes for 1 July 2000 was unprecedented. To illustrate, over the 12 months to 1 July 2000 we:

- registered almost 2.8 million businesses for the new Australian Business Register, with 0.5 million of these being registered on line through the Internet;
- responded to over 2.4 million reform telephone enquiries and almost 40 000 written or email reform enquiries;
- conducted over 100 000 business advisory visits;
- conducted 1000 seminars around the country, produced and distributed educational videos and something like 12 million booklets, etc;
- conducted a high profile media and marketing campaign;
- issued 46 significant GST public rulings;
- implemented massive systems changes, the TR2 release for July 2000 involved some 4000 program changes and 17 million lines of code (done while facing Y2K risks and in the middle of outsourcing the ATO's IT infrastructure);
- undertook the largest direct distribution of accounting software ever seen in this country with 1.5 million CD copies of e-record distributed in that period;
- recruited, trained and equipped more than 4000 staff;
- acquired and fitted out an extra 53 000 square metres of accommodation across an extra 50 sites to give us a new network of field presences around the country;
- implemented not only the GST and the PAYG system but also
 - an extension of the Diesel Fuel rebate for off road vehicles and the introduction of the new Diesel and Alternative Grants Scheme for certain on road transport
 - the Fuel Sales Grant Scheme for regional and remote service stations; and
 - the new product stewardship arrangements for waste oil that from 1 July 2000 saw the ATO collecting the levy on relevant oils and paying benefits to companies recycling waste oil in environmentally appropriate ways.

ANTS call centre volumes for June 2000 were:

- 242 000 calls per week (average)
- daily calls peaked at 72 800, most of which related to the registration process and status of registration details.

By 1 July 2001:

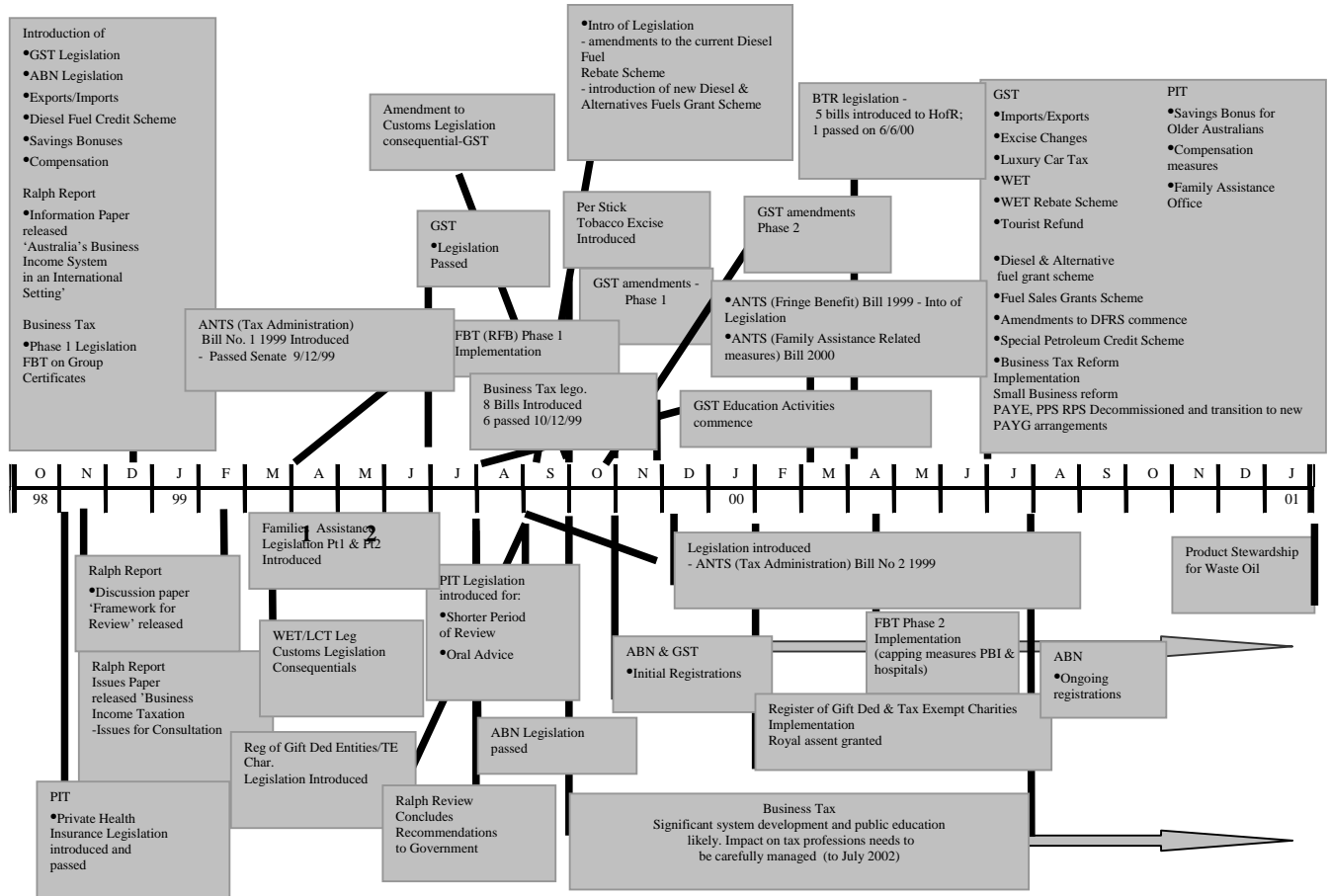
- 2300 ANTS correspondence were on hand
 - volumes for March May 2001, approximately 400 per week
 - ATO completed 98 000 requests for written advice on ANTS in the period March 2000 – 30 June 2001
- ANTS call centre volumes for June 2001
 - 93 000 calls per week (average)
 - daily calls peaked at 27 500
 - 7.1 million calls since 1 July 2000 (10.9 million since July 1999)
 - most calls were on annual instalment variations, lodgement and refunds

- 400 000 advisory visits completed
 - 50 000 client verification calls
 - 20 000 field verification visits
 - gradual redeployment of field resources to field verification activities from March 2001
- 3.6 million ABNs issued (in total)
 - 3.6 million ABNs issued
 - 2.2 million GST registrations
 - 213 500 GST cancellations
 - 35 per cent of new registrations were by this time being completed online
 - significant increase in use of ABR online by business (for example, establishing registration status of other businesses)
- 3.164 million Activity Statements issued in the June 2001 quarter (quarterly and monthly BAS, IAS)
 - 3.065 million paper, 45 000 ELS and 54 000 ECI
 - new customised forms gave effect to new GST/PAYG reporting and payment options
- 109 507 851 hits to taxreform.at.gov.au in 2000– 01
 - 1500 public education seminars
 - 100 000 users of e-record
 - over 1.6 million e-record CDs distributed in total at a rate of 9450 CDs requested per month and 1214 downloads per month

Importantly, we had to continue to successfully manage our existing revenue systems, including our newly acquired responsibilities for excise and self-managed superannuation funds.

G Legislative Activity

The period to January 2001 was also a hive of legislative activity:



While the range of tax measures introduced into Parliament has remained high, there has been a decline in Bills passed (except for the 2002 calendar year)¹²:

CALENDAR YEAR	BILLS ¹³		
	Introduced	Passed	Passed in Year of Introduction
1999	50	65	43
2000	35	37	30
2001	15	20	15
2002	36	30	30
2003	20	18	12
TOTAL	156	170	130

¹² Difficulties arise for taxpayers and the ATO where a Bill has a commencement date prior to its enactment date.

¹³ There may be some small discrepancies in numbers as Bills can be reintroduced in subsequent years.

H Business Tax Reform

In August 1998 the government established a review, chaired by Mr John Ralph AO to consult with business and industry on the proposed business tax reforms. As part of this process the committee issued a number of information papers.¹⁴ John Ralph's final report, *Review of Business Taxation: 'A Tax System Redesigned'* was released by the government on 21 September 1999, along with the government's decisions on many of the measures. A second set of decisions was announced on 11 November 1999.

During 2000, the business tax reform changes included:

- A reduction in the company tax rate from 36 to 34 per cent, with effect from 1 July 2000 and a further cut to 30 per cent from 1 July 2001;
- Alienation of personal services income, introducing new rules for the income tax treatment;
- A limit to the extent non-commercial losses can be used to reduce tax paid on other income;
- A change to the timing of deductions for prepayments for services under tax shelter arrangements; and
- A range of benefit and grants schemes including excess imputation credits and diesel and fuel rebates and grants schemes.

There were also a further seven Tax Law Amendment Acts passed in 2000 which supported the changes to a New Business Tax System.

In 2001 the Uniform Capital Allowance regime was introduced, along with the Simplified Tax System, and new rules for determining the equity and debt borderline for tax purposes and a new Thin Capitalisation regime.

In 2002, the Business Tax Reform initiatives including Consolidation, General Value Shifting regime, Demergers and a new approach to imputation—the Simplified Imputation System—were introduced.

In 2003 further Business Tax Reform initiatives were introduced, such as Foreign Exchange Gains and Losses, and more of the Consolidation regime.

From 2001 – 2004 there have been numerous Tax Law Amendment Acts passed by the parliament which have supported, refined and expanded upon the Business Tax Reform initiatives.

The story of the implementation of these measures maps out its own administrative challenges.

¹⁴ Review Committee (chaired by John Ralph), 'A Strong Foundation' 23 November 1998; 'An International Perspective', 23 December 1998; 'A Platform for Consultation', 22 February 1999.

I ATO Management Perspective

The ATO's main focus from August 1998 had been the implementation of the governments reform agenda by:

- meeting absolute policy implementation deadlines;
- changing our relationship with the community;
- introducing or reengineering our administration processes; and
- changing the way we support our work.

Even in the ATO's Strategic Statement for 2003 – 05 one of the current challenges is [c]ontinuing to implement reform and deliver the revenue and compliance improvements promised by the new revenue system.

However, as we started to shift resources more towards active compliance activities from 2002 – 03,¹⁵ as envisaged in the ATO Output Pricing Agreement with government, we recognised that this had to be balanced by a program of making it administratively easier for people to comply.¹⁶

The challenges posed by building systems for legislation are not yet finalised — the challenge of integrating policy, law and administration is still maturing.¹⁷

Most people focus on the measures and mechanisms contained in the ANTS package when they think about Reform Implementation — GST, PAYG, Diesel Fuel Rebate Scheme, ABN, Business Activity Statement, Personal Tax Simplification, Family Tax Benefits, Private Health Insurance Rebates and successive waves of Business Tax Reform. From a management perspective we would also include:

- Recognising the ATO as only one player in the larger system — but with a unique role/niche;
- Taking into account change occurring in the broader environment particularly technological change, for example, greater use of electronic media, public key infrastructure, call centre processes, natural language speech recognition (telefiling), and contributing purposefully to wider government policy outcomes, for example, more small business participating in the electronic world;
- Managing several waves of reform concurrently:
 - ANTS initiative which commenced on 1 January 1999, through to registration for ABN in November 1999 and GST/PAYG from 1 July 2000
 - Early BTR initiatives (Alienation and Non Commercial Losses measures from 1 July 2000)

¹⁵ See ATO Compliance Program 2002 – 03, and ATO Compliance Program 2003 – 04 both for outcomes of 2002 – 03 plan and for 2003 – 04 planned activities (www.ato.gov.au).

¹⁶ ATO, 'Making it easier to comply' July 2003 (www.ato.gov.au).

¹⁷ See Ralph Report, *Review of Business Taxation, 'A Tax System Redesigned'* (1999) recommendation 1.1, 95 regarding an integrated design process. On 2 May 2002 the Commonwealth Treasurer announced that from 1 July 2002 responsibility for the design of tax laws and regulations would shift from the ATO to Treasury. However, the Treasurer noted that the 'new working arrangements between the agencies in developing future tax measures should seek to build on progress to date in ensuring a high level of integration across the policy, legislative and administrative aspects of change.'

- Progressive tranches to implement other BTR measures (from July 2001)
- Establishment of the Board of Taxation and other mechanisms to strengthen alliances with business, industry and professional associations, and the community;
- Challenges posed by building systems for legislation not yet finalised — integrating policy, law and administration when the policy is still evolving;
- Recognising that the scale of reform poses significant challenges for the ATO in meeting clients' needs and expectations, for example:
 - awareness, education and support mechanisms for taxpayers
 - increased collaboration and business support for tax practitioners and other intermediaries;
 - skilling, education and support for ATO staff;
- Further big shifts in how we do our business and the need to 'do business the way our clients do business';
- Organisational changes following the 1998 election — separating from the Child Support Agency; inclusion of Excise, and the creation of the GST and Excise Business Lines. The ATO positioned by government as the main revenue collection agency but with new roles in relation to the payments of benefits and transfers and new regulatory responsibilities;
- Shifts in the way we resource our operations. For example, the ATO, out of a total budget of some \$2 billion, would 'invest':
 - in a 'typical year' about \$200 –300 million (10 – 15 per cent of the budget)
 - during 1998 – 2002 this was about \$500 – 600 million (ie > 25 –30 per cent of the budget)
- Increased accountabilities because of the GST administration arrangements with the states, and integration of whole of government activities including formal purchaser–provider arrangements with Family and Community Services and Department of Health and Aged Care
- Cross-agency partnerships with Centrelink, Veterans Affairs and Employment, Workplace Relations and Small Business requiring greater collaboration and an increased understanding of the interconnectedness of systems;
- Progressive ATO organisational shifts from a separate internal business line management structure to more end to end and corporate processes, while maintaining a strong market focus in the respective ATO business lines.

J Learnings

Key managerial learnings from Reform Implementation include:

- Flexible organisational arrangements are essential.
 - There is a need to recognise the constraints that can be posed by existing organisational arrangements, and to be more flexible and rapid in approaches and changes
 - Organisationally, we developed a stronger appreciation of the need for shared as well as single responsibility, particularly the need to develop

end to end processes, and to recognise interdependencies and flow-on effects earlier in the process of design.

- Need to maintain multiple views of the business (market segment, product, process, and structure) to be better placed for the early identification of emerging risks to the system and to develop appropriate responses.
- Investment in the design stage is critical: lack of design focus at all levels can create unaligned products, slow down subsequent work, shorten viable product life and create reverse work.
- The ATO would be destined to remain in the constraints of the annual cycle, unless there is deliberate investment in the longer term, although this is not always easy because of budgetary constraints and competing priorities.
- Need to articulate clear future intent and longer-term strategy, and set aside specific resources to enable this, while still focussing on the delivery of the current system.
- Program and/or project management is a significant cultural shift
- Support staff in:
 - understanding and responding to the stresses and impacts on staff
 - management approaches/language/communication
 - skilling in program/project management and in change/reform areas
 - recognition of achievement and being sympathetic to the impact of waves of change

In relation to policy design, and the design of administrative systems, learnings include:

- The importance of effective consultation and co-design with effected parties;¹⁸ and
- Listening to the community to make administrative compliance for taxpayers easier, cheaper and more personalised.

In respect of the wider community, another critical learning is the difficult task of assisting others in coping with change including the need to 'walk them through' new technology. This issue is exacerbated because people and businesses have different levels of technological accounting sophistication and support. Accordingly, it is important for empathetic understanding to recognise the capability limits of others in absorbing and dealing with massive change. For example, many businesses faced new arrangements and increased interactions with the ATO under the new tax system, and key intermediaries such as tax agents struggled to keep pace with the magnitude of the tax reform agenda.

CONCLUSION

The tax system has undergone unprecedented change in recent years, with particular impact on the business community and tax professionals. Inevitably, some changes have been smoother than others. However, in regard to the scale and intensity of the reform agenda, that's a commendable result.

¹⁸ Ibid 107–108.

AUSTRALIA'S CAPITAL GAINS TAX DISCOUNT: MORE CERTAIN, EQUITABLE AND DURABLE?

PAUL KENNY

Senior Lecturer of Taxation Law, Flinders University, Adelaide.

I INTRODUCTION

The Ralph Committee, consisting of three leading businessmen, John Ralph (Chairman), Rick Allert and Bob Joss, was established in 1998 to make recommendations on reforms to the Australian tax system. The Committee sought to achieve three national taxation objectives: optimising economic growth, promoting equity and promoting simplicity and certainty.¹ Additionally, the Committee considered that fiscal adequacy was important as the reforms were designed to achieve revenue neutrality.²

In 1999 the Ralph Committee recommended sweeping reforms to the Australian income tax system. Its final report consisted of eight parts³ and made 280 recommendations. Many of these have since passed into law in a staggered series of stages since 1999. Relevantly, numerous Capital Gains Tax-related (CGT) recommendations were made and many of these have also passed into law. In accordance with the Ralph Committee's four tax policy criteria set out above (equity, economic efficiency, simplicity and fiscal adequacy), this paper evaluates the CGT discount⁴ for individuals, trusts, superannuation funds and other related reforms⁵ that flowed from the 1999 Ralph Report. The paper finds that the CGT discount has greatly undermined equity and fiscal adequacy. Further, this policy appears to have created significant economic distortions and contributed to complexity.

¹ Review of Business Taxation, *A Tax System Redesigned, More Certain, Equitable and Durable*, Report (July 1999) 104.

² *Ibid* v–vi.

³ *Ibid* xi–xii. The eight parts are:

1. Building a strong foundation
2. Establishing a durable framework for income taxation
3. Reinforcing integrity and equity
4. Applying the cash flow/tax value approach
5. Implementing a unified entity regime
6. Recognising direct investors and small business
7. Rewarding risk and innovation
8. Responding to globalisation

⁴ *Income Tax Assessment Act 1997* (ITAA 1997) Div 115.

⁵ CGT averaging was abolished, *Income Tax Rates Act 1986*, Sch 7; and CGT indexation was frozen, Div 114 ITAA 1997.

II THE TAX POLICY CRITERIA

This paper provides the following definitions for the four tax policy criteria.

A Fiscal Adequacy

Fiscal adequacy refers to the ability of the taxation laws to finance government expenditure. Fiscal adequacy is a fundamental requirement for a tax system given the government's need for revenue to ensure good governance.⁶

CGT plays a vital role in fiscal adequacy since it produces a small but significant amount of tax revenue. CGT produced revenue of \$5330 million in 1900–2000,⁷ \$4412 million in 2000–01⁸ and \$3657 in 2001–02.⁹ Additionally, CGT reinforces the tax base and prevents tax avoidance since taxpayers are prevented from converting ordinary income into tax-free capital gains.

B Equity

The Ralph Report asserted that equity is important: 'equity is a basic criterion for community acceptance of the tax system'.¹⁰ Tax equity is generally defined in terms of horizontal equity and vertical equity.¹¹ Horizontal equity demands equal treatment for people in similar circumstances.¹² This requires the determination of a tax base to measure 'similar circumstances' so that an appropriate amount of tax be imposed on a taxpayer. Accordingly, most commentators¹³ have defined the tax base in terms of a taxpayer's 'ability to pay'.

Thus horizontal equity requires those having an equal ability to pay to bear equal burdens of tax.¹⁴ As horizontal equity concerns the equal treatment of equals, as a

⁶ *Nichols v Ames*, 173 US 509 (1898), 515, the United States Supreme Court stated:

The power to tax is the one great power upon which the whole national fabric is based. It is as necessary to the existence and prosperity of a nation as is the air he breathes to a natural man. It is not only the power to destroy, but the power to keep alive.

⁷ Australian Taxation Office, *Australian Taxation Statistics 1999-2000* (2002) <www.ato.gov.au> 77.

⁸ Australian Taxation Office *Annual Report 2000-2001* (2001) <www.ato.gov.au>, 120.

⁹ Australian Taxation Office, *Annual Report 2002-2003* (2003).

<<http://www.ato.gov.au/corporate/content.asp?doc=/content/39007.htm&page=50&pc=001/001/002/001/005&mnu=104&mfp=001&st=&cy=1>>.

¹⁰ Above n 1, 105.

¹¹ J Waincymer, *Australian Income Tax principles and policy*, (2nd ed, 1993), 30.

¹² R Kreyer and N Brooks, *A Capital Gains Tax for New Zealand* (1990) Victoria University Press, Wellington, 43, finds horizontal equity as a widely accepted and fundamental principle of social justice.

¹³ D F Bradford, *Untangling the Income Tax* (1986) Cambridge Mass, Harvard University Press 150–51.

¹⁴ N B Cunningham, and D H Schenk, 'The Case for a Capital Gains Preference' (1993) 48 *Tax Law Review* 319, 365.

corollary, vertical equity is required to ensure that tax imposed on people in different circumstances is also fair. Most countries have progressive rates of income tax¹⁵ so as to try to ensure that a person with a greater ability to pay, pays not only more tax, but at a higher income tax rate. Vertical equity requires both progressive income tax rates and a tax based on the 'ability to pay'.

C Economic Efficiency

The Ralph Report¹⁶ noted that economic efficiency is vital since the tax system 'can significantly influence the efficiency with which Australia's natural resources, capital and labour are used'. Ideally the tax system should have a neutral impact on the economy so as to maximize economic efficiency. There is no shortage of literature on the economic virtues of such a neutral tax system and the ideal of a comprehensive income tax base¹⁷. Cooper's¹⁸ literature survey found that economic income has long remained a popular tax base ideal with western countries. Indeed since the 1980s there has been a long-term international trend towards comprehensive income taxation.¹⁹ Further, the Ralph Report's business taxation design principles advocated that 'the tax base adopted should be as close as possible to comprehensive income'.²⁰ Similarly, the Asprey Report²¹ and Draft White Paper²² preferred this tax base. The results from large scale surveys of economists further illustrate the wide support for this tax base.

¹⁵ J Norregaard, 'The Progressivity of Personal Income Tax Systems' in International Monetary Fund, *Tax Policy Handbook*, P Shome P, (ed) (1995) 130.

¹⁶ Above n 1, 13.

¹⁷ Ibid 112. Comprehensive income, defined as the sum, over an annual period, of a taxpayer's current revenue less current costs, and the net change in value of the taxpayer's assets and liabilities.

¹⁸ G Cooper, 'An Optimal or Comprehensive Income Tax?' (1995) 22 *Federal Law Review* <http://uniserve.edu.au/law/pub/edinst/anu/flrv22/anoptima.htm>

¹⁹ C Sandford, (ed) *Further Key Issues in Tax Reform* (1998) Fiscal Publications, Bath, UK, 204–07, explains the tax base broadening by governments in the 1980s as a reaction to the failure of the interventionist government policies of the sixties and seventies. A fundamental change in economic philosophy occurred, the overriding objective was economic efficiency and tax neutrality, leading the push to a broader income tax base.

²⁰ Above n 1, 111. See also J Ralph, (Chairman of Committee) Review of Business Taxation, Third Report, *A Platform for Consultation* (1999) 28. The report points to the benefits of comprehensive income:

the imposition of income tax to raise revenue would have minimal impact on investment choices; the law could be far simpler and clearer; tax avoidance opportunities would be kept to a minimum. Business could focus on commercial choices rather than spend time and resources seeking to minimise liability.

But the third report, at 12 states:

While the comprehensive income tax base may never be implemented in practice, most successful market economies use that base in designing and evaluating the performance of their operating income tax systems ... Not surprisingly, the prospect of unbridled application of the conceptual comprehensive income tax base in all circumstances attracts taxpayer concern—especially in relation to liquidity, valuation, volatility, loss offset and effects on international competitiveness.

²¹ K W Asprey, (Chairman of Committee) Taxation Review Committee, *Full Report*, (1975) paras 3.23–3.26.

²² Australian Government, *Reform of the Australian Taxation System, Draft White Paper Reform of the Australian Taxation system* (1985) 15.

Behrens²³ surveyed 450 registrants of a 1971 National Taxation Conference and found that tax professionals overwhelmingly chose income tax as the fairest tax. Slemrod²⁴ reported on a 1994 survey of economists that similarly found a strong preference for income and wealth taxation.

D *Simplicity*

In regards to simplicity, the Ralph Report noted that '[a] major consideration in the formulation of the Review's recommendations has been to remove anomalies and inequities between the treatment of economically similar transactions. This will allow significant simplification of the tax system'.²⁵

Simplicity, though, is an attribute that appears to have never sat very well with taxation laws,²⁶ and is a difficult concept to define.²⁷ There is, however, general agreement that simplicity is considered in terms of the compliance costs of taxpayers and the administration costs of government.²⁸ Simplicity can, theoretically at least, be measured by estimating these costs, known as operating costs, and dividing this amount over the amount of tax revenue. Simplicity thus improves where the operating costs or this ratio falls.

Compliance costs can be defined as the costs 'incurred by taxpayers, or third parties such as businesses, in meeting the requirements laid upon them in complying with a given structure and level of tax'.²⁹ These costs will include the costs of keeping records, preparing taxation financial statements and taxation returns, obtaining tax advice, undergoing tax audits, tax planning and disputes. Taxes, though, can provide a number of benefits to taxpayers that may offset these costs.

²³ J O Behrens, 'The Public and the Publicans Talk Taxes' (1995) 36 *National Tax Journal* 221.

²⁴ J Slemrod, 'Professional Opinions About Tax Policy: 1994 and 1934' (1995) 48 *National Tax Journal* 121: Slemrod reports on a tax policy opinion survey of 503 members of the National Tax Association with a response by 45 per cent academics, 32 per cent government employees, 28 per cent private sector. The survey repeats a 1934 senior American public finance professor's survey verbatim (and asks additional questions).

²⁵ Above n 1, 16.

²⁶ United Kingdom Parliament Hansard, May 27 1853: col 722. In 1853 Gladstone said:

the Honourable Gentleman said that laws of this kind ought to be made intelligible to all persons who has not received a legal education. To bring the construction of these laws within the reach of such persons, was no doubt extremely desirable, but very far from being easy ... The nature of property in this country, and its very complicated forms, rendered it almost impossible to deal with it for the purpose of the income tax in a very simple manner.

H H Monroe, QC 'Intolerable Inquisition? Reflections on the Law of Tax' (1981) The Hamlyn Lecture Series 33. In 1980 the United Kingdom Special Commissioner of Taxation stated: 'the plea today is that it would be some advance if laws of this kind were intelligible to those who have received a legal education'.

²⁷ B I Bittker, 'Tax Reform and Simplification' (1974) 29 *University of Miami Law Review* 1, 1.

²⁸ B Tran-Nam, 'Tax Reform and Tax Simplicity: A New and "Simpler" Tax System?' (2000) 23 *University of New South Wales Law Journal* 241, 245.

²⁹ C Sandford, M Godwin, and P Hardwick, *Administrative and Compliance Costs of Taxation* (1989) 10.

Managerial benefits are provided as a result of improved business decision making flowing from tax law compliance.³⁰ That is, the record keeping and financial information requirements of the tax laws provide taxpayers with better information to make business and investment decisions. Additionally, taxpayers obtain a benefit since these compliance costs are generally tax-deductible³¹ under s 8-1 and s 25-5.

There will also be cash flow benefits³² to taxpayers who are able to defer the payment of tax. Compliance costs can thus be represented by the following equation:

$$\begin{aligned} \text{Compliance costs} &= \\ &\text{costs of taxpayers complying with tax laws} \\ &- \text{managerial benefits to taxpayers} \\ &- \text{tax deductibility benefits} \\ &- \text{cash flow savings} \end{aligned}$$

Taxation administration can be categorised into four types of government activities: tax policy, design and planning; tax law drafting and enactment; Australian Taxation Office; and tax dispute resolution.³³ Administration costs can thus be represented by the following equation:

$$\begin{aligned} \text{Administration costs} &= \\ &\text{tax policy, design and planning costs} \\ &+ \text{tax law drafting and enactment} \\ &+ \text{Australian Taxation Office costs} \\ &+ \text{tax dispute resolution} \end{aligned}$$

³⁰ B Tran-Nam, C Evans, M Walpole, and K Ritchie, 'Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia' (2000) Vol LIII NTJ 229, 232-33.

³¹ Ibid.

³² Ibid.

³³ Tran-Nam B., 'Assessing the revenue and simplification impacts of the Governments tax reform' (1999) JAT 329, 332-333.

E The Relative Importance of the Tax Policy Criteria

These policy criteria, however, are both complex and highly controversial.³⁴ Firstly, there exists no known method of quantifying each of the criteria so as to facilitate a comparison. Secondly, there is no universal method for weighting each of the criteria. Given these limits, it is considered that all of these policy objectives are important.

Ideally the 'optimal CGT' structure maximises the equity, efficiency, simplicity and fiscal adequacy criteria. Whilst it is widely accepted that comprehensive income is the ideal income tax base³⁵ commentators find that compromises must be made to this ideal in designing tax laws³⁶ given the conflicting tax policy objectives. As Stiglitz noted,³⁷ an optimal tax is 'the one that maximizes social welfare, in which the choice between equity and efficiency best reflects society's attitudes toward these competing goals'.

III THE CGT DISCOUNT AND RELATED RALPH REPORT CGT REFORMS

A The CGT Discount

The Ralph Report recommendations 18.2 and 18.3³⁸ resulted in the new Div 115 of the *Income Tax Assessment Act 1997* (ITAA 1997) that replaced the former averaging and indexation concessions (noted below). Division 115 provides a CGT discount to individuals, trusts and complying superannuation entities. However, the CGT discount does not apply to companies. Prior to this reform, net capital gains were generally taxed at a taxpayer's marginal income tax rate. The Ralph Report provided the following rationale for this reform:³⁹

³⁴ Kenny P.L., 'Capital gains taxation for New Zealand' (2001) Vol. 7 No.4 *New Zealand Journal of Taxation Law and Policy* 265, 266.

³⁵ Review of Business Taxation Report above n 1, 112, defined comprehensive income as 'the sum, over an annual period, of a taxpayer's current revenue less current costs, and the net change in value of the taxpayer's assets and liabilities.' Relevantly, all of the recent Australian income tax inquiries agreed, at least conceptually, on the neutrality advantages of a comprehensive income tax base. Unlike the current income tax system such a tax base would comprehensively tax capital gains and other forms of wealth. See Taxation Review Committee above n 21, 414; Australian Treasury Draft White Paper above n 22, 78.

³⁶ C Evans, 'Taxing capital gains: One step forwards or two steps back?' (2002) 5(1) *Journal of Australian Taxation* 114, 120-122.

³⁷ J Stiglitz, *Economics of the public sector*, (2nd ed, 1988) 478-479.

³⁸ Above n 1, 600.

³⁹ *Ibid* 598-602.

A structural shift in capital taxation for individuals

The Review's recommendations for capital gains taxation are designed to enliven and invigorate the Australian equities markets, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources. In the first three or four years of the new regime there is likely to be considerable extra turnover on Australian equity markets as equity holders respond to reduced lock-in by realigning their portfolios. Even in the medium to longer-term, the Review expects a heightened level of realisations activity amongst individual shareholders and CIVs [Collective Investment Vehicles]. The Review's recommendations in regard to scrip-for-scrip rollover will also stimulate significant turnover in the wake of expected increased takeover activity (see Recommendation 19.3).

The choice of option

A number of stepped rate scales to provide relief that increased with the holding period of the asset were discussed in A Platform for Consultation (page 291). Such an approach has the appeal that it provides a reward for 'patient capital'. However, there is an inherent tension between rewarding patient investors and seeking to free up capital markets. Realisation-based capital gains tax systems generally suffer from a tendency to lock asset holders into less than optimal positions. Providing any further reward for delaying realisation (for example, by means of a stepped rate related to holding period) would, in some cases, exacerbate the lock-in effect.

In consultation with business — especially the venture capital industries — it has also become clear to the Review that start-up ventures proceed through various stages, often needing to have capital restructurings even after only a few years in order to fund further development. A stepped rate scale would not appropriately reward shorter term investment at each such stage of the venture's development.

For these reasons, the Review has decided to recommend a broad form of CGT relief which has only a limited relationship to the period of holding of the asset.

The Review's recommendation of an exclusion of 50 per cent of capital gains for eligible assets held for a year or more by individuals will increase significantly the attractiveness of investing in capital-gains-bearing assets by individuals (see Recommendation 18.2). It will reduce the effective top marginal rate on capital gains income to 24.25 per cent.

Section 115-5 states that a discount capital gain is a capital gain that meets the following basic requirements:

1 *Basic Requirements*

1. The capital gain must be made by an individual; or a complying superannuation entity; or a trust.
2. The capital gain must result from a CGT event happening after or on 21 September 1999.⁴⁰
3. The capital gain must have been worked out using a cost base that excludes indexation.⁴¹
4. The capital gain must result from a CGT event happening to a CGT asset that was acquired by the entity making the capital gain at least 12 months before the CGT event.⁴² The following ten CGT events though do not obtain the CGT discount: D1, D2, D3, E9, F1, F2, F5, H2, J2 and J3.⁴³

2 *Anti Avoidance Rules*

Also, there are two anti avoidance rules for the 12-month holding period. Section 115-40 provides that where the CGT event occurred under an agreement you made within 12 months of acquiring the CGT asset the CGT discount will not apply. Section 115-45 excludes a CGT discount for capital gains from certain disposals of equity interests in companies or trusts where the taxpayer could not have otherwise accessed the CGT discount if the taxpayer directly owned the underlying assets of the company or trust.

3 *The Discount Percentage*

The discount percentage for an amount of a discount capital gain is 50 per cent if the gain is made by an individual or by a trust and 33.33 per cent if the gain is made by a complying superannuation entity.⁴⁴

4 *Special Rules for Trusts*

Special rules for trusts apply so that the CGT discount is appropriately traced through to beneficiaries receiving capital gains and so that company beneficiaries do not receive the CGT discount.⁴⁵

⁴⁰ Section 115-15 ITAA 1997.

⁴¹ Section 115-20.

⁴² Section 115-25. Note s115-30 provides special rules about time of acquisition that deem earlier times of acquisition where assets are acquired under certain rollover provisions.

⁴³ Section 115-25(3).

⁴⁴ Section 155-100.

⁴⁵ Sections 155-200 to 115-225.

It is also noted that access to the CGT discount was expanded to include assets realised by listed investment companies on or after 1 July 2001.⁴⁶

B Related Ralph Report CGT Reforms

In conjunction with the introduction of the CGT discount a number of related CGT reforms were implemented. These reforms are set out below.

1 CGT Averaging Abolished

Ralph Report recommendation 18.1(a)⁴⁷ resulted in the removal of the CGT averaging concession. Previously, under CGT averaging, individuals and certain trustees could average their net capital gains to reduce the bunching effect of an accumulated capital gain⁴⁸. The net capital gain for the income year was generally divided by five to provide the marginal rate of tax that would apply to the capital gain when added to other income. That rate of tax (for the one fifth of the capital gain) was multiplied by five to calculate the total gain. Ralph Report asserted:⁴⁹

[i]n order to deliver such a deep reduction in effective rates within the constraint of revenue neutrality, the Review has necessarily had to identify other features of the current regime which do not contribute to the objectives of encouraging investment or removing inflexibilities in the capital markets.

Australia's averaging provisions were identified early as contributing little to these aims while reducing revenue substantially. They are used by a section of the asset-holding community to reduce capital gains taxation to zero, or near to zero, while others who are not in a position to engineer the same benefit carry the burden of taxation at close to their full marginal rate. This results in considerable inequity. In practice, investors facing high marginal rates of tax remain locked in to a significant extent rather than realise and, where realising, have to secure a much higher return on the reduced capital available for reinvestment. Some individuals, of course, achieve a very low tax rate on capital gains through the averaging provisions and that may encourage more investment by such people. But the Review is not convinced that overall efficiency is best promoted by present provisions.

Were averaging to remain for a period after announcement, the Review expects that many taxpayers would seek to structure their affairs in order to take full advantage of averaging in 1999–2000 while it remained available. Accordingly, the Review recommends removal of averaging in relation to any gain realised on sales contracted from the date of announcement (Recommendation 18.1(a)).

⁴⁶ Subdiv 115-D. A listed investment company is an Australian resident listed company that has at least 90 per cent of its assets in allowed investments that include shares, units, options, rights, certain financial instruments and goodwill, s115-290.

⁴⁷ Above n 1, 599–600.

⁴⁸ *Income Tax Rates Act 1986*, Sch 7.

⁴⁹ Above n 1, 599–600.

This may create some complexity in the transition year for certain taxpayers and in the administration of the tax law. But the potential disruption to collections otherwise justifies this one-time complexity.

In accordance with this recommendation⁵⁰ the CGT averaging system was abolished, effective from 21 September 1999.

2 CGT Indexation Frozen

The Ralph Report recommendation 18.1(b)⁵¹ resulted in the freezing of CGT indexation at 30 September 1999. Prior to this reform, the CGT provisions freely permitted a taxpayer who owned a CGT asset for at least 12 months to index the cost base of the asset for inflation in calculating a capital gain.⁵² The indexation commenced in the quarter when the expenditure on the cost base was incurred, and ceased in the quarter when the CGT event occurred.⁵³

As a result of this recommendation, these rules were amended to deny indexation of the cost base for CGT assets acquired from 21 September 1999.⁵⁴ Additionally, the indexation amount of the cost base of CGT assets acquired at or before 21 September 1999, and disposed of after that time, is frozen as at 21 September 1999.⁵⁵ The Ralph Report explained:⁵⁶

The freezing of indexation adjustments after the September quarter 1999 adjustment is the other major adjustment recommended by the Review to achieve revenue neutrality (Recommendation 18.1(b)).

The case for freezing indexation is not as clear-cut as for averaging. Though indexation provides a significant reduction in effective rate for many taxpayers, this is probably not well recognised, especially amongst foreign investors. Indeed, the perception has been that the Australian tax system imposes tax at full income tax rates. Such misperceptions are not easily corrected and a change in the form of concession to something more akin to the types of concession available abroad would, in the Review's judgment, be more effective in attracting investors to Australian assets.

Notably, indexation still applies for pre-21 September 1999 assets but cannot be used in addition to the CGT discount.⁵⁷

⁵⁰ Ibid 595.

⁵¹ Above n 1, 595.

⁵² Div. 114 ITAA 1997.

⁵³ Section 114-1.

⁵⁴ Section 114-1.

⁵⁵ Ibid.

⁵⁶ Above n 1, 599–600.

⁵⁷ Section 115–20.

(a) Evaluation of the CGT Discount and Related CGT Reforms

As noted above, this paper evaluates the CGT discount and related reforms in regard to the tax policy criteria of fiscal adequacy, equity, economic efficiency and simplicity.

IV FISCAL ADEQUACY

The following table sets out net capital gains and CGT revenue before and after the September 1999 Ralph CGT reforms.⁵⁸

Table 1
Australian net capital gains and CGT revenue 1999–2002

Year	Net capital gains \$ m	Capital Gains Tax revenue \$ m
1998–99	17 490	4356
1999–2000	19 803	5330
2000–01	16 924	4423
2001–02	12 465	3657

The levels of capital gains and CGT collections have fallen in the years following the Ralph CGT discount in 1999–2000. This may, however, be also due to other factors such as the decline in the stock market. It is clear though that the CGT discount has proven to be very costly to tax revenue as the following Treasury estimates illustrate:⁵⁹

Table 2
Estimated tax expenditures from the CGT discount 2001 to 2006

Year	Estimated tax expenditure from the CGT discount (\$ billion)
2000–01	1.31
2001–02	1.81
2002–03	1.81
2003–04	1.81
2004–05	1.91
2005–06	2.03

⁵⁸ Australian Taxation Office, *Australian Taxation Statistics 1998-1999* (2001) <www.ato.gov.au>, 99; Australian Taxation Statistics 1999-2000 above n 7, 77; Australian Taxation Office, Australian Taxation Statistics 2000-2001 (2003) <www.ato.gov.au>, 120; Australian Taxation Office, Annual Report 2002-2003 (2003)

<http://www.ato.gov.au/print.asp?doc=/content/39007.htm&page=50#P678_71401, preliminary CGT figures 2001-02>.

⁵⁹ Australian Treasury, Tax Expenditure Statement 2002, (2003) <<http://www.treasury.gov.au/documents/505/XLS/07Table51.xls>>.

The CGT discount has an enormous influence over CGT collections as seen by the size of the revenue loss of \$1.8 billion in 2001–02 compared to CGT revenue of about \$3.6 million in 2001–02.

In contrast, the reforms that removed CGT averaging⁶⁰ and froze indexation⁶¹ have been revenue positive although the quantum of revenue raised is unknown.

V EQUITY

A Equity: The Case Against a CGT Discount

1 Horizontal and Vertical Equity

The CGT discount seriously undermines both horizontal and vertical equity as demonstrated by the following examples.

Example 1

X who earns interest income of \$50 000 and pays \$11 322 income tax (including Medicare levy) in the income tax year ended 30 June 2004 will be in a horizontally equitable position with Y who realises a capital gain of \$50 000 and pays \$11 322 income tax. However, if only 50 per cent of Y's capital gain is taxed, horizontal equity will be breached as Y only pays \$3897 income tax and X pays \$11,322 income tax, yet both have the same ability to pay.

Also, the CGT discount breaches vertical equity as demonstrated by the following examples.

Example 2

A high income earner, M, at the top marginal income tax bracket of 48.5 per cent (including Medicare levy), earns \$70 000 of capital gains and pays tax of \$20 757 income tax in the income year ended 30 June 2004. A taxpayer, N, with a top marginal income tax bracket of 31 per cent (including Medicare levy), earning \$50 000 of salary pays \$11 322 income tax. Thus vertical equity is maintained. However, if M is only taxed on 50 per cent of the capital gain, M will pay income tax of \$7197 whilst N pays \$11 322. Thus vertical equity is breached.

Further, if both taxpayers receive a discounted capital gain, the high income earner obtains a greater benefit from this exemption as seen below.

⁶⁰ The Explanatory Memorandum to the New Business Tax System (Miscellaneous) Act (No 2) 2000 failed to estimate the revenue saving.

⁶¹ Ibid.

Example 3

M, a high income earner at the top marginal income tax rate of 48.5 per cent, receives a \$10 000 50 per cent discounted capital gain and thus obtains a tax saving of \$2425 as a result of the CGT discount. N, on a 31.5 per cent marginal income tax rate, receives a \$10 000 50 per cent discounted capital gain and thus only saves \$1575 of income tax.

As the above examples show, the CGT discount has an ‘upside down effect’ in providing the greatest benefit to asset holders. Given the high concentration of wealth in Australia⁶² this preference results in significant losses to vertical equity. The benefit of the CGT discount is highly skewed since 10 per cent of the population have 43 per cent of the total wealth and 50 per cent have 90 per cent of the wealth.⁶³ The bottom half of the population only have 10 per cent of the wealth, whilst the poorest 10 per cent have no wealth at all.⁶⁴

However, the reforms that removed CGT averaging and froze CGT indexation, improved horizontal equity and vertical equity since these concessions were only available to a limited number of CGT asset holding taxpayers.

2 Tax Integrity

Tax preferences damage tax integrity as they provide taxpayers and tax advisers with both the rationale and opportunity for tax avoidance⁶⁵ and tax evasion.⁶⁶ Additionally, it may lead to the corruption of tax administration.⁶⁷

(a) Provides the Rationale for Avoidance and Evasion

A number of researchers⁶⁸ have found that the belief that tax laws are unfair encourages the acceptability of avoidance and evasion. Pederick provides a telling analysis of the impact of tax preferences on community attitudes:⁶⁹

⁶² S Kelly, ‘Wealth on Retirement – Latest Estimates for Australia’, paper presented to the 9th Annual Colloquium of Superannuation Researchers, University of New South Wales, 9–10 July 2001, <www.natsem.canberra.edu.au>, 15.

⁶³ Ibid.

⁶⁴ Ibid.

⁶⁵ R Woellner, S Barkoczy, S Murphy, and C Evans, *Australian Taxation Law* (2004) 1580–588, notes the tension that exists in defining tax avoidance, whether it involves tax planning, or whether it is confined to highly artificial arrangements. Rather than delineate these concepts in the context of CGT, this thesis adopts a broad definition of tax avoidance that includes tax planning, tax arbitrage (tax arbitrage occurs where taxpayers minimise tax by taking advantage of different tax consequences that apply to the various types of income, deductions, assets and types of entities) and highly artificial arrangements.

⁶⁶ Ibid 1582. Defines tax evasion as ‘the non-payment of the tax which would properly be chargeable to a taxpayer if the taxpayer made a full and true disclosure of assessable income and allowable deductions’.

⁶⁷ *Wills v Petroulias* (2003) NSWCA 286.

⁶⁸ C Coleman, and L Freeman, ‘Cultural Foundations of Taxpayer Attitudes to Voluntary Compliance’, (1997) 13 *Australian Tax Forum* 311, 335–36; K A Kinsey, K W Smith, ‘Income Tax Cheating:

If the tax system and its administration are seen as to press heavily on some but lightly on other taxpayers in essentially the same circumstances, with essentially the same tax paying capability, then the confidence of the citizenry in the fairness and justness of the system, of their government, erodes. Cynicism grows apace and a race not to be left out of the tax minimisation derby, by hook or by crook, infects the body politic. Since government in our societies truly is “of the people, by the people and for the people”, to escape collection of one’s share of the costs of our joint enterprises is to rifle the common treasury, to take from one’s neighbour. A society that breeds an attitude that one’s duty is wholly to one’s self and not to the community, not to one’s country, when it comes to taxes, is a society with a cancer at work. It is, moreover, a cancer that threatens the quality of life on a wider front and, indeed, perhaps the long term stability of the society it infects.

This suggests that Australia’s CGT exemptions⁷⁰ such as the CGT discount would have a profound impact on community attitudes. Thus, fully taxing capital gains would appear to greatly stem such cancer in community attitudes, although other tax exemptions would also need to be closed to effectively change attitudes and behaviour.

(b) Provides the Opportunity for Avoidance and Evasion

Tanzi found evasion is likely to occur where evasion opportunities exist.⁷¹ Other researchers have noted that tax advisers take full advantage of any ambiguity in tax laws. Porcano et al⁷² found that tax returns prepared with tax assistance, especially prepared by Certified Practising Accountants (CPA) and lawyers had much higher levels of non-compliance than returns that were self-prepared. This could be due to interpretational problems—as Ayres et al⁷³ found, advisers adopt an aggressive stance in ambiguous tax deduction cases. Also, Grbich⁷⁴ noted that tax planners use time-honoured legalistic games to exploit the language of the law. Tax officers are mesmerised by the legalistic arguments and occasionally by superficial economic rhetoric.⁷⁵

Opportunities, Preferences and Sanctions’ American Bar Foundation. Working paper series #8718, presented at the 1986 meeting of the Midwestern Sociological Society, Des Moines, Iowa; C Sandford, ‘Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation’ (2000), 149.

⁶⁹ W H Pederick, ‘Fair and Square Taxation in Australia’ (1984) 19 *Taxation in Australia* 570, 575–76.

⁷⁰ Other CGT exemptions include: main residences, pre-20 September 1985 assets and death.

⁷¹ V Tanzi, *The Individual Income Tax and Economic Growth an International Comparison*, (1969) 83–84. He further notes that the effect of evasion means that all income and other taxes are higher.

⁷² T M Porcano, D M Shull, and A V Tran, ‘Alignment of Taxable Income with Accounting Profit’ (1993) 10 *Australian Tax Forum* 475; V C Milliron, and D R Toy, ‘Tax Compliance: An Investigation of the Key Features’ (1988) 9 *Journal of the American Taxation Association* 84, 84.

⁷³ F L Ayres, B R Jackson, and P A Hite, ‘The Economic Benefits of Regulation: Some Evidence from Professional Tax Preparers’ (1989) 64 *The Accounting Review* 300.

⁷⁴ Y Grbich, ‘After Bellinz and Ralph, A New Focus for Decision Making in the Australian Tax System’ (2000) paper presented at the ATAX University of New South Wales 4th International Conference on Tax Administration, Sydney, 28–29 April 2000, 2.

⁷⁵ *Ibid.*

Certainly CGT exemptions such as the CGT discount provide opportunities to transform income into exempt or concessionally taxed capital gains. Also, they provide tax advisers with the opportunity to exploit the ambiguities in the income–capital distinction.

Indeed, the Draft White Paper⁷⁶ and the Australian Senate Finance and Public Administration References Committee Inquiry⁷⁷ into the Business Taxation Reform both observed that exempting capital gains opens one of the greatest tax loopholes. A view shared by Burman.⁷⁸ Australia's income tax experience well illustrates such tax minimisation and evasion, as follows.

(i) Australia's Pre-CGT Experience

There is much evidence in Australia's pre-CGT era of taxpayers and tax advisers exploiting the CGT exemption by transforming income into tax-free capital gains. For example, in the 1920s property development companies were established with the profits retained in the company which was subsequently placed in liquidation.⁷⁹ In the absence of a CGT or any specific taxing provisions,⁸⁰ the profits were then paid out as tax-free distributions of capital. The Treasurer said:⁸¹

This has been done almost entirely for the purpose of enabling the shareholders to escape income tax on the liquidation dividends, because the courts have held that liquidation dividends are distributions of assets, and, in the present form of the income tax law, they cannot be classed as income even to the extent to which they have been distributed out of profits.

In the 1970s many companies engaged in a dividend-stripping process of tax avoidance.⁸² Companies with profits where no income tax was paid were acquired by promoters and then subsequently stripped of assets leaving the company unable to pay any taxes due. The vendor shareholders of the company received a tax-free capital payment for their shares whilst the promoters went on to strip assets. This practice was aided by the absence of a CGT that would assess the capital gains.⁸³ The Explanatory

⁷⁶ Reform of the Australian Taxation System, above n 22, 78. See the following statement: 'The lack of a general CGT represents a structural defect in the income tax system which lies at the core of many avoidance arrangements'.

⁷⁷ Commonwealth, Senate Finance and Public Administration References Committee Inquiry into the Business Taxation Reform, (1999), para 4.25.

⁷⁸ L E Burman, *The Labyrinth of Capital Gains Tax Policy, A Guide for the Perplexed* (1999) 68.

⁷⁹ Commonwealth, Parliament Hansard, House of Representatives, 11 September 1928, 6569, 6570

⁸⁰ Section 16B of the Income Tax Assessment Act 1928 (Cth) was introduced to counter such tax avoidance schemes (now s 47 ITAA 1936).

⁸¹ Above n 79, 6569, 6570

⁸² Above n 65, 10.

⁸³ Consequently, the Crimes (Taxation Offences) Act 1980 was introduced in December 1980 to counter such tax evasion. Additionally, in 1982 a number of Acts were introduced to create a liability for the unpaid tax on the vendors as well as on the promoters. This legislation included: Taxation (Unpaid Company Tax) Assessment Act 1982; Taxation (Unpaid Company Tax - Vendors) Act 1982; Taxation (Unpaid Company Tax - Promoters) Act 1982; Taxation (Unpaid Company Tax) (Consequential Amendments) Act 1982.

Memorandum to the *Taxation (Unpaid Company Tax) Assessment Act 1982* Part I explains that:

[a] typical scheme of pre-tax company profit stripping would ordinarily involve a sale of all (in isolated cases practically all) of the shares in a company (the 'target company') which had successfully traded for a substantial part of the income year and which had, up until the implementation of the scheme, current year profits on which a contingent company tax liability existed. In addition, if the target company concerned was a private company for income tax purposes it would in due course become liable to pay undistributed profits tax in the event that it failed to pay a dividend of a specified proportion of its profits within 10 months after the end of the income year.

The trading activities of the target company would first have been transferred to another entity (company or trust) controlled by the former owners of the company and the target company's assets reduced to cash or other liquid form. It would be a condition of the scheme promoter that all liabilities of the company except its actual or contingent tax liabilities be paid or indemnified by the vendor-shareholders.

The former owners of the company would be paid a price for their shares that was fixed on the basis of the value of the company's assets, not taking into account the contingent tax liability on company profits. This capital sum would however have been reduced to reflect the fee charged by the promoter or other stripper.

By further processes the target company would be stripped of its liquid assets (e.g., by the making of a loan that could not be repaid) and thus rendered incapable of meeting the company tax liability in due course assessed to it. It is this unpaid company tax that is the subject of the Bill.

There were yet other situations in which the ownership of companies was sold and the companies rendered incapable of paying their income tax.

Grbich estimated that revenue losses through avoidance and evasion from the bottom of the harbour schemes in the 1970s amounted to a minimum of \$10 000 million in total.⁸⁴

In the 1980s the provision of lease incentives by owners of rental properties in the central business districts of Australian cities appeared to be another way in which taxpayers sought to exploit the absence of CGT. The Australian Taxation Office (ATO) described such arrangements in taxation ruling IT 2631:⁸⁵

The incentives take many forms, including large upfront cash payments, non-cash items such as top of the line motor vehicles or boats, expensive paintings, holiday packages, rent-free or rent-discounted periods for the leased premises or for premises in other cities, free fit-outs of the premises, payment of removal costs or

⁸⁴ Y Grbich, 'Problems of Tax Avoidance in Australia' in J G Head (ed) *Taxation Issues of the 1980s* (1983) 413.

⁸⁵ Australian Taxation Office, Income Tax Ruling IT 2631, para 2.

for the surrender of the existing lease, interest-free loans, or a combination of these incentives.

(ii) Australia's Post-CGT Experience

The introduction of CGT into Australia in 1985 greatly improved the integrity of the tax laws. As well as taxing capital gains it has helped maintain levels of other tax revenue since ordinary income is prevented from being converted to tax-free capital gains. However, given the numerous exemptions,⁸⁶ capital gains are only lightly taxed. The introduction of the CGT discount⁸⁷ in 1999 further diluted the effectiveness of CGT as discussed below.

(iii) Ralph CGT Discount

Under the CGT discount with no limit on negative gearing, the interest paid on investment loans is fully deductible. Thus a dollar of interest expense that produces \$1 of capital gain reduces the investor's taxable income by 50 cents. Deferral of capital gains under a realisation CGT⁸⁸ offers an even greater profit, since the interest is fully deductible in the current period when it is incurred, yet the capital gains are deferred until realisation.

The CGT discount was expected to have a huge impact of tax arbitrage. The government's estimate⁸⁹ of \$100 million per annum tax revenue losses was considered to be too low. Evidence from the Senate inquiry⁹⁰ pointed to a massive loss of tax revenue. At the time of the Ralph Review, Krever found that the reforms would have a revenue leakage of hundreds of millions of dollars.⁹¹ Evans considered the reforms could transform the positive revenue estimate of \$350 million into a significant revenue leakage of \$5.5 billion in a worst-case scenario.⁹² Early Treasury estimates have clearly proven to be too low as the tax revenue lost on the CGT discount for individuals and trusts amounted to about \$1.8 billion.⁹³

⁸⁶ The major asset class, residences are exempted by subdiv 118-B. Also, numerous other exemptions and rollovers apply for business assets, eg, see Divs 122, 124, 126 & 152. Also, death does not trigger CGT per Div 128. Further, numerous exemptions apply for non-residents per Div 136.

⁸⁷ Div 115.

⁸⁸ See s 104-10(1) 'CGT Event A1 Happens if You Dispose of a CGT Asset'.

⁸⁹ Commonwealth, Senate Finance and Public Administration References Committee Inquiry in to the Business Taxation Reform, (1999) para 4.31.

⁹⁰ Ibid.

⁹¹ Ibid para 4.25.

⁹² Ibid para 4.29.

⁹³ See Table 2.

(c) Corruption of Tax Administration

Additionally, CGT exemptions can lead to the corruption of tax administration. The Petroulias affair demonstrates how a tax loophole can result in such corruption. Petroulias, a former Assistant Tax Commissioner with the Australian Taxation Office, is subject to legal action⁹⁴ over allegedly improperly receiving money for providing favourable private binding rulings to tax planners in respect of superannuation deductions. As Sandford noted, such behaviour is likely to severely damage taxpayer compliance.⁹⁵

(i) Summary

It is apparent that such a CGT preference such as the CGT discount has a significant and adverse impact on community attitudes and encourages tax minimisation. Taxing capital gains at the taxpayers marginal income tax rate would be a vast improvement on the current regime.

3 Housing Affordability

The current Australian housing price bubble appears to be partially fuelled by preferential CGT treatment as investors sought to take advantage of the personal residence exemption, CGT discount and negative gearing.⁹⁶ Relevantly, Sandford noted that preferential CGT treatment for housing creates inflated prices.⁹⁷ This is unfair to purchasers, and especially for first home buyers who do not benefit from a price appreciation associated with a CGT exemption.

Since the 1999 Ralph Report, Australia has witnessed a surge in real estate investment as seen by the following Productivity Commission estimates of median city housing prices over the period 1998–2003.⁹⁸

⁹⁴ *Wills v Petroulias* (2003) NSWCA 286, para 12, ‘The charge before the magistrate ... was in the following terms: “That between about 1 September 1997 and 17 February 1999 Nikytas Nicholas Petroulias, also known as Nick Petroulias, did defraud the Commonwealth, namely the Australian Taxation Office contrary to s 29D of the Crimes Act 1914 in that, while an officer of the Australian Taxation Office he did, by dishonest means, assist taxpayers to avoid the payment of taxation”.’

⁹⁵ C Sandford, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (2000) 149.

⁹⁶ A Mitchell, ‘Wrecking Ball to Property Myths’ *The Weekend Australian Financial Review* (Sydney) 20–21 December 2003, 53. Mitchell noted that the Australian Bureau of Statistics found that almost 100 000 Australians were homeless on census night in 2001. Further, Mitchell stated that ‘[n]egative gearing and concessional taxation of capital gains have magnified the surge of investment in rental property’.

⁹⁷ C Sandford, ‘Taxation and Social Policy: An Overview’ in C Sandford, C Pond, R Walker (eds), *Taxation and Social Policy* (1980) 4–5. Sandford found that tax concessions to house owners raise the value of homes providing capital gains to owners but reduce the capacity of would be purchasers.

⁹⁸ F Anderson, and K Wheatley, ‘Rich May be Barred From First Home Buyer’s Grant’ *The Advertiser* (Adelaide) 19 December 2003, 6. Sourced from Productivity Commission estimates.

Table 3
Median value of housing in Australian cities
June 1998 – June 2003

City	Value June 1998	Value June 2003	Change %
Sydney	249 000	388 000	56
Melbourne	155 000	316 000	104
Brisbane	144 000	277 000	92
Perth	143 000	206 000	44
Adelaide	119 000	212 000	79
Hobart	107 000	173 000	61
Darwin	174 000	211 000	21
Canberra	156 000	285 000	83
Average	155 875	258 500	66

This table illustrates the price surge over the period 1998–2003 with a 66 per cent average increase in city housing prices. This equates to an increase of 13.2 per cent per annum.

Commentators such as Warren⁹⁹ have noted the investment advantages of appreciating investment property, given the benefit of a 50 per cent CGT discount on any capital gain and the immediate deductions for expenses including interest. Similarly, Bassanese¹⁰⁰ noted that the benefit of the CGT discount for individual investors (as well as of other tax benefits such as negative gearing and capital allowances) led to a ‘stampede into investment properties in recent years’. He provided the following example from Reserve Bank of Australia’s (RBA) submission to the Productivity Commission inquiry into first home ownership:¹⁰¹

A high income earner who partly draws against existing home equity to obtain 100 per cent interest only, financing for a \$400,000 newly constructed investment property.

Even with a rental yield of only 3.5 per cent versus a loan interest rate of 6.5 per cent, the RBA shows that the investor need only outlay \$81 in after tax dollars per week to maintain the investment after allowing for various other tax benefits like negative gearing and depreciation.

What the RBA does not say, but can be inferred, is that the implied annual capital gain required to break even on such an investment is less than 2 per cent, or long run expected inflation. It’s still true if we assume a higher long run interest rate of 7.25 per cent.

⁹⁹ N Warren, ‘No Easy Way to Unwind Negative Gearing’ (2003) Issue 2 Tax Matters, Atax, University of New South Wales, 7.

¹⁰⁰ D Bassanese, ‘Too Many Property Investors’, Australian Financial Review (Sydney) 21–22 February 2004, 17–18.

¹⁰¹ Ibid.

Also pertinent to this discussion is the Commission's public inquiry into the affordability and availability of housing for first home buyers.¹⁰² Relevantly, its discussion paper found that CGT was an influence over housing prices:¹⁰³

To the extent that currently low housing affordability reflects cyclical price pressures, this will eventually be reversed. (Evidence of market cooling is already emerging.) However, there is a role for policy to address any forces that cause prices to be excessive over time.

On the demand side, interactions within the taxation system between negative gearing, capital gains provisions and marginal income tax rates lend impetus to investment demand when prices are rising.

Additionally, Bassanese¹⁰⁴ observed that the preferential tax treatment for housing in Australia had caused great difficulty for new entrants to the housing market given the influx of investors buying housing. He observed,¹⁰⁵ 'Australia now has twice as many landlords among its taxpayers as North America, and six times as many as the United Kingdom, on a per capita basis'. Further, the lack of housing affordability appears to be a real problem given the high levels of homeless people¹⁰⁶ and high levels of people renting.¹⁰⁷

4 *Distributional Consequences*

There is no known distributional modelling for the impact of the CGT discount in Australia. However, the distributional consequences can be inferred from estimates of the concentration of Australian wealth noted above. Therefore, it appears that the CGT discount appears to be one of the contributing factors to Australia's growing inequality of income and wealth.¹⁰⁸ This is supported by a study by Saunders¹⁰⁹ who noted that

¹⁰² Australian Productivity Commission, 'First Home Ownership Key Points' 18 December 2003, <<http://www.pc.gov.au/inquiry/housing/draftreport/keypoints.html>>.

¹⁰³ Ibid.

¹⁰⁴ Bassanese above n 100, 17.

¹⁰⁵ Ibid.

¹⁰⁶ A Horin, 'Housing Boom, Economic Growth Fail Young Homeless' Sydney Morning Herald (Sydney) 19 November 2003.

<http://www.smh.com.au/articles/2003/11/18/1069027128076.html?from=storyrhs>

¹⁰⁷ Australian Bureau of Statistics, Australian Social Trends 2002

Housing - Housing Arrangements: Renter households

<<http://www.abs.gov.au/ausstats/abs@.nsf/0/9B2FD09ABCEB81B0CA256BCD00827312?Open&HighLight=0,renting>>.

See the statement: 'There were nearly 2.0 million renter households in Australia in 1999, representing a quarter of all households'.

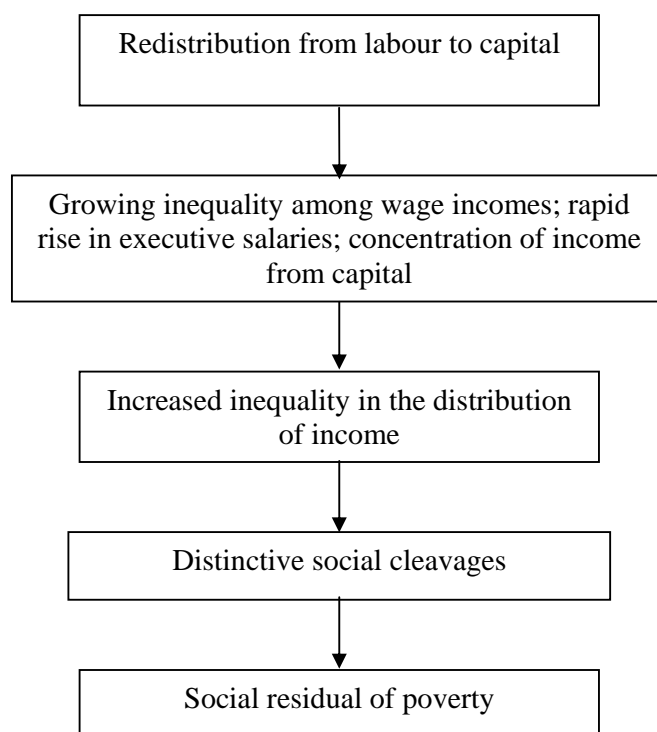
¹⁰⁸ Australian Council of Social Services, 'Tax Figures Show Growing Gap Between Rich and Poor' ACOSS INFO 202, 21 January 2000, <www.acoss.org.au/info/2000/info202.htm>. This paper cites United Nations data which shows that Australia is one of the most unequal of all developed countries, having slipped from 7th to 15th place on their index of human development. There are two million people in Australia living below the poverty line; F Stillwell, Economic Inequality, Who Gets What in Australia (1993) 17. Stillwell notes research at the Social Policy Research Centre at the University of New South Wales, in conjunction with the international 'Luxembourg study', found that compared to eight other comparable nations, Australia ranks third highest in terms of the proportion of income in the top 20per

‘taxes and transfers may have exacerbated the existing pressures on inequality, particularly in recent years’.

(a) Implications of Income Inequality

A growing divide between low income and high income households leads to unequal access to jobs, education, community services and justice.¹¹⁰ Further, this results in an increase in disharmony, social conflict and crime.¹¹¹ As Stillwell found, this trend resulted in the following network of interlocking socio economic inequalities.¹¹²

Figure 1
Network of interlocking socioeconomic inequalities



Additionally, a study by Bloomquist¹¹³ found a statistically significant correlation between income inequality and tax evasion consistent with behavioural and economic

cent of households. Also, Australia ranks third in terms of the proportion of income in the poorest 20 per cent of households. Consequently, Australia is among the most unequal of the countries studied.

¹⁰⁹ P Saunders, ‘Examining Recent Changes in Income Distribution in Australia’ (2003) Social Policy research Centre discussion paper No 130, October 2003, <http://www.sprc.unsw.edu.au/dp/DP130.pdf>, 16. Saunders found that the degree of inequality has grown faster in the mid-1990s and speculated that market forces created the growing inequality as well as tax and social welfare rules.

¹¹⁰ Stillwell above n 108, 25.

¹¹¹ Ibid.

¹¹² Ibid.

¹¹³ K M Bloomquist, ‘Income Inequality and Tax Evasion: A Synthesis’ (2003) winner of the OECD Jan Francke Tax Research Award <<http://www.oecd.org/dataoecd/51/26/2501390.pdf>>, 19–20.

theories of tax evasion. Thus Bloomquist concluded that a tax policy that widens income equality would also be likely to lead to greater levels of tax avoidance and evasion.¹¹⁴

5 International Tax Equity

It is a principle of international tax that there should not be any discrimination between capital gains accruing to residents and non-residents.¹¹⁵ Failing to tax capital gains though would contravene this principle and mean that Australia would not get its fair share of international CGT since most countries in the Organisation for Economic Cooperation and Development (OECD) tax capital gains.¹¹⁶ Such an exemption would mean that equity is breached between domestic investors investing in Australia and overseas. Domestic taxpayers investing in Australia will enjoy tax-free capital gains yet be taxed on foreign capital gains. Equity is also breached between foreign investors who invest in Australia because they would pay no CGT in Australia yet be subject to CGT in their country of residence.

With the great divergence in the way OECD countries tax capital gains,¹¹⁷ it is clear that the current Australian CGT rules would not always achieve international tax equity. However, the CGT discount may be justified on international equity grounds if other countries similarly discounted capital gains.

Notably, in 1999 (and prior to the CGT discount) Evans and Sandford made a comparison of CGT rates for selected countries including Australia.¹¹⁸ They found that Australia had the highest CGT rate of 48.5 per cent (including Medicare levy) compared to the maximum rate in the United Kingdom of 40 per cent, Canada and United States of America with maximum CGT rates of about 30 per cent, Ireland's 20 per cent flat tax rate and New Zealand's zero CGT rate.¹¹⁹

B Equity: The Case for a CGT Discount

A number of arguments are put forward for the preferential taxation of capital gains on equity grounds. Some of the concerns are based on the definition of 'equity' and the appropriateness of a comprehensive income tax base. Other arguments are based on the practical problems inherent in the operation of a CGT.

¹¹⁴ Ibid.

¹¹⁵ A G A Faria, 'Tax Coordination and Harmonisation' in P Shome (ed) *Tax Policy Handbook* (1995), 231.

¹¹⁶ Evans Taxing capital gains above n 36, 116. Notes the exception of New Zealand.

¹¹⁷ Review of Business Taxation, An International Perspective, Information Paper, December 1998 (1998), 81–82.

¹¹⁸ C Evans, C Sandford, 'CGT: the Unprincipled Tax' (1999) 5 *British Tax Review* 387, 394.

¹¹⁹ Ibid.

1 *What is Equity?*

The traditional view of horizontal and vertical equity is debated by commentators¹²⁰ who argue over the meaning of equity. The concept of vertical equity poses difficulties. How does a society agree on the level of taxes for taxpayers who have different abilities to pay? These difficulties are seen in the divergence of personal income tax rates between countries.¹²¹ Although most countries appear to embrace vertical equity by adopting progressive income tax rate structures, the ideal degree of vertical equity is highly contentious.¹²² The goal of horizontal equity, however, demands the taxation of capital gains and, as asserted previously,¹²³ this goal should not be negotiable.

2 *Bunching*

CGT causes bunching of a capital gain that has accrued over a period of time. Thus it is asserted that it is unfair to tax these gains in the one income year as this pushes a taxpayer into a higher tax bracket.¹²⁴ Bunching would appear to impact on many taxpayers given the number of taxpayers who receive capital gains and who have taxable incomes of less than \$62 500 in 2003–04 year.¹²⁵ Below \$62 500 of taxable income taxpayers face progressive marginal income tax rates. At \$62 500, the top marginal income tax rates cuts in and thus bunching is not a problem for taxpayers with taxable incomes over this level in the 2003–04 year.

As discussed previously, Australia's CGT originally provided averaging of capital gains for individuals to alleviate the problem of bunching,¹²⁶ but was removed for capital gains derived from 21 September 1999 with the introduction of the 1999 Ralph CGT reforms.¹²⁷

¹²⁰ Bradford above n 13, 148. Notes that 'identifying an improvement in tax equity is difficult because there is no single measure of fairness ...'; G S Cooper, 'The Benefit Theory of Taxation' (1994) 11 Australian Tax Forum 397, 410. Cooper states: 'Like all good ideas, the idea of equity is not a simple proposition but, rather, a complex idea capable of sustaining contradictory claims all alleged to be justified by it.'; H H Zee, 'Taxation and Equity' in P Shome (ed) *Tax Policy Handbook* (1995), 30–34.

¹²¹ See, for example, OECD, OECD Tax Database (2001) <<http://www.oecd.org/dataoecd/43/63/1942474.xls>>. This table shows that New Zealand's top marginal personal income tax rate is 39 per cent, whilst in Denmark the top marginal personal income tax rate is 63.3 per cent (including social security taxes).

¹²² Zee above n 120, 30–34. Zee notes the many problems of measuring vertical equity.

¹²³ See para 5.1.1.

¹²⁴ A Reynolds, 'Capital Gains Tax: Analysis of Reform Options for Australia' (1999). A study commissioned by the Australian Stock Exchange for the Review of Business Taxation, <http://www.asx.com.au/shareholder/13/MR160799_AS3.shtm>, 21.

¹²⁵ Australian Taxation Statistics 1999–2000 above n 7, 77. There were 596 995 individual taxpayers with taxable incomes below \$50 000 that received capital gains in 1999–2000.

¹²⁶ Income Tax Rates Act 1986 (Cth), s 12; Sch 7.

¹²⁷ Div 115.

The bunching argument flounders on the fact that capital gains constitute income in the same way as salary and wages form part of a person's ability to pay and should be taxed. In any event many taxpayers will not be greatly affected by bunching because most CGT is paid by taxpayers in the top marginal tax bracket.¹²⁸ A taxpayer in the top marginal tax bracket on a 48.5 per cent income tax rate will pay the same CGT liability regardless of whether the gains are incurred annually or whether a long-term capital gain is lumped into one tax year. Additionally, bunching will not have a great impact since the average net capital gain for individuals with taxable incomes below \$50 000 is only \$3073 in the 1999–2000 year.¹²⁹ Additionally, under Australia's CGT the bunching effect is offset by the benefit of CGT deferral until realisation.¹³⁰

3 Inflation

It is argued¹³¹ that the capital gain on an asset includes an inflation component and that CGT should not apply since this component of the gain is not a real gain. As noted previously, Australia's CGT initially featured a system of inflation indexation.¹³² However, following the introduction of the 1999 Ralph CGT reforms, indexation was restricted to assets acquired at or before 21 September 1999, with the indexation factor being frozen as at 30 September 1999.

There appear to be strong reasons for full indexation. If the tax system is not adjusted for inflation, reforms may not achieve their distributional goals. That is, the taxation and social security systems may not adequately achieve a redistribution of income from the wealthy to the poor.

For example, failing to index the income tax brackets for inflation will cause low and middle income taxpayers to be pushed into higher tax brackets as their incomes rise, even where there is no change in their real incomes. The 1975 Inflation and Taxation Report¹³³ recommended that personal tax indexation, via consumer price index be applied to the taxable income brackets and deduction limits. It found that low income large families were the most adversely effected by inflation.¹³⁴

Further, Jorgenson and Kun-Young modelled the effects of the United States *Tax Reform Act 1986* that broadened the income tax base and reduced tax rates, finding that much of the potential gain to welfare dissipated through the failure to index the income tax base for inflation.¹³⁵ They argued that the tax system should be indexed for

¹²⁸ Australian Taxation Statistics 1999–2000 above n 7, 77–78. Seven per cent of individual income taxpayers received capital gains in 1999–2000. Individuals with taxable incomes above \$50 000 paid 67 per cent of all CGT paid by individuals.

¹²⁹ Ibid 77–78. Also, note that only 7 per cent of individual income taxpayers received capital gains in 1999–2000.

¹³⁰ Section 104-10(1).

¹³¹ Reform of the Australian Taxation System above n 22, 79–80. This paper noted this argument.

¹³² Div 114.

¹³³ Report of Committee of Inquiry into Inflation and Taxation, *Inflation and taxation* (1975).

¹³⁴ Ibid.

¹³⁵ D W Jorgenson, and Y Kun-Young *Tax Reform and the Cost of Capital* (1991).

inflation otherwise welfare gains from tax reform will fail to materialise.¹³⁶ Additionally, Musgrave¹³⁷ asserted that an equitable concept of income must be in real terms.

However, inflation actually impacts more heavily on other types of capital income such as interest, rent and dividends over the course of a tax year than capital gains.¹³⁸ Given that these other types of income are taxed without any inflation adjustment, then the inflation component of capital gains should also be taxed since it would be highly inequitable to differentiate between taxpayers receiving different types of income.

4 Double Taxation

It is also argued¹³⁹ that CGT is unfair since it taxes the same asset twice thus capital gains should be exempted or concessionally taxed. As the value of an asset is equal to the discounted value of the expected future cash flow generated by the asset, then any capital appreciation must flow from an increase in the expected future cash flow.¹⁴⁰ This results in double taxation as the increased cash flow will be taxed when it is actually realised.¹⁴¹

This argument misses the point that there are two parts to economic income from a business or investment asset. The first is the income flow and the second is the increase in asset value. Both contribute to a taxpayer's ability to pay and should form part of the tax base, as seen in the following examples.

Example 4

A person X discovers a gold mine which has a 20-year life. If, instead of mining the gold, that person sells the mine to Y and pays CGT, in this situation there will be no double taxation. Person Y will amortise the cost of the purchase against mining income and/or the cost base and this will offset any capital gains on the subsequent sale of the mine by Y. There is no double taxation.

¹³⁶ Ibid.

¹³⁷ R A Musgrave, 'An Evaluation of the Report' (1967) 15 *Canadian Tax Journal* 349.

¹³⁸ Burman above n 78, 46.

¹³⁹ Reynolds above n 124, 8; M David, *Alternative Approaches to Capital Gains Taxation* (1968), 55–57. David expressed this argument by reference to rate of return formulas. He found though that the change in present value of an asset should be subject to CGT since the change generally responds to some value added to the original asset value by the owner or his or her agents. Even if the appreciation is a true windfall gain, there is no double taxation since upon sale the buyer obtains a real yield and amortises the cost base.

¹⁴⁰ Ibid.

¹⁴¹ Ibid.

Example 5

Alternatively, if the asset is a share in a public company with an indefinite life, the result is the same. Person V sells the share to W, and instead of receiving dividends, V pays CGT. There will not be any double taxation for W since W includes the cost of the share purchase against sales proceeds of the share thus offsetting the capital gain.

Krever points out that the double tax argument is based on the following unrealistic assumptions:¹⁴²

- (1) that the purchaser gets no stepped up cost basis on sale;
- (2) that the future earnings of an asset can be determined with certainty;
- (3) that all sellers and the purchasers of assets pay tax at the same rates;
- (4) that changes in the value of an asset are never due to changes in the discount rate;
- (5) that all assets offer explicit and taxable flows of income; and
- (6) that all markets are perfect.

Overall, this argument does not appear to be valid in Australia since the purchase price of an asset would generally be included in the asset's cost base.¹⁴³

5 Capital Gains are Unexpected

Since the Courts have generally maintained that capital gains are not ordinary income, being unexpected, non-recurring and unlike gains that flow from productive effort, it has been suggested that they should not be taxed or should be concessionally taxed.¹⁴⁴ It is submitted that there is no basis though for formulating taxation policy on the basis of taxpayer expectations rather than on a taxpayer's ability to pay. If unexpected gains are exempt this will only lead to the artificial creation of many such unexpected gains by taxpayers. Further, this argument simply does not apply to modern investment practices which well anticipate appreciation in the value of assets such as marketable securities and real estate. Alternatively, it could be argued that unexpected capital gains should be taxed more heavily, since the gains are unexpected, the tax will not be missed.

It is also argued that introducing or modifying CGT is unfair to those people who have purchased assets on the understanding that the current CGT provisions would not change.¹⁴⁵ However, other taxpayers who do not obtain such tax preferences end up paying higher taxes in order to make up the lost tax revenue. This is obviously more unfair. Thus this argument does not carry much weight.

¹⁴² Krever Brooks above n 12, 58.

¹⁴³ Section 110-25.

¹⁴⁴ Cunningham Schenk above n 14, 325.

¹⁴⁵ Krever Brooks above n 12, 59-60.

6 *Deductibility of Losses*

To minimise the risk to tax revenue from the manipulation of capital losses by strategic trading, a CGT must limit the deductibility of capital losses to capital gains, rather than other income.¹⁴⁶ Thus the Australian CGT regime restricts capital losses —such losses can only be offset against capital gains.¹⁴⁷ It is argued that this is unfair as capital gains are included in assessable income but there is only limited tax relief for capital losses.¹⁴⁸ On this basis capital gains should be exempted or concessionally taxed.

Indeed this restriction means that undiversified investors may pay substantial tax if their investment prospers yet they may obtain no benefit for failures.¹⁴⁹ This unfairness though is offset to some extent by the benefit of deferral of tax on capital gains provided by a realisation CGT.¹⁵⁰ The CGT discount, however, reduces the value of capital losses where such losses have to be offset against capital gains on assets that qualify for the CGT discount.¹⁵¹ In this situation an individual taxpayer having capital losses will only obtain benefit of 50 per cent of the capital losses being offset against capital gains. Thus the CGT discount reduces the value of deductible losses.

C *Conclusion: CGT Discount and Equity*

It is clear that the current CGT discount breaches both horizontal and vertical equity. The available evidence suggests that this exemption greatly undermines tax integrity and the redistribution goal of income taxation. The arguments for the CGT exemptions lack merit. However, the reforms to remove CGT averaging and to freeze indexation are welcomed as these have provided some assistance to horizontal and vertical equity.

¹⁴⁶ Reynolds above n 124, 9; virtually all countries restrict the deductibility of capital losses under realisation.

¹⁴⁷ Section 102-10(1).

¹⁴⁸ Burman above n 78, 6.

¹⁴⁹ Ibid 11.

¹⁵⁰ A J Auerbach, L E Burman, and J M Siegel, 'Capital Gains Taxation and Tax Avoidance: New Evidence From Panel Data', paper presented at a conference sponsored by University of Michigan office of tax policy research, October 24–25 1997 <www.urban.org/tax/capg11.html>, 129.

¹⁵¹ Section 102-5(1). Note, this restriction does not apply for CGT assets that do not qualify for the CGT discount, ie, indexed capital gains.

VI ECONOMIC EFFICIENCY

*A Arguments Against the CGT Discount**1 Improves Neutrality*

There is widespread support in Australia for tax policies that have a neutral impact on economic behaviour. All of the recent Australian income tax inquiries, the Asprey Report,¹⁵² the Draft White Paper¹⁵³ and the Ralph Report,¹⁵⁴ agreed, at least conceptually, on the neutrality advantages of a comprehensive income tax base. Relevantly, under this tax base all forms of income should be taxed similarly. In particular, since capital gains are a form of capital income, they should be taxed in similar manner to other types of capital income such as interest, dividends and rent, and this would allow capital to achieve the highest possible rate of return. To exempt or lightly tax capital gains will lead to a misallocation of capital.¹⁵⁵

(a) Taxation of Australian Capital Income

The following analysis of capital gains and other types of capital income seeks to demonstrate the economic impact of tax preferences such as the CGT discount in Australia's CGT regime. Reported capital income from Australian taxpayers for the 1999–2000 year is set out in the following table.

Table 4
Reported capital income in Australia 1999– 2000

Type of capital income	Assessable income \$ billion	Percentage
Gross dividends	7.6	40
Realised net capital gains	5.9	31
Gross interest	5.4	28
Net rent	0.2	1
Total	30.4	100

Dividends provide the greatest source of savings returns followed closely by net capital gains and gross interest. Notably, rent provides little reported net return, a mere \$220 million.¹⁵⁶

¹⁵² Taxation Review Committee above n 21, 414.

¹⁵³ Reform of the Australian Taxation System above n 22, 78.

¹⁵⁴ Review of Business Taxation Report above n 1, 112.

¹⁵⁵ Sandford et al Taxation and social policy above n 97, 164; A J Auerbach, *The Taxation of Capital Income* 1983, 9. Auerbach states:

One point that is commonly made is that the introduction of a differential tax on capital income from different sources is deleterious to social welfare because it induces inefficiency in production arising out of a misallocation of capital.

¹⁵⁶ Warren above n 99, 7, notes that gross rental income was \$11.5 billion in 1999/2000. He notes the investment advantages of appreciating investment property, the immediate deductions for expenses

A complex picture emerges on the taxation of Australian capital income given the myriad of tax rules, income tax rates¹⁵⁷ and CGT exemptions that apply to the various types of taxpayers: individuals, trusts, companies and superannuation funds. Within the limits of this paper a full analysis of these differences is not possible. Rather, the paper focuses on the enacted Ralph Report CGT discount.

Interest, dividends and rent are included in a taxpayer's assessable income¹⁵⁸ and taxed annually at the taxpayers' marginal rate of income tax. However, a CGT discount¹⁵⁹ applies to the CGT rate for individuals, trusts and superannuation funds. The following examples illustrate the tax advantages for capital gains.

(i) A Simple Comparison of Capital Gains and Interest Income

At the top marginal income tax rate of 48.5 per cent, \$100 of annual interest income from bonds will generate income tax of \$48.50. A capital gain on an asset held by an individual for a year or more will be taxed at the discounted CGT rate of 50 per cent. This equates to income tax of only \$24.25 (50 per cent of \$48.50). Under this simple analysis, and ignoring other factors, taxpayers would prefer capital gains from income, given the lower tax rates. Thus other assets such as interest bearing deposits would need to produce higher rates of return to attract capital.

(ii) Effective Tax Rates, Inflation and CGT Deferral

The above analysis though ignores inflation, CGT deferral and differences in asset characteristics that also impact on the asset holding decision.¹⁶⁰ As is evident from the example in Table 5 below, a capital appreciating asset is subject to an even lower effective tax rate¹⁶¹ than a bond in the presence of inflation since the tax is deferred until realisation. Indeed the higher the inflation rate the greater the difference between the effective tax rates for bonds and appreciating assets.¹⁶² Inflation affects capital gains less than interest, dividends and rent.¹⁶³ Thus, as noted previously,¹⁶⁴ there exists a strong case for indexing income and expenses.¹⁶⁵

including interest and the benefit of a 50 per cent CGT discount on any capital gain. This helps explain the prevalence of negative gearing and the low rental returns.

¹⁵⁷ For example, an individual in the 2003–04 tax year has a top marginal income tax rate of 48.5 per cent (including Medicare levy), yet companies are only taxed at 30 per cent and superannuation funds are taxed at 15 per cent.

¹⁵⁸ Interest and rent are included as assessable income per s 6-5 ITAA 1997. Dividends are included as assessable under s 44(1) ITAA 1936. Franking credits for dividends are included as assessable income under s 160AQT.

¹⁵⁹ Div 115 ITAA 1997.

¹⁶⁰ Burman above n 78, 44.

¹⁶¹ Ibid 43–44 provides a measure of the effective tax rate as the difference between the rates of return before and after all individual income tax expressed as a percentage of the before tax return.

¹⁶² Ibid 46.

¹⁶³ Ibid.

¹⁶⁴ See para 5.2.3.

¹⁶⁵ Note that such a policy would be radical given that the income tax system is not indexed for inflation. Thus this issue is outside the scope of this paper.

The following table compares two investments held by an individual taxpayer at the top marginal income tax rate of 48.5 per cent. The taxpayer has \$100 of bonds yielding 10 per cent per annum over five years and \$100 of capital-appreciating shares paying no dividends but yielding 10 per cent per annum constant growth over five years. All of the net yield from the bonds and shares are reinvested and both investments are realised after five years.

Table 5
The benefit of CGT deferral and CGT discount:
A comparison of reinvested bonds and growth shares

Year	Bond \$	Yield \$	48.5% Tax \$	Shares \$	Yield \$	48.5% Tax \$
0	100			100		
1	105.2	10	4.9	110	10.0	
2	110.6	10.5	5.1	121.0	11.0	
3	116.3	11.1	5.4	133.1	12.1	
4	122.2	11.6	5.6	146.4	13.3	
5	128.3	12.2	5.9	161.1	14.6	14.8
Net value After tax	128.5			146.2		

With the after tax yield reinvested, the bonds will be worth \$128 and shares \$146 at the end of five years. The shares will have a capital gain of \$61 and CGT of \$14.80.¹⁶⁶ Thus the after tax value of the shares is 13.8 per cent more than the bonds' value. This difference of \$17.70 arises from the benefit of the CGT discount (\$14.80) and the greater compounding of asset growth due to the deferral of CGT (\$2.90).

Introducing a 4 per cent inflation rate into the above example, the bonds and shares both provide a real pre tax return of 5.77 per cent.¹⁶⁷ The real after tax return on the bond though is 1.6 per cent¹⁶⁸ and for the shares it is 3.75 per cent.¹⁶⁹ The effective tax rate is the percentage of reduction in the real annual return from an asset caused by taxes.¹⁷⁰ For bonds the effective tax rate is 100 per cent¹⁷¹ and for the shares it is 62 per cent.¹⁷² This reflects the higher tax rate on bonds and the benefit of deferral on shares. Moreover, the longer the holding period the larger the benefit of deferral.

¹⁶⁶ CGT = net capital gain \$61 x 48.5 per cent x 50 per cent CGT discount = \$14.80

¹⁶⁷ Burman above n 78, 47. $1 + \text{real return} = 1 + \text{nominal return} / 1 + \text{inflation rate}$; $(1.10/1.04 = 1.0577)$

¹⁶⁸ Bonds annualised after tax return over 5 years is 5.1 per cent, thus the after tax real return is 1.1 per cent $(1.051/1.04 = 1.011)$

¹⁶⁹ Shares annualised after tax return over 5 years is 7.9 per cent, thus the after tax real return is 3.75 per cent $(1.079/1.04 = 1.0375)$

¹⁷⁰ Burman above n 78, 47.

¹⁷¹ Ibid. The effective tax rate = $(\text{real pretax return} - \text{real after tax return}) / \text{real pretax return}$; $(0.10 - 0.011)/0.1 = 100$ per cent.

¹⁷² $(0.10 - 0.0375)/0.1 = 62$ per cent.

(iii) Summary

Overall, taxing capital gains at normal tax rates minimises the discrepancies between the taxation of the types of capital income. A realisation CGT though still distorts decisions given the advantage of deferral and the impact of inflation. However, an annual accruals CGT has other problems.¹⁷³ Further, indexation should only be applied to capital gains if it is also extended to the entire income tax system. Introducing a CGT discount further exacerbates the differences. Financial markets and taxpayers are very adept in exploring such preferences as seen by Australia's CGT experience, discussed previously.¹⁷⁴

(b) Australian Evidence of the Misallocation of Resources from CGT Preferences

Prior to September 1985, Australia generally excluded capital gains from income tax. Numerous commentators noted the significant economic costs of such a policy. Head¹⁷⁵ outlined the distortions caused by Australia's selective tax concessions for retirement savings, imputed rent and capital gains. He found that far from promoting growth, these provisions have only served to produce an extremely conservative pattern of saving and investment unsuited to the requirements of a dynamic and growing economy.¹⁷⁶ Groenewegen¹⁷⁷ similarly noted the economic distortions stemming from the failure to tax capital gains. Dixon¹⁷⁸ also concluded that the gross misdirection of resources into property with low yields and tax avoidance schemes in the late 1970s would not have occurred if a CGT had been in place in Australia.

Additionally, Freebairn¹⁷⁹ asserted that failing to tax capital gains penalises investment in risky ventures and favours large conglomerates over small enterprises. Krever¹⁸⁰ noted that the seventy years experience in Australia of exempting CGT suggested that CGT exemptions are an inefficient tool for directing investment towards entrepreneurial activities. Rather it leads to low risk investment in real estate or blue chip shares.¹⁸¹ Further, Krever noted that a CGT preference extends beyond productive

¹⁷³ As commentators have noted, an accruals CGT has liquidity and valuation problems that pose serious equity and complexity issues, and thus is not advocated in this paper. See, J Alworth, A Giampaolo, R Hamai, 'What's Come to Perfection Perishes: Adjusting Capital Gains Taxation in Italy' 2003 LVL 1(2) *National Tax Journal* 197.

¹⁷⁴ See para 5.1.2.2.

¹⁷⁵ J G Head, 'Capital Gains Taxation – An economist's Perspective' (1984) 1(2) *Australian Tax Forum* 148, 150–51.

¹⁷⁶ Ibid.

¹⁷⁷ P Groenewegen, 'Taxation of Capital and Capital Gains: Reflections on Objectives and Potential Instruments', paper presented at the CEDA and Australian Tax Research Foundation Seminar, 1 May 1985, 15.

¹⁷⁸ D Dixon, 'Capital Gains and Income Tax Design Alternatives' (1984) 1(2) *Australian Tax Forum* 185, 186.

¹⁷⁹ J Freebairn, 'Microeconomic Reform and Tax Simplification' (1993) 10 *Australian Tax Forum* 461, 469.

¹⁸⁰ R Krever, 'The Continuing Debate Over Capital Gains Tax' in S Ross, P Burgess, *Income Tax: A Critical Analysis* (2nd ed, 1996), 67–68.

¹⁸¹ Ibid.

Australian assets to foreign shares, real estate and Australian holiday homes.¹⁸² These arguments would similarly be relevant to a partial exemption such as the CGT discount.

Following the commencement of CGT in 1985, the introduction of the CGT discount in 1999 imposed certain economic distortions. As noted previously,¹⁸³ this policy has contributed to an over investment in housing. Warren asserted that the CGT discount and other property tax concessions have resulted in the Australian economy's over reliance on the property sector for economic growth (given the strong multiplier effect of the building boom) and have led to a property price bubble.¹⁸⁴ This creates further economic problems since a policy change that removes the capitalised value of tax concessions would in turn damage the building industry, lead to loan defaults and lower consumer confidence.¹⁸⁵ Also, the RBA's Deputy Governor, Glenn Stevens¹⁸⁶ warned that the housing boom was a threat to the durability of Australia's long economic upswing.¹⁸⁷

(c) International Evidence of the Misallocation of Resources from CGT Preferences

Sandford¹⁸⁸ noted that the 1960s and 1970s saw burgeoning government expenditures and increasing government intervention in many countries, based on over-optimistic assumptions of how the government could influence society and the economy for the better. Concerns over the economic and social costs from the tax distortions flowing from these interventionist policies heralded a worldwide change in economic philosophy in the 1980s.¹⁸⁹ This philosophy saw a revival of belief in the efficacy of markets and the need for tax neutrality.¹⁹⁰ Countries pushed back the role of the state's influence in the economy and deregulated, freed exchange rates, privatised, promoted competition and improved the efficiency of the public sector.¹⁹¹ Sandford found that this not only greatly affected the capitalist world but also 'undermined the socialist planned economies'.¹⁹² This movement illustrates the widespread support for neutral tax policies and suggests the acceptance of the goals of comprehensive income taxation, and the full taxation of capital gains.

¹⁸² Ibid.

¹⁸³ See para 5.1.3.

¹⁸⁴ Warren above n 99, 7.

¹⁸⁵ Ibid.

¹⁸⁶ HSBC Bank, 'RBA's Stevens Warns on Housing' 14 October 2002, <http://download.hsbc.com.au/markets/ausen/rba_stevens_14oct02.pdf>.

¹⁸⁷ Ibid.

¹⁸⁸ C Sandford, 'Tax Reform of the Eighties in Retrospect: What Can We Learn?' in C Sandford (ed), *Further Key Issues in Tax Reform* (1998) 206.

¹⁸⁹ Ibid.

¹⁹⁰ Ibid.

¹⁹¹ Ibid.

¹⁹² Ibid.

(i) *United States*

A number of United States analysts have noted economic distortions created by CGT preferences. McGee¹⁹³ concluded that a CGT rate cut is nearly always more beneficial to the existing firm than the new start-ups. In many cases the cut will decrease new firm investment.¹⁹⁴ McIntyre et al¹⁹⁵ found that a CGT preference is incoherent and will remain that way until Congress defines the scope of the preference and matches it to a public policy.

McIntyre et al queried why a CGT preference should encourage a hoarder of gold coins or a passive real estate investor.¹⁹⁶ Gordon and Slemrod's¹⁹⁷ analysis of 1983 income tax returns suggested that moving to uniform tax rates on real capital income would raise revenue and improve efficiency.

(ii) *United Kingdom*

Kay and King¹⁹⁸ reviewed the impact of the United Kingdom income tax laws finding that they have a great impact on household portfolios. Over the last 25 years the proportion of personal wealth held in the form of privileged assets such as houses, life insurance policies and pension funds, rose from 29 per cent to 64 per cent.¹⁹⁹ Over the same period the personal holdings of shares and marketable securities fell by almost 75 per cent.²⁰⁰ Thus they concluded that preferential tax treatment for gains made from certain assets has had a major impact on the allocation of resources.²⁰¹

Sandford²⁰² found that tax concessions to house owners raised the value of homes, providing capital gains to owners, but reduced the capacity of would-be purchasers. Also, concessions given to housing, life insurance and pensions in the United Kingdom divert savings to safe investments rather than riskier and innovative investments.²⁰³ He asserted that this provides the strongest argument for neutrality, via a progressive consumption tax or a comprehensive income tax.²⁰⁴

¹⁹³ M K McGee, 'Capital Gains and New Firm Investment' (1998) LI(3) *National Tax Journal* 653, 654.

¹⁹⁴ Ibid.

¹⁹⁵ M McIntyre, F E A Sander, D Westall editorial comment in M McIntyre, F E A Sander, D Westall (eds) *Readings in Federal Taxation*, (2nd ed, 1983) 400.

¹⁹⁶ Ibid.

¹⁹⁷ R H Gordon, J Slemrod, 'Do We Collect any Revenue From Taxing Capital Income?' in J Poterba (ed) *Tax Policy and the Economy* Vol 2 (1988), 89–130.

¹⁹⁸ J A Kay, M A King, *The British Tax System* (1990), 105.

¹⁹⁹ Ibid.

²⁰⁰ Ibid.

²⁰¹ Ibid.

²⁰² Sandford et al Taxation and social policy above n 97, 4–5.

²⁰³ Ibid.

²⁰⁴ Ibid.

(iii) South Africa

The South Africa Department of Finance²⁰⁵ noted the many distortions created in the economy from the failure to tax capital gains as one of the primary reasons for the introduction of CGT in 2001.

(iv) Sweden

In 1991 the Swedish government undertook massive policy changes in its 'tax reform of the century'.²⁰⁶ The government reduced the income tax rates resulting in a revenue loss to the government of 6 per cent of gross domestic product.²⁰⁷ In return for these massive tax cuts the government broadened the tax base with a new system of taxing capital income and by broadening the value added tax and eliminating other loopholes.²⁰⁸ Auerbach reviewed the economic literature on the impact of the Swedish tax reforms and found that these reforms reduced tax planning, induced a shift away from owner-occupied housing and improved economic efficiency.²⁰⁹ He concluded that these reforms had a positive albeit modest impact. He asserted:²¹⁰

Agell, Englund and Sodersten conclude that Sweden which started with a very complex tax structure and high marginal tax rates, improved economic efficiency through its reform aimed at simplification and base broadening. But they also found that the changes in real behaviour, such as saving and labor supply, were modest, and the transaction costs considerable. Thus, the reform was beneficial, particularly with Sweden's initial tax system, but not the panacea some might have predicted. Engen and Skinner conclude that tax policy can impact at least short run economic growth by enough to make an important difference in a country's standard of living.

[T]he economic effects of policies are difficult to evaluate; long run effects are the most difficult. Engen and Skinner conclude, for example, that we really do not know the extent to which tax policy can change long run growth.

2 Reduces Tax Avoidance and Tax Minimisation

As set out previously,²¹¹ Australia's pre-CGT experience provides much evidence of high levels of tax arbitrage and avoidance emanating from a CGT preference such as the CGT discount. Thus taxing capital gains at ordinary income tax rates would promote efficiency since it helps stem wasted resources on tax avoidance and evasion.

²⁰⁵ South African Department of Finance 'Guide to Capital Gains Tax' <www.sars.gov.za>, 4.

²⁰⁶ J Agell, P Englund, J Sodersten, 'Tax Reform of the Century – the Swedish Experiment' (1996) 49 *National Tax Journal* 643, 643.

²⁰⁷ Ibid.

²⁰⁸ Ibid.

²⁰⁹ A J Auerbach, 'Measuring the impact of tax reform' (1996) XLIZ *National Tax Journal* 665, 671–72.

²¹⁰ Ibid.

²¹¹ See para 5.1.2.2.

3 *Deductibility of Losses*

Under the CGT discount capital gains are not fully included as assessable income and thus capital losses are not generally fully deductible. If such losses were deductible against capital gains this would provide a greater incentive for people to save, invest, take risks and be entrepreneurial, as the government shares in the risk of such saving and investing.²¹² For example, a taxpayer in the top marginal tax rate of 48.5 per cent will virtually split the risk of investing in an asset subject to CGT with the government where capital losses are fully deductible against other capital gains. Removing the CGT discount permits greater deductibility of losses.

4 *Builds Social Capital*

A case for fully taxing capital gains can also be made on the grounds that it builds the social capital²¹³ of a society and thus enhances economic growth. Slemrod²¹⁴ argued that a society has a stock of social capital and that trusting societies tend to have stronger incentives to innovate and accumulate both physical and human capital. Knack and Keefer²¹⁵ tested the impact of these attitudes on the growth and investment rates of 29 countries, using a measure of trust and civil norms from world surveys in 1981 and 1990–91. They found that social capital variables exhibit a strong and significant positive relationship to economic growth.²¹⁶ Trust is more correlated with per capita income in later years than early years showing that causation runs from trust to growth.²¹⁷ Also, Hjerppe's²¹⁸ survey of the literature found a close correlation between high levels of social capital and economic success. This also ties in to an extent with the Australian Productivity Commission's²¹⁹ analysis of underlying influences on economic growth.

Slemrod²²⁰ also found social capital possibly explained the most striking puzzle of public finance, the positive association with a country's tax to GDP ratio and its level

²¹² Burman above n 78, 151.

²¹³ E M Uslaner, 'Democracy and Social Capital' in M E Warren (ed) *Democracy and Trust* (1999), 122. Social capital refers to 'features of social organization, such as core values and norms (including social trust) and networks, that facilitate coordination and cooperation for mutual benefit.'

²¹⁴ J Slemrod, 'On Voluntary Compliance, Voluntary Taxes and Social Capital' (1998) *LI National Tax Journal* 485, 485.

²¹⁵ S Knack, P Keefer, 'Does Social Capital Have an Economic Payoff? A Cross Country Investigation' (1997) 112 *Quarterly Journal of Economics* 1251, 1251.

²¹⁶ *Ibid.*

²¹⁷ *Ibid.*

²¹⁸ R Hjerppe 'Social Capital and Economic Growth' from the Government for Institute of Economic Research Finland, presented at the International Conference on Social Capital, Tokyo 24–25 March 2003, <<http://www.esri.go.jp/en/workshop/030325/030325paper2-e.pdf>>, 20.

²¹⁹ Australian Productivity Commission, Research Paper 'Microeconomic reforms and Australian Productivity: Exploring the Links' 12 November 1999, Volume 1, <<http://www.pc.gov.au>>, 160. The Australian Productivity Commission reviewed international studies into national wealth, finding that the most important determinants of wealth were policy, openness to trade, rule of law, quality of institutions, geography, resource endowments and human capital. Interestingly taxation and the level of savings and investment were not directly highlighted.

²²⁰ *Ibid* 487–88.

of affluence. He surmises that a high level of social capital and rule obedience contributes to affluence and facilitates a higher level of government activity than otherwise.²²¹ He acknowledges other explanations for this puzzle; that is, rising income and urbanisation engender a greater demand for government services.²²² He further notes that affluence is associated with demographic factors such as literacy and non-agricultural market activity and that these also require more government services.²²³ This suggests that higher levels of tax revenue would raise social capital.

Relevantly, a policy change lowers social capital if it reduces the incentive to be a good citizen or fails to increase the cost of not being one.²²⁴ Thus, 'voluntary'²²⁵ taxes, such as Australia's realisation CGT are risks to social capital. This tax is very ineffective as seen by the significant level of CGT exemptions such as the CGT discount.²²⁶ Additionally the risk of tax audit is low.²²⁷

Given Australia's extensive history of tax avoidance and loophole ridden tax legislation,²²⁸ one may surmise that the stock of social capital has dissipated. This is evident from an ATO survey of taxpayers' attitudes to income tax.²²⁹ The ATO refused to release the results claiming that it would not be in the public interest to do so,²³⁰ implying a very negative public attitude to income taxation, which lowers social capital.

5 Capital Gains Tax Lowers Income Tax Rates

As discussed previously, Australia's CGT only produces modest levels of tax revenue, but CGT plays a greater role in that it prevents leakage from income tax. However, it is clear that taxing capital gains at normal tax rates would produce significantly greater levels of tax revenue.²³¹ This would permit a reduction to income tax rates. As the following analysis suggests lower income tax rates may aid economic growth.

The following commentators have noted the positive economic effects of income tax base broadening and lowering personal income taxes. The International Monetary Fund (IMF)²³² recommended reduction of the income tax rate graduations and broadening of the tax base by limiting deductions, exemptions, and other tax

²²¹ Ibid.

²²² Ibid.

²²³ Ibid.

²²⁴ Above n 214, Slemrod, On voluntary compliance above n 214, 485.

²²⁵ A voluntary tax refers to a tax that has no withholding taxes. The taxpayer voluntarily declares the tax liability to the tax administrator. Under the self-assessment system of income tax, CGT is voluntary since it requires a taxpayer to record all net capital gains in their annual income tax return.

²²⁶ See para 2.1.2.

²²⁷ Unattributed, 'CGT – An Issue That Never Dies' (1955) 3(3) *Canadian Tax Journal* 164, 166.

²²⁸ See Table 2.

²²⁹ Unattributed, 'Taxpayer Survey' Adelaide, *The Advertiser* (Adelaide) 9 January 2001, 7.

²³⁰ Ibid.

²³¹ See Table 2.

²³² J Stotsku, 'Summary of IMF Tax Policy Advice' in P Shome (ed) *Tax Policy Handbook* (1995) 281.

preferences. Additionally, Tanzi²³³ undertook an international comparison of individual income tax and economic growth, finding that a highly progressive income tax with many exemptions is highly detrimental to economic growth.

Indeed such a policy generally falls in line with international tax reform trends. Sandford²³⁴ illustrates this worldwide reduction of personal income tax rates made possible by the base broadening of the 1980s and beyond in the following table.

Table 6
Top rates of central government personal income tax for 1976, 1986 and January 1992 for selected OECD countries

Country	Top tax rates per cent			Reduction percentage points
	1976	1986	1992	1992 minus 1976
Australia	65	57	48	17
Austria	62	62	50	12
Canada (a)	43	34	29	14
Finland (a)	51	51	39	12
France	60	65	57	3
Germany	56	56	53	3
Ireland	77	58	52 (d)	25
Italy	72	62	50	22
Japan (a)	75	70	50	25
Netherlands (b)	72	72	60	12
New Zealand	60	57	33	27
Norway (a)	48	40	13	35
Sweden (a)	57	50	20	37
United Kingdom (c)	83	60	40	43
United States	70	50	31	39
Unweighted average	63.4	56.3	41.7	21.7

Notes

- (a) Countries with income tax at lower levels of government, typical rates for 1992 being flat: Canada 17, Finland 16, Norway 28, Sweden 31; progressive: Japan 5 to 14, United States 2 to 14.
- (b) 1976 and 1986 figures refer to personal income tax only; 1992 includes social security contributions now levied on same basis as income tax.
- (c) In 1976 only, an additional 15 percentage points for investment income above a threshold.
- (d) Reduced to 48 per cent in the 1992 Budget.
- Source: OECD various.

²³³ Tanzi above n 71. 123–26.

²³⁴ Sandford 'Why tax systems differ' above n 95, 159.

However, more recently there has been an upward movement of marginal individual income tax rates. In 2001 the top individual marginal income tax rate of 48.5 per cent in Australia was comparable to the top marginal income tax rates in other OECD countries.²³⁵

Additionally, the following evidence suggests that a lower income tax rate from such base broadening may stimulate labour and human capital and thus aid economic growth. The Australian Productivity Commission²³⁶ highlighted the importance of human capital to economic growth. The Commission found that a society's level of human capital had a close and tangible link with economic growth, along with other factors.²³⁷

Furthermore, Boyer and Russell²³⁸ found that human capital is the most important determinant of wealth and income for most individuals—that is salary and wage earners.²³⁹ Yet they noted that most income tax analysis usually focuses on physical capital and labour supply.²⁴⁰ They asserted that in today's knowledge-based economy the fundamental ingredients of growth are people and brain power.²⁴¹ The manufacturing economy is becoming less and less important.²⁴² Thus they question the provision of investment benefits in plant and equipment.²⁴³ On this basis, it appears that income tax rates for labour should be reduced to stimulate labour and human capital and thus aid economic growth.

There has been little research though on the influence of taxation on human capital. Heckman et al²⁴⁴ examined the impact of a switch from income to consumption taxation that exempts capital gains. They found that a consumption tax will be more pro capital but less favourable to human capital as it reduces the aggregate stock of human capital and the stock of human capital per worker for each skill group.²⁴⁵

²³⁵ OECD, 'OECD Tax Database' (2001) <<http://www.oecd.org/dataoecd/43/63/1942474.xls>>. On average the top marginal income tax rate for labour income for 30 OECD countries was 50.1 per cent in 2001. This rate included marginal personal income tax and social security contribution rates.

²³⁶ Australian Productivity Commission above n 219, 51.

²³⁷ Ibid 54. Other factors were: technological advances, physical capital, firm organization, management practices and work arrangements, resource allocation, scale scope and specialisation, and plant – firm turnover within industries.

²³⁸ D J Boyer, S M Russell 'Is it Time for a Consumption Tax?' National Tax Association Symposium, A new Agenda—Old Constraints, Arlington, VA, 363, 364;

OECD, 'OECD Survey: Poland' (2000) <www.oecd.org>.

²³⁹ Ibid.

²⁴⁰ Ibid.

²⁴¹ Ibid.

²⁴² Ibid.

²⁴³ Ibid; OECD, 'OECD in Figures: Statistics on Member Countries' (2000) <www.oecd.org>, 87. Australia's spending in investment in knowledge, that is public spending on education, research and development expenditure and software, of 6.7 per cent of GDP ranks below the OECD average of 8 per cent of GDP, implying a need for a greater focus on human capital.

²⁴⁴ J J Heckman, L Lochner, C Taber, 'Tax Policy and Human Capital Formation' (1998) 88 *The American Economic Review* 293, 297.

²⁴⁵ Ibid.

Judd²⁴⁶ analysed optimal taxation in a dynamic model with human capital, finding that consumption tax proposals are biased against human capital as they deny expenses for human capital investments. This bias to physical capital breaches the neutrality goal of consumption taxes.²⁴⁷ Judd also noted that human capital might have a greater return than comparable financial assets.²⁴⁸ Education means that the risk of unemployment is low thus the price of risk attached to human capital is smaller than corporate equity.²⁴⁹ Judd found, though, that there is little empirical evidence about the critical determinants for the theory of optimal taxation of human capital.²⁵⁰

However, there is considerable research on the impact on labour caused by tax rate changes. The responsiveness of labour to tax changes is known as the intratemporal elasticity of substitution.²⁵¹ If a CGT preference leads to a tax increase for wage income and after tax wages are decreased, people may either increase or decrease the labour supply.²⁵² A lower income may lead to consuming less leisure and supplying more labour. This is known as the income effect.²⁵³ This effect is offset, however, by lower wages making leisure cheaper.²⁵⁴ The latter is known as the substitution effect.²⁵⁵ This is defined as the desired ratio of goods to leisure changes in response to a change in the ratio of wages to the price of goods at a particular age, compensating for the income effect of the wage change.²⁵⁶ A large value implies that a decrease in after tax wages from a higher tax rate will lead to a large decrease in labour supply, and thus lower economic efficiency.²⁵⁷

The research suggests that this responsiveness does not have a significant impact on the economy. Randolph and Rogers²⁵⁸ and Gravelle²⁵⁹ reviewed the empirical evidence on labour responses and found that the labour supply response, too, is probably small. Also, Goolsbee²⁶⁰ examined the responsiveness of taxable income to tax rate changes using data on several thousand corporate executives from 1991–95. The higher tax rates of 1993 led to a short run decline in taxable income since the responses came almost entirely from a large increase in exercise of stock options in anticipation of rate

²⁴⁶ K L Judd, 'Taxes, Uncertainty and Human Capital' (1998) 88 *The American Economic Review* 289, 289.

²⁴⁷ Ibid.

²⁴⁸ Ibid.

²⁴⁹ Ibid.

²⁵⁰ Ibid.

²⁵¹ W C Randolph, D L Rogers, 'The Implications for Tax Policy of Uncertainty about Labor-Supply and Savings Responses' (1995) 48 *National Tax Journal* 429, 431.

²⁵² Ibid.

²⁵³ Ibid.

²⁵⁴ Ibid.

²⁵⁵ Ibid.

²⁵⁶ Ibid.

²⁵⁷ Ibid.

²⁵⁸ Ibid 438.

²⁵⁹ J G Gravelle, 'Behavioural Feedback Effects and the Revenue Estimating Process' (1995) National Tax Association Symposium, A New Agenda—Old Constraints, Darlington, VA, 463, 468.

²⁶⁰ A Goolsbee, 'What Happens when you Tax the Rich? Evidence From Executive Compensation' 108 *Journal of Political Economy* 352, 375.

increases.²⁶¹ There was no permanent effect.²⁶² Executives without stock options, though, showed little responsiveness to the tax rate changes.²⁶³

Sammartino and Weiner²⁶⁴ analysed the responses of taxpayers' reported taxable incomes to tax rate increases in the 1990s. They acknowledged previous research that found that the tax rate cuts in 1986 caused a disproportionate increase in reported incomes for high income earners.²⁶⁵ They found that whilst the tax increases in 1993 resulted in a fall in reported incomes for high income taxpayers, especially for salary and wages, the changes were not permanent.²⁶⁶ By 1995 the decline in income for the highest income group was recouped.²⁶⁷

(a) *Summary*

Overall the removal of the CGT discount would permit a reduction to income tax rates and this may have a positive albeit small impact on economic growth. However, more research is needed to quantify the effect.

B Arguments for the CGT Discount

There are numerous arguments put forward in support of the full exemption or preferential treatment of capital gains. These include the impact of such a policy on: savings, investment, economic growth, lock in, risk taking, entrepreneurial activity, new ventures, equity financing, international competitiveness and foreign investment, as well as the impact of inflation. These issues will be dealt with in turn.

1 *Hinders Savings, Investment and Economic Growth*

It is contended that a realisation CGT drives a wedge between current and future consumption and thus distorts the decision to save.²⁶⁸ Preferentially taxing capital gains reduces the size of this wedge and thus, it is argued, encourages saving.

²⁶¹ Ibid.

²⁶² Ibid.

²⁶³ Ibid.

²⁶⁴ F Sammartino, D Weiner, 'Recent Evidence on Taxpayers' Response to the Rate Increases in the 1990s' (1997) L *National Tax Journal* 683, 683–84.

²⁶⁵ Ibid 701.

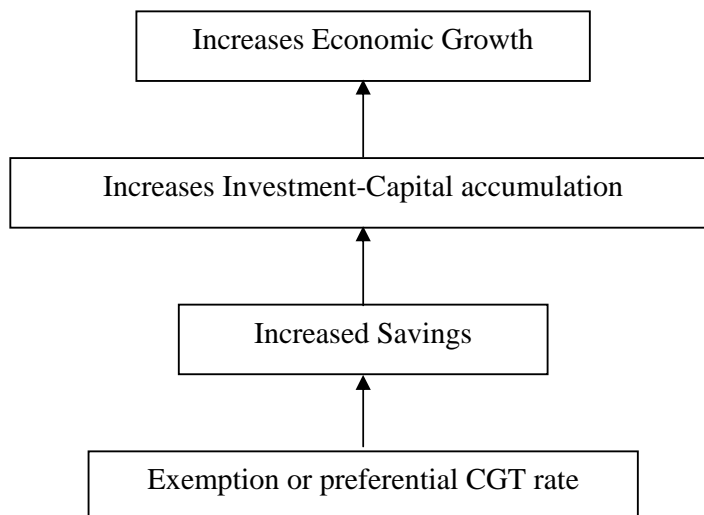
²⁶⁶ Ibid.

²⁶⁷ Ibid.

²⁶⁸ A J Auerbach, 'On the Design and Reform of Capital Gains Taxation' (1992) 82 (2) *The American Economic Review* 263, 264.

Some commentators²⁶⁹ consider that the level of saving and investment is linked to capital formation and they assert that capital formation is the driving force behind economic growth. Indeed countries establish targets for capital accumulation.²⁷⁰ Consequently, it is argued that a CGT exemption or preference, such as the CGT discount, stimulates savings and thus spurs investment, capital accumulation and economic growth,²⁷¹ as seen in the following diagram.

Figure 2
Savings, investment and capital accumulation and economic growth



The government's Ralph reforms appear to be at least partially inspired by the push to increase savings. The Treasurer and Minister of Finance stated that 'raising national savings is the primary focus of the Government's medium term fiscal strategy.'²⁷² The Treasurer, Peter Costello, also stated that²⁷³ 'with more saving we can finance more out of investment to grow the economy faster and produce jobs. Higher savings will raise the speed limits to growth.' The Explanatory Memorandum²⁷⁴ accompanying the Ralph CGT reforms stated that '[t]he New Business Tax System will provide Australia with an internationally competitive business tax system that will create the environment for achieving higher economic growth, more jobs and improved savings'.

²⁶⁹ American Council for Capital Formation, 'Overcoming Barriers to US Economic Growth, International Competitiveness, and Retirement Security' (1999) <www.accf.org/June99test.htm>, 16, M Feldstein (ed), *Capital Taxation* (1983) 1.

²⁷⁰ P B Gann, 'Neutral Taxation of Capital Income: An Achievable Goal?' (1985) 48(4) *Law and Contemporary Problems* 77, 77, 82.

²⁷¹ Reynolds above n 124, 64–70.

²⁷² Commonwealth, House of Representatives, Budget Strategy and Outlook 1997-98 Budget Paper No 1 1997 (P Costello, Treasurer; J Fahey Finance Minister), 1–12.

²⁷³ Commonwealth, House of Representatives, Budget Speech 1997 (P Costello, Treasurer) 2.

²⁷⁴ Explanatory Memorandum, New Business Tax System (Integrity and Other Measures) Act 1999, para 12.13.

The influence of the CGT discount on savings, investment and capital accumulation on economic growth though is highly debatable and as the following analysis shows, there are weaknesses in every link of this chain of argument.

(a) Capital Gains Tax and Savings

A lower CGT rate provides a higher after tax return on savings²⁷⁵ and this may increase private savings but it will also reduce government revenue. Government saving is important since the smaller the government debt the more funds are available for private investment, and the lower the cost of capital for business.²⁷⁶ Overall the impact on national savings of exempting or preferentially taxing capital gains will depend on whether a CGT preference results in an increase in private savings in excess of the increase in government debt. The following discussion explores this impact.

(i) Private Savings

As noted above, the government's rationale for the Ralph CGT preferences included the positive impact the reforms would have on savings. A CGT preference provides a greater after tax return as demonstrated by the following example that compares the returns on discounted (50 per cent CGT discount) and undiscounted growth shares held by an individual in the top marginal tax bracket. The shares are held for five years and appreciate at a constant 10 per cent per annum and pay no dividends.

²⁷⁵ W G Gale, J Sabelhaus, 'The Savings Crisis: In the Eye of the Beholder?' (1999) The Milken Institute Review, 26 August 1999,

<<http://www.brook.edu/views/articles/gale/19990826.htm>>, 2. Examines a number of ways of defining savings, before providing a simple definition of savings equals income minus consumption. Although they note that this definition flounders with the defining of what is 'income'.

²⁷⁶ Burman above n 78, 53.

Table 7
The benefit of the CGT discount:
A comparison of discounted and undiscounted growth shares

Year	Shares (no discount) \$	Yield \$	48.5% Tax \$	Shares (50% discount) \$	Yield \$	48.5% Tax \$
0	100	10.0		100	10.0	
1	110	11.0		110	11.0	
2	121.0	12.1		121.0	12.1	
3	133.1	13.3		133.1	13.3	
4	146.4	14.6		146.4	14.6	
5	161.1		29.6	161.1		14.8
Net value	131.4			146.2		

The undiscounted shares will be worth \$131 and the discounted shares \$146 at the end of five years. Thus the after tax value of the discounted shares is 11.3 per cent more than the undiscounted shares' value.

However, there are a number of reasons that suggest that a higher rate of return from a CGT discount will not have much of an impact on private savings. Firstly, realised capital gains comprise only 31 per cent of reported capital income.²⁷⁷ Many capital assets produce a significant part of their returns in the form of dividends, interest and rent. Additionally, a CGT discount would not greatly impact on tax exempt bodies or low taxed superannuation funds.²⁷⁸ Since non-resident investors in Australian shares are generally not subject to Australian CGT,²⁷⁹ the CGT discount will have no impact on these investors.²⁸⁰ Further, saving that is done for precautionary or liquidity reasons would be insensitive to the rate of return. As discussed later, lock in²⁸¹ from a higher CGT rate will also increase the effective return from saving.²⁸²

Further, the following research suggests that savings do not appear to be very responsive to an increase in the return of saving. As discussed previously,²⁸³ the responsiveness of certain economic parameters (such as savings or labour) have a substitution and income effect. Failing or lightly taxing capital gains appears to

²⁷⁷ See Table 4.

²⁷⁸ Notably the CGT discount for superannuation funds is only 1/3rd compared to the 50 per cent individual discount.

²⁷⁹ Section 136-25.

²⁸⁰ M Lally, 'The Cost of Capital Under Dividend Imputation' (2002) prepared for the Australian Competition and Consumer Commission <http://www.accc.gov.au/gas/br_reg_iss/Cost_capital_dividend.pdf>, 9. Lally notes that in 1996, foreign investors hold around 30 per cent of shares in the Australian equity market.

²⁸¹ Lock in refers to the impact of a realisation CGT on investors that encourages them to hold onto assets in order to defer tax.

²⁸² Burman above n 78, 55.

²⁸³ Randolph Rogers above n 251, 430-31.

provide an incentive for people to increase their savings rather than consume (the substitution effect).²⁸⁴ Offsetting this though is the fact that people will save less given a higher rate of return to enable a higher level of current consumption whilst maintaining their future consumption needs (the income effect).²⁸⁵ This responsiveness is defined as the resulting percentage change in the ratio of future to current consumption, substitution effect, after compensating for the income effect. A large value makes it more likely that there are large efficiency gains from either switching from an income tax to a consumption tax,²⁸⁶ or by exempting capital gains from taxation. As these effects work in opposite directions it is not clear whether a CGT exemption would actually spur savings.

Clearly the introduction of CGT in Australia in 1985 was not associated with a fall in savings. Rather, during the 1990s the ratio of net national saving to GDP rose from 2 per cent to 2.8 per cent.²⁸⁷

International researchers have not found a strong responsiveness of savings to tax rate changes. Burman's²⁸⁸ research suggests that the impact of taxation on savings is minimal. He noted, however, that there is a degree of ambiguity in the theory.²⁸⁹ Also, a literature survey by Randolph and Rogers²⁹⁰ concluded that empirical studies of this elasticity provide little information to base a confident judgement on the responsiveness of savings to tax rate changes, but they found existing estimates suggest that the value is small. Similarly, Gravelle²⁹¹ found that the empirical research is limited for such savings responses and faces greater challenges. Gravelle found that, overall, the research suggests small effects of uncertain sign for savings responses to tax rate changes.

Additionally, Kay and King²⁹² asserted that savings are not very responsive to the rate of return, as the private sector savings did not exhibit volatility during the 1970s and 1980s when large changes in real interest rates occurred in the United Kingdom and where real interest rates were sometimes negative after tax.

Gann²⁹³ found that empirical studies have been unable to show that a reduction in income tax rates will result in an increase in saving. Also, she notes that gross private savings have been constant, staying between 16–17 per cent of Gross National Product

²⁸⁴ Ibid.

²⁸⁵ Ibid.

²⁸⁶ Ibid.

²⁸⁷ Australian Bureau Of Statistics Year Book 2002

<<http://www.abs.gov.au/ausstats/abs%40.nsf/dc057c1016e548b4ca256c470025ff88/edb9d919a7651da9ca256bdc00122418!OpenDocument>>.

²⁸⁸ Burman above n 78, 56, states 'available evidence suggests that, in the aggregate, saving does not respond to the rate of return'.

²⁸⁹ Ibid.

²⁹⁰ Randolph Rogers above n 283, 432–34.

²⁹¹ Gravelle Behavioural feedback above n 259, 468.

²⁹² J A Kay, M A King, *The British Tax System* 1990, 96.

²⁹³ Gann above n 270, 90. Gann refers to Boskin and Shoven, 'Issues in the Taxation of Capital Income in the United States' (1980) 70 *American Economic Review* 164.

(GNP) since 1951.²⁹⁴ Thus, she notes that some economists argue that government savings via surpluses in periods of high employment are preferable to stimulating private savings via tax preferences.²⁹⁵

Gordano²⁹⁶ considered that saving and borrowing were not heavily influenced by after tax returns and costs, finding that Americans gave up current for future consumption very grudgingly. Since the early 1970s to mid 1980s real consumer spending has not deviated much from its trend.²⁹⁷ Thus he considered that tax has only a small influence.²⁹⁸

Further, Boyer and Russell²⁹⁹ noted that during the 1980s, tax rates were reduced and new savings incentives introduced but the rate of savings in the United States still fell. Also, they noted that Japan had the least consumption tax but the highest rate of savings and GDP growth in the 1980s³⁰⁰. Further, a 1986 OECD study³⁰¹ of 23 OECD countries compared the rate of national savings as a percentage of GDP to each country's use of consumption tax, and found no correlation.

Additionally, studies by Sears, Roebuck and Co Economics Department³⁰² showed that the lack of savings has more to do with demographics of the population than any other item. In the 1980s the United States had a young population and, as it ages, savings will increase.³⁰³ Also, Tanzi³⁰⁴ undertook an international comparison of the individual income tax and economic growth. He found that savings are not responsive to tax changes.³⁰⁵ Krever and Brooks noted that during 1978–86 private savings in the United States declined to the lowest level since World War II yet the CGT rate was reduced from 35 per cent to 28 per cent and then to 20 per cent.³⁰⁶

The Canadian government³⁰⁷ estimated that the exemption of capital gains from tax raises the after tax rate of return on total private savings by only a small amount: one quarter of a percentage point.

²⁹⁴ Ibid.

²⁹⁵ Ibid.

²⁹⁶ R M Gordano, a Wall Street economist, commented on E Steuerle's paper 'Effects on Financial Decision Making' in J A Pechman (ed) *Tax Reform and the United States Economy* (1986) 67.

²⁹⁷ Ibid.

²⁹⁸ Ibid.

²⁹⁹ Boyer Russell above n 238, 367.

³⁰⁰ Ibid.

³⁰¹ Ibid.

³⁰² Ibid.

³⁰³ Ibid.

³⁰⁴ Tanzi above n 71.

³⁰⁵ Ibid 111–15.

³⁰⁶ Krever Brooks above n 12, 80.

³⁰⁷ Ibid 77.

(ii) *Government Savings*

Whilst a CGT discount reduces tax revenue and thus lowers public savings, some economists³⁰⁸ believe that such a policy would actually have the opposite impact. It is suggested that a CGT cut would increase the number of CGT realisations so as to raise tax revenue and government savings.³⁰⁹

The responsiveness of asset realisations to CGT cuts is known as ‘the elasticity’.³¹⁰ If the elasticity is zero a CGT cut will not change taxpayer behaviour.³¹¹ If the elasticity is one or more, a CGT rate cut would be self financing³¹² since tax revenues would be maintained as a result of a greater number of realisations. Given that shares and other marketable securities provide the vast majority of reported capital gains in Australia,³¹³ research by Feldstein et al³¹⁴ is highly relevant. This research was based on cross-sections of tax returns and found that capital gains on shares were very responsive to tax changes and a rate cut would not result in any loss of tax revenue.³¹⁵

Reynolds made a similar finding on research provided to the Ralph Report in relation to lowering Australia’s CGT rate. Reynolds³¹⁶ found that a cut in the CGT rate would increase the realisation of assets. The elasticities of realisations were estimated at 1.7 in the short-term and 0.9 in the long term, meaning that the CGT rate reductions would be revenue positive.³¹⁷

A lower CGT rate may produce extra revenue in the short run since appreciating assets will be more attractive to investors.³¹⁸ Demand will drive up the price of such assets and this will lead to greater capital gains.³¹⁹ However, there are a number of reasons why elasticity will not be high. As noted above, a CGT rate cut will have little impact on tax exempt assets and investors such as exempt bodies, exempt foreign investors and low taxed superannuation funds. Also, Burman³²⁰ noted that the long-term price of capital assets is based on their replacement costs. Such costs will not be affected by a CGT cut thus any short-term gains will be at the expense of longer-term gains.³²¹ Thus Burman concluded that this only has a transitory impact on tax revenue.³²² Further, a

³⁰⁸ M Feldstein, and S Yitzhaki, ‘The Effects of the Capital Gains Tax on the Selling and Switching of Common Stock’ in M Feldstein (ed), *Capital Taxation* (1983) 237, 250. The study indicated that reducing the tax on capital gains on corporate stock would increase realisations and tax revenue.

³⁰⁹ Ibid.

³¹⁰ Burman above n 78, 59.

³¹¹ Ibid.

³¹² Ibid.

³¹³ Australian Taxation Statistics 2000–2001 above n 58, 124

³¹⁴ Feldstein Yitzhaki above n 308, 237–39.

³¹⁵ Ibid.

³¹⁶ Review of Business Taxation Report above n 1, 733–34.

³¹⁷ Ibid.

³¹⁸ Burman above n 78, 63.

³¹⁹ Ibid.

³²⁰ Ibid.

³²¹ Ibid.

³²² Ibid.

CGT preference will lead to the transformation of other types of income into capital gains.³²³ The elasticity measure ignores these losses in tax revenue.³²⁴

Additionally, Burman³²⁵ noted that the models used by economists to determine the ways investors realise assets imply that the elasticity depends on how taxpayers value their portfolios and on the diversity of their attitudes. Thus, if realisations are highly elastic, investors should have similar expectations. However, he points to the high CGT rates in the United States in 1996 and the plethora of realisations.³²⁶ Another contributing issue raises the question of who buys the assets when everyone is selling.³²⁷ This diversity of investor attitudes implies a lack of sensitivity to rate changes.³²⁸

Also, some assets such as real estate are illiquid and have high transaction costs, such as stamp duty and selling fees. Such assets would be less sensitive to CGT rates.

Thus, it is not surprising that other research, based on time-series studies, suggests that elasticities are quite small.³²⁹ Empirical research by Burman and Randolph³³⁰ on variances in tax rates among states in the United States sheds some light on these conflicting studies of the elasticity of asset realisations. The study found that the permanent effect of a tax rate cut on individuals' responses was very small and close to zero.³³¹ Individuals' short-term responses, though, varied greatly in response to changes in tax rates. Although, Burman³³² noted that this does not answer the impact on tax revenues and concluded that it is unlikely that a permanent elasticity would be large enough to be self financing.³³³ To achieve this unlikely scenario the rate cut would have to be small since elasticity increases with tax rates.³³⁴

(iii) Ralph's CGT Discount

The introduction of the CGT discount appears to illustrate the deficiencies with Reynold's approach. In 1999 the following evidence about the impact of a CGT rate cut³³⁵ on tax revenue collections was provided to the Australian Senate Finance and Public Administration References Committee Inquiry into the Business Taxation Reform:³³⁵

³²³ Ibid.

³²⁴ Ibid.

³²⁵ Ibid 59.

³²⁶ Ibid.

³²⁷ Ibid.

³²⁸ Ibid.

³²⁹ Burman above n 78, 62.

³³⁰ L E Burman, W C Randolph, 'Measuring Permanent Responses to Capital Gains Tax Changes in Panel Data' (1994) 84 (4) *The American Economic Review* 794, 795.

³³¹ Ibid.

³³² Burman above n 78, 62–63.

³³³ Ibid.

³³⁴ Ibid.

³³⁵ Senate Inquiry into the Business Taxation Reform above n 89, para 4.26.

Table 8
Capital gains tax elasticity estimates provided to the Australian Senate Inquiry

Researcher	Short-term elasticity	Long-term elasticity
Ralph Report	-1.7	-0.9
Gravelle	-0.6	-0.2
Auerbach	-<1.0	-0.25

The Ralph Report³³⁶ expected that a cut in the CGT rate would increase the realisation of assets and thus be revenue positive.³³⁷ Gravelle³³⁸, a senior economic specialist in the Congressional Research Service in Washington, concluded, however, that the Ralph Report's long run elasticity figure was too high. She estimated that the long run elasticity was around 0.2 and the short run elasticity was about 0.6. Auerbach³³⁹ had similar findings. Both Gravelle and Auerbach considered that Reynold's findings were inadequate, as he relied on methodologies containing significant flaws and was unable to distinguish between transitory responses to temporary tax changes, short run responses to permanent tax cuts and long run permanent effects.³⁴⁰

Indeed, the CGT discount has proven to be very costly to tax revenue (see Treasury estimates and projections illustrated in Table 2, above, which shows revenue losses of \$1.8 billion per annum from 2001–02 through to 2004–05).³⁴¹

Table 1 (above) sets out net capital gains and CGT revenue before and after the September 1999 Ralph CGT reforms. The tax revenue lost on the CGT discount of \$1.3 billion³⁴² in 2000–01 is very substantial compared to the CGT revenue of \$4.4 billion. Further, CGT realisations and CGT collections have actually fallen since the Ralph Reforms. Thus it can be inferred that the CGT discount has not had a positive affect on CGT revenue. This may, however, be largely due to other factors such as the decline in the stock market.

However, the average number of daily transactions on the Australian stock exchange appears to have increased markedly following the introduction of the CGT discount. As Evans³⁴³ noted, prior to the CGT discount, the average number of daily share transactions in the quarters ended 30 September 1998 (27 190 transactions), 31 December 1998 (28 390 transactions), 31 March 1999 (35 290 transactions), 30 June 1999 (40 250 transactions) and 30 September 1999 (39 300 transactions). Following the CGT discount, the average number of daily share transactions increased, in the

³³⁶ Review of Business Taxation Report above n 1, 733–34.

³³⁷ Ibid.

³³⁸ Ibid.

³³⁹ Senate Inquiry in to the Business Taxation Reform above n 89, para 4.24.

³⁴⁰ Ibid.

³⁴¹ Australian Treasury above n 59.

³⁴² Ibid.

³⁴³ Evans Taxing capital gains above n 36, 129.

quarters ended 31 December 1999 (47 260 transactions), 31 March 2000 (75 870 transactions), 30 June 2000 (57 130 transactions), 30 September (53 630 transactions), 31 December 2000 (48 180 transactions).³⁴⁴

This increase for March and April 2000, though, would appear to be largely attributed to the height of the tech boom.³⁴⁵ Thus it appears difficult to filter out the impact of the CGT discount. Notably, the CGT discount is generally only available for assets that are held for 12 months³⁴⁶ and this limits its availability. Other factors clearly impact on share turnover. For example, the average number of daily share transactions were 36 per cent greater in the month of August 2002 compared to the month August 2003.³⁴⁷ Given that the CGT discount had been present for about four years it is logical that other factors, such as market supply and demand, drove this increase. Notably, the largest trading day up to 29 August 2003, with \$6982 million worth of share trades, occurred prior to the introduction of the CGT discount (on 22 June 1998).³⁴⁸ Again, this suggests that the CGT discount may not have had a great impact on stock market turnover.

(iv) National Savings

It is unlikely that private savings will be greatly affected by the CGT discount given the limited responsiveness of savings to the rate of return. The CGT discount has reduced the level of government savings and it is also unlikely that private savings would have increased sufficiently to make up this shortfall of about \$1.8 billion per annum.³⁴⁹ Overall national savings would appear to decline under the CGT discount.

(v) Influence of Savings on Investment and Capital Accumulation

Schmidt³⁵⁰ and Chaudhri et al³⁵¹ both found that there does not appear to be a clear link between Australian savings and investment. Further, the Australian Productivity Commission³⁵² observed that investment expenditure is closely related to macroeconomic conditions, rather than savings. Indeed the Australian Bureau of Statistics³⁵³ noted that between 1990–92, real gross capital formation per capita fell by more than 6 per cent and that this was associated with the recession experienced by

³⁴⁴ Ibid.

³⁴⁵ Australian Stock Exchange, Media Release, 'New Share Trading Records Set' 29 August 2003, <<http://www.asx.com.au/shareholder/pdf/TradingVols290803.pdf>>. The media release also notes the average number of daily share transactions.

³⁴⁶ Sections 115-25, 115-30.

³⁴⁷ Ibid.

³⁴⁸ Ibid.

³⁴⁹ See Table 2.

³⁵⁰ M B Schmidt, 'Savings and Investment in Australia' (2003) 35 (1) *Applied Economics* 99, 99–100.

³⁵¹ D P Chaudhri, E Wilson, 'Savings, Investment, Productivity and Economic Growth of Australia 1861–1990: Some Explorations' (2000) 76 (232) *Economic Record* 55, 55–57.

³⁵² Australian Productivity Commission above n 219, 64.

³⁵³ Australian Bureau Of Statistics Year Book 2002 <<http://www.abs.gov.au/ausstats/abs%40.nsf/dc057c1016e548b4ca256c470025ff88/edb9d919a7651da9ca256bdc00122418!OpenDocument>>.

Australia in the late 1980s and early 1990s. Additionally, since savings are affected by international capital flows, an increase in domestic savings may not increase domestic investment.³⁵⁴

Similarly, international researchers, Boyer and Russell³⁵⁵ did not find a relationship between savings and investment. They found that investment decisions are made on projected future consumption, and that investment tracks consumption.³⁵⁶ They found that investment has been increasing in the United States in recent years, although savings had declined.³⁵⁷

Even assuming that the CGT discount could provide a higher level of investment it can be queried whether it is appropriate to give the preference to all types of assets, productive and non-productive?³⁵⁸ Thus, a CGT discount, if justified at all, should be targeted to productive assets.

(vi) Influence of Savings on Economic Growth

Research indicates that there does not appear to be any clear link between savings and economic growth. A study by Schmidt³⁵⁹ examined the long-term and short-term relationship between Australia's savings, investment rates and economic growth. He found that in regard to the various neoclassical growth models that a policy directed at increasing saving would not change national investment and thus not affect economic growth.³⁶⁰

Another study, by Chaudhri and Wilson,³⁶¹ used a growth model to examine the relationship between Australian savings, investment and productivity growth for the periods 1861–1900 and 1949–90. They found that an increase in savings was neither necessary, nor a necessary requirement, for economic growth in a small open economy like Australia.³⁶² Australian savings have been well below investment rates throughout most of Australia's economic experience, with foreign capital funding capital accumulation.³⁶³

The Australian Productivity Commission³⁶⁴ found that Australia's high rate of economic growth in the 1990s could not be explained by a high level of savings but rather by an increase in multifactor productivity stemming from a range of factors. These include an increase in the adoption of new technologies, greater use of innovation and research and development, improvements in human capital,

³⁵⁴ Ibid.

³⁵⁵ Boyer Russell above n 238, 371.

³⁵⁶ Ibid.

³⁵⁷ Ibid.

³⁵⁸ McGee above n 193, 653. McGee found that a CGT rate cut is not a well targeted means of encouraging new firm capital formation.

³⁵⁹ Schmidt above n 351, 99–100.

³⁶⁰ Ibid.

³⁶¹ Chaudhri Wilson above n 352, 55–57.

³⁶² Ibid.

³⁶³ Ibid.

³⁶⁴ Australian Productivity Commission above n 219, 81.

organisational change, new management techniques, enterprise bargaining, reallocation of resources, greater specialisation, greater openness and competition in the Australian economy and changes to business expectations about reliance on government support.³⁶⁵

International research supports this view. Gravelle³⁶⁶ found that there is no automatic argument that greater savings would spur economic growth. An increase in savings reduces current consumption and increases future consumption when these savings are consumed.³⁶⁷ This must damage current economic growth given the reduced level of current consumption. This shifts consumption and hence welfare to future generations.³⁶⁸

(b) Capital Gains Tax and Investment and Capital Accumulation and Economic Growth

It is further argued³⁶⁹ that CGT reduces the level of investment and capital accumulation since it increases the cost of capital and thus capital gains should be concessionally taxed. The American Council for Capital Formation³⁷⁰ found that the 1997 CGT cuts in the United States from 28 per cent to 20 per cent reduced the net cost of capital for new investment by around 3 per cent. The Council argued that United States CGT rates are higher than other industrial countries and that savings rates and investment in recent decades was low.³⁷¹ Additionally, Goolsbee³⁷² found that tax significantly affects prices and investment and that conventional research results understated this by a factor of four. Using panel data on different types of capital equipment, he found a measurement error in the tax component of the cost of capital.³⁷³ This measurement error stems from the impact of expected future tax reforms, tax loss asymmetries, inflation and the complexity of tax laws.³⁷⁴

These concerns must be balanced firstly against the impact on government debt of the CGT discount.³⁷⁵ Secondly, the CGT discount offers no benefit for productive depreciating assets that are exempt from CGT.³⁷⁶ Thirdly, the CGT discount reduces the value of deductions for investments that fail. Logically, this may deter investment.

³⁶⁵ Ibid.

³⁶⁶ Gravelle 'The economic effects of taxing capital income' above n 259, 15.

³⁶⁷ Ibid.

³⁶⁸ Ibid.

³⁶⁹ American Council for Capital Formation, 'Capital Gains Taxes and United States economic growth; A Retrospective Look' (1999) <www.accf.org/capgainsDR1799.htm>.1-2. Burman above n 78, 53: the cost of capital is the before rate of return a business must earn on new investments.

³⁷⁰ American Council for Capital Formation Capital Gains Taxes above n 370, 1-2.

³⁷¹ Ibid 4-5.

³⁷² A Goolsbee, 'The Importance of Measurement Error in the Cost of Capital' (2000) *LIII National Tax Journal* 215, 215.

³⁷³ Ibid.

³⁷⁴ Ibid.

³⁷⁵ Burman above n 78, 54.

³⁷⁶ Section 118-24.

Fourthly, much of the capital provided for investment is provided by low taxed superannuation funds³⁷⁷ and CGT exempt foreign investors³⁷⁸ and is thus not greatly affected. Fifthly, large corporations would not be greatly impacted by an increase in the cost of capital that may make share issues unattractive since they can borrow funds or rely on retained earnings.³⁷⁹ Companies would also not be greatly affected given the low company income tax of 30 per cent. Certain individuals though would be affected given the high top marginal income tax rate of 48.5 per cent.

Finally, the introduction of the Australian CGT in 1985 did not appear to result in any discernible slump in Australian investment and capital accumulation.³⁸⁰ The Australian Bureau of Statistics³⁸¹ found that between 1992–93 and 2000–01, real gross capital formation per capita grew by almost 37 per cent.

Other international research suggests that a CGT preference has a minor impact on investment and capital accumulation. Hulten³⁸² concluded that a CGT rate reduction would not have a great impact on the cost of capital. Tax changes may affect marginal investment, but investment that embraces new technology will not be marginally profitable.³⁸³

Overall, the CGT discount does not appear to greatly reduce the cost of capital. Such a policy is likely to have only a marginal impact on investment and capital accumulation.

(i) Influence of Investment and Capital Accumulation on Economic Growth

A study by Chaudhri and Wilson³⁸⁴ found an interdependent relationship between Australian investment and productivity growth for the period 1949–90. They noted that the interactions between investment, GDP and productivity growth were complex and evolving.³⁸⁵ Other public finance specialists, such as Feldstein,³⁸⁶ assert that capital accumulation plays a central role in the growth of every economy, and thus is a major

³⁷⁷ This can be inferred from the fact that superannuation funds provided 38 per cent of reported net capital gains in 1999–2000, and 45 per cent in 2000–2001, Australian Taxation Statistics 2000–2001 above n 58, 123–24.

³⁷⁸ Australian Department of Foreign Affairs and Trade, 'Exploding the Myths - Facts about Trade and International Investment' (2000), <http://www.dfat.gov.au/publications/exploding_myths/exploding_the_myths.html>. In 2000, foreign direct investment in Australia comprised 6 per cent of total Australian assets.

³⁷⁹ Ibid.

³⁸⁰ Australian Bureau Of Statistics Year Book 2002 <<http://www.abs.gov.au/ausstats/abs%40.nsf/dc057c1016e548b4ca256c470025ff88/edb9d919a7651da9ca256bdc00122418!OpenDocument>>.

³⁸¹ Ibid.

³⁸² C R Hulten 'Comments on a Paper by L L Dildine 'Effects on Industry' in J A Pechman (ed) *Tax Reform and the United States Economy* (1986) 50.

³⁸³ Ibid.

³⁸⁴ Chaudhri Wilson above n 352, 55–57.

³⁸⁵ Ibid.

³⁸⁶ Feldstein Capital Taxation above n 269, 1.

focus of economic theory and empirical research. Gann³⁸⁷ also found a broad consensus that higher levels of capital formation are desirable.

The American Council for Capital Formation³⁸⁸ referred to research by Bradford and Summers that found investment in equipment is perhaps the single most important factor in economic growth, with every 1 per cent of GDP invested in equipment being associated with an increase in GDP growth of one-third of a per cent. The Council³⁸⁹ also argued that the slow economic growth in the United States in the last twenty years is partly attributed to low investment.³⁹⁰ They pointed to a recent study by the World Bank³⁹¹ that suggested countries with high levels of investment grow faster. The research referred to fifteen countries in the study that compared average annual GDP growth for 1974–93 and savings and investment. There was a general correlation between these parameters, with some sharp exceptions.³⁹² Hong Kong had double the GDP growth of Japan, yet its level of savings and investment was only slightly higher than Japan's.³⁹³ South Korea had high saving and investment, but not the highest GDP growth, whereas Denmark had low saving and investment, but not the lowest, and had the lowest GDP growth.³⁹⁴ This comparison, though, was unusual in that it did not refer to comparable countries, that is, OECD countries. The Council also referred to Jorgenson's findings that increases in capital stock had the strongest impact on the growth in output.³⁹⁵

Other evidence suggests, however, that capital accumulation may not have such a strong impact on economic growth. Firstly, depreciable assets will not be affected by the CGT discount given the exemption from CGT.³⁹⁶ Further, the Australian Productivity Commission found that investment expenditure is not a direct contributor to productivity growth, with productivity gains driving growth.³⁹⁷ This is also borne out by recent OECD³⁹⁸ data that shows that capital accumulation is becoming less important as a factor in Australia's growth given the increasing dominance of services as a proportion of GDP. In 1987 services accounted for 64.9 per cent of GDP and 70.6 per cent in 1997.³⁹⁹ Over the same period industry declined from 31 per cent to 26.2 per cent and agriculture declined from 4.1 per cent to 3.2 per cent.⁴⁰⁰ Notably this trend is present in virtually every OECD country.⁴⁰¹

³⁸⁷ Gann above n 270, 93; she also notes though that increased capital formation will only have a modest impact on growth; and at 81 finds a substantial consensus that income tax needs to be modified to achieve increased neutrality in the taxation of capital.

³⁸⁸ American Council for Capital Formation Overcoming barriers above n 269, 6.

³⁸⁹ Ibid 13.

³⁹⁰ Ibid.

³⁹¹ Ibid.

³⁹² Ibid.

³⁹³ Ibid.

³⁹⁴ Ibid.

³⁹⁵ Ibid.

³⁹⁶ Section 118-24.

³⁹⁷ Australian Productivity Commission above n 219, 64.

³⁹⁸ OECD Survey Poland above n 238.

³⁹⁹ Ibid 22.

⁴⁰⁰ Ibid.

⁴⁰¹ Ibid.

Other international commentators have found that investment and capital accumulation have a relatively small impact on economic growth. Pechman⁴⁰² disagreed with Feldstein et al's analysis above, finding that capital accumulation is not as significant. He estimated a 1 per cent increase in the ratio of investment to GNP will only generate a 0.2 per cent increase in productivity.⁴⁰³ Although Fazzari⁴⁰⁴ noted that most quantitative analyses assume a 1 per cent increase in capital stock will increase output by 0.3 per cent, he felt this only has a small transitory impact. It has no permanent effect, as the level of output permanently changes, not the growth rate of output.⁴⁰⁵ Also, Fazzari⁴⁰⁶ placed the impact of a CGT rate cut on economic growth in the context of economic modelling terms. He asserted that when one multiplies three numbers substantially less than one, then this results in a very small number.⁴⁰⁷

Relevantly, Gann⁴⁰⁸ found that productivity growth declined in the United States in the late 1970s and early 1980s, even though investment in non-residential fixed capital as a percentage of GNP remained strong throughout the 1970s.

Hulten⁴⁰⁹ similarly concluded that multifactor productivity, not capital formation, accounted for nearly all the postwar growth in the United States. He found that variations in economic growth are closely tied to multifactor productivity.⁴¹⁰ From 1948–73 the United States business sector grew at 3.6 per cent and from 1974–81 it fell to 2.3 per cent.⁴¹¹ The decline was almost all due to the fall of multifactor productivity.⁴¹² Measuring multifactor productivity is difficult, as it is a combination of factors.⁴¹³ These include technical and organisational change, changes in the quality and utilisation rates of capital and labour, changes in allocational efficiency and pure measurement error.⁴¹⁴

Bosworth⁴¹⁵ also considered that capital formation had a limited impact. The United States productivity slowdown in the late 1970s was only marginally affected, by only 0.1 to 0.2 percentage points, by differing rates of change in the capital labour ratio.⁴¹⁶

⁴⁰² J A Pechman, 'Tax Policies for the 1980s' (1980) 11 *Tax Notes* 1195, 1196.

⁴⁰³ *Ibid.*

⁴⁰⁴ S M Fazzari, 'Capital Income Taxes and Economic Performance' (1998) 91st National Tax Association Conference Proceedings, Austin, Texas 433, 434.

⁴⁰⁵ *Ibid.*

⁴⁰⁶ *Ibid* 433.

⁴⁰⁷ *Ibid.*

⁴⁰⁸ Gann above n 270, 92–93.

⁴⁰⁹ Hulten above n 383, 48–50.

⁴¹⁰ *Ibid.*

⁴¹¹ *Ibid.*

⁴¹² *Ibid.*

⁴¹³ *Ibid.*

⁴¹⁴ *Ibid.*

⁴¹⁵ B P Bosworth *Tax Incentives and Economic Growth* (1984) 29.

⁴¹⁶ *Ibid.*

Gravelle⁴¹⁷ noted that the slowdown in productivity growth in the 1970s has not been easily explained, but seemed unrelated to tax policies or capital accumulation rates.

The following comparison of 29 developed countries does not show any link between CGT policy and economic growth.⁴¹⁸

Table 9
International comparison of OECD countries
GDP growth 1995–1999 and CGT policy

Country	GDP Growth Average 1995–99	Countries without CGT
Ireland	9.0	
Iceland	5.5	
Poland	5.3	
Luxembourg	5.1	
Mexico	5.0	
Finland	4.8	
Australia	4.2	
United States	4.1	
Turkey	3.7	
Hungary	3.6	
Korea	3.6	
Portugal	3.4	
Spain	3.4	
Netherlands	3.4	
Greece	3.2	Minimal CGT
Canada	3.1	
Norway	3.0	
Denmark	2.5	
United Kingdom	2.5	
Sweden	2.5	
Belgium	2.3	
France	2.2	
Austria	2.1	
New Zealand	1.6	No CGT
Germany	1.5	Minimal CGT
Switzerland	1.4	
Japan	1.2	
Italy	1.2	Minimal CGT
Czech Republic	0.3	Minimal CGT

⁴¹⁷ Gravelle Behavioural feedback effects above n 259, 473.

⁴¹⁸ OECD, 'OECD in Figures: Statistics on Member Countries' (2000) <www.oecd.org>, 14, 15, 78; Ernst and Young, 'Doing Business in' (2000) <www.doingbusinessin.com>, Czech Republic, Italy, New Zealand, Netherlands and Greece have minimal taxation of capital gains.

If anything, this table shows that the absence of a CGT is associated with weak rather than strong economic growth. Some of the highest GDP growth rate countries such as Ireland, Iceland and Poland all have a CGT. Czech Republic and Italy have only minimal capital gains taxes and yet are very poor performers on GDP growth. New Zealand has no CGT and has poor growth. Further, Burman found that in the United States, a dozen changes to CGT rates in the past 45 years has shown no perceptible affect on economic growth.⁴¹⁹

Overall there appears to be a relationship between investment, capital accumulation and economic growth. The Australian and international research though indicates that investment may not have a strong influence over economic growth in Australia.

(c) Summary

The CGT discount is a very blunt instrument to raise savings and such a policy appears to reduce Australian national savings. Even if it raised national savings, there is no clear link between Australian savings and investment, nor between Australian savings and economic growth.

The CGT discount reduces the cost of capital but the impact on economic growth appears to be small. Whilst the cost of capital is related to capital formation, the introduction of the Australian CGT did not appear to have dampened capital formation. Capital formation does contribute to Australia's growth but it appears to be subordinate to other factors such as productivity gains.

Overall, the impact of a CGT discount on economic growth does not appear to be significant.

2 Lock In Effect

Since a CGT liability usually only arises upon the sale of an asset, this encourages taxpayers to hold onto assets for longer than otherwise planned. Thus investors may be unwilling to sell assets in response to new information. This is known as the lock in effect.⁴²⁰ This results in a misallocation of capital among industries and firms.⁴²¹ It distorts the demand for portfolio assets, alters the mix of financial assets that firms supply, the ratio of debt to equity and the allocation of risk bearing in the economy.⁴²² Capital may be retained in less productive or inefficient investments.⁴²³

However, there are a number of reasons why the lock in effect would not have a significant economic impact. The vast majority of reported capital gains arise from

⁴¹⁹ Burman above n 78, 81.

⁴²⁰ Burman above n 78, 68.

⁴²¹ Ibid.

⁴²² Ibid.

⁴²³ Ibid.

shares⁴²⁴ and it is apparent that major players in the Australian share market, lower taxed superannuation funds⁴²⁵ and foreign investors⁴²⁶ are not greatly affected by Australia's CGT. Such investors would sell quickly in response to poor company performance.⁴²⁷ Additionally, lock in does not apply to CGT exemptions such as pre CGT assets, main residences and depreciating assets.

Further, the Ralph Report must not have thought lock in was a problem for companies since the CGT discount was not extended to companies.⁴²⁸ Also, the tax deferral advantage of CGT may have a reverse lock in effect.⁴²⁹ That is, an alternative investment may appreciate faster and thus provide an even greater benefit from CGT deferral.⁴³⁰ Thus an investor may sell too soon and pay taxes now rather than in the future.⁴³¹ Additionally, the CGT discount may encourage another type of lock in given the requirement for a 12-month holding period.⁴³²

Lock in would also not have a great impact on many taxpayers since investors that receive capital gains generally own a number of assets.⁴³³ With a large portfolio of assets investors will have capital losses and gains, thus capital loss assets can offset any gains. An investor can then simply buy back the loss asset or buy a replacement asset to avoid any real economic loss. Alternatively, an investor can reduce lock in by buying other assets whose returns are negatively correlated with the asset subject to lock in.⁴³⁴

There may in fact be some benefit from lock in. An individual's trading may be made on the basis of information on the future potential of an investment or be made on ignorant speculation.⁴³⁵ Clearly, ignorant speculation does not improve the efficiency

⁴²⁴ Australian Taxation Statistics 2000–2001 above n 58, 123–24.

⁴²⁵ Australian Prudential Regulation Authority 'Superannuation Market Statistics' (2003) <<http://www.apra.gov.au/Statistics/Superannuation-Market-Statistics.cfm>>. This report notes that superannuation funds have \$218 billion invested in Australian equities and units in trusts as at June 2002; Australian Stock Exchange, 'Australian market overview' (2003) <http://www.asx.com.au/about/13/marketoverview_aa3.shtm>. At the end of June 2002, the market capitalisation was \$700 billion.

⁴²⁶ Section 136-25, shares in Australian public companies are generally exempt from CGT for foreign investors; also see Lally above n 280, 9. Lally notes that in 1996, foreign investors hold around 30 per cent of shares in the Australian equity market. He finds that there is virtually a free flow of equity capital between Australia and the world's principal equity markets.

⁴²⁷ Australian Stock Exchange, 'Australian market overview' above n 426. This report relevantly states 'Australia has deep and efficient markets in equity securities and related derivative products. In terms of market capitalisation, Australia's premier stock exchange, the ASX, is currently the twelfth largest stock market in the world and the third largest in the Asia-Pacific behind Japan and Hong Kong'.

⁴²⁸ Review of Business Taxation Report above n 1, 595–98.

⁴²⁹ Burman above n 78, 70.

⁴³⁰ Ibid.

⁴³¹ Ibid.

⁴³² Section 115-25.

⁴³³ Kelly above n 62, 13–15. This research also shows a concentration of Australian wealth, with 10 per cent of individuals holding 43 per cent of Australian wealth. They hold the wealth in diversified assets such as: interest bearing deposits (13 per cent); shares and other investments (14 per cent); home (30 per cent); rental properties (13 per cent); business (18 per cent); and superannuation (13 per cent).

⁴³⁴ Burman above n 78, 70–71.

⁴³⁵ Ibid.

of the market and history indicates that investors overreact to short-term information on profits, mineral discoveries or new technologies.⁴³⁶ This was evident in the dot com share boom in Australia and overseas.⁴³⁷ Thus there may be some benefit gained from lock in by reducing ignorant speculation and short-term overreactions, as it stabilises investments.⁴³⁸ Also, people may hold investments rather than consuming, this promotes investment. Further, taxing capital gains and allowing deductions for capital losses may also increase the mobility of capital in recessions, and thus enable the transfer of capital to more efficient uses.⁴³⁹

Krever and Brooks⁴⁴⁰ point to a number of situations where the lock in effect will not apply to asset holders. For example, where the taxpayer has no choice but to sell assets for business considerations or through forced disposals.⁴⁴¹ Also, lock in will not be much of a problem for assets having a short life such as leases, patents, minerals deposits and wasting assets.⁴⁴² Additionally, it will only marginally apply to assets having low capital gains.⁴⁴³ Relevantly, the average capital gain in 2000–01 was only \$4726.⁴⁴⁴ There will also be negligible impact on individuals having low marginal income tax rates.⁴⁴⁵

(a) *Summary*

Overall, lock in does not appear to be a great problem. If lock in was considered to be a problem then death should not be exempted from CGT. Exempting CGT on death provides one of the primary reasons for lock in since it enables the elimination of all CGT liability.

3 *Hinders Corporate Equity*

As Burman⁴⁴⁶ noted, some argue that CGT results in the double taxation of corporate income since corporate income is subject to company income tax and dividends are taxable at the shareholder level. This results in a misallocation of capital to the corporate sector and results in high levels of corporate debt.⁴⁴⁷ Ideally, corporate and personal income tax systems should be fully integrated since this enhances economic efficiency.⁴⁴⁸ This prevents the double taxation of income at the company level and of

⁴³⁶ Ibid.

⁴³⁷ D Futrelle 'A Penny for Your dotcom' (2003) 32(9) *Money* 28 (New York) 28.

⁴³⁸ Burman above n 78, 70–71.

⁴³⁹ Ibid 73–74.

⁴⁴⁰ Krever Brooks above n 12, 69.

⁴⁴¹ Ibid.

⁴⁴² Ibid.

⁴⁴³ Ibid.

⁴⁴⁴ Australian Taxation Statistics 2000–2001 above n 58, 121.

⁴⁴⁵ Krever Brooks above n 12, 69.

⁴⁴⁶ Burman above n 78, 76.

⁴⁴⁷ Ibid.

⁴⁴⁸ D Chua, J R King, 'The Mechanics of Integration' in P Shome (ed) *Tax Policy Handbook* (1995) 151.

the individuals who are the ultimate owners of the business entity. Under full integration the income of all entities would be attributed to individual taxpayers who are the ultimate owners of the company.⁴⁴⁹ The income tax would be payable by these individuals at their marginal rate of income tax.⁴⁵⁰ Given a number of practical considerations no countries have implemented a full integration regime.⁴⁵¹

However, this argument does not apply since Australia utilises a partial form of integration known as the dividend imputation system.⁴⁵² This provides tax relief to domestic shareholders for company tax paid. The individual shareholder includes the sum of the dividend plus the tax credit, known as the grossed up amount as assessable income.⁴⁵³ The taxpayer's marginal tax rate is then applied to the grossed up amount and this is reduced by the credit for the corporate tax paid. If the taxpayer's marginal income tax rate is greater than the company tax rate of 30 per cent (assuming that the dividend is fully franked) additional tax is payable, if less a refund is due. Thus a taxpayer on the top marginal income tax rate of 48.5 per cent would pay an extra 18.5 per cent tax on a fully franked dividend.

The CGT discount though may distort corporate equity markets.⁴⁵⁴ Under this policy companies favour retained earnings since shareholders prefer CGT advantaged capital growth.⁴⁵⁵ Companies have less reason to pay out dividends and are less reliant on new share issues to finance growth.⁴⁵⁶ This means that investment markets are unable to allocate capital to those firms that produce the highest returns.⁴⁵⁷ Notably, the Ralph Report did not extend the CGT discount to companies.

4 *Inflation*

Some commentators⁴⁵⁸ argue that real capital gains should only be taxed and that this enhances economic efficiency. Thus a CGT discount is required to offset the impact of inflation. As discussed previously,⁴⁵⁹ inflation provides a comparative advantage to capital gains compared to other forms of capital income. Consequently, any indexation of capital gains would require the indexation of other types of capital income and the income tax system. Full indexation though is highly unlikely given that no country appears to have embraced such a policy. Consequently the inflation argument for a CGT preference such as the CGT discount lacks merit.

⁴⁴⁹ Ibid.

⁴⁵⁰ Ibid.

⁴⁵¹ Ibid, notes that such a system would require a vast amount of information about geographically diverse spread of owners, difficulties in attributing retained earnings, problems in tracing of ultimate owners, and has liquidity issues.

⁴⁵² Part 3-6 ITAA 1997.

⁴⁵³ Section 44(1), 160AQT ITAA 1936.

⁴⁵⁴ Krever Brooks above n 12, 62.

⁴⁵⁵ Ibid.

⁴⁵⁶ Ibid.

⁴⁵⁷ Ibid.

⁴⁵⁸ Slemrod 'Professional opinions about tax policy' above n 24, 124-132.

⁴⁵⁹ See para 6.1.1.1.

5 Discourages Risk Taking

As noted above, it is argued that a lower CGT rate will decrease the cost of capital for business. Thus it is argued that this may encourage risk taking,⁴⁶⁰ equity financing,⁴⁶¹ entrepreneurial activity and new business start ups.⁴⁶² In particular fully taxing capital gains would appear to affect businesses that rely on the equity market such as public utilities that need large amounts of capital and for high growth companies that need to frequently raise equity capital.⁴⁶³ Small growth companies have insufficient retained earnings and limited borrowing capacity to raise funds would also be affected.⁴⁶⁴ Thus it is argued the higher the cost of capital will reduce investors' appetite for risk and thus some of the most dynamic and productive sectors of the economy may be hindered.⁴⁶⁵

Relevantly, Gompers and Lerner⁴⁶⁶ examined the forces affecting fundraising by independent venture capital organisations from 1972 to 1994, finding that the surge in venture capital in the 1980s was a product of demand of venture capital by entrepreneurs, stimulated by a growing economy, technological change and CGT rate cuts.

These arguments though may be overstated. The finding by Gompers and Lerner has been subject to some criticism.⁴⁶⁷ Blair casts doubts since the paper was based only on a small sample size of 17 relevant observations.⁴⁶⁸ This does not have much power to reject the null hypothesis that the CGT rate does not matter to risk taking.⁴⁶⁹

Further, Hellman asserted that given that an entrepreneur would not cash out business gains until a fairly distant time down the track, and that the investment or business returns are highly uncertain, then any changes to the current CGT rates must have little influence.⁴⁷⁰ Also, typically entrepreneurs realise their capital gains at a very slow rate, using various techniques to delay payment of taxes.⁴⁷¹ It is unclear as to how entrepreneurs look at the current CGT rates as a predictor of future tax liability. Complaints about high CGT are likely to stem from successful entrepreneurs trying to avoid tax rather than entrepreneurs wanting to start a new project.⁴⁷² Also, Poterba found that there is no empirical evidence that a CGT preference would stimulate entrepreneurial activity and venture capital.⁴⁷³

⁴⁶⁰ American Council for Capital Formation 'Overcoming barriers' above n 269, 4.

⁴⁶¹ Reynolds above n 124, 58–59.

⁴⁶² American Council for Capital Formation 'Overcoming barriers' above n 269, 4.

⁴⁶³ Ibid.

⁴⁶⁴ Ibid.

⁴⁶⁵ Ibid.

⁴⁶⁶ P A Gompers, J Lerner, 'What Drives Venture Capital Raising?' in M N Baily et al (eds) *Brookings Papers on Economic Activity: Microeconomics* (1998) 149.

⁴⁶⁷ Ibid.

⁴⁶⁸ Ibid.

⁴⁶⁹ Ibid.

⁴⁷⁰ Ibid.

⁴⁷¹ Ibid.

⁴⁷² Ibid.

⁴⁷³ Krever Brooks above n 12, 84.

Additionally, as McGee⁴⁷⁴ noted, a CGT preference provides encouragement to existing firms rather than new firms. New firms will have no or few capital gains since capital gains accumulate over time.⁴⁷⁵ Whereas established firms will enjoy capital growth from goodwill, real estate, investments and other business assets.

Also, since low taxed superannuation funds⁴⁷⁶ and exempt foreign investors⁴⁷⁷ are major contributors to equity financing this may not appear to be a significant issue since a CGT rate cut will have little impact on their after tax rate of return (as noted previously). Importantly, entrepreneurs largely provide human capital rather than financial capital to their business ventures and rely on outside investors for financial capital.⁴⁷⁸ Thus the current CGT policy may have little impact on many entrepreneurs.⁴⁷⁹

Further, the CGT discount poorly targets entrepreneurship as it applies to all types of assets. For example the CGT discount applies to unproductive assets such as holiday homes, hobby farms, antiques, artwork and yachts. It does not apply to productive assets such as depreciating assets.⁴⁸⁰ Commentators have noted⁴⁸¹ that a CGT preferences or exemption encourages low risk investments such as real estate and blue chip shares.

As noted above, if capital gains are not treated as income then logically capital losses will not be deductible. This may discourage risk taking. Indeed, Kaplow⁴⁸² refers to a study of risk taking done by Domar and Musgrave⁴⁸³ that shows that an income tax in which investment losses are deductible without limit, increases risk taking.

Fully taxing capital gains would not have much impact on many large companies since they can borrow funds or use retained earnings.⁴⁸⁴

⁴⁷⁴ McGee above n 193, 653.

⁴⁷⁵ Ibid.

⁴⁷⁶ Australian Prudential Regulation Authority 'Superannuation Market Statistics' (2003) <<http://www.apra.gov.au/Statistics/Superannuation-Market-Statistics.cfm>>.

Superannuation funds have \$218 billion invested in Australian equities and units in trusts as at June 2002; Australian Stock Exchange above n 426. At the end of June 2002, the market capitalisation was \$700 billion.

⁴⁷⁷ Lally above n 280, 9. Lally notes that in 1996, foreign investors held around 30 per cent of shares in the Australian equity market.

⁴⁷⁸ Burman above n 78, 75–76.

⁴⁷⁹ Ibid.

⁴⁸⁰ Section 118–24.

⁴⁸¹ Head Capital gains taxation above n 175, 150–51; Groenewegen above n 177, 15,

Freebairn above n 179, 469; R Krever, 'Structural issues in the taxation of capital gains' (1984) 1(2) *Australian Tax Forum* 164, 67–68.

⁴⁸² L Kaplow, 'Taxation and Risk Taking: A General Equilibrium Perspective' (1994) 47 *National Tax Journal* 789, 789.

⁴⁸³ E D Domar, R A Musgrave, 'Proportional Income Taxation and Risk Taking' (1944) *Quarterly Journal of Economics*, 388, 388–422.

⁴⁸⁴ M L Louie, 'Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities' (1982) 34 *Stanford Law Review* 857, 867.

Between 1985 and 1998, Australia's CGT applied normal rates of income tax but this did not appear to have affected risk taking as seen by the steady increase in share and business assets since 1985.⁴⁸⁵

Even assuming that a CGT preference will encourage risk taking there is no evidence that demonstrates risky rather than safe investment should be supported. Economist Sandmo surveyed the literature and found that 'It seems reasonable to conclude that the few studies which have been made of the optimum taxation of risky assets cannot provide any a priori foundation for a recommendation that risky assets be taxed at higher or lower rates than safe ones'.⁴⁸⁶

Overall, the evidence suggests that a CGT discount would not greatly discourage risk taking.

6 Damages International Competitiveness

Since 1788, Australia's small open economy has relied extensively on international trade and capital links.⁴⁸⁷ In this context, it is asserted⁴⁸⁸ that a CGT preference is necessary to maintain Australia's international competitiveness.

This argument would appear to have merit if Australia imposed a harsher tax regime than other OECD countries. However, all other OECD countries, with the exception of New Zealand, impose CGT it would seem difficult to see how CGT could damage our competitiveness unless Australia imposed significantly higher CGT rates. Relevantly, Evans noted that prior to the 1999 CGT discount Australia's CGT regime imposed higher levels of CGT than other OECD countries.⁴⁸⁹

However, Australia also competes with non-OECD countries but does that mean it is appropriate to import the CGT policy of the lowest CGT country. Under this approach, the personal income tax and company tax rates must also be reduced to maintain our competitiveness. Also, why preferentially tax capital gains and not other types of capital income? Such approaches lower government expenditure and services, and thus

⁴⁸⁵ Kelly above n 62, 12, The Australian wealth held in shares and other investments increased in 1998 dollars from \$40 billion in 1986 to \$120 billion in 1998. The Australian wealth held in net businesses increased in 1998 dollars from \$103 billion in 1986 to \$222 billion in 1998.

⁴⁸⁶ Burman above n 78, 72, citing A Sandmo, 'The Effects of Taxation on Savings and Risk Taking', in J Alana, A J Auerbach, M Feldstein (eds), *Handbook of Public Economics*, vol 1 (1985) 307.

⁴⁸⁷ D Guen, G Shuetrim, 'Internationalism and the Macroeconomy' Reserve Bank of Australia publication, (1994) <<http://www.rba.gov.au/PublicationsAndResearch/Conferences/1994/GruenShuetrim.pdf>>, 1.

⁴⁸⁸ Reynolds above n 124, 5; B Howe, B Howell, 'Understanding the New Venture Capital Concessions' (2003) 7(1) *Tax Specialist* 3, 3. Howe and Howell note that Australia was traditionally considered to be a high tax jurisdiction for foreign venture capitalists.

⁴⁸⁹ Evans 'Taxing capital gains' above n 36, 133. Evans modelled the CGT impact for an unmarried individual on twice average earnings with a capital gain of US\$40 000. In Australia the effective tax rate was 47 per cent (ignoring Medicare levy), in Canada 38 per cent, in UK and US both 20 per cent, in Ireland 19 per cent and in New Zealand 0 per cent. The average tax payable in all countries was US\$8068 whilst the CGT amounted to \$15 801 in Australia.

undermine important institutions such as the education, health, defence and justice systems.

Further, a tax policy should promote competitiveness and this is best achieved through a competitive domestic economy.⁴⁹⁰ Thus a neutral tax policy that taxes capital gains at ordinary income tax rates would appear to allow market forces to better allocate resources.

Overall, the arguments run both ways and there does not appear to be a compelling case for preferentially taxing capital gains on the basis of international competitiveness. Although, more economic research is needed to ascertain the affects of discounted CGT rates on international competitiveness.

7 Discourages Inward Foreign Investment

Further, it is argued⁴⁹¹ that a CGT preference is necessary to attract foreign investment. Importantly, research suggests that inward foreign investment enhances economic growth.⁴⁹² Given Australia's strong reliance on foreign investment a harsher CGT may be costly. This reliance was noted in an empirical study from 1861 to 1900 and from 1949 to 1990 by Chaudhri and Wilson.⁴⁹³ The study found that Australian savings were well below investment rates through most of Australia's economic experience and noted that foreign capital provided additional funding for capital accumulation.⁴⁹⁴ Also, in 2001–02, the total foreign investment inflow into Australia amounted to \$72.5 billion.⁴⁹⁵ This amounted to a significant sum being 10 per cent of GDP in 2001–02.⁴⁹⁶

However, a number of factors may reduce the impact of CGT on inward foreign investment. Firstly, CGT generally only applies to a limited number of foreign investors having permanent establishments and that acquire assets such as Australian real estate and shareholdings of greater than 10 per cent in Australian companies.⁴⁹⁷

⁴⁹⁰ J A Pechman in J A Pechman (ed) *World Tax Reform: A Progress Report* (1987), 253.

⁴⁹¹ Reynolds above n 124, 5.

⁴⁹² B McLean, S Shrestha, 'International Financial Liberalisation and Economic Growth' Reserve Bank of Australia Research Discussion Paper (2002), <<http://www.rba.gov.au/PublicationsAndResearch/RDP/RDP2002-03.html>>. This paper concluded that both foreign direct investment and portfolio inflows enhance economic growth.

⁴⁹³ Chaudhri Wilson above n 352, 55–57.

⁴⁹⁴ Ibid.

⁴⁹⁵ Australian Foreign Investment Review Board, Report 2001-2002, 'Chapter 4: International Investment Issues and Australia's International Investment Position' (2002) <<http://www.firb.gov.au/content/publications/annualreports/2001-2002/Chap4.asp>>.

⁴⁹⁶ Australian Bureau of Statistics, Australia Now 2003, Measuring Australia's Economy, Section 1. Measuring Economic Activity, (2003) <<http://www.abs.gov.au/Ausstats/abs%40.nsf/94713ad445ff1425ca25682000192af2/70ef43745fa5445eca256cbf0017216f!OpenDocument>>. Australia's GDP in 2001-2002 was \$716 billion.

⁴⁹⁷ Section 136-25 sets out the assets that have the necessary connection with Australia that non-resident investors may be liable to CGT. These include: land and buildings located in Australia; a CGT asset used in carrying on a permanent establishment; a share in a private company or trust that is a resident; a share in a public company that is a resident in which the taxpayer owns more than 10 by value of the

Secondly, the introduction of the Australian CGT in 1985 did not correspond with any fall in foreign investment. From 1991 to 2000, foreign direct investment in Australia increased from 5 per cent to 6 per cent of total Australian assets.⁴⁹⁸

Thirdly, Gravelle⁴⁹⁹ noted other limits in the responsiveness of international capital flows. The mobility of capital may be restricted since investors do not see investments in different countries as perfect substitutes.⁵⁰⁰ Also, as Gravelle noted, investment flows require changes in trade flows. Additionally the tax revenue from attracting foreign capital may be limited as debt financed capital is subject to a negative income tax and investment subsidies attract both debt and equity.⁵⁰¹

Overall, it appears that the CGT discount provides some limited encouragement for foreign investment and this may aid economic growth. This must be balanced though against the economic costs from the lack of neutrality and the loss of CGT revenue. The problems of such a CGT preference is evident in the move by OECD countries to remove harmful tax preferences and to retain the taxation of capital income.⁵⁰²

C Conclusion: CGT Discount and Economic Efficiency

A CGT rate set at the same level that applies to other types of capital income would provide a more neutral treatment for capital income than the current CGT. This would lead to a better and more productive use of resources. Certainly there is considerable evidence of over investment in the building and housing industry. However, the economic cost of this misallocation of resources is unknown.

Additionally, the removal of the CGT discount would help close a major exemption in the income tax system as seen by the massive levels of discounted capital gains. This would restrict the opportunities for tax avoidance and minimisation. The removal of the CGT discount offers greater deductibility for capital losses and enhances social capital. Additionally, there appears to be some economic benefit from its great revenue raising ability that would enable the lowering of tax rates.

There are, however, many opposing economic arguments for the CGT discount. Overall the evidence suggests that a CGT levied at normal income tax rates though would not greatly hinder savings, investment and economic growth, nor would lock in be likely to have a significant impact. The inflation argument for preferential CGT

shares; a share in a unit trust that is a resident in which the taxpayer owns more than 10 per cent by value of the units.

⁴⁹⁸ Australian Department of Foreign Affairs and Trade, 'Exploding the Myths - Facts about Trade and International Investment' (2000), <http://www.dfat.gov.au/publications/exploding_myths/exploding_the_myths.html>.

⁴⁹⁹ Gravelle 'Behavioural feedback effects' above n 259, 472-73.

⁵⁰⁰ Ibid.

⁵⁰¹ Ibid.

⁵⁰² J M Weiner, H J Ault, 'The OECD's Report on Harmful Tax Competition' (1998) National Tax Association Symposium: What do We Mean by Taxpayer Relief, Arlington, VA, 601, 601.

treatment is baseless given that indexation does not apply to other types of capital income and to the income tax system.

The arguments based on CGT hindering corporate equity lack merit. Also, the CGT discount does not appear to greatly affect risk taking. Further, it is not readily apparent that the removal of the CGT discount would seriously damage international competitiveness or significantly discourage inward foreign investment.

Whilst the economic arguments run both ways, overall the arguments for taxing capital gains at ordinary income tax rates appear to be more compelling. More economic research is greatly needed though to quantify the economic benefits and costs of exempting, preferentially taxing and comprehensively taxing realised capital gains.

The reforms related to the CGT discount do not appear to hinder economic efficiency. Indexation for capital gains cannot be supported unless indexation is similarly extended across the income tax system. The preferential CGT treatment for averaging is limited to a few taxpayers and thus this leads to distortions and a loss of neutrality.

VII SIMPLICITY

A Compliance Costs

There is only limited research into Australian CGT compliance costs but the data generally shows that compliance costs are high. The first study by Pope et al⁵⁰³ of federal compliance costs in the late 1980s to early 1990s found compliance costs to be significant. The study estimated personal income tax compliance costs of \$3642 million or 9.2 per cent of personal income tax revenue in 1990–91. Corporate income tax compliance costs were estimated at \$3246 million or 22.9 per cent of corporate income tax revenue⁵⁰⁴. The data though did not separately identify CGT compliance costs.

A study by Wallschutzky and Gibson⁵⁰⁵ in a qualitative approach, examined 12 small businesses and their tax compliance costs. The study was conducted over a year from November 1991 to November 1992. They found few taxpayer problems complying with Commonwealth taxes, apart from sales tax.⁵⁰⁶ They also noted however, that CGT was a longer-term problem given the poor record keeping of small business.⁵⁰⁷ Nevertheless, the report concluded that compliance costs were not significant.⁵⁰⁸

⁵⁰³ J Pope, 'The Compliance Costs of Major Taxes in Australia' in C Sandford (ed) *Taxation Compliance Costs Measurement and Policy* (1995) 102.

⁵⁰⁴ C Evans 'The Operating Costs of Taxing Capital Gains – A Conspectus' in C Evans, J Pope, J Hasseldine (eds) *Tax Compliance Costs: A Festschrift for Cedric Sandford* (2001) 164.

⁵⁰⁵ I Wallschutzky, B Gibson, *Small Business Cost of Compliance Project: Final Report* (1993) Australian Taxation Office, 29.

⁵⁰⁶ Ibid.

⁵⁰⁷ Ibid 54.

⁵⁰⁸ Ibid 74.

Following a study⁵⁰⁹ to examine the incremental costs of compliance, Evans et al⁵¹⁰ were further commissioned by the Australian Taxation Office to estimate compliance costs for Australian taxpayers in respect of federal tax in the 1994–95 tax year. Using a large mail survey, the social compliance costs were estimated at \$10.4 billion or 11.9 per cent of all tax revenue and 2.29 per cent of GDP.⁵¹¹ After taking into account the tax deductibility benefit and cash flow benefits from tax deferral, compliance costs fell to \$6.2 billion, or 7 per cent of tax revenue and 1.36 per cent of GDP.⁵¹² Two and one half million business taxpayers incurred 75 per cent of the compliance costs and 7.3 million individual taxpayers incurred the other 25 per cent of costs.⁵¹³

The survey also found that only 1.2 per cent of 1528 personal tax (non-business) respondents received CGT income in 1994–95 tax year.⁵¹⁴ Of these, 583 used paid tax practitioners but only 4.5 per cent used a practitioner because of a need for CGT advice.⁵¹⁵ Rather, personal taxpayers mainly sought practitioners so as to prepare the income tax return.⁵¹⁶ Personal taxpayers spent 18 minutes on average per annum in maintaining CGT records, which was only 2 per cent of time spent on tax compliance.⁵¹⁷

The survey found that business taxpayers generally had little exposure to CGT.⁵¹⁸ There were 2462 business taxpayer respondents with 3.5 per cent having frequent CGT issues, that is four or more times a year.⁵¹⁹ Another 19.6 per cent of business taxpayers had occasional CGT issues (1–3 times per week).⁵²⁰ Others never dealt with CGT (48.4 per cent), or failed to respond to the question (28.5 per cent).⁵²¹ Business taxpayers spent four hours per annum on average on CGT matters out of a total of 90.7 hours.⁵²² Only 4 per cent of their time was spent on CGT.⁵²³ Thus CGT was not a significant compliance cost, estimated as costing \$155 million out of \$4.6 billion in

⁵⁰⁹ Evans et al, *A report into the Incremental Costs of Taxpayer Compliance* (1996) Australian Government Publishing Service. Evans et al were commissioned by the Australian Taxation Office to examine the incremental costs of compliance so as to calculate the impact of law reform on compliance costs. This 1994–95 year study relied on three extensive mail surveys of 10 000 taxpayers. The study though made no calculation of compliance costs but sought to identify methodologies and information needed to make such a computation.

⁵¹⁰ C Evans, K Ritchie, B Tran-Nam, M Walpole, *A Report into Taxpayer Costs of Compliance*, (1997) Australian Government Publishing Service.

⁵¹¹ Evans 'The operating costs of taxing capital gains' above n 505, 165.

⁵¹² Ibid.

⁵¹³ Ibid.

⁵¹⁴ Ibid.

⁵¹⁵ Ibid.

⁵¹⁶ Ibid.

⁵¹⁷ Ibid.

⁵¹⁸ Ibid.

⁵¹⁹ Ibid.

⁵²⁰ Ibid.

⁵²¹ Ibid.

⁵²² Ibid.

⁵²³ Ibid.

total business compliance costs.⁵²⁴ Significantly, when compared to CGT revenue of \$994 million, compliance costs were high, being 15.59 per cent of CGT revenue.⁵²⁵

The compliance costs for CGT and other federal taxes are set out in the following table:⁵²⁶

Table 10
Australian federal tax compliance costs: ATAX research

	Income tax (not including CGT)	Capital gains tax⁵²⁷	PAYE	Sales Tax	Prescribed payments system	Fringe Benefits Tax
Percentage of total federal compliance costs	42%	3.3%	14.8%	11.2%	10.3%	6.2%
Percentage of revenue yield	6.5%	16%	1.3%	4.7%	22%	10.5%

The table demonstrates that CGT compliance costs are generally significantly more expensive than other taxes when compared on a percentage of revenue yield basis.

Evans et al⁵²⁸ were further commissioned by the Australian Taxation Office to furnish annual updates of compliance costs for 1997–98, 1998–99 and 1999–2000 based on random stratified samples of over 3000 taxpayers. The 1997–98 figures have been produced and indicate significant changes to CGT compliance costs for business taxpayers compared to 1994–95.⁵²⁹

The annual internal labour time spent on CGT issues rose from two hours to 27 hours.⁵³⁰ This meant that CGT internal compliance time increased from 4 per cent of all internal time to 13 per cent.⁵³¹ It was estimated that CGT compliance costs for

⁵²⁴ Ibid.

⁵²⁵ Ibid.

⁵²⁶ Evans et al 'A report into taxpayer costs of compliance' above n 511, 54–57.

⁵²⁷ Ibid at 17, 31, Compliance costs equated to the costs of taxpayers complying with tax laws, including external advisers and the taxpayer's own time and costs, less tax deductibility benefits, and less cash flow benefits. This compliance costs equation though does not reflect the following compliance benefits. Firstly, compliance with CGT will provide managerial benefits through improved record keeping. Secondly, these compliance costs are offset by temporary and permanent tax savings provided by the deferral benefit (that is the benefit of deferring the payment of CGT at the time of realisation) and CGT exemptions (for example the small business CGT reliefs in Division 152).

⁵²⁸ Evans 'The operating costs of taxing capital gains' above n 505, 167.

⁵²⁹ Ibid 167–68.

⁵³⁰ Ibid.

⁵³¹ Ibid.

business taxpayers had risen from 3.3 per cent of all business compliance costs to 10.2 per cent.⁵³² The data also suggested that the CGT compliance costs as a ratio to CGT revenue yield remained high at 13.1 per cent.⁵³³ Notably over this time, the number of business taxpayers receiving capital gains increased from 290 380 in 1994–95 to 762 679 in 1997–98.⁵³⁴ The increase in compliance costs may be attributable to the large increase in business CGT payers or it may be due to CGT changes such as the new business exemptions,⁵³⁵ rollover⁵³⁶ and retirement reliefs⁵³⁷ introduced on 1 July 1997. As Evans notes:⁵³⁸

the greatest increase in personnel involved in CGT internal time was at the level of business proprietors and directors—those who would tend to have the greatest stake in determining whether the new reliefs were applicable and in accessing the reliefs where possible. It may be an ironic conclusion (but one that is nonetheless intuitively true) that the introduction of concessional treatment to the tax regime can often lead to increased compliance costs. The same can be true of choice—the more choice a taxpayer has, the greater the likely compliance costs as the taxpayer explores each possibility to obtain the optimal tax outcome.

However, the study found no significant increase in CGT compliance costs for personal (non-business) taxpayers.⁵³⁹ The number of personal taxpayers receiving capital gains increased from 270 531 in 1994–95 to 709 880 in 1997–98.⁵⁴⁰ More respondents obtained paid tax assistance as a result of CGT, up from 4.5 per cent to 5.2 per cent.⁵⁴¹ Overall though CGT record keeping time fell from 2 per cent of total compliance time to less than half of 1 per cent.⁵⁴²

Evans⁵⁴³ recently surveyed Australian tax practitioners regarding their attitudes to the compliance costs of the Australian CGT. Relevantly, he found that the survey showed that the compliance burden faced by personal taxpayers is directly influenced by the design features of CGT.

Relevantly, tax practitioners very strongly agreed that the ‘CGT legislation is complex’ (82 out of 94 respondents).⁵⁴⁴ Further, they also very strongly agreed that ‘compliance

⁵³² Ibid.

⁵³³ Ibid.

⁵³⁴ Ibid.

⁵³⁵ Ibid.

⁵³⁶ Ibid.

⁵³⁷ Ibid.

⁵³⁸ Ibid 168.

⁵³⁹ Ibid.

⁵⁴⁰ Ibid.

⁵⁴¹ Ibid.

⁵⁴² Ibid.

⁵⁴³ C Evans ‘Taxing Personal Capital Gains in Australia: Causes of Complexity and Proposals for Reform’, paper presented at the Australasian Tax Teachers Association National Conference, Flinders University, Adelaide, 29–30 January 2004, 1. Over 300 practitioners were surveyed.

⁵⁴⁴ Ibid 19–20.

costs for CGT do not relate to the amount of the gain' (84 out of 94 respondents).⁵⁴⁵ Importantly, they very strongly disagreed with the statement 'compliance costs for CGT are lower now than they were five years ago' (69 out of 94 respondents).⁵⁴⁶ Also, there was strong agreement for the statement 'compliance costs for CGT do not closely relate to the size of the transaction' (81 out of 93 respondents).⁵⁴⁷

Further, Evans asked practitioners to assess the impact of 18 possible drivers for CGT complexity.⁵⁴⁸ The results were tabled as follows:⁵⁴⁹

Table 11
Drivers of CGT compliance costs – descending order by mean

Rank	Factor	No.	Mean score	Frequency of citation (raw)	Frequency of citation (weighted)
1	(c) complexity of legislation	93	7.6	54	128
2	(q) the noof rules and exceptions	93	7.3	23	40
3	(g) Frequently changing legislation	93	6.9	28	49
4	(a) Record keeping requirements	93	6.6	27	64
5	(b) Poor legislative drafting	92	6.5	25	54
6	(i) Small business concessions	93	6.4	18	35
7	(d) Valuation issues	92	6.3	23	43
8	(n) Uncertainty of application	93	6.2	19	33
9	(m) Application to different entities	92	5.9	15	27
10	(k) Other reliefs and concessions	89	5.8	4	7
11	(r) The forms and instructions	90	5.8	10	22
12	(o) The no of calculations	93	5.6	4	6
13	(e) Calculating the cost base	93	5.5	8	14
14	(p) The difficulty of the calculations	91	5.1	2	3
15	(l) Identifying whether CGT applies	93	4.7	8	14
16	(j) The main residence exemption	93	4.5	1	1
17	(f) Calculating capital proceeds	93	4.4	1	1
18	(h) The CGT discount	93	4.0	1	1

⁵⁴⁵ Ibid.

⁵⁴⁶ Ibid 20–21.

⁵⁴⁷ Ibid.

⁵⁴⁸ Ibid 21–22.

⁵⁴⁹ Ibid 22.

The major driver of compliance costs was the complexity of legislation. Other important influences were the number of rules and exceptions, frequently changing legislation, record keeping requirements, poor legislative drafting and the small business concessions.

Evans concluded that the CGT compliance costs are high compared to the tax payable and the tax revenue collected.⁵⁵⁰ He also inferred from the tax practitioner responses that CGT compliance costs were higher in 2002 than five years ago, in 1997, prior to the enacted Ralph CGT reforms.⁵⁵¹ Evans also concluded that CGT compliance costs are high in comparison to the costs involved with other taxes.⁵⁵²

Thus these studies suggest that the CGT discount with its 28 pages of complex rules have added to the complexity and thus to the compliance costs of taxpayers. Although given the findings from Evans these extra costs may not be substantial.

On the other hand, the abolition of averaging would appear to simplify CGT since it removes an extra calculation. Similarly the freezing of indexation will remove time consuming indexation calculations for post 21 September 1999 assets. This appears to have reduced compliance costs.

B Administration Costs

The administration costs of a realisation CGT include the costs of tax design and drafting by Treasury, introducing and maintaining legislation by Parliament, and the administration start up costs of the Australian Taxation Office.⁵⁵³ The Australian Taxation Office will also incur costs for tax collection, assessing and auditing, debt recovery, forecasting tax revenue, advising, writing private and public rulings, dispute resolution and litigation.

There exists limited information about Australian administration costs given that the Australian Taxation Office does not provide a separate costing for CGT. Evans though provides the following table that shows the administration costs in the United Kingdom and Australia as a percentage of revenue yield.⁵⁵⁴

⁵⁵⁰ Ibid 24.

⁵⁵¹ Ibid 24.

⁵⁵² Ibid 25.

⁵⁵³ Tran-Nam et al 'Tax compliance costs' above n 30, 332-33.

⁵⁵⁴ Evans 'The operating costs of taxing capital gains' above n 505, 171.

Table 12
Administrative costs in the United Kingdom and Australia
as a percentage of revenue yield

Year	UK		Australia	
	Capital gains tax	All taxes	Capital gains tax	All taxes
1990–91	2.10	1.70	3.64	1.14
1991–92	3.80	2.06	4.15	1.26
1992–93	3.91	2.09	3.28	1.25
1993–94	5.90	2.14	1.78	1.21
1994–95	3.62	1.81	2.61	1.13
1995–96	4.10	1.70	2.61	1.03
1996–97	2.68	1.57	2.77	0.92
1997–98	2.30	1.41	1.64	0.85

Some caution must be exercised in relying upon these figures. Firstly, the UK figures were obtained from the annual reports of UK Inland Revenue and annual Taxation Statistics from the Australian Taxation Office.⁵⁵⁵ Thus other government administration costs⁵⁵⁶ incurred outside of the UK Inland Revenue and the Australian Taxation Office are excluded. Secondly, when interpreting UK figures it should be noted that such foreign research may not provide a good indicator for Australian tax administration given the differences in foreign tax regimes, taxpayer behaviour and tax administration. Thirdly, given the absence of a CGT costing by the Australian Taxation Office, Evans estimated the administration costs based on number of taxpayers with CGT compared to the overall number of taxpayers.⁵⁵⁷ Also, the CGT/yield ratio needs to be read carefully since it fails to take into account the integrity role of a CGT in preventing the transformation of ordinary income into exempt capital gains. As previously noted, a CGT prevents significant leakage from the income tax system.

The table firstly shows that for both countries the administrative costs of all taxes as a percentage of all tax revenue are falling over the eight-year period. Secondly, the table shows that CGT administration cost as a percentage of CGT revenue is highly volatile. This appears to be the result of the instability of CGT collections that move with the performance of the share and real estate markets. Thirdly, and most importantly, the administration costs of CGT as a percentage is significantly greater than the all taxes administration costs percentage. This is not surprising given the impact of CGT complexity on compliance costs.

Not surprisingly, the quantum of the impact of the CGT discount and other related reforms on administration costs is unknown. The CGT discount involved significant set up costs associated with tax design and drafting by Treasury, introducing and maintaining legislation by parliament and the administration start up costs of the

⁵⁵⁵ Ibid.

⁵⁵⁶ For example, Parliament and Treasury costs.

⁵⁵⁷ Evans 'The operating costs of taxing capital gains' above n 505, 171.

Australian Taxation Office. Also, it can be inferred that the CGT discount and its complex rules would have contributed to ongoing administration costs.

The abolition of averaging would appear to simplify CGT administration since it removes an extra calculation. Also, the freezing of indexation has removed indexation calculations for post 21 September 1999 assets and this would also appear to reduce administration costs.

VIII CONCLUSION

On a positive note the reforms that abolished CGT averaging and that froze CGT indexation are to be welcomed. Both reforms worked to increase CGT revenue. Secondly, since both concessions only applied to a limited number of asset holders they did not assist neutrality and hence economic efficiency. Again, the limited availability of these concessions and the tax minimisation opportunities all damage horizontal equity. Further, vertical equity was also breached given the upside down effect of such an exemption and the concentration of wealth. Additionally, both provisions required cumbersome calculations and this added to CGT complexity and thus to operating costs. These concessions failed all four of the tax policy criteria.

However, the CGT discount has had a great and negative impact upon fiscal adequacy. Further, the CGT discount has breached horizontal and vertical equity since it is only available to asset holders. The loss of equity is serious given the great concentration of Australian wealth. Additionally, the discount adds to complexity given the numerous requirements and anti avoidance provisions totaling 22 pages of legislation. These all contribute to operating costs.

Whilst the Ralph Report asserted that this reform would enliven and invigorate the share market and achieve a better allocation of resources,⁵⁵⁸ other evidence suggests the economic impact is mixed. It may have reduced lock in but this does not appear to be a serious problem. The discount appears to have created inefficiencies through the tax advantages that provides to capital growth assets and thus damages neutrality.

Overall, this reform is not supported since it imposes great costs on fiscal adequacy and equity, as well as adding to complexity. Economic efficiency does not appear to be greatly assisted by this exemption.

⁵⁵⁸ Review of Business Taxation Report above n 1, 598.

MUCH ADO ABOUT NOTHING: RALPH'S CONSIDERATION OF SMALL BUSINESS

MICHAEL DIRKIS AND BRETT BONDFIELD

*Michael Dirkis is the Tax Director at the Taxation Institute of Australia.
Brett Bondfield is a Lecturer in the Faculty of Economics and Business, the University
of Sydney.*

I INTRODUCTION

In August 1998 the government, following the release of the *Tax Reform, Not a New Tax, a New Tax System* (the ANTS document),¹ established the Review of Business Taxation chaired by John Ralph (commonly known as the 'Ralph Committee' or 'Ralph Review').² The Ralph Committee's tax policy objectives were to:

- improve the competitiveness and efficiency of Australian business;
- provide a secure source of revenue;
- enhance the stability of taxation arrangements;
- improve simplicity and transparency; and
- reduce the costs of compliance

against an overall revenue neutrality objective.

¹ Treasurer, 'Business Income Tax Consultation' (Press Release 14 August 1998). The origins of this round of business tax reforms was a statement by the Prime Minister John Howard on 25 May 1997 setting the framework for the reform process (see Michael Dwyer 'PM's tax reform rules' *The Australian Financial Review* 26 May 1997, 1). This process was advanced by the Tax Task Force (a Liberal Party's backbench committee chaired by Senator Brian Gibson (the Gibson Committee)), which completed its review in early 1998. Its findings, which were not published, were adopted in the Liberal government's proposals for a revamp of the Australian tax system. These proposals contained Peter Costello, Commonwealth, *Tax Reform, Not a New Tax, a New Tax System* (August 1998) (commonly called ANTS), were released on 13 August 1998 and included recommendations to introduce a goods and services tax (GST) and to tax trusts as companies.

² Review of Business Taxation, Commonwealth, *A Tax System Redesigned* (1999), v and vii. These policy aims had been earlier stated by the Ralph Committee in *Review of Business Taxation*, Commonwealth, *A Strong Foundation: Discussion Paper Establishing Objectives Principles and Processes* (1998), and two further discussion papers, *Review of Business Taxation*, Commonwealth, *An International Perspective: An Information paper commissioned from Arthur Andersen Examining how other countries approach business taxation* (1998) and *Review of Business Taxation*, Commonwealth, *A Platform for Consultation: Discussion Paper 2 Building on a Strong Foundation* (1999).

Thus, the Ralph Committee was charged with devising measures aimed at increasing the efficiency of all Australian businesses and, most importantly, tackling the related problems of the lack of simplicity and burgeoning compliance costs faced by business.

This compliance/simplification focus of the Ralph Review was crucial for small business as tax was, and is, seen as the largest regulatory compliance issue for small business.³ Prior to the Ralph Review the Small Business Deregulation Task Force (Bell Taskforce), which was charged with assessing the regulatory burden on small business and the options for reducing that burden,⁴ agreed noting in its November 1997 report *Time For Business* that the '[t]ime consumed in taxation compliance is a dead loss, adding no value to business'.⁵ The report elaborated further, stating that:

[t]he complexity of regulations, the frequency of complying and coping with constant changes, and the time needed to comply with the record keeping requirements, added to the frustration felt by small business.⁶

This point and the fact that tax compliance was the largest component in small business compliance costs was unambiguously accepted by the Howard Government early in its first term.⁷ The government⁸ and the Ralph Committee⁹ also accepted that no matter what method of evaluation is used tax compliance costs are strongly regressive and inversely proportional to the size of the business concerned.¹⁰ This regressive nature of tax compliance costs is endemic¹¹ founded as it is on the scale of the business and

³ Yellow Pages Small Business Index, Working Overtime: A National Survey of the Paperwork Burden on Small Business Background Paper 3 Small Business Deregulation Task Force (October 1996) and House of Representatives Standing Committee on Industry, Science and Technology Small Business In Australia – Challenges, Problems and Opportunities: Recommendations and Main Conclusions, (David Beddall MP (Chair)) (January, 1990) xxix (Beddall Report).

⁴ Small Business Deregulation Task Force (Charlie Bell (Chair)), Commonwealth, *Time For Business: Report of the Small Business Deregulation Task Force* (1996) (Time for Business), vii. The Small Business Deregulation Task Force was established to, amongst other things, compare the different approaches to reducing government 'red-tape' taken recently at Commonwealth, State and Territory levels; and to identify the lessons learned in devising and applying policies to reduce regulatory burden.

⁵ Ibid 28. See also Chris Evans, et al, *A Report into Taxpayer Costs of Compliance* (1997) concludes the costs are significant as well as including consideration of the positive business effects flowing from tax compliance.

⁶ Above n 4, 16.

⁷ John Howard, Prime Ministerial Statement More Time for Business (24 March 1997), iv noted '[d]ealing with our complex tax system was the number one compliance issue identified by small business'.

⁸ Treasurer, 'The New Business Tax System' (Press Release No 58, 21 September 1999).

⁹ A Tax System Redesigned, above n 2, 575–76 citing with approval Evans et al (1997) above n 5 and Chris Evans et al, *Costs of taxpayer compliance — Final Report* (1996).

¹⁰ Evans et al (1997) above n 5, viii and 85; Yellow Pages Small Business Index, above n 3, 3–7 and Chapter 3, OECD Businesses' Views on Red Tape: Administrative and Regulatory Burdens on Small and Medium-Sized Enterprises (2001), 8 [Located at: <http://www1.oecd.org/publications/e-book/4201101E.PDF> on 20 December 2003]; and Gary Banks (Chair, Productivity Commission), 'The Good, the Bad and the Ugly: Economic Perspectives on Regulation in Australia' (Paper presented at the Conference of Economists, Business Symposium, Canberra, 2 October 2003), 5. In the NZ context the results are comparable: Cedric Sandford and John Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (1992), 110.

¹¹ Stephen Rimmer and Stuart Wilson, *Compliance Costs of Taxation in Australia Staff Information Paper, Office of Regulation Review* (July 1996), 26–27. See also above n 10, OECD, 8 and 13.

available resources taken in order to meet the taxpayer's obligations.¹² However, despite the recognition by the government in 1997 of the importance of compliance/simplification issues to small business, and the asserted continuation of the reduction objectives in the Ralph Review compliance costs for small business have in fact increased.

Therefore, it is argued in this paper that the SME sector is the big loser under post-Ralph tax reform as:

- Ralph failed to meet its stated objective of reducing compliance costs for small business; and
- the small business concessions (the Simplified Tax System (STS) and the small business CGT concessions)¹³ introduced to 'compensate' small business for the increased compliance costs have proved to be inadequate in compensating small business.

The reasons underlying this compliance cost reduction failure and why compensation failed are also discussed. Although the paper focuses on the key policy objective for small business (compliance costs) any departure from the other Ralph tax policy objectives will be noted in that discussion. However, as the legal/policy analysis approach adopted does not easily lend itself to detailed analysis of system-wide objectives such as revenue neutrality, stability of tax arrangements and the tax base, these Ralph policy objectives will not be evaluated. Having established these arguments, the paper concludes by briefly exploring the possible ways forward for future reform processes to ensure that small business is not again the major casualty of tax reform.

The paper's approach to analysing the increased level of compliance costs is in the main qualitative, not empirical, as there is to date no empirical data on the total cost to the taxpayer of tax system compliance post the implementation of the GST and the Ralph recommendations. A qualitative analysis of the situation of small business tax compliance after Ralph is at one level speculative. However, at a policy and system design level it is instructive so that we can identify and learn from the triumphs as well as the mistakes.

¹² A Tax System Redesigned, above n 2, 74 expresses the issue succinctly: 'Small business proprietors must prepare and retain a myriad of documents for taxation and other purposes' incurring substantial costs and having sub-optimal systems and expertise to do so'. See also Ralph Lattimore, et al, Design Principles for Small Business Programs and Regulations, Productivity Commission Staff Research Paper (August 1998) generally and particularly, xxiv.

¹³ Chapter 17 of A Tax System Redesigned, above n 2 STS was generally endorsed by government and enacted by The New Business Tax System (Simplified Tax System) Act 2001. Chapter 17 also recommended streamlining and rationalising Capital Gains Tax (CGT) provisions for small business. This was accepted by government with minor alterations and enacted by The New Business Tax System (Capital Gains Tax) Act 1999 effective 21 September 1999.

II CONTEXT: THE IMPORTANCE OF SIMPLIFICATION AND COMPLIANCE FOR SMALL BUSINESS

Before embarking on exploring these arguments, it is important to provide some background and context, by briefly examining the importance of simplicity and the costs of tax compliance (and its quantification) on small business.

A common thread in the reviews and studies conducted from Adam Smith in 1776¹⁴ to the Board of Taxation's 2003 report on the Review of International Taxation Arrangements¹⁵ is the use in most of those inquiries of the tax policy objective of simplicity in evaluating the effectiveness of existing laws and the proposed tax reforms.¹⁶ Academic commentators also broadly accept simplicity as one of three key tax policy objectives (equity, efficiency and simplicity) traditionally used for evaluating tax systems.¹⁷

A Why Simplicity is Important to Compliance Costs¹⁸

Initially it is important to be clear what constitutes the term 'simplicity' and why it is of particular importance to small business.

Simplicity is broadly accepted as an obvious goal of any revenue raising and regulatory system.¹⁹ It is generally accepted that income tax is in varying degrees intrinsically

¹⁴ Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* (1776) in Edwin Cannan (ed) (1904, reprinted 1961).

¹⁵ The Treasury, Commonwealth, *Review of International Taxation Arrangements: Consultation Paper* (2002); The Board of Taxation, Commonwealth, *International Taxation: A Report to the Treasurer* (2003) and Treasurer, 'Review of International Taxation Arrangements' (Press Release No 32, 13 May 2003).

¹⁶ See Paul Kenny 'A "Simplified Tax System" for small business' (2002) 6 *The Tax Specialist* 36, who reviews the Ralph Committee's small business specific initiative, STS, against the good tax objectives of equity, efficiency and simplicity.

¹⁷ See, for example, Geoffrey Lehmann and Cynthia Coleman, *Taxation in Australia* (5th ed, 1998), 65; Robin H Woellner et al, *Australian Taxation Law* (13th ed, 2003), 26-37; Jeffrey Waincymer *Australian Income Tax: Principles and Policy* (2nd ed, 1993), 24-39 and Rodney Fisher, 'Ralph Review: Reform by Name but Not Nature?' (2003) 7 *The Tax Specialist* 61, 62. However, not all commentators agree that the objectives of simplicity, efficiency and equity are good predictors of the tax system. For example Simon Blount 'The Art of Taxation' (2001) 16 *Australian Tax Forum* 345, 355 argues that the better predictors are the objectives of elasticity, complexity and invisibility. Further, Graeme Cooper, Richard Krever, and Richard Vann, *Income Taxation: Commentary and Materials* (4th ed, 2002) 3, warn that although the three tax policy objectives dominate bureaucratic thinking, since the 1970s tax policy analysis in public finance literature has been based upon the use of welfare economics (ie, optimal taxation).

¹⁸ This part of the paper is drawn from work done as part of Michael Dirkis's PhD program.

¹⁹ Though this is considered by some to be advanced as a platitude, for example Graeme S Cooper 'Themes and Issues in Tax Simplification' (1993) 10 *Australian Tax Forum* 417, 420 and also at 426-32, suggests 'there is little empirical work that can verify the grand, but largely unsupported, claims for the benefits of simplification.'

complex²⁰ and there have been continual complaints in reports and in the literature about the complexity of the tax system since its inception.²¹

The importance of simplicity is that in its absence tax laws are complex (uncertain) and poorly designed, which in turn:

- imposes high compliance costs on the community;²²
- imposes high administrative costs on the tax authorities;²³
- results in socially unproductive and costly tax litigation;²⁴
- is counterproductive to the economic development of the country,²⁵ in particular by jeopardising economic neutrality;²⁶
- acts against public involvement in policy development;²⁷ and
- generates disrespect for the rule of law.²⁸

Despite the self-evident nature of the concept of simplicity, the myriad writings on the topic present what appears to be an unending array of definitions of what constitutes simplicity. Cooper, having reviewed the literature, suggests that the many and varied concepts discussed by writers can be distilled down to seven concepts that are

²⁰ United Kingdom, Report of the Income Tax Codification Committee Cmd 5131 (1936), 17 noted '[t]he impossibility of producing a simple code of income tax law must be obvious to anyone who reflects for a moment ... The countless complications of modern life must inevitably reflect in the complexity of the code which has to cope with them'. This was cited with approval by the Commissioner of Taxation. See the Commissioner of Taxation, Commonwealth, Eighteenth Report (1936), 14. Also see Stanley S Surrey, 'Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail' (1969) 34 *Law and Contemporary Problems* 673, 680; Commonwealth, Reform of the Australia Tax System: Draft White Paper (1985), 42, 15; Michael Carmody, 'Issues Confronting Australia's Tax System' (Paper presented in Financial Review Leaders Lunch, Sydney, 29 July 2002), 14. Copy located at: <http://www.ato.gov.au/content.asp?doc=/content/Corporate/sp200207.htm> accessed 22 December 2003, and Banks, above n 10, 3.

²¹ Commonwealth, Royal Commission on Taxation, Reports (1933–34) (the 1932 Royal Commission), 6.

²² Discussed in the following sections.

²³ As complexities continue to rise so do complex boundaries for the ATO to police. The total cost of the tax system may rise as it is the sum of compliance costs and administrative costs borne primarily by the ATO. See Evans, above n 5, 86; and Cedric Sandford, 'International Comparisons of Administrative and Compliance Costs of Taxation' (1994) 11 *Australian Tax Forum* 291, 301.

²⁴ 1985 Draft White Paper, above n 20, 14, 15.

²⁵ See, for example, Law Reform Commission of Victoria Plain English and the Law (1987), 59; Editor, 'Counting the Costs' (1991) 26 *Taxation in Australia* 248; and Brian Nolan and Tom Reid 'Re-Writing the Tax Act' (1994) 22 *Federal Law Review* 448, 450.

²⁶ Complexity can create a lack of economic neutrality by favouring projects with more predictable tax outcomes. See Mark Burton, and Michael Dirkis, 'Defining Legislative Complexity: A Case Study - the Tax Law Improvement Project' (1995) 14 *University of Tasmania Law Review* 198, 204.

²⁷ Certainty about tax laws allows for a widespread, informed debate upon taxation policy issues, which is essential to the functioning of democracy. See C Havighurst, and R Hobbet 'Foreword' (1969) 34 *Law and Contemporary Problems* 671 cited in Burton, above n 26, 206.

²⁸ It is argued that if taxpayers lose faith with the tax law as a body of rules, voluntary compliance will suffer and the government in introducing measures, which protect the revenue, will incur greater cost. See Ross Parsons, 'Income Tax - An Institution in Decay?' (1986) 3 *Australian Tax Forum* 233; and Adam Broke, 'Simplification of Tax or I Wouldn't Start From Here' (2000) *British Tax Review* 18, sees four causes of complexity: diversity, volume, drafting and language.

embodied in the notion of simplicity.²⁹ Although other writers have distilled what appear to be different concepts underlying simplicity, these are generally based upon subtle differences in classification and expression.³⁰ A common thread is that low compliance costs of both taxpayers and the tax system generally is a desirable goal within the rubric of simplicity that is in turn a central pillar of good tax policy. Why it and compliance costs are of such specific relevance to small business is that compliance costs are regressive.

Bearing in mind the above, the key measurement approach is to focus on the cost of compliance.³¹ Most academic research has focussed on the compliance costs from the taxpayer's perspective³² as the global costs of collection are usually obtained from the budgets of the revenue authorities.³³ Although there has been a lot of research, the accuracy of the results has been questioned, based on methodological concerns³⁴ including sample size, response rates³⁵ and the inability to measure the impact upon compliance costs when changes are implemented.³⁶ The Australian position regarding these fundamental issues of the identification and the quantification of tax compliance costs is discussed under the following two headings.

²⁹ Cooper, above n 19, 424 being: predictability (ease of understanding) of a rule's intended (and actual) scope; proportionality (complexity proportional to the policy); consistency (avoids arbitrary distinctions); low compliance; easy administration; coordination with other tax rules; and clear expression.

³⁰ For example: predictability, enforceability, difficulty and manipulability. See Joel Slemrod, 'Complexity, Compliance Costs and Tax Evasion' in JA Roth and JT Scholtz, *Taxpayer Compliance: Social Science perspectives* (1986) 156 cited in Binh Tran-Nam 'Tax Reform and Tax Simplicity: A New and "Simpler" Tax System?' (2000) 6 *University of New South Wales Law Journal Forum* 6.

³¹ Joel Slemrod, 'Did the Tax Reform Act of 1986 Simplify Tax Matters?' (1992) 6 *Journal of Economic Perspective* 45. Slemrod suggests that the total operating costs of the tax system is a measure of the complexity of the system—cited by Jeffrey Pope, 'Policy Implications of Research on Compliance Costs of Taxation' in John G Head and Richard Krever (eds), *Taxation towards 2000* (2000), 617, 637.

³² Chris Evans, et al 'Taxation Compliance Costs: Some Recent Empirical Work and International Comparison' (1998) 14 *Australian Tax Forum* 93. For an excellent overview of some of the current debates and trends in this area see: Chris Evans, Jeff Pope and John Hasseldine (eds) *Tax Compliance Costs: A Festschrift for Cedric Sandford* (2001), 17:4 *Australian Tax Forum* focussing on tax compliance cost research and dedicated to Cedric Sandford and a series of studies by Jeff Pope et al starting with Jeffrey Pope, Richard Fayle and Dong-Ling Chen *The Compliance Costs of Personal Income Taxation in Australia 1986/87* (1990) and more recently Jeff Pope and Prafula Fernandez 'The Compliance Costs of the Superannuation Surcharge Tax' (2003) 18 *Australian Tax Forum* 537.

³³ For example Banks, above n 10, 3 notes that in 2001–02 the ATO employed 19 381 staff of the 30 720 employed by the main Commonwealth regulatory agencies with expenses of \$3043 million (out of an all main regulatory agency expense total of \$4566 million).

³⁴ OECD, above n 10, 13–15.

³⁵ Joel Slemrod, 'Which is the Simplest Tax System of Them All' in Henry J Aaron and William G Gale (eds), *Economic Effects of Fundamental Tax Reform* (1996) and Banks, above n 10, 5.

³⁶ Cooper, above n 19, 426. However, the identification and measurement of transitional compliance costs is an area receiving considerable recent attention (possibly due to the pace of tax system change). See for example Binh Tran-Nam, and John Glover 'Estimating the Transitional Compliance Costs of the GST in Australia: A Case Study Approach' (2002) 17 *Australian Tax Forum* 499; and Nthathi Rametse, and Jeff Pope, 'Start-up Tax Compliance Costs of the GST: 'Empirical Evidence from Western Australian Small Businesses' (2002) 17 *Australian Tax Forum* 407.

B Compliance Costs with Special Reference to Small Business

The Small Business Deregulation Taskforce Report provides a useful definition of compliance costs that it refers to as ‘burden’ being:³⁷

The additional paperwork and other activities that small business must complete to comply with government regulations. The time and expense outlaid are over and above normal commercial practices. The burden includes lost opportunities and disincentives to expand the business.

This accords with accepted writings in the area,³⁸ though more recent writings also net these compliance costs against managerial benefits from tax compliance,³⁹ for example cash flow monitoring benefit as part of GST compliance.

At a macro level compliance costs must be viewed within the context of two overarching facts. First, from September 1985, when it was first announced that traditional taxation administration arrangements were to be replaced with self assessment, a large compliance burden has shifted from the tax administrator to the taxpayer.⁴⁰ In Australia it is submitted that its introduction from 1 July 1986 was piecemeal and that there has been a failure of the system to fully address the power imbalance created through ensuring timely, accessible and binding information.⁴¹

Second, this macro community cost can be increased through incompetent advice and inadvertent non-compliance as a result of complexity.⁴² Complex income tax laws, which make it impossible to form a defensible view in respect of the law, discourage thorough tax advisers, as they are unable to justify their fees for such uncertain outcomes. As a result, less thorough advisers can charge less for their equally uncertain advice (the so called Gresham’s Law).⁴³

³⁷ Time for Business, above n 4, 1.

³⁸ Binh Tran-Nam, and Chris Evans, ‘The Impact of Cedric Sandford on the Discipline of Tax Compliance Costs’ (2002) Australian Tax Forum 389, 396–97.

³⁹ See generally Binh Tran-Nam et al, ‘Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia (2000) 53 National Tax Journal 229; and Kenny, above n 16, 37.

⁴⁰ Aspects of the self-assessment system are to be reviewed by the Department of the Treasury: Treasurer, ‘Review of Aspects of Income Tax Self-Assessment’ (Press Release No 98, 24 November 2003).

⁴¹ Michael Dirkis, and Michael Payne-Mulcahy, ‘Time for a Change: Self Assessment 14 years on’ (2002) 36 Taxation in Australia 417.

⁴² Margaret Mc KERCHAR, The Impact of Complexity Upon Tax Compliance: A Study of Australian Personal Taxpayers Research Study No. 39 Australian Tax Research Foundation (2003).

⁴³ H H Monroe, ‘Fiscal Statutes: A Drafting Disaster’ (1979) British Tax Review 265, 268; Committee on Tax Policy of the New York State Bar Association’s Tax Section, ‘A Report on Complexity and the Income Tax’ (1972) 27 Tax Law Review 325, 327; and Burton, above n 35, 205.

III FAILURE TO REDUCE COMPLIANCE COSTS?

In order to establish that Ralph failed to meet its stated objective of reducing compliance costs for small business it is important to set out the level of compliance costs pre-Ralph, the level of change and the compliance burden post-Ralph.

A The Pre-Ralph Compliance Burden

As far back as 1990 a parliamentary committee expressed major concern at the growth in the tax laws in the preceding five years⁴⁴—the pace of change has only picked up from there. At the time of the 1996 Bell Taskforce Australia's tax compliance burden was '[g]enerally towards the higher end of comparable tax regimes, but by no means the highest in the OECD'.⁴⁵

A recent OECD paper analyses and compares small and medium business compliance costs in three areas of regulation: tax, employment and environment for the April 1998 to May 1999 (pre-Ralph) period of 11 countries, including Australia and New Zealand.⁴⁶ This report is instructive as it reinforces the points made previously in this paper that overall tax is the largest single component of the small business regulatory burden⁴⁷ and that regulatory burden is regressive, cumulative, significant⁴⁸ and increasing.⁴⁹

The OECD report finds 80 per cent of those surveyed in Australia asserted that their tax compliance increased in the two years before 98–99—this is the second highest ranking after Mexico.⁵⁰ In terms of a pre-Ralph sample the report identifies complexity of the tax laws as the main compliance cost vector,⁵¹ though now tax system change may be an increasingly significant cost component in the current Australian environment. In a study published twelve years ago on the New Zealand tax compliance situation, researchers were of the view that the stability of the system was important in order to minimise 'temporary compliance costs'.⁵² Given the acknowledged rate of change in Australia's tax system these costs may well be near endemic, skewing the responses to research and inflating the costs as located.

The OECD study found that Australian firms surveyed were particularly critical of the service provided by their regulations and regulators. High by comparison to other surveyed countries 94 per cent of Australian respondents were of the opinion that

⁴⁴ Beddall Report, above n 3, xxix.

⁴⁵ Chris Evans, and Michael Walpole, Compliance Cost Control: A Review of Tax Impact Statements in the OECD Australian Tax Research Foundation Research Study No 27 (1999), 15.

⁴⁶ OECD above n 10.

⁴⁷ Ibid, 23.

⁴⁸ Ibid, 21 asserting significance.

⁴⁹ Ibid, 30 found that 60 per cent of those surveyed asserted this increase and the Australian position approximates that figure, 59.

⁵⁰ Ibid, 56. 80 per cent figure cited by Banks above n 10, 4.

⁵¹ Ibid, 30–31.

⁵² Sandford and Hasseldine above n 10, 119.

regulations did not achieve their goals as simply as possible.⁵³ Further, Australian firms rated the quality of their contacts when seeking information from regulators (tax, employment and environment) consistently lower than firms in comparable countries.⁵⁴

Overall the OECD report finds Australia to be just above the average for compliance costs over the aggregate of the three areas sampled. For the purposes of Trans-Tasman comparison the report finds the New Zealand aggregate costs of compliance over tax, employment and the environment to be the lowest of the eleven countries analysed.⁵⁵ However, the tax compliance cost per employee in Australia was reported as being slightly less than the cost in New Zealand.⁵⁶

B Ralph Proposals Impacting on Small Business

Despite the awareness of the compliance burden on small business and its compliance reduction focus, the Ralph Committee⁵⁷ in its final 808 page report, *A Tax System Redesigned*,⁵⁸ made 280 recommendations and was accompanied by 274 pages of draft legislation accompanied by 320 pages of Explanatory Notes. The recommendations included proposals to:

- introduce a Board of Taxation;⁵⁹
- introduce an integrated tax code;⁶⁰
- improve the reliability, certainty and timeliness of the rulings program and fees for selected rulings;⁶¹
- lower company tax rates;
- alter the capital gains regime by removing indexation and averaging but halving the capital gains tax rate and altering the retirement concessions for small business;
- introduce a new regime for determining taxable income—a cashflow/tax value approach (commonly referred to as ‘Option 2’, but renamed the Tax Value Method (TVM));⁶²
- associated with the TVM change, treat individuals on a cash basis,⁶³ while businesses with turnovers under \$1 million be assessed under a new Simplified Tax System (STS);⁶⁴

⁵³ OECD, above n 10, 64

⁵⁴ Ibid, 73.

⁵⁵ Ibid, 22.

⁵⁶ Ibid, 108 figure 5.

⁵⁷ The following description of the Ralph outcomes is drawn from Michael Dirkis, ‘Observations on the Development of Australia’s Income Tax Policy and Income Tax Law’ (2002) 56 Bulletin for International Fiscal Documentation 522.

⁵⁸ *A Tax System Redesigned*, above n 2. For a more detailed history of the reform process see Peter A Harris, ‘Will Australia Go “The Full Monty?”’ (1998) 52 Bulletin for International Fiscal Documentation 478; and Peter A Harris, ‘Corporate Tax Reform Down-Under: Maybe Not The Full Monty But . . .’ (1999) 53 Bulletin for International Fiscal Documentation 249.

⁵⁹ *A Tax System Redesigned*, above n 2, recommendations 1.4–1.7.

⁶⁰ Ibid, recommendation 2.1.

⁶¹ Ibid, recommendation 3.1 to 3.6.

⁶² Ibid, recommendations 4.1 to 4.24.

- tax trusts as companies (the entity taxation regime), including the introduction of a profits first rule and new dividend imputation rules;
- introduce a system of consolidated group taxation; and
- review reform recommendations in respect of the taxation of non-residents, source rules and double tax agreements.⁶⁵

The government's accepted the majority of the recommendations contained in the final Report.⁶⁶ This led to the government, between June 1999 and the dissolution of parliament on 5 October 2001 for the Federal Election, introducing into Parliament 144 taxation, superannuation, excise and license fee bills, with a further 44 taxation and superannuation related bills introduced in 2002 and 20 taxation and superannuation bills in 2003. The Productivity Commission has noted that more telling than the number of bills is the steady increase in the average length of legislation and that the length of the *Income Tax Assessment Act 1936* (ITAA1936) and *Income Tax Assessment Act 1997* (ITAA1997) alone was about 7000 pages.⁶⁷

Although the length of the law in itself does not give rise to complexity,⁶⁸ the impact of the measures upon tax law affecting small business does indicate increased complexity and compliance costs. These bills contained a new business registration system (the Australian Business Number (ABN) System), the Goods and Services Tax (GST),⁶⁹ the new tax collection system (the Pay As You Go (PAYG) System⁷⁰—mooted to get rid of provisional tax) and a new penalty regime.⁷¹ The PAYG system introduced quarterly activity statements for most small business. For many other taxpayers with GST refunds, such as pharmacists, monthly activity statements are the norm. This measure alone results in small business having between five and thirteen visits to an accountant compared with one previously.⁷²

⁶³ Ibid, recommendation 4.4.

⁶⁴ Ibid, recommendations 17.1 to 17.6.

⁶⁵ Ibid, recommendations 22.18–22.24 and 23.1–23.3.

⁶⁶ The recommendations were accepted by the government in Press Release No 58, above n 8; and Treasurer, 'The New Business Tax System: Stage 2 Response' (Press Release No 74, 11 November 1999).

⁶⁷ Banks, above n 10, 2–3.

⁶⁸ Despite some claims that length inevitably causes complexity, for example, Trevor Boucher, 'Tax Simplification: Some Different Dimensions' (paper presented to the Monash University Law School Foundation, Melbourne, 3 September 1991) 2; edited version 'The Simplification Debate: Too Simplistic' (1991) 26 *Taxation in Australia* 277.

⁶⁹ The GST measures were part of a package of 17 Bills. The main GST implementation provisions were contained in the following three Acts: A New Tax System (Goods and Services Tax) Act 1999, A New Tax System (Goods and Services Tax Transition) Act 1999, and A New Tax System (Goods and Services Tax Administration) Act 1999. The GST measures, since introduction, have been subjected to hundreds of changes. These are principally contained in A New Tax System (Indirect Tax and Consequential Amendments) Act (No 1) 1999 and A New Tax System (Indirect Tax and Consequential Amendments) Act (No 2) 1999.

⁷⁰ A New Tax System (Pay As You Go) Act 1999.

⁷¹ The legislation is contained in A New Tax System (Tax Administration) Act (No 2) 2000.

⁷² For a brief examination of the early difficulties faced by small business see Michael Dirkis, 'The BAS Changes: They Promised it Would be Easy' (2001) 35 *Taxation in Australia* 414; and Michael Dirkis, 'The BAS Changes – A Failure in Consultation or a Failure to Listen?' (2001) 35 *Taxation in Australia* 417.

Small business was specifically targeted by so called integrity measures such as the anti-alienation of personal services income measures (which specifically increased compliance costs for small contractors),⁷³ and the non-commercial losses quarantining regime (which attacked new small business ventures).⁷⁴ The alienation and non-commercial loss measures continued and introduced extra artificial distortions in the tax system, further decreasing efficiency of small business. Other integrity measures having a compliance impact were the modifications to the prepayment rules⁷⁵ and new specific general anti-value shifting measures (GVSR).⁷⁶

The new capital allowance (depreciation) regime⁷⁷ was another measure that imposed additional compliance costs on small business. Of lesser direct effect on small business are the corporate consolidation regime (which takes away from all companies the benefit of the inter-corporate dividend rebate provisions, loss transfer provisions, capital gains tax rollover concessions, and the transfer of excess foreign tax credits),⁷⁸ the demerger regime,⁷⁹ and a new dividend imputation regime (Simplified Imputation System (SIS)).⁸⁰

Compounding the level of initial compliance costs arising from the sheer volume of legislative change is the fact that much of recent tax reform has been approached by throwing away the old provisions, terminology and understanding and creating a new

⁷³ New Business Tax System (Alienation of Personal Services Income) Act 2000, New Business Tax System (Alienated Personal Services Income) Tax Imposition Act (No 1) 2000 and New Business Tax System (Alienated Personal Services Income) Tax Imposition Act (No 2) 2000.

⁷⁴ See, for example, Robert Douglas, 'Farmers Nil, Commissioner Nil. Thanks, Ralph Great Result' (2001) 35 *Taxation in Australia*, 387, 392 who argues that any innovative farm value-adding activity runs the risk of being classified as a separate business activity with the resultant quarantining of losses. Similar concerns are expressed in a pending RIRDC Report, prepared by Alistair Watson, Rick Lacy and John Crase entitled 'Economic Effects of Income-Tax Law on Investment in Australian Agriculture (with Particular Reference to New and Emerging Industries)'.

⁷⁵ The changes are contained in New Business Tax System (Integrity and Other Measures) Act 1999 and New Business Tax System (Miscellaneous) Act (No 2) 2000.

⁷⁶ The core provisions are contained in the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002 and the special rules applying in relation to the consolidation regime in the New Business Tax System (Consolidation and Other Measures) Act 2003. Further modifications are contained in the Taxation Laws Amendment Bill (No 9) 2003.

⁷⁷ New Business Tax System (Capital Allowances) Act 2001 and New Business Tax System (Capital Allowances - Transitional and Consequential) Act 2001.

⁷⁸ The basic operative provisions of the new consolidation regime are contained in four Acts: the New Business Tax System (Consolidation) Act (No 1) 2002, the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002, the New Business Tax System (Consolidation and Other Measures) Act 2002 and the New Business Tax System (Consolidation and Other Measures) Act 2003.

⁷⁹ Also contained in the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002.

⁸⁰ The new Imputation system was introduced from 1 July 2002 via a package of Acts: the New Business Tax System (Imputation) Act 2002, the New Business Tax System (Over-franking Tax) Act 2002 and the New Business Tax System (Franking Deficit Tax) Act 2002. Further changes were contained in the New Business Tax System (Franking Deficit Tax) Amendment Act 2002, the New Business Tax System (Consolidation and Other Measures) Act 2003 and Taxation Laws Amendment Act (No 8) 2003. Further proposed changes are set out in Minister for Revenue and Assistant Treasurer, 'Business Tax Legislation Introduced' (Press Release 27 September 2002) and Minister for Revenue and Assistant Treasurer, 'Amendments to Further Simplify Dividend Imputation Rules' (Press Release 20 December 2002).

model (for example, the capital allowances regime and the SIS). This approach deprives taxpayers of the advantages of historic learning, thereby creating greater uncertainty and higher initial compliance costs.

Further, much of the ‘new’ drafting style is highly theoretical, abstract and vague—a point appreciated by the drafters of the GVSR law who appear compelled to follow each definition with a concrete example.⁸¹ Such expansive drafting, combined with removal of historic precedent is inexcusable in a self-assessment environment where there is a clear obligation upon taxpayers to be aware of their legal rights and obligations.⁸² Without clear laws taxpayers have little hope of meeting that expectation. As a result, the validity of the self-assessment model in the current post-Ralph tax reform landscape is further undermined⁸³ as well as transitional and (probably continuing) compliance costs being higher than they otherwise would be.

However, some of these problems may not be Ralph per se but a demonstrated failure by the ATO, Treasury and Office of Parliamentary Council to heed the Ralph’s recommendations in respect of a better legislative design and consultative process.⁸⁴

To compound this problem of the pace of legislative change the Commissioner continued the flood of rulings, determinations and interpretative decisions.⁸⁵ For example, the number of rulings, etc issued by the Commissioner in:

- 2002 were: Rulings: 89 Class, 11 draft and 6 final GST, 147 Product, 1 draft and 1 final Fuel Grant and Rebate, 2 Wine Equalisation Tax and 13 draft and 21 final Tax; Determinations: 5 draft and 5 final GST, 4 Superannuation Contributions, 1 Superannuation Guarantee and 16 draft and 28 final Tax;⁸⁶ and
- 2003 were: Rulings: 112 Class, 9 draft and 16 final GST, 82 Product, 3 Product Grants and Benefits, 10 draft and 16 final Tax; Determinations: 23 draft and 32 final Tax, 5 draft and 3 final GST, 4 Superannuation Contributions, 1 Luxury Car Taxation and 7 Superannuation Guarantee; and Bulletins: 2 GST.⁸⁷

Add to this huge information flow the list of non-binding statements (on the taxpayer, contra for ATO staff) such as ATO Interpretative Decisions (ATOID), Practice Statements, fact sheets and explanatory material (for example, the Consolidation Guide, the Receivables Manual and ATO Access Guidelines). The ATOID count for

⁸¹ Michael Dirkis, ‘Improved Model or Another Old Banger? Evaluating the New General Value Shifting Regime (GVSR)’ (presented at Taxation Institute of Australia’s 10th National Tax Intensive Retreat, Coolom, 29 August 2002) 10.

⁸² Expansive drafting produces ‘imprecise, fluid and elastic provisions’ which lack clear policy direction and creates uncertainty for taxpayers. See Ian Stanley, ‘The Debt Equity Rules: Debt Interests’ (Paper presented at NSW Division of the Taxation Institute of Australia Seminar, Sydney, 16 August 2001) 1.

⁸³ See for example Dirkis and Payne-Mulcahy, above n 41.

⁸⁴ See Dirkis (IBFD 2002), above n 57 and in section IV point B following.

⁸⁵ For example, released in 1999 were: Rulings: 14 draft and 1 final GST, 104 Product and 21 draft and 19 final Tax; and Determinations: 103 draft and 84 finalised Tax and 6 Sales Tax. Released in 2000 were: Rulings: 23 draft and 37 final GST, 119 Product and 36 draft and 18 final Tax; and Determinations: 6 draft and 12 final GST, 1 final Superannuation Guarantee, 1 Superannuation Contributions 2 Sales Tax, 23 draft and 54 final Tax.

⁸⁶ TR 2002/List issued 19 December 2002.

⁸⁷ TR 2003/List issued 19 December 2003.

2002 alone stands at 1116 and at 1135 for 2003.⁸⁸ Much of this activity has been generated by the GST and post-Ralph changes.⁸⁹

C The Compliance Burden Post-Ralph

Given this amount of change it would seem logical to expect that small business has faced huge initial compliance costs from the introduction of these changes. However, there is yet to be a study published of the global tax compliance position of Australian small business post the implementation of the GST and the Ralph recommendations, nor has there been any published research on the cumulative impacts of the introduction of the GST and the Ralph initiatives. Therefore, in attempting to assess the quantum of current tax compliance costs, we are relying on available qualitative information and as such there is plenty of room for conjecture.

Anecdotally, post-Ralph tax compliance is considered by many as horrendous and that overall the post-Ralph tax system is making considerably more compliance demands on taxpayers.⁹⁰ There are significant voices from tax practitioners claiming that the post-Ralph changes have led to an intolerable compliance burden that especially (probably predictably) impacts on small business.⁹¹ The issue has also been raised at various National Tax Liaison Group (NTLG) meetings, including 2 December 1999⁹² just after the government's initial responses to the Ralph Committee.

⁸⁸ As at 12 December 2003.

⁸⁹ Although the Administrative Appeals Tribunal (AAT) and the Courts have also been busy with 109 Court and 42 AAT decisions in 2003 (as per CCH reports at 19 December 2003), with the major areas of focus being in the areas of deductibility of interest and Part IVA, this litigation is not a direct result of Ralph, rather it is business as usual. For example, there were 95 Court and 61 AAT decisions in 1999 and in 2000 there were 87 Court and 15 AAT decisions.

⁹⁰ 'Instead of simplifying the compliance to the law, [the RBT reforms] actually increased the burden significantly.' Ray Conwell, former President of the Taxation Institute of Australia, quoted in Allesandra Fabro, 'ATO not Delivering, Say CEO's', Australian Financial Review, 2 September 2002, 5.

⁹¹ Stephen Harrison, (CEO: Institute of Chartered Accountants in Australia), 'Open Letter to Tax Commissioner Carmody' (13 August 2002) Located at <http://www.icaa.com.au/news/index.cfm?menu=226&id=A105289876> accessed on 17 December 2003); Ray Regan, (President: National Tax & Accountants' Association), 'NTAA Supports Call for Tax Practitioners to Revolt' (NTAA Press Release 15 August 2002); and Gil Levy (President, Taxation Institute of Australia) 'Tax Crisis – Hard Times Call for Hard Actions' (Taxation Institute of Australia Press Release 13 August 2002) located at <http://www.taxinstitute.com.au/cda/media/1,1316,1-39159,00.html> accessed on 20 December 2003. CPA Australia while not endorsing the ICAA response identifies the same problems existing in the tax system: Greg Larsen (CEO CPA Australia), 'CPA Australia Works to Resolve Australian Tax Administration Issues' (14 August 2002) located at: http://www.cpaustralia.com.au/01_information_centre/24_advocacy/1_24_6_13_ato.asp accessed on 17 December 2003. In the context of FBT this is referred to in the ATO's NTLG FBT Sub-committee Minutes 21 February 2002, point 9 accessed at: <http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/21199.htm&page=1&pc=001/005/036/002/003&mnu=6547&mfp=001&st=&cy=1> on 19 December 2003.

⁹² National Tax Liaison Group Minutes, item 11 located at: <http://www.ato.gov.au/content.asp?doc=/content/Professionals/NTLGMinutesDecember1999.htm&page=1#H11> on 2 April 2002: no longer available on ATO website. Also raised at 31 August 2000 NTLG meeting: Minutes located at: <http://www.ato.gov.au/content.asp?doc=/content/Professionals/NTLGMinutes31August2000.htm&page=2#H12> on 20 September 2002: no longer available on ATO website.

This seems at odds with the first phase Treasurer's response to the Ralph Committee recommendations, which included a special press release directed at small business that included 'selling' STS with a focus on its compliance cost benefits.⁹³ Such a focus on sectional interests via discrete government response was not the norm in the initial post-Ralph tax reform period. The existence of a separate release may lend support to the government's continued concern over small business compliance costs, or a cynic may say it was an appeal to one of its constituencies.

However, care must be taken to separate out the elements that practitioner bodies claim to have led to this situation, including poor ATO administration of the system, the rate of legislative change and poor legislative and policy design of both the law and the administrative systems. Yet it is clear that a considerable proportion of the current compliance burden can be sheeted to the laws themselves.⁹⁴ On the other hand the authors could not locate considered statements claiming that the compliance burden has reduced post-Ralph.

As set out previously, research into Australian tax compliance costs with reference to small business indicates that at the time of the Ralph Review (and before the introduction of the GST) these costs were either above average for comparable OECD countries⁹⁵ or high (but not in the highest) in comparison with such countries.⁹⁶ Add to this a recent study by the State Chamber of Commerce (NSW) which lends support for there being a significant rise in compliance costs in the post GST and Ralph period.⁹⁷ That study found 'the most time consuming tax for business is the quarterly GST returns and associated Business Activity Statement.'⁹⁸ To this GST impact we need to add the impact of Ralph, remembering that several of its integrity measures would be expected to impact disproportionately on small business.

Another recent study concluded that tax (including tax compliance) and government charges remain the most obvious constraint to small business investment.⁹⁹ Yet, as discussed in this section, tax compliance costs have just kept rising (maybe to crisis point). This is despite the tax compliance burden on small business being known to governments for a long time. In fact the Howard government expressed concern over the 'plight' of small business in this regard, along with a strong commitment to address the problem, as part of its first term policy from as far back as 1996.¹⁰⁰

⁹³ Treasurer, 'Small Business and Primary Producers to Benefit from the New Business Tax System' (Press Release No 59, 21 September, 1999).

⁹⁴ Harrison, above n 91; Regan, above n 91; Levy, above n 91; and Ray Conwell quoted above n 90.

⁹⁵ OECD, above n 10.

⁹⁶ Evans and Walpole, above n 45, 15

⁹⁷ State Chamber of Commerce (NSW) Red Tape Register – The Tax Burden (2003)

⁹⁸ *Ibid* 2.

⁹⁹ Australian Chamber of Commerce survey of the non-farm sector reported that '[t]ax still biggest constraint on SMEs investment' cited in Centre for Professional Development, 31 CPD Communicator, 27 May 2002. This result was 'not unexpected' and was consistent with the last 10 years' results. See also Yellow Pages A Special Report on Small Business Growth Aspirations and the Role of Exports (February 1995) cited in Time for Business, above n 4, 16.

¹⁰⁰ Evans and Walpole, above n 45, 12–15.

Thus, from the above it can be seen that there are clear and consistent claims and some supporting empirical evidence that the global small business tax compliance costs post-Ralph have increased significantly and are probably even more regressive than they were previously.

IV WHY DID RALPH NOT SUCCEED IN REDUCING COMPLIANCE COSTS?

Given the apparent Ralph failure to reduce compliance costs, the following discussion explores some reasons why the Ralph changes have led to this position, despite a key objective of the Review being the reduction in compliance costs. The reason can be broken into two broad categories, failures by the Review and failures in implementation.

A Failures by the Ralph Review

The failures by the Review relate to two areas: a failure to engage with the wealth of small business compliance cost research and the strict adherence to revenue neutrality.

1 A Failure to Engage with the Wealth of Small Business Compliance Cost Research

In his Chairman's Introduction John Ralph describes the desired outcome in respect of small business as:

[a] tax system for small business, with a more concessional approach to writing off their capital and expenditure and a reduced record keeping load.¹⁰¹

And, just before that:

[a] tax system which is easier to understand and comply with, and makes fewer demands on the time of ordinary taxpayers.¹⁰²

The first Ralph Committee discussion paper, *A Strong Foundation*, had an emphasis on the need to, and benefit of, reducing the complexity of tax laws and tax compliance.¹⁰³ It strongly asserted the importance of simplicity and considered complexity inherent in the tax system and the issue was how to avoid complexity increasing.¹⁰⁴ Despite this focus *A Strong Foundation* does not make reference to previous reports on the issue of compliance costs and complexity¹⁰⁵ nor are there any references back to previous inquiries in Chapter 17 of *A Tax System Redesigned* which recommends STS.¹⁰⁶

¹⁰¹ A Tax System Redesigned, above n 2, 2.

¹⁰² Id.

¹⁰³ A Strong Foundation, above n 2; in particular chapters 3 and 4.

¹⁰⁴ Ibid, xviii and xxix

¹⁰⁵ However, A New Tax System, above n 1, 131 makes brief reference to Time for Business above n 4.

¹⁰⁶ It does reference ATAX reports: Evans et al (1997) above n 5; and Evans et al (1996) above n 9.

At this point the authors' questioning of the depth of the Ralph Review's concerns for the compliance cost position of small business and those of the government that accepted its recommendations becomes more pointed. Ralph does cite some empirical research on compliance costs undertaken by ATAX¹⁰⁷ but there appears no taste to discuss the factors and forces that underlie these costs, the pressures for their increase nor the pitfalls to avoid in seeking to address and redress those costs.

The Ralph report seems to have little overt regard to the November 1996 report of Small Business Deregulation Task Force, *Time For Business*,¹⁰⁸ the Prime Ministerial Statement on 24 March 1997 entitled *More Time for Business* running to some 121 pages,¹⁰⁹ nor the *Lessons Learnt*, a Background Paper for the Small Business Deregulation Taskforce¹¹⁰ (which identified seven standout reports that dealt with regulatory burdens). At that time the Taskforce and the government's response were prominent articulations of the government's concern over small business compliance costs.

It is submitted here and in the STS discussion above that the Ralph Report discloses an approach that asserts conclusions on small business compliance costs, rather than reasoning them. As identified under this heading this stands in stark contrast with several reports into the compliance burden of small business that are considered by the authors as providing clear, though in places unpalatable, analysis and ways forward when dealing with the impact on small business of the tax system. Basically the Ralph recommendations baldly conclude the desired small business outcomes first quoted above and effectively leave the analysis at that, not advancing far from stating platitudes.

The key points from previous reports and initiatives into small business compliance cost reduction identified in *Lessons Learnt* are listed as:¹¹¹

- Success in achieving regulatory reform is critically dependent on political commitment and support;¹¹²
- If regulatory reductions are to be achieved, the necessary adjustments will need to be made from the government side [a whole of government approach is required];
- The extent of reforms have often been greatest in smaller jurisdictions by virtue of the close contact between stakeholders, the fact that the absolute scale of logistical charges are more manageable, and the political process is perhaps more closely attuned to the needs of the local small business community;
- Before substantial improvements in red tape can be introduced methods for the systematic evaluation of potential regulatory costs and benefits must be in place;

¹⁰⁷ Ibid.

¹⁰⁸ Above n 4.

¹⁰⁹ Above n 7.

¹¹⁰ Price Waterhouse Economic Studies and Strategies Unit *Lessons Learnt: Review of Inquiries and Reports on Regulatory Reform, Background Paper 1 Small Business Deregulation Taskforce* (August 1996) (*Lessons Learnt*).

¹¹¹ Ibid 20–21, also see ii.

¹¹² Reinforced in *Time for Business*, above n 4, 19.

- Dedicated research offers sound prospects for improving policy targeting and delivery;
- The prospects for successful reform are highest under strategies where incremental changes, sustained over the longer term, receive adequate political backing and attract reasonable resources;
- Even the best policies for regulatory reform may fail to deliver results if insufficient attention is given to the logistical aspects of their delivery; and
- Overseas experience can play only a limited role in assisting Australia to select the most appropriate reform strategies.

We can add to this:

- The acknowledged restrictive impact of the requirement of revenue neutrality.¹¹³
- The acknowledged scale of the task to make meaningful inroads into compliance costs.¹¹⁴
- The importance of transparency and consultation in the design phase of law and policy.¹¹⁵
- Regulation Impact Statements (RISs) in their current guise stem from the government's response to the Bell Taskforce.¹¹⁶
- The scale and complexity in tax compliance cost reduction was summarised in 1996 as:¹¹⁷

[A]fter a decade of sustained efforts at regulatory reform, taxation remains perhaps the single most important area of Government regulation of concern to small business. However, in the absence of fundamental changes to the way in which the government approaches economic management, reforms in this area have in some cases reached the point where further rationalisation may place equity at risk.

The points above can be used as a guide to assess the Ralph small business scorecard as well as providing a platform to discuss broader tax system impacts. It is not that the above points are sacrosanct because they come from the Bell Taskforce. Rather they are considered a fair distillation of the reports and initiatives in the area of small business cost compliance reduction and were endorsed by the government.¹¹⁸

Under the following three headings we firstly consider revenue neutrality as a significant limitation to Ralph's response to small business. The two headings following assess important consultative and institutional issues that may impact on the future treatment of small businesses' compliance cost interests.

¹¹³ The Bell Taskforce stressed in several places the significant level of constraint that was placed on its recommendations by the requirement of revenue neutrality: *Time for Business*, above n 4, 12 and 31.

¹¹⁴ *Time for Business*, above n 4, 19.

¹¹⁵ *Time for Business*, above n 4, 19.

¹¹⁶ Evans and Walpole, above n 45, 54.

¹¹⁷ *Lessons Learnt*, above n 110, ii see also pages 20–21.

¹¹⁸ See, for example, the *Time for Business* report was endorsed in *More Time for Business*, above n 7.

2 Strict Adherence to Revenue Neutrality

The pursuit of avoidance coupled with a very parsimonious approach to not deviate from revenue neutrality, would seem some of the keys as to why the Ralph reforms have adversely impacted on small business, especially in terms of compliance costs.¹¹⁹ The terms of reference to the Ralph Committee made it clear that the policies contained in the government's policy document *A New Tax System*¹²⁰ would direct but not bind the Review's deliberations and recommendations.¹²¹

A New Tax System stresses that the policy approach is not just to 'tinker' with the existing tax system.¹²² However, there is no evidence from the post-Ralph writings or research published to date that much more than tinkering has happened with the tax system as regards reducing or stemming the increase in small business compliance costs. This is evidenced by the low STS take-up rate and the assertions from the profession that compliance costs have significantly increased.

As discussed later STS may provide some assistance. Though the discussion of STS in chapter 17 of Ralph does not expressly recognise the potential for the integrity driven initiatives that particularly impact on small business (as detailed previously) to overrule the STS concessions. This represents more than just a lack of any real fundamental tax system reform flowing from Ralph due to institutional and political dynamics.¹²³ The tax compliance position of small business evidences callous neglect, with Ralph recommendations in many places explicitly raising the compliance burdens on small business and its compensatory responses being inadequately structured, or at the very least poorly articulated. This occurred in an environment where the pre-existing pace of system change¹²⁴ and tax law complexity was of considerable concern.¹²⁵

B Failures in Implementation

There are two key areas where Ralph's implementation has impacted on compliance costs, continued institutional failures and a failure to consult.

1 Continuing Institutional Failures

A considered approach to government regulatory enactments has been identified as important in small business compliance cost reports. This takes several forms including the need to take a whole of government approach when making new regulations, transparency in the process of regulatory design and analysis to seek to ensure the

¹¹⁹ For an example of how these have instructed legislative design see Brett Bondfield, 'If There is an Art to Taxation the Simplified Tax System is a Dark Art' (2002) 17 Australian Tax Forum 313, generally and in particular at 355–56.

¹²⁰ Above n 1.

¹²¹ A Tax System Redesigned above n 2, Terms of reference, v–vii and also 10.

¹²² Above n 1, 3–5.

¹²³ Fisher, above n 17, discusses these dynamics.

¹²⁴ Beddall Report, above n 3, xxix.

¹²⁵ Time for Business, above n 4, 28–31, confirmed by the OECD, above n 10, 30–31.

regulations have as low a compliance cost as possible (given their objective (proportionality)). RISs are intended to achieve these and other objectives.¹²⁶

The Australian experience with tax RISs (pre-Ralph) is discussed by Evans and Walpole,¹²⁷ the authors conclude that the tax RIS process was having some impact in meeting these objectives but was falling a long way short of ideal with form, as opposed to the underpinning policy, being followed.¹²⁸ They saw it as a real concern with an increasing volume of legislative change that the officials would pay lip service to them rather than seeing them integral to tax design.¹²⁹ The experience with the flood of Ralph reforms and their associated RISs suggests that this concern was justified. The RIS process has not proved an impediment to the claimed explosive increase in compliance costs.

Ralph took the issue of intra governmental (as well as public)¹³⁰ consultation and involvement in legislative design as a serious issue. *A Strong Foundation* expressed the concerns as:

- ‘the potential for policy to be developed without a full appreciation of all its implications and its interaction with the wider tax law and tax system. Conversely, practical solutions to technical issues might often compromise policy intentions’; and
- poor law design arising from the various agencies failing ‘to clarify progressively their understanding of the proposal and its intended effect and application’ and the inclusion of OPC [Office of Parliamentary Counsel] drafters, often after announcement of a policy change.¹³¹

Following the re-emergence in early 2002 of the debate concerning the removal of the tax policy and law development functions from the ATO,¹³² the Treasurer¹³³ accepted the Board of Taxation’s recommendation to transfer ATO policy staff to Treasury.¹³⁴ The debate arose due to concerns about the ATO’s ability to deliver integrated design given some very public failing in respect of the implementation of new tax systems and laws.¹³⁵

¹²⁶ Evans and Walpole, above n 45, 78–84.

¹²⁷ Evans and Walpole, above n 45, 54–77.

¹²⁸ Evans and Walpole, above n 45, 77.

¹²⁹ Evans and Walpole, above n 45, 76–77 and 85.

¹³⁰ Discussed under the following heading.

¹³¹ *A Strong Foundation*, above n 2, 48.

¹³² This issue was flagged by Hon Senator Helen Coonan (Minister for Revenue and Assistant Treasurer) in her 27 February 2002 speech to the Sydney Institute ‘Safety in Numbers: Tax Reform and the National Nest Egg’, 6; and in evidence to Senate Economic Legislation Committee, Estimates Hearings 20 February 2002 at E7.5.

¹³³ Treasurer, ‘Reforms to Community Consultation Processes And Agency Accountabilities in Tax Design’ (Press Release No 22 2 May 2002).

¹³⁴ Board of Taxation, ‘Government Consultation with the Community on the Development of Taxation Legislation: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer’ (March 2002). Recommendation 10.

¹³⁵ Dirkis (IBFD 2002), above 57, 532.

Although there was a positive response to the announcements, concerns remain. The centralisation of policy in one area outside the ATO may not resolve the implementation and administration design issues, which often plague policy implementation.¹³⁶ Further, in general, Treasury's culture is imbued with even higher levels of secrecy than the ATO, which could result in less open consultation and discussion and a policy team further isolated from the community.¹³⁷ Further, it is believed in some quarters that the growth in complexity and compliance costs in the tax law can be directly related to the growing ascendancy of the Treasury in tax policy over the last 10 to 17 years. Further, by leaving OPC outside the equation, accountability for poorly drafted law remains elusive.¹³⁸

In summary, as with the new consultative process (discussed following), whether the new administrative arrangements work can only be gauged in the future.

*2 Failure of Consultation*¹³⁹

Ralph and previous small business reports¹⁴⁰ saw consultation as important to improve legislative quality and minimise compliance cost increases. The post-Ralph position set out below evidences some matters of concern as to whether this was taken to heart in the transition from Ralph recommendation to tax law.

Flagged in the STS discussion following are the problems with consultation in the post-Ralph era. Consultation generally was conducted through convened committees with selected invitees (usually specialists or key stake holders).¹⁴¹ Many meetings were one off¹⁴² and in the authors' view token.¹⁴³ Where the issue under consideration was deemed to need more than one consultation meeting,¹⁴⁴ the meetings were often organised in a haphazard way and (except for consolidations consultative process) and

¹³⁶ Ibid.

¹³⁷ Jeff Schubert of Australian Business Limited warns that 'with policy removed from the ATO and effectively completely installed in Treasury ... [t]he people making tax policy may then be even further removed from the practical business community, with a danger that events like the consolidation consultation ... will not occur' at 'Business shoots itself in the foot!!' 25 February 2002 - <http://www.australianbusiness.com.au/economytoday> web news broadcast accessed 26 February 2002.

¹³⁸ Dirkis (IBFD 2002), above 57, 532–33.

¹³⁹ The following description of the failure of consultation is drawn from Dirkis (IBFD 2002), above n 57.

¹⁴⁰ Time for business, above n 4, 19.

¹⁴¹ Part of the problem is the number of representative groups. As well as the members of the NTLG there is the Corporate Taxpayer Association (CTA), the business Coalition for Tax Reform (BCTR)—a coalition of industry Associations, accounting bodies, accounting firms and corporates, peak business Associations (Business Council of Australia (BCA) and Australian Business Limited (ABL)) and the National Farmers Federation (NFF).

¹⁴² These include meetings on ruling changes (ATO sponsored), changes to the 13 month Rule (payments in advance and expenditure under tax shelters), partnerships and other joint activities, the taxation regime for buildings and structures, leases and rights, non-resident withholding tax, offshore trusts and foreign expatriates and residents departing Australia.

¹⁴³ Alienation of personal services income and non-commercial losses consultative meetings.

¹⁴⁴ Tax Value Method, Simplified Tax System, scrip for scrip, entity tax (including simplified imputation, loans by members, excluded trusts, trust transitionals, capital allowances, thin capitalisation, debt/equity and consolidation).

there was little feedback following meetings.¹⁴⁵ Also strict secrecy requirements imposed upon external parties attending the meetings acted to limit input.

The meetings generally focussed on technical improvement rather than policy, with the Review's recommendations generally viewed as sacrosanct. Generally it was only where political pressure arose that there were departures from the recommendations.¹⁴⁶ A positive feature was the extended use of exposure draft legislation releases. However, these drafts and associated explanatory material (despite some being reissued) tended to be 'final' documents, rather than first or second cut documents intended to create discussion. Further, the time allowed for submissions was unreasonable (usually four weeks), particularly given the size of the material and the timing of the release of the drafts (a number were released just prior to Christmas shutdowns). Even where externals made submissions,¹⁴⁷ despite the impediments, there was rarely feedback from the law design teams, with externals left to ponder why certain policy alternatives were unacceptable.

An outcome of the failure to adopt a user based design system was that the resultant law and administrative systems were of a mixed standard. Where consultation was not undertaken (such as in the new tax collection system (PAYG) and the circular trust anti-avoidance (ultimate beneficiary statement) measures) or was token (such as in the non-commercial loss and anti alienation of personal service income measures¹⁴⁸) the legislative outcomes were poor, requiring remedial legislative or administrative intervention.¹⁴⁹ The measures that seem to work better are those where more consultation was carried out, such as in respect of STS (ignoring whether its policy basis is flawed). Even where the law was perfected, the lack of integration with ATO administrative systems led to severe pressures on the ATO systems.¹⁵⁰

This leads one to be cautious about the value of consultation in policy development. Even if the consultation is seen to be of a high order it may not have been grounded in the best available material and policy viewpoints. There is no way of knowing whether

¹⁴⁵ For example at the NTLG meeting of 4 December 2001 questions were posed as to why issues announced for a 1 July 2002 start had no consultation for over 12 months. In fact there had been no updates of progress. The three areas identified were: non-resident withholding tax (last meeting 11 May 2000), foreign expatriates and residents departing Australia (last meeting 19 May 2000) and simplified imputation (last wide consultation on 19 October 2000 following entity tax draft release). With the pressures of a looming 1 July 2002 legislative start date a number of consultative meetings have been convened. For example a consultative meeting (under strict confidentiality conditions for the five invited external representatives) on simplified imputation was held on 25 February 2002 with draft legislation circulated on 10 May and a meeting to review draft legislation in respect of expatriate on 30 April.

¹⁴⁶ Examples are the artist and primary production exemption from the non-commercial loss provisions and the elevation of the results test in s 87-18 of the 1997 Act to the primary test for the anti-alienation of personal service income provisions.

¹⁴⁷ The Taxation Institute of Australia's submissions can be found at www.taxinstitute.com.au.

¹⁴⁸ The Alienation measures were a typical example where a single meeting was held on 24 November 1999 and although participants were briefed on the proposal, all policy concerns as well as requests for further consultation were rebutted.

¹⁴⁹ The need for this intervention is evidenced by the existence of ATO working parties such as the PAYG working party, Alienation working party, and the Non-commercial loss working party.

¹⁵⁰ An example of a failed system was the Running Balance Account (RBA) System, which was introduced to record a taxpayer's liabilities and credits on one file. Problems are still being resolved two years after introduction.

such material was part of the consultation process as there is no public transparency into those discussions and the Ralph report does not discuss them.

In summary, the level of consultation is a major improvement on any previous reform process. However, the failure to adopt the recommendations of user based design has again compromised the most recent round of tax reform.

V THE FAILURE TO ADEQUATELY COMPENSATE?

Reflecting on those Ralph changes that specially impact on small business (anti alienation of personal services income and non-commercial loss quarantining are the prime examples) leads back to a consideration of compliance cost reduction and its link to the good tax policy criteria, simplicity. There is inevitably a trade-off between the good tax policy criteria of efficiency, equity and simplicity in the design of any tax system, given that many of the objectives operate inconsistently, give rise to conflicting policy directions¹⁵¹ (as various tax rules serve different policy aims¹⁵²), and are unable to provide definitive policy guidance.¹⁵³ Thus, the more one tax policy objective is satisfied the less another is adequately realised. For example,

adopting a particular tax provision might increase the rate of economic growth. However, the same provision might also reduce the fairness of the system by providing some group of individuals with a tax advantage relative to others in the same circumstances.¹⁵⁴

Ultimately the most appropriate methodologies adopted will arise from a compromise being struck between often unavoidable conflicts between policy objectives.¹⁵⁵ Thus, a measure that reduces simplicity (and in all probability increases compliance costs) may be justifiable because it remedies an anomaly that was inequitable.

In the opinion of tax professionals, as discussed above, there is no such trade-off evident from the Ralph measures. Therefore, it is difficult to see what justifies the increasing of the already regressive tax compliance costs on small business.

However, these costs may have been inevitable and outside the control of Ralph. This may explain why Ralph identified the loading of social policy considerations and programs into the tax system as placing a considerable cost burden on small

¹⁵¹ McKerchar, above n 42, 24–36; and Canada, Report of the Royal Commission on Taxation (1966) (the Carter Commission) 3.

¹⁵² Taxation Review Committee, Commonwealth, Full Report (1975) (Asprey Report) 20.

¹⁵³ RI Downing, et al, Taxation in Australia — An Agenda for Reform (1964), 48. The authors, after noting the conflicts, recommend that any changes based upon economic efficiency should only be made having examined the possible effects on income distribution. Also Robert Couzin, 'The Process of Simplification' (1984) 32 Canadian Tax Journal 487, 494. Couzin suggests that the cause of much complexity is the competing objectives of the tax system, which affect tax policy, the legislation and its administration.

¹⁵⁴ Carter Commission, above n 151, 3.

¹⁵⁵ The Asprey Report, above n 152, 12 and 1985 Draft White Paper, above n 20, 14

business.¹⁵⁶ The Ralph Committee agreed that the appropriate response was to *compensate* small business for this regressive cost impost in acting on the government's behalf, though how to do it through the tax system was identified as problematic [emphasis added].¹⁵⁷

The main Ralph compensatory initiatives, from the vantage point of small business, were:

- Simplified income tax calculation rules and capital allowance and prepayment concessions for small businesses (STS measures);¹⁵⁸ and
- CGT concessions that mainly assisted passive investors or persons selling a business, and had most value if the person was retiring from running a business, yet they did not provide a great deal of benefit for those running a business as a going concern.

Thus, with the exception of these concessions, and the SIS, the balance of the Ralph changes mentioned above are integrity or tax base focussed.¹⁵⁹

The STS, the centrepiece of Ralph's compensation for small business, was projected to be one of the most revenue expensive of the Review's initiatives.¹⁶⁰ The public selling point of STS was and remains compensation through the simplification of records and accounting systems with the concessional depreciation advantages (the main concession) being down played.¹⁶¹

Whether the package as a whole, and STS in particular, can deliver the necessary level of compensation will be ultimately determined by a combination of the number of taxpayers who can access the particular concession and the actual number who, in turn, see value in and actually access the concession. Given the claimed size of the STS concession and the claimed large numbers of eligible taxpayers, the following discussion focuses on evaluating the actual number of taxpayers who have opted to take up the STS element of the compensation package. The CGT small business

¹⁵⁶ Such as HECS and Child Support Payments. See A Tax System Redesigned above n 2 at 73. The scope of the ATO's involvement in areas outside the traditional tax collection role are evident in Michael Carmody (Commissioner of Taxation) 'The Art of Tax Administration', Address to the 5th International Conference on Tax Administration (4 April 2002) 1. Located at: <http://www.ato.gov.au/corporate/content.asp?doc=/content/sp200203.htm> accessed on 20 December 2003.

¹⁵⁷ A Tax System Redesigned, above n 2, 74, para 336.

¹⁵⁸ New Business Tax System (Simplified Tax System) Act 2001. The original proposal for a simplified tax system for small business arose out of concerns about the application of the proposed TVM on small business. The STS's main features are a cash accounting regime, a simplified depreciation regime and a simplified trading stock regime. For further discussion see Michael Dirkis, 'Staying in the Shallows: Simplified Tax System' (Paper presented to Taxation Institute of Australia's 2001 Queensland State Convention, Gold Coast, 18 May 2001); Kenny, above n 16; and Bondfield, above n 119.

¹⁵⁹ This focus on integrity is seen as consistent across comparable OECD countries and greatly increasing system complexity. Adrian Sawyer, 'Compliance Cost Impact Statements in New Zealand – How Far Have we Come?' (2003) 17 Australian Tax Forum 443, 446.

¹⁶⁰ A Tax System Redesigned, above n 2 chapter 24, in particular at 698 and 720–22.

¹⁶¹ Bondfield, above n 119, 350–60. A recent press release continues this trend: Minister for Revenue and the Assistant Treasurer, 'Roll-Over Relief for Simplified Tax System Partnerships' (Press Release C013/03, 4 March 2003).

concessions are also briefly discussed, with the focus, in absence of uptake data, on the scope of the concession for a trading small business.

A Failure in STS Uptake

The pessimistic views of the practicality of STS appear to be supported by its current take-up rate.¹⁶² The government, adopting Ralph report figures,¹⁶³ claimed that 95 per cent of all businesses and 99 per cent of farming businesses would be eligible for STS.¹⁶⁴ Available figures at 17 April 2003 disclose that, of eligible taxpayers having lodged their 2002 tax returns, only 14 per cent have opted into STS.¹⁶⁵ This may not be representative as take-up may require a period of time to mature but it does seem very low.

When reviewing take-up rates it is also important to consider whether businesses are entering something like STS for the 'right' reasons. For example after three or more bad seasons primary producers, otherwise ineligible to enter STS because of the \$1 million turnover bar, may well fit the STS criteria. They may be willing to accept the increased costs associated with cash accounting and working out the interface with primary production specific tax concessions to enter STS in order to lock assets into the accelerated depreciation pools. This would not be a triumph of STS reducing compliance costs.

In the writers' submission a more concerning element is the assertion that the Ralph Committee anticipated that only 60 per cent of those eligible would elect into STS.¹⁶⁶ The costings in the Ralph report recognised the central importance of the participation rate of eligible businesses and that this would be less than 100 per cent.¹⁶⁷ Yet, the authors cannot locate a reference to the 60 per cent take-up estimate referred to above within the Ralph report. It seems disingenuous and playing on public perceptions to claim STS eligibility in the high 90 per cents while costings are being based on 60 per cent of those eligible. A more important question to be answered is why bother implementing a *system* of small business taxation that was expected to be of benefit to a little over half of those eligible.

As stated previously equity (in its various guises) is a central pillar of good tax policy. If small business compensation for the regressive impacts of tax compliance costs is important surely a near 100 per cent expected take-up rate would be equitable. A

¹⁶² Fisher, above n 17, 65.

¹⁶³ A Tax System Redesigned, above n 2, 74. The figures in the report were based on the sole criterium of turnover and do not take into account the effects of the other eligibility criteria.

¹⁶⁴ Explanatory Memorandum to New Business Tax System (Simplified Tax System) Bill 2000 (STS EM), para 1.5.

¹⁶⁵ ATO Tax Practitioner Forum (ATPF) issues log (register No A27). Figures reported in Australian Tax Practice 'Simplified Tax System (STS): 14 per cent Take-Up Rate so Far' ATP Latest Tax News (No 163, 25 August 2003).

¹⁶⁶ Ibid.

¹⁶⁷ A Tax System Redesigned above n 2, 721 paras 152–53.

targetted direct concession would be far more likely to be of more general application, unless weighed down by integrity measures.¹⁶⁸

B *CGT Concessions*

Small business directed CGT concessions that flowed from Chapter 17 of Ralph were generally well received.¹⁶⁹ They were aimed at rationalising the then existing concessions that applied to small business.¹⁷⁰ However, there is a view that they do not simplify the provisions enough.¹⁷¹ Even though the provisions of the legislation have been rationalised their fundamental design requires very careful and long-term planning to take maximum advantage of them.¹⁷² In this regard they have not delivered a significant compliance cost reduction dividend. Further, as the events to which these concessions apply occur infrequently in the life cycle of a small business the compensation that they offer is not a meaningful response to compliance cost impact per se.

VII WHY DID THE COMPENSATION PACKAGE FAIL?

The failure of STS uptake combined with the infrequency of application of the small business CGT concession illustrates that the compensation package is not commensurate compensation for compliance costs. Further, both measures are complex in operation, and thereby impose further compliance costs. The following discussion focuses on why the compensation package appears inadequate. This discussion will focus on STS, although the rationalisation of the capital gains concessions will be briefly examined.

A *Why is STS a Failure*

The reasons for the failure of STS are twofold, there appears to be, first, no compelling argument for STS and, secondly, that the rules were poorly designed.

¹⁶⁸ Poor design and onerous integrity measures are asserted as causes for a low take-up rate of the baby bonus: Deputy Leader of the Opposition, 'Further evidence the Howard Government's Baby Bonus is a Big Flop' (Media Release, 14 December 2003) Copy located at <http://www.jennymacklin.net.au/infocentre.asp?data=480A010307074F5851515E587E45555F48454B4E> on 20 December 2003.

¹⁶⁹ Chris Evans, 'Small Business CGT Concessions: A Little Ray of Sunshine' (2001) 36 *Taxation in Australia* 99.

¹⁷⁰ A *Tax System Redesigned*, above n 2, 586–89.

¹⁷¹ Arthur Athanasiou, Keith Harvey and Shane Bilardi, 'Get a Grip! – CGT' (2002) 36 *Taxation in Australia* 290.

¹⁷² Paul Ingram, 'CGT: Small Business Relief' (2000) 4 *The Tax Specialist* 85, 93

1 Lack of Reasons for STS

The Ralph Committee's recognition of a need to compensate small business for the regressive compliance burden of the tax system was seen by interested parties at the time as a positive step.¹⁷³

However, Ralph's reasoning as to why STS was the appropriate response is far from persuasive. The diversity of the functions performed by business on behalf of government and the diversity of small business itself were seen as issues of concern in using the tax system to compensate small business.¹⁷⁴ Yet, the articulated reasoning leading to STS was really only a conclusion being that the review was 'firmly of the view' that some recognition for this impost was required and that the reduction of compliance costs associated with the business tax system was the appropriate way to do this.¹⁷⁵ If there were persuasive arguments why the reduction of compliance costs was *the* answer (short of the base need for revenue neutrality) they are not set out. This is a significant omission as there were credible reports suggesting that the scope for a compliance cost reduction dividend was both marginal and a complex whole of government issue to achieve at a meaningful level.¹⁷⁶

2 Failure to Meet Good Law Design Principles

The incarnation as STS of Ralph's small business support was not warmly endorsed. Although the concept was attractive the actual design of the measure was not.¹⁷⁷ Overall the thresholds for eligibility to enter STS, the integrity measures within it,¹⁷⁸ and the fact that it was an all or nothing package that delivered the tax concessions indirectly (mainly through accelerated depreciation) were cited as the main design problems.¹⁷⁹

¹⁷³ Taxation Institute of Australia, Submission on the Exposure Draft: Business Tax System (Simplified Tax System) Bill 2000 (17 November 2000), 8; Chris Evans, and Jacqui McManus, Tax Reform Issues for Small Business Australian Society of CPA's Discussion Paper on "A Tax System Redesigned" (November 1999), 22; and Robert Douglas, 'The Simplified Tax System for Small Business: An Overview' (2000) 35 Taxation in Australia 28, 34.

¹⁷⁴ A Tax System Redesigned above n 2, 74 para 336.

¹⁷⁵ Ibid.

¹⁷⁶ Lessons Learnt, above n 110, ii; see also 20–21.

¹⁷⁷ The concept of a separate small business system does have merit. The New Zealand government agreed (in part) to a recent New Zealand review of business compliance costs recommendation that saw benefit in researching the applicability of a separate simplified tax regime for small business starting from analysis of STS: New Zealand Government, Striking the Balance: Government Response to the Ministerial Panel on Business Compliance Costs (December 2001), 37 responses to recommendation 154.

¹⁷⁸ In particular grouping rules and the turnover calculation.

¹⁷⁹ See Brett Bondfield, 'A Year on in the Simplified Tax System: Has the Reality Matched the Rhetoric?' (2002) 37 Taxation in Australia 251 at 252; and brief list of articles describing and analysing STS, 255–56; and Dirkis (2001), above n 158

It is not the purpose of this paper to deal in any detail with the operational aspects of STS. However, emblematic of the changes made to the tax system from the Ralph recommendations, STS itself is long and in places convoluted. The STS Explanatory Memorandum is 84 pages excluding index and Regulatory Impact Statement. The STS provisions in ITAA 1997 run to some 27 pages in the 2003 CCH version.¹⁸⁰ Then there are two Tax Rulings: TR 2002/6: *Income tax: Simplified Tax System: Eligibility – Grouping Rules* (38 pages) and TR 2002/11 *Income Tax: Simplified Tax System Eligibility – STS Average Turnover* (33 pages).

Conceptually STS is a potentially concessional tax system that sits on top of and has to interact with the rest of the tax laws. Surely having an add-on system that delivers concessional treatment of some tax items (prepayments (really a timing issue) and capital allowances) is not inherently simple.¹⁸¹ Why not have some simple concession or rebate the eligibility for, and quantum of, being dependent on a measure of business size?

As stated before, integrity has made the STS system itself complex and potentially impractical. For example, STS eligibility is set out in s 328-365 and contains 11 terms that themselves have a definition, which illustrates that the basic proposition that eligibility to STS is a simple three point test is misleading.¹⁸² Those three points are tightly defined and potentially complex in their operation. So much so that the ATO has issued the two TRs mentioned previously.

As identified by other writers, the government has often proved slow in widening the ambit of tax concessions such as STS.¹⁸³ It was identified at the outset of STS that eligibility based on turnover would discriminate against otherwise worthy businesses that operate on large volumes and low margins such as petrol stations.¹⁸⁴ Seemingly confirming the alacrity of concessional legislative response, it has taken till 20 March 2003 for a regulation to be made that provides petrol stations relief from the \$1 million maximum turnover threshold for STS (retrospective to 1 July 2001).¹⁸⁵

From a legislative design perspective, it may be argued that STS has basic design flaws as it ignores commercial reality of small business operations such as asset protection aspects of accounting and business structures.¹⁸⁶ Its stated focus of benefiting ‘small businesses with straightforward and uncomplicated affairs’¹⁸⁷ may be too focussed at the micro business end of the spectrum. This is compounded by concerns over its

¹⁸⁰ CCH, Australian Income Tax Legislation (2003), Vol 1.

¹⁸¹ Bondfield above n 119, 330–31.

¹⁸² Under subdivision 328-F ITAA 1997 to be eligible to be an STS taxpayer a taxpayer must:
carry on a business in that year;

have an average business turnover net of GST (including the turnover(s) of entities that it is grouped with) of less than \$1 million; and

have less than \$3 million in depreciating assets held by it and other entities with which it is grouped.

¹⁸³ Douglas (2000) above n 173, 30.

¹⁸⁴ Dirkis (2001) above n 158, 25.

¹⁸⁵ Income Tax Assessment Amendment Regulations 2003 (No 1) (Statutory Rules 2003 No 39)

¹⁸⁶ Bondfield above n 179, and articles referred to at 255–56.

¹⁸⁷ STS EM above n 164, 6.

practicality given the thresholds for entry, the fact that its concessions are indirect, and its integrity driven complexities.

All this is then wrapped up in a ‘take it or leave it’ system sitting beside and interacting with the rest of the tax laws. This then requires a potential user to undertake an analysis to determine whether *on balance* they will be better off. Thus, it is submitted that the failure of STS lies in poor legislative design.¹⁸⁸ This legislative design being informed by a strong revenue protection starting position which points to the tight eligibility criteria and strong integrity focus.

3 Summary

As discussed above, the reasons why STS was appropriate at all are opaque. Thus using STS as a case study of Ralph’s addressing the small business specific issue of compliance costs has to remain qualitative at this stage and to an extent involves some conjecture. Yet, an analysis of STS suggests the government’s attempts to compensate small business for the regressive nature of compliance costs is flawed¹⁸⁹ and, we suggest, misdirected. This is demonstrated by its low take-up rate to date.

Consultation cannot be blamed, as the consultation on the implementation of the flawed design was one of the better post-Ralph consultations.¹⁹⁰ However, the slavish adherence by Treasury and the ATO to only permitting consultation on the Ralph model as accepted by government, despite now justified concerns by tax professionals, is a weakness of all of the post-Ralph consultation, not just STS.

This leaves us with the culprit being poor legislative design that is overly concerned with both revenue protection and meeting overall revenue neutrality constraints. This leads one to conclude that the low take-up rate is explicable because: the system does not provide adequate monetary compensation to justify entering it; the non-monetary compensation of the touted lower tax compliance costs is illusory when looked at in the light of the totality of the post-Ralph tax system changes; or poor targeting and setting of entry criteria (or a combination of all three).

The vectors of failure set out above are of particular concern because small business compliance costs had been previously well researched and reported on. Ralph did not overtly engage with this wealth of small business compliance cost research and reports analysing the underlying pressures that cause these costs. Rather, there is an emphasis on revenue protection at the expense of accessible compensation. The focus is on simplification rather than direct compensation and the compensation that is provided is indirect (a weakness), mainly via accelerated depreciation.

¹⁸⁸ Bondfield above n 119; Dirkis (2001) above n 158.

¹⁸⁹ Bondfield above n 119 and n 179 (referring to other papers on STS); Dirkis (2001) above n 158.

¹⁹⁰ Treasury at the NTLG meeting of 7 December 2000 asserts that STS consultation was very close to ‘ideal’, but were concerned that professional bodies did not share this view. Copy of minutes located at: <http://www.ato.gov.au/content.asp?doc=/content/Professionals/13389.htm&page=3#H6> accessed on 2 April 2002 checked at 20 December and no longer listed on ATO website.

B *The CGT Concessions*

The CGT concessions as such are not a failure, but they are little compensation for the generic increase in compliance cost burden, as they are mainly of benefit when selling or retiring from a business as opposed to running one. As the events that these concessions apply to occur infrequently in the life cycle of a small business the compensation that they offer is not a meaningful response to a continuing compliance cost impact per se.

Further, the concessions appear to fail Ralph's efficiency objective as the 15 year retirement concession is considered by some to be too generous and leading to market distortion by the locking in of assets rather than their active redeployment.¹⁹¹

IX CONCLUSIONS ON RALPH

The Ralph Review noted that:

[i]n the end, tax design in a complex environment is as much art as it is science: judgement is often as important as fact and analysis.¹⁹²

The 'judgment' has not been exercised for small business. If tax compliance costs are an endemic systematic issue, what are needed are radical solutions. As this paper shows what we have from the Ralph implementation has not worked. If the tax rules cannot be simplified, then instead of focussing on regulatory burden it may be time to debate arguments about compensation.

The case study of STS above and its low take-up to date provides a window into how Ralph failed small business by increasing compliance costs and failing to provide appropriate compensation.¹⁹³

When this is expressed in terms of good tax policy objectives, the lack of simplicity is being skewed even further against small business given the Ralph changes that particularly impact small business. This puts at issue tax system equity if there is not adequate compensation for those disproportionate cost increases.

The outcome noted above is of particular concern because the difficulties of tax compliance cost reduction (and small business compliance cost reduction more generally) were well known through various government reports and initiatives. At the time of Ralph the most current ones respectively were *Time For Business* and *More Time for Business*. These reports stressed the difficulty, complexity and cost to government involved in implementing meaningful tax compliance cost reductions and reinforced the importance of attention to detail and consultation in the design and implementation phases. Given this backdrop it is a very real concern that Ralph and its implementation as regards small business are so open to criticism over poor consultation, policy and legislative design and implementation.

¹⁹¹ Chris Evans, 'CGT After Ralph' (2000) 3 Tax Specialist 313, 324.

¹⁹² A Strong Foundation, above n 2, xvi.

¹⁹³ See also Fisher, above n 17, 65.

This gives cause to reflect on the presence or absence in Ralph and its implementation of the first indicator of successful small business compliance cost reform: political will.¹⁹⁴ As this paper has sought to point out, even though tax compliance costs are an issue recognised by government as a concern as to their impact on small business, the elements in the tax system that increase these costs are omnipresent and show no signs of abating. Nor has there been any effective government action to its slowing. This is all in the context of vociferous and well-informed groups pointing out that we are drowning in tax compliance post-Ralph.

Overall, the consideration of small business by Ralph and in its implementation have been shown to be, in effect, *much ado about nothing*.

X THE WAY FORWARD

Given that the Ralph Review and the subsequent implementation processes have combined to increase compliance costs for small business and failed to adequately compensate for those costs, it is important to briefly explore the possible ways forward for future reform processes to ensure that small business is not the major casualty of tax reform. This is not intended to be a comprehensive plan, but rather a series of suggestions built on some of the current features of the tax administration and review systems and others flowing from the conclusions drawn from this paper. They are intended to generate discussion and further work.

A Direct Concession or Lower Tax Rate for Business Income of Small Businesses

The initial suggestion is, rather than persevere with STS, investigate the feasibility of a direct concession or lower tax rate for business income of small businesses. This has the advantages of being able to be clearly monitored for its revenue costs and take-up rate. It is also more amenable to adjustment up or down or to widen or contract the eligibility criteria should circumstances require.

In part this suggestion stems from our conclusion that the Ralph treatment of small business evidences the intractability of tax compliance costs that regressively impact on small business, as well as the tendency for them to continue to rise. That the compliance cost reduction return is marginal in the absence of very significant whole of government efforts, is also relevant to this point.

B Reducing or Limiting Compliance Costs

There are things that cannot be compensated such as business opportunities missed because business resources were needed to meet the tax compliance requirements. Therefore it is still important to focus on compliance cost reduction. The suggestions that follow focus on compliance cost containment and reduction:

¹⁹⁴ Time for Business, above n 4, 19.

- Research, especially into the global costs of compliance post-Ralph and the GST is a priority. The authors would be pleased if empirical research could show that on balance small business is better off post-Ralph in terms of their compliance costs when all tax system improvements are taken into account. However, all the available signs suggest that this is not the case.
- Rather than criticise the methodology of academic compliance cost researchers, the ATO should enter the debate by developing an enhanced ability to monitor and model the compliance costs of the tax system. This should be supported by technological infrastructure that allows for a timely and methodologically robust monitoring capacity. Although it is recognised this has political implications, the government has instructed the ATO to collect compliance statistics in respect of activity statements and some other post-Ralph measures, which should be expanded upon.

The United States has no such reservations with the Internal Revenue Service (IRS) currently reported as working with IBM to develop such a system wide capacity.¹⁹⁵ Failure to do so merely raises conspiracy theories about hiding the true compliance cost picture.

C Continuing Institutional Reforms Post-Ralph

Given the above discussion on the reasons for the failures it is also important to maintain the momentum of institutional reform. The key areas include:

- Have in place the capacity to undertake transparent and independent post-implementation reviews of tax laws and policies. The Board of Taxation is currently commencing its first such review of the quality and effectiveness of the non-commercial loss quarantining provisions.¹⁹⁶
- Have in place independent quality assurance monitors of the tax system. Post-Ralph the Board of Taxation and the Inspector General of Taxation have roles in this regard and this is to be welcomed. Though the multiplicity of review mechanisms may of itself cause system complexity.¹⁹⁷
- Meaningful consultation at the legislative design and implementation phase of new tax initiatives. The infrastructure is in place with the requirement for RISs and the establishment of the Board of Taxation. However, concern has been expressed (as detailed in this paper) that in the Ralph implementation phase, with the exception of the consolidation regime, meaningful consultation has not necessarily occurred. The resultant design of tax law and administration has been the worse for this.

¹⁹⁵ Peter Arena, John F O'Hare, and Michael P Stavrianos, 'Measuring Taxpayer Compliance Burden: A Microsimulation Approach' in Ranjana Madhusudhan (ed), National Tax Association: Proceedings of 95th Annual Conference (2002), 333.

¹⁹⁶ Post-implementation reviews were foreshadowed in Treasurer, 'Reforms to Community Consultation Processes and Agency Accountabilities in Tax Design' (Press Release No 22, 2 May 2002). For details of the non-commercial losses review see Board of Taxation website at: http://www.taxboard.gov.au/content/post_imp_reviews.asp accessed 21 December 2003.

¹⁹⁷ Fisher above n 17, 63.

Thus there must be a will to meet the spirit of consultation and open up debate on all design aspects, rather than the details of a set policy position. A greater role for consultation in a more publicly accountable RIS process can also be investigated.¹⁹⁸

In summary, in order to safeguard future small business reform, the way forward should involve both compliance cost reduction and compensation based upon robust research. Implementation should be based upon co-design principles.

¹⁹⁸ See Sawyer above n 159 for comment on the NZ experience.

TRANS-TASMAN TRIANGULAR TAXATION RELIEF: AN EXERCISE IN POLITICAL FUTILITY

DAVID DUNBAR

*David Dunbar is a Senior Lecturer in the School of Accounting and Commercial Law,
Victoria University, Wellington New Zealand.*

I INTRODUCTION

On 19 February 2003 the Australian Treasurer and the New Zealand Minister of Finance announced a solution to a longstanding taxation problem known as triangular taxation:¹

[1] To resolve this problem, Australia and New Zealand will extend their imputation systems to include companies resident in the other country. Under this reform, Australian and New Zealand shareholders of trans-Tasman companies that choose to take up these reforms will be allocated imputation credits, representing New Zealand tax paid, and franking credits, representing Australian tax paid, in proportion to their ownership of the company. However, each country's credits will be able to be claimed only by its residents.

This paper critically examines the extent to which the pro rata allocation (PRA) solution will solve:²

[2] what is known as the triangular tax problem, where Australian and New Zealand shareholders investing through a company resident in the other country that earns income and pays tax in their own jurisdiction are unable to get imputation credits arising from the payment of such taxes.

The extent of the tax relief associated with the PRA solution was outlined by the two ministers in a joint Discussion Document released in March 2002.³ The current trans-Tasman taxation treatment of a triangular investment by a New Zealand shareholder results in an effective tax rate of 57.3 per cent. The Discussion Document claims that the PRA solution will reduce the effective tax rate to 43.6 per cent. If that claim is true, the effective tax rate will have been reduced by 24 per cent. Is that claim a fair

¹ <http://www.taxpolicy.ird.govt.nz/news/archive>. Php year = 2003 at 2.

² Ibid.

³ 'Trans-Tasman Triangular Tax: An Australian and New Zealand Government Discussion Document' at 4. Available at either: ATO-Triangular@ato.gov.au, or webmaster@ird.govt.nz.

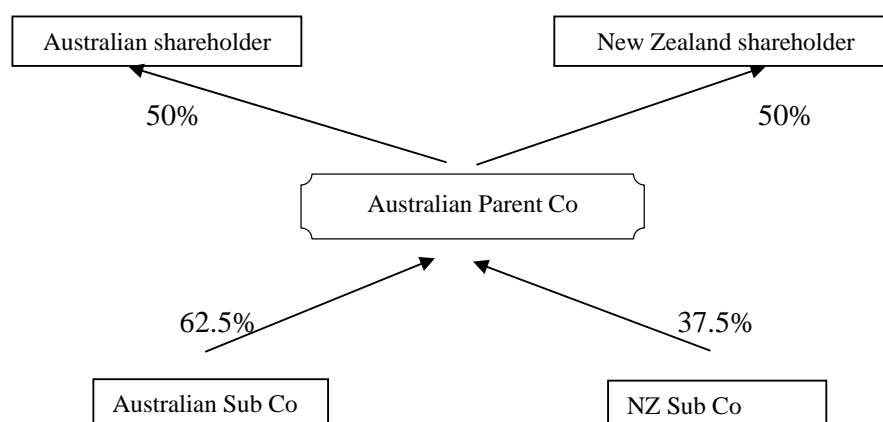
representation of the benefits of PRA? What are the underlying assumptions the calculations were based on and to what extent are they reflected in the ownership structure of a 'typical' trans-Tasman company?

II PRO RATA ALLOCATION (PRA): THE DISCUSSION DOCUMENT

A The Hypothetical Trans-Tasman Company

The Discussion Document states that the PRA solution will reduce an individual New Zealand shareholder's effective tax rate by 24 per cent.⁴ This saving is based on the hypothetical group structure illustrated in Diagram 1.⁵

Diagram 1



B Why Was a 50/50 Shareholding Structure Chosen?

The shareholding of the hypothetical Australian parent company that is used in the Discussion Document discloses that 50 per cent of the parent company share capital is owned by individual Australian shareholders. The remaining 50 per cent is held by individual New Zealand shareholders. That is not a typical trans-Tasman shareholding structure. Empirical evidence suggests that a more realistic shareholding is for the dominant group of trans-Tasman shareholders to own approximately 95 per cent of the parent company share capital with the remaining 5 per cent held by the other group of trans-Tasman shareholders (see Table 2).

It would appear that a 50/50 shareholding was chosen because it fits well with one of the key design features of the PRA solution. The available franking credits and

⁴ From 57.3 per cent to 43.6 per cent.

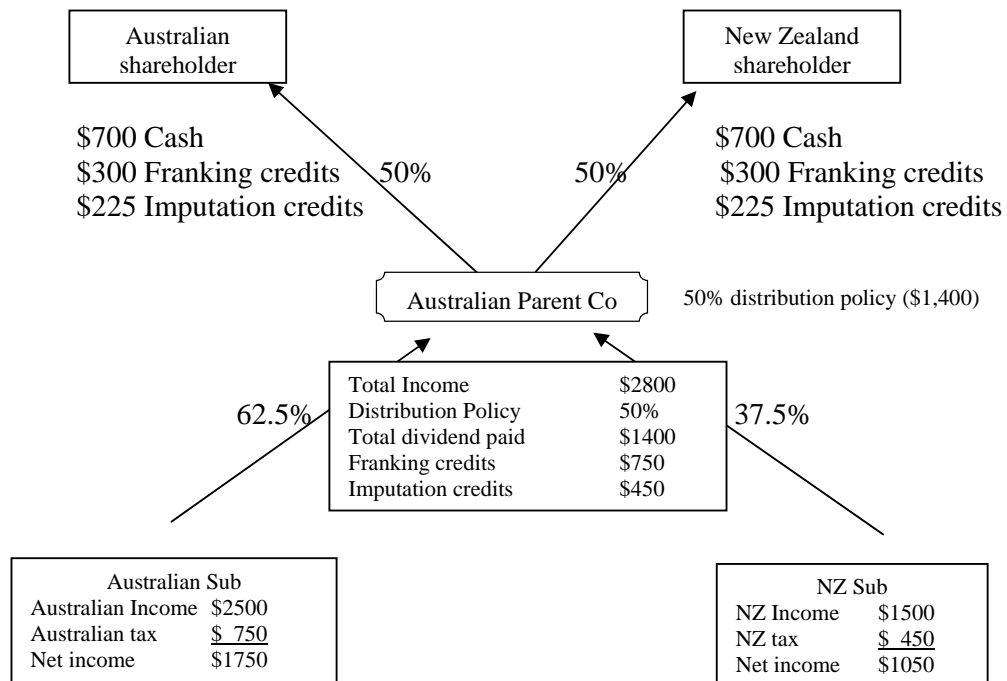
⁵ Above n 1, 19.

imputation credits will be allocated equally to the two groups of trans-Tasman shareholders. This is one of the reasons why the tax saving appears to suggest that the solution will be welcomed by individual shareholders of a typical trans-Tasman company. The second unusual feature of the hypothetical example is the underlying income flows and the distribution policy of the parent company.

C The Hypothetical Income and Dividend Flows

The following diagram includes the tax payments: dividend flows, franking credits and imputation credits. For simplicity, the example assumes a 30 per cent corporate tax rate in both Australia and New Zealand, rather than the actual rates of 30 per cent and 33 per cent, respectively. It should be noted that all figures are in Australian dollars and no currency adjustment has been applied in this diagram or in any other diagrams or tables in the paper.

Diagram 2



Under the current law, only the Australian franking credits are attached to the dividend paid by the Australian parent company to trans-Tasman shareholders. However, the New Zealand shareholders are not able to utilise the \$300 franking credits. Under the PRA solution, the New Zealand shareholders will be able to access the imputation credits of \$225. The Australian shareholders can only access the franking credits of \$300.

III TAX BENEFITS OF PRA: THE DISCUSSION DOCUMENT

A The New Zealand Shareholder's Tax Reduction

The Discussion Document refers to a 24 per cent reduction in the effective tax rate of a New Zealand shareholder who has invested in a trans-Tasman company with the above ownership and income flows. That reduction is calculated as follows:

Table 1
The Discussion Document example of the tax savings

NZ Shareholder	Before reform \$AU	Pro rata allocation \$AU
Cash dividend	700	700
Imputation credits	Nil	225
Franking credit	Nil	300
Gross income	700	925
Tax due @ 39%	273	361
Less imputation credit	Nil	(225)
Franking credit	Nil	Nil
Tax payable	273	136
Net dividend	427	564
Effective tax rate	57.3% ¹	43.6% ²

¹. $(273 + 300 \text{ (uncredited underlying corporate tax)} / 1000)$

². $(361 + 75 \text{ (uncredited underlying corporate tax)} / 1000)$

A significant point to note is that even under this optimal hypothetical company, the effective tax rate is not 39 per cent. This is due to the fact that the dividend is not fully imputed and that follows from the fact that the percentage of profits distributed to the 50 per cent New Zealand shareholders is significantly higher than the 37.5 per cent profit generated from sources within New Zealand. Consequently the dividend is partly generated from Australian source income which was subject to Australian and not New Zealand income tax. Accordingly the 50 per cent New Zealand shareholders will only receive a partly imputed dividend whenever the percentage of the Australian parent company profit distributed (50 per cent) exceeds the percentage of the parent company's income (37.5 per cent), which is generated from sources within New Zealand.

B *Reaction to the February 2003 Announcement*

The professional advisers to trans-Tasman companies and the business community did not share the minister's euphoria. For example, the National Business Review reported:⁶

[3] This is certainly not the breakthrough it is being portrayed as, Ernst & Young tax partner Michael Stanley said ... only a very small minority of shareholders are going to be affected by this. For a real breakthrough there would have to be full recognition of the tax paid.

The problem Michael Stanley alludes to is the fact that the PRA method allocates the available imputation and franking credits according to the respective shareholding in each country. Secondly, the shareholder can only utilise the appropriate imputation or franking credit. It therefore follows that a parent company with a small shareholder presence in the other jurisdiction would find it difficult to justify the compliance and administrative costs of implementing a regime which only provided a small benefit to a minority group of non-resident shareholders. The only type of trans-Tasman company which would derive a significant benefit from the PRA solution, is the hypothetical company described in the Discussion Document.

This conclusion is supported by Minter Ellison Rudd Watts:⁷

[4] Companies which pay a relatively small portion of their total tax bill ... to the country in which the company is not resident will not experience a significant benefit from adopting the election to maintain a tracking account ... companies who do not pay a relatively significant portion of their total tax bill ... in the country in which they are not resident will have a greater benefit ...

The Discussion Document implicitly acknowledges that the hypothetical Australian parent company has very few (if any) incentives to implement a solution, which will only benefit its 50 per cent New Zealand individual resident shareholders. There is no benefit to the Australian individual shareholders and the inevitable compliance costs will be partly borne by that group of shareholders who receive no increase in their after tax income.⁸

⁶ Rob Hosking, 'Tax Specialists Pour Scorn on Tax Deal', *National Business Review*, 21 February 2003, 5.

⁷ Minter Ellison Rudd Watts, *Tax Newsletter*, May 2002, 5, available online at <http://www.minterellison.co.nz>.

⁸ Above n 3, 7 Table 2.

IV A MORE REPRESENTATIVE EXAMPLE OF THE PRA SOLUTION

A A Sample of Trans-Tasman Companies

The Discussion Document support of the PRA solution is based on a hypothetical trans-Tasman company with, inter alia, a 50 per cent New Zealand and 50 per cent Australian shareholding. However, the following table demonstrates that the Discussion Document example is not a reliable indicator of a representative company.

Table 2
The shareholding composition of trans-Tasman companies

Source: Company Annual Reports

Company	Year Ending	New Zealand Shareholding	Australian Shareholding
Australian Gas Light Company	2003	1.66%	97.71%
AXA	2003	2.95%	97.05%
Goodman Fielder Wattie	2003	4.64%	94.86%
National Australia Bank	2002	0.64%	98.58%
Telstra	2002	0.50%	93.20%
The Warehouse Group*	2003	97.02%	2.47%
Tower*	2003	78.81%	20.64%
Westpac	2003	3.34%	95.15%

* A New Zealand company

The New Zealand shareholding in this sample of Australian parent companies is less than 5 per cent. In the case of Westpac, the approximately 95 per cent Australian shareholders will gain no advantage from the PRA solution, and only approximately 4 per cent of the total tax paid by the New Zealand group will be passed on as an imputation credit to the small minority of New Zealand shareholders. It is perhaps not surprising that as at 1 July 2004, no major trans-Tasman public company has announced that it will implement the PRA solution.

B A More Realistic Example of an Australian Parent Company

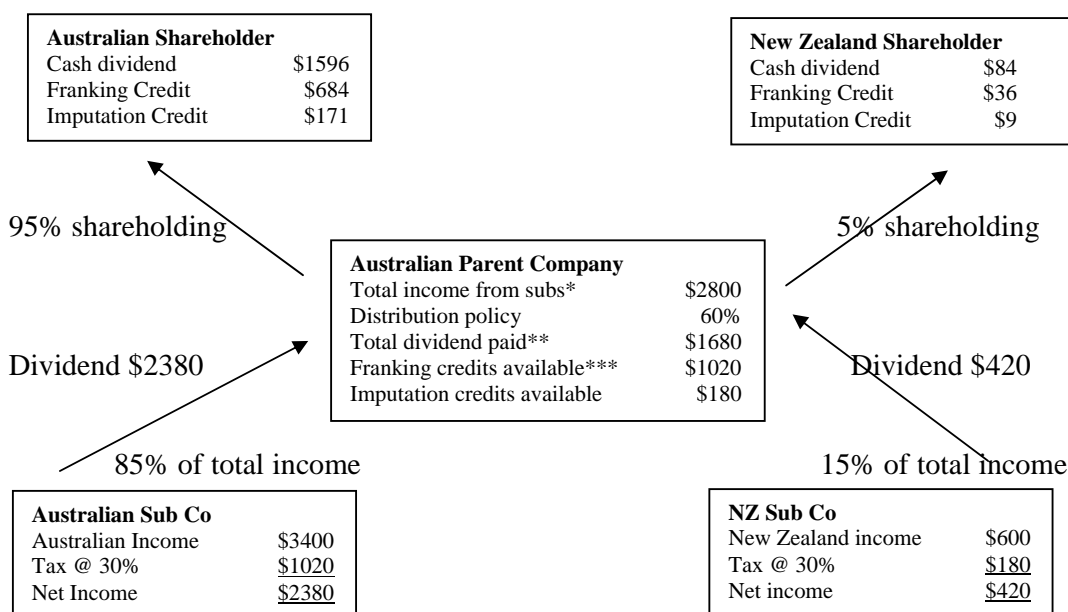
The following diagram illustrates the impact of the PRA solution on an Australian parent company, which is dominated by Australian individual shareholders. The diagram is based on selected information taken from the Annual Report of Westpac Australia.⁹ The shareholding percentages, income mix and distribution were taken from the 2002 Concise Annual Report and the 2002 Financial Report. However, the combined total pre tax income of both the New Zealand and Australian and operating subsidiaries (\$4000) is based on the example used in the Discussion Document.

⁹ Shareholding statistics taken from *Westpac Australia Concise Annual Report 2002*. Income statistics taken from *Westpac Financial Report 2002*, Note 29, 114. Both documents are available online at <http://www.westpac.gov.au>.

1 Assumptions

The Australian operating subsidiary earns 85 per cent of the total combined income.
 The New Zealand subsidiary earns 15 per cent of the total combined income.
 Australian shareholders own 95 per cent of the Australian company.
 New Zealand shareholders own 5 per cent of the Australian company.
 Both subsidiaries distribute 100 per cent of their net profit after tax to the parent.
 The Australian parent distributes 60 per cent of its after tax income as a dividend.
 The corporate tax rate is 30 per cent for both operating subsidiaries.

Diagram 3
The pro rata allocation regime



Pro-Rata Allocation	
Australian Shareholder	
Franking credits available	\$969
Franking credits at maximum ratio	\$684
Imputation credits available	\$171
Imputation credits at maximum ratio	\$180
New Zealand Shareholder	
Franking credits available	\$51
Franking credits at maximum ratio	\$36
Imputation credits available	\$9
Imputation credits at maximum ratio	\$36

*Total income from subsidiaries = \$2380 + \$420 = \$2800.
 **Total dividends paid = \$2800 x 60% = \$1680.
 ***Franking credits (FCs) available = \$969 + \$51 = \$1020.
 The New Zealand company tax paid of \$200.13 is not eligible for imputation to dividends distributed by the Australian company. FITC is reflected in this calculation (but not in the dividend flows):
 A supplementary dividend of 17.65% of the ordinary dividend (of \$420) is paid to the non-resident parent company: \$420 x 17.65% = \$74.13

Cash dividend	\$420.00
Plus supplementary dividend	\$74.13
	<u>\$494.13</u>
NRWT @ 15%	\$74.13
Net cash dividend	<u>\$420.00</u>
Company tax	\$126.00
NRWT	<u>\$74.13</u>
Total	<u>\$200.13</u>

C PRA: The Tax Saving Revisited

The total income of the two subsidiaries is \$4000. In Diagram 3, the New Zealand Subsidiary Company only contributes 15 per cent (compared to 37.5 per cent) of the income earned by the Australian Parent Company whereas the Australian Subsidiary Company contributes 85 per cent of the income (compared to 62.5 per cent in the example portrayed in the Discussion Document.) The following table illustrates the change in the effective tax rate, which a New Zealand shareholder would expect to derive from a company such as Westpac. The fall in the effective tax rate is from 57.3 per cent to 52.5 per cent (5 per cent), which is only an 8 per cent reduction in the effective tax rate. This is significantly less than the 24 per cent benefit referred to in the Discussion Document. The difference between the respective results reflects the change in shareholding and the change in the underlying sources of income.

Table 3
The pro-rata allocation (Australian parent)

New Zealand shareholder	\$AU	Australian shareholder	\$AU
Cash dividend	84	Cash Dividend	1,596
Imputation credit	9	Imputation Credit	171
Franking credit	36	Franking credit	684
Taxable income	93	Taxable income	2,280
Tax due @ 39%	36	Tax due @ 48.5%	1,106
Less imputation credit	9	Less imputation credit	0
Less franking credit	0	Less franking credit	684
Tax payable	27	Tax payable	422
Net dividend	57	Net dividend	1,174
Effective tax rate	52.50%	Effective tax rate	48.50%
Pre-tax cash dividend	120	Pre tax cash dividend	2280
Company tax	36	Company tax	684

D Compliance Costs

The Discussion Document acknowledges that, from an individual shareholder's perspective, the PRA method does not provide the optimal solution. This conclusion is based on the fact that only a proportion of the tax paid in each country is available to the resident shareholders of that country.

Secondly, the PRA solution will result in additional compliance costs for any company that elects to adopt it. For example, the Australian Parent Company, described in Diagram 1 and Table 1, will be required to maintain an additional memorandum account which would track the imputation credits generated in New Zealand and to attach those credits to any dividend paid to its trans-Tasman shareholders. The PRA method will only increase the after tax return of an individual New Zealand shareholder.

Unless the pro rata allocation solution provides significant additional benefits to individual Australian shareholders, the Australian Parent Company may have difficulty justifying the increased compliance costs. This could become an issue if there are alternative and more cost effective ways of achieving the desired benefits for shareholders.

V FULL STREAMING

A Introduction

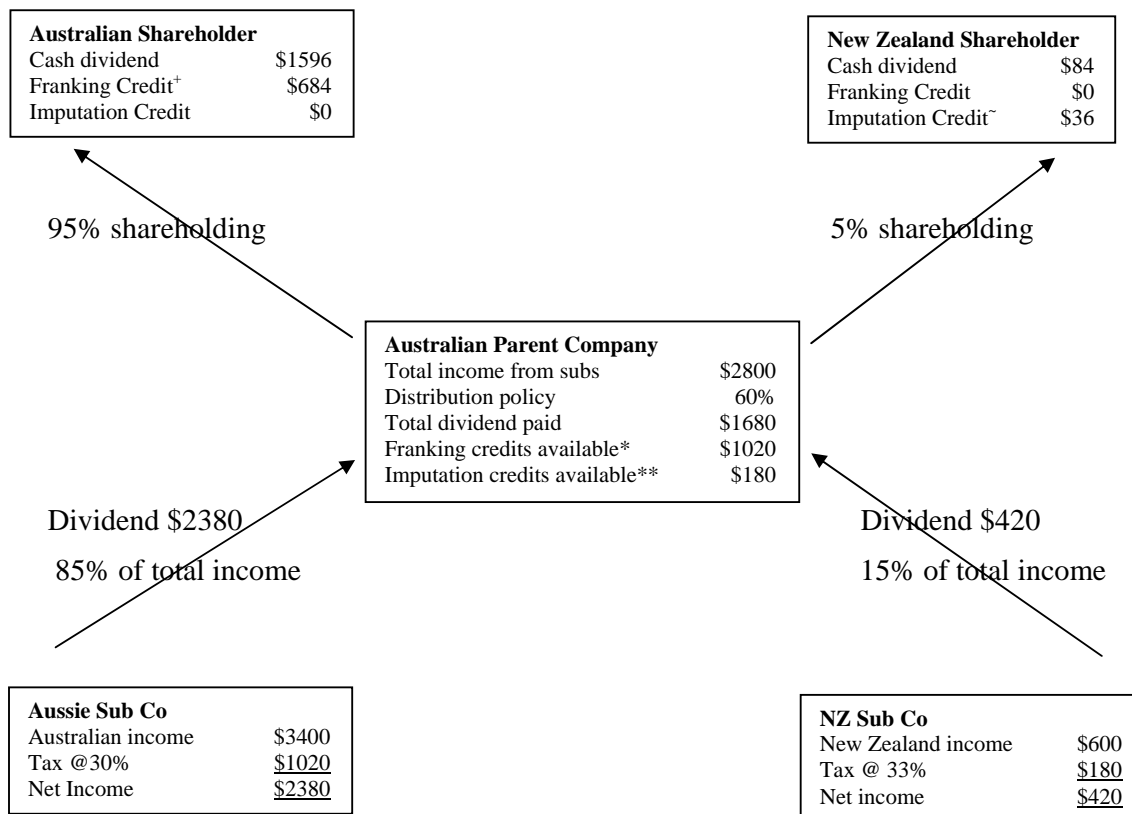
One of the major criticisms of the PRA solution is that it will force an Australian parent company to allocate its available imputation and franking credits to individual shareholders that are unable to utilise them. Under the alternative of full streaming, all tax paid by the hypothetical Australian Parent Company would be allocated to the Australian shareholders whereas the tax paid by the New Zealand Subsidiary Company would be allocated solely to the New Zealand shareholders' in the Australian Parent Company. From a trans-Tasman shareholder's perspective, this is the optimal solution because it does not involve the wastage or misallocation of a proportion of the available imputation and franking credits and is therefore superior to the pro rata solution. It would appear from the Discussion Document that both governments rejected this alternative because they did not wish to signal that the streaming of available credits should become more acceptable.¹⁰ One of the four design features of both countries' imputation regimes, which have not altered since their introduction, is the principle that credits must be allocated equally to all shareholders irrespective of their ability to utilise the credit. For example, a shareholder on a marginal rate of 19.5 per cent who receives an imputation credit at the maximum rate of \$33 on a \$67 cash dividend is not able to effectively utilise the surplus imputation credit, unless he/she has alternative sources of unimputed income.

B The Full Streaming Methodology

Diagram 4 is based on the Australian parent company used in Diagram 3 to demonstrate the actual tax saving associated with the PRA solution. This will enable a valid comparison to be made between the two alternatives. The key difference is that the Australian shareholder no longer receives an imputation credit and the New Zealand shareholders no longer receive a franking credit. A second important difference is that the respective operating subsidiaries' franking and imputation accounts now disclose a credit balance. In other words, there are surplus tax credits that are available even after the payment of a fully imputed dividend. The wastage associated with the PRA solution is avoided under the full streaming alternative. There is no longer any wastage of domestic credits that are otherwise allocated to the Australian Parent Company's non-resident shareholders.

¹⁰ Above n 3, 16, para 3.27.

Diagram 4
The full streaming model



*Total income from subsidiaries = \$2380 + \$420 = \$2800.

**Total dividends paid = \$2800 x 60% = \$1680.

***Franking credits (FCs) available = \$969 + \$51 = \$1020.

The New Zealand company tax paid of \$200.13 is not eligible for

imputation to dividends distributed by the Australian company.

FITC is reflected in this calculation (but not in the dividend flows):

A supplementary dividend of 17.65% of the ordinary dividend (of \$420) is paid to the non-resident parent company: \$420 x 17.65% = \$74.13

FULL STREAMING	
Australian Shareholder	
Franking credits available*	\$1020
Franking credits at maximum ratio	<u>\$684</u>
Balance in franking credit account	<u>\$336</u>
New Zealand Shareholder	
Imputation credits available**	\$180
Imputation credits at maximum ratio	<u>\$36</u>

Cash dividend	\$420.00
Plus supplementary dividend	<u>\$74.13</u>
	\$494.13
NRWT @ 15%	<u>\$74.13</u>
Net cash dividend	<u>\$420.00</u>
Company tax	\$126.00
NRWT	<u>\$74.13</u>
Total	<u>\$200.13</u>

C An Effective Tax Rate That is Equal to a Comparable Domestic Market Investment

Table 4 demonstrates the significant reduction in the effective tax rate associated with the full streaming option. Under this option, there is no improvement in the Australian shareholder's after tax return. However, the full streaming option enables the New Zealand shareholders to receive a dividend with an effective tax rate that is comparable to an equivalent domestic investment. Double taxation is completely eliminated.

Table 4
The full streaming model (Australian parent)

New Zealand shareholder	\$AU	Australian shareholder	\$AU
Cash dividend	84	Cash Dividend	1596
Imputation credit	36	Imputation Credit	0
Franking credit	0	Franking credit	684
Taxable income	120	Taxable income	2280
Tax due @ 39%	47	Tax due @ 48.5%	1106
Less imputation credit	36	Less imputation credit	0
Less franking credit	0	Less franking credit	684
Tax payable	11	Tax payable	422
Net dividend	73	Net dividend	1174
Effective tax rate	39.00%	Effective tax rate	48.50%
Pre tax cash dividend	120	Pre tax cash dividend	2280
Company tax	36	Company tax	684

For a New Zealand investor Table 4 demonstrates that their after tax position has substantially improved. Full streaming enables the New Zealand shareholders to gain the benefit of the total amount of New Zealand company tax paid by the New Zealand subsidiary,¹¹ whereas PRA solution links the tax benefit to an investor's ownership in the Australian Parent Company.¹² The profile of the Australian Parent Company summarised in Diagram 4 will completely eliminate double taxation, reducing the New Zealand tax rate to 39 per cent. This amounts to a reduction of approximately 32 per cent compared to the approximately 8 per cent reduction associated with the PRA method.

¹¹ Subject to the maximum imputation ratio.

¹² We saw earlier in Table 3, section IV C that a small NZ shareholding will only create a reduction of 8 per cent in the New Zealand shareholder's tax liability.

VI BEHAVIOURAL IMPLICATIONS: CAPITAL RAISING SOLUTIONS

A Introduction

The combined effect of the waste of credits associated with the pro rata allocation solution and its complexity and compliance costs will limit its appeal. The Australian Parent Company in the hypothetical example considered in the Discussion Document has very few (if any) incentives to implement a solution which will only benefit its 50 per cent New Zealand individual resident shareholders. There is no benefit to the Australian individual shareholders and there will be inevitable compliance costs arising from the PRA solution.

The rejection by both governments of the full streaming alternative is likely to see a continuation of ad hoc solutions which achieve the same underlying benefits associated with the full streaming option. Recent examples include:

- (1) Capital raising solutions;
- (2) Equity instruments;
- (3) Bonus issues;
- (4) Computer software and management fees;
- (5) Debt solutions; and
- (6) Cross border solutions.

B Capital Raising Solutions

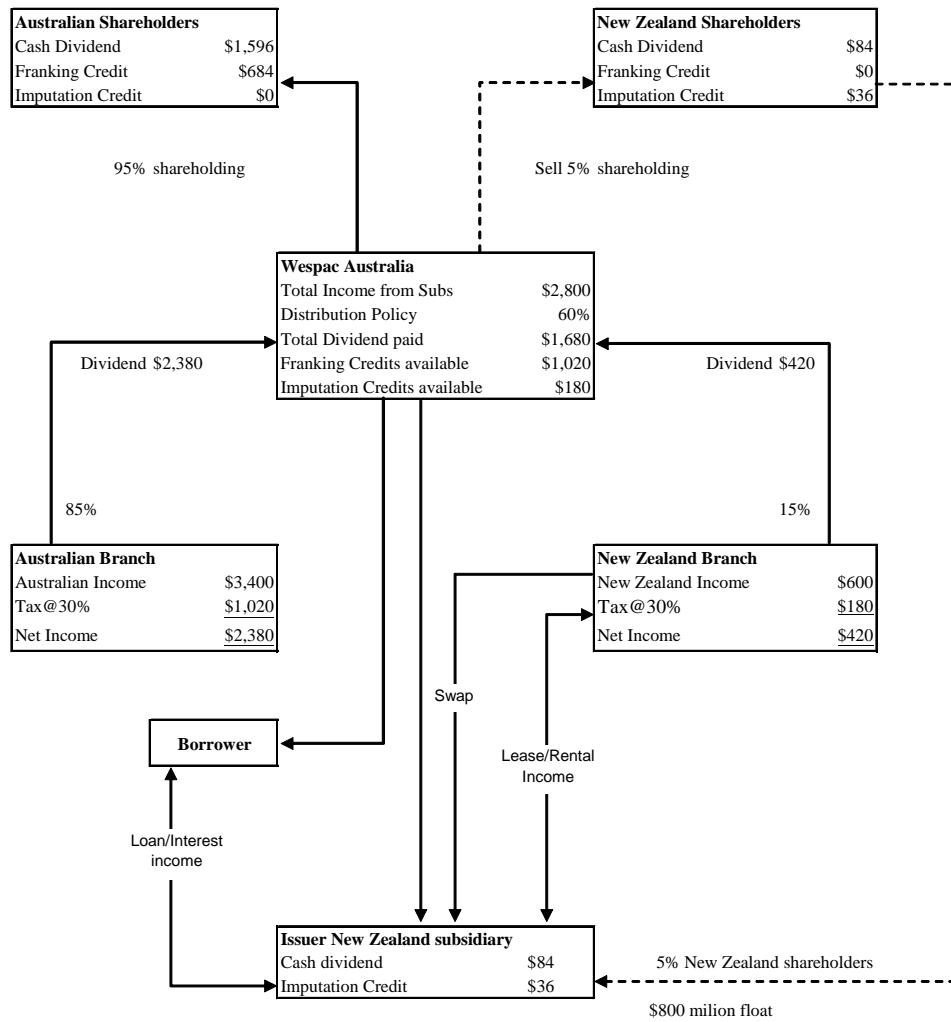
An obvious solution to triangular taxation is for an Australian Parent Company to incorporate a special purpose New Zealand subsidiary that pays a fully imputed dividend to the New Zealand shareholders. This solution would involve the New Zealand shareholders realising their investment in the Australian parent company and subscribing for shares in the new New Zealand subsidiary. The most significant example of the strategy is the \$A800 million successful capital raising which was undertaken by Westpac in late 1999. Following the successful Westpac \$A800 million float, the ANZ Banking Group announced a similar proposal but it has yet to proceed to making a public offer.

C The Westpac Share Issue

As part of the capital raising exercise, Westpac obtained a binding product ruling from the Inland Revenue Department which stated that the proposal did not contravene the specific anti imputation streaming provisions contained in the Income Tax Act 1994 (ITA94) including the general anti avoidance provisions. The essential features of the proposal are described in BR Prd99/13.¹³ The relationship between the parties is summarised in the following diagram, which has incorporated the actual shareholding, disclosed in the 2002 Annual Report. The combined income of the Australian branch and the New Zealand branch of \$A4000 is the same as the income flow used in the Discussion Document.

¹³ BR Prd 99/13, *Tax Information Bulletin*, Vol 11:10 (November 1999) 7. This ruling was replaced with BR Prd 02/14, *Tax Information Bulletin* Vol 14:11 (November 2002) 5.

Diagram 5
The Westpac solution to triangular taxation



D De Facto Full Streaming

A key feature of the capital raising exercise is to enable the New Zealand issuer to earn taxable income and thereby generate imputation credits. The New Zealand issuer derived rental income from their ownership of a property portfolio which was leased to Westpac affiliates throughout New Zealand. The issuer also lent the funds raised from the float to another member of the New Zealand group which generated gross interest income. Finally, a swap was entered into to ensure that the dividend payment to the New Zealand shareholders was based on the dividend paid by the Australian parent company to its Australian shareholders. The tax advantage arising from the structure was the creation of imputation credits for the New Zealand shareholders. The following table shows the advantage for the New Zealand shareholders from investing in the New Zealand issuer (which is essentially the same as Table 4).

Table 5
The Westpac solution to triangular taxation

New Zealand Shareholder	\$AU	Australian Shareholder	\$AU
Cash Dividend	84	Cash Dividend	1,596
Imputation Credit	36	Imputation Credit	0
Franking Credit	0	Franking Credit	684
Taxable Income	120	Taxable Income	2,280
Tax due @ 39%	47	Tax due @ 48.5%	1,106
Less Imputation Credit	36	Less Imputation Credit	0
Less Franking Credit	0	Less Franking Credit	684
Tax Payable	11	Tax Payable	422
Net Dividend	73	Net Dividend	1,174
Effective Tax rate	39.00%	Effective Tax rate	48.50%
Pre-tax cash dividend	120	Pre-tax cash dividend	2,280
Company tax	36	Company tax	684

VII BEHAVIOURAL IMPLICATIONS: FUNDING THE NEW ZEALAND GROUP

A Introduction

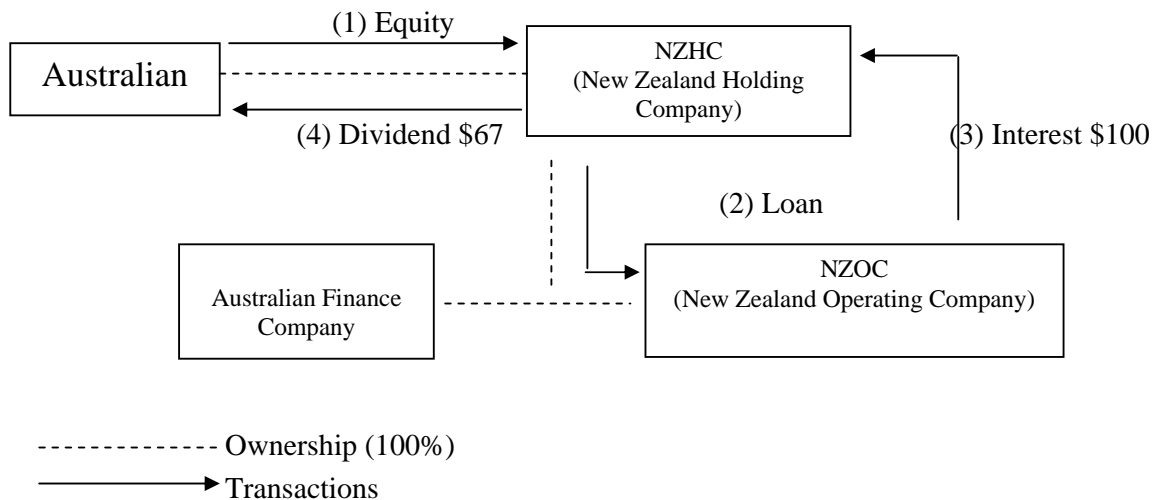
The Westpac solution effectively provides its New Zealand shareholders with all of the advantages of the full streaming option which has been rejected by both the Australian and New Zealand Governments. Note that with the Westpac solution there is no inefficient allocation of the available tax credits. All of the transaction costs are effectively borne by the New Zealand investors who derive all of the taxation advantages.

In view of the high level of wastage associated with the PRA solution, there are very few (if any) taxation reasons why an Australian parent company would wish to fund its New Zealand subsidiary in a manner that created imputation credits. A more efficient solution is for the Australian Parent Company to finance the New Zealand operations in a manner that creates franking credits. A possible response to the rejection of the full streaming alternative is for Australian companies to refinance their New Zealand operations in the following tax effective way.

B A Hypothetical Current Structure

The following diagram summarises the New Zealand tax implications of a typical trans-Tasman group. The Australasian tax group consists of inter alia a New Zealand Holding Company and New Zealand Operating Company. Finance is provided via the Australian Parent Company subscribing for equity in the New Zealand Holding Company (NZHC). The NZHC lends the proceeds its wholly owned New Zealand Operating Company (NZOC). The NZOC pays interest (which is an allowable deduction) to NZHC (which is gross income). Finally, the NZOC remits the after tax income to the Australian Parent Company in the form of a dividend. The total New Zealand tax (\$33) consists of \$22.11 company tax and 11.82 NRWT (met via supplementary dividend).

Diagram 6
Current structure



C A More Tax Efficient Alternative: Hybrid Instruments

The following more complex diagram is designed to reduce the amount of New Zealand tax and create a corresponding increase in the dividend paid to the Australian parent company. Under a conventional funding arrangement, an after tax dividend of \$67 is paid to the Australian parent company. Under the following rearrangement, the net after tax New Zealand sourced dividend is increased from \$67 to \$90.

For the purposes of illustration only the underlying assumption is that the structure will be used to refinance the existing NZ group. The concepts are equally applicable to financing an expansion of the NZ group associated with for example a merger or acquisition. The ‘anti avoidance’ risks and implications have been ignored.

The initial rearrangement (Steps 1–5) is designed to replace the NZ group’s original equity (which created the tax consequences described in section 7.2) with a more tax effective alternative.

Step one. The Australian Parent Company subscribes for equity issued by the NZHC. The proceeds from that transaction are ultimately returned to the Australian Parent Company via, for example, a share repurchase of the original equity.

Step two. The NZHC uses the proceeds from step one to finance the acquisition of a *hybrid instrument* issued by the NZ Branch of the Australian Finance Company. The transaction is undertaken by the NZ branch to avoid non-resident withholding tax (NRWT) that would otherwise be payable if the transaction was booked with the Australian Finance Company instead of its New Zealand branch. The *hybrid instrument* will be treated as *debt* for Australian tax purposes, and as *equity* for New Zealand tax purposes. Despite the recent Australian changes to the debt/equity boundaries it is still possible to create tax efficient *hybrid instruments* which contain all of the tax attributes and advantages of, for example, the pre July 2001 ‘Section FC 1 Debentures’. The tax

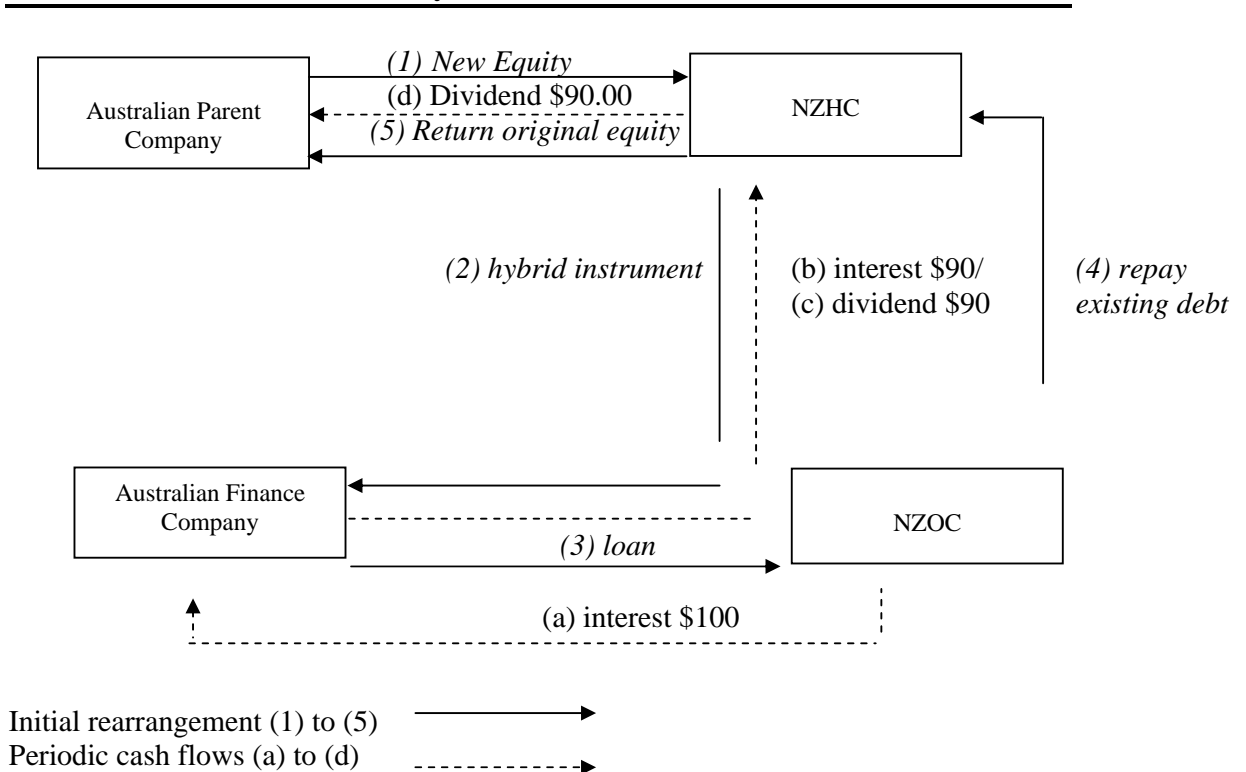
advantages associated with the *hybrid instrument* arise from the period cash flows described below and summarised in Table 6.

Step three. The New Zealand branch of the Australian Finance Company leads the proceeds (raised from issuing the *hybrid instrument* to NZHC) to the NZOC. For New Zealand tax purposes this is a transaction between two resident entities and therefore the non-resident withholding tax provisions are not applicable.

Step four. The NZOC uses the loan finance to repay the original loan shown as Step 2 in Diagram 6. From the NZOC perspective it has simply replaced its current creditor (NZHC) with a new creditor (the New Zealand branch of Australian Finance Company), which means that everything else being equal, the new arrangement will have no impact on its current business activities.

Step five. NZHC will use the loan repayment (from NZOC) to return the original equity obtained from the Australian Parent Company. One tax effective method of unwinding the original transaction would be for NZHC to repurchase the original shares from Australian Parent Company. Provided all the technical requirements contained in s CF 3(1)(b) of the ITA94 are satisfied, this transaction will not constitute a dividend and no NRWT would be payable.

Diagram 7
Hybrid instruments



D *The New Zealand Tax Consequences of the Hybrid Instrument*

The New Zealand tax consequences associated with Steps 1–5 described in section VII C above are designed to reduce the current level of New Zealand company tax from \$33 to zero. The only tax payable will be \$10 Australian NRWT. If everything else has been equal, the Australian Parent Company will receive a dividend of \$90 from the NZHC. This represents an increase of \$23 or a 34 per cent increase in the Australian Parent Company's after tax return from its investment in the NZHC. The Australian Parent Company is in a position to invest the additional \$23 in a manner that will increase the franking credits which can be distributed to, inter alia, its Australian shareholders.

(1) **Periodic cash flow (a).** NZOC pays interest to the New Zealand branch of Australian Finance Company. The interest is deductible to NZOC, and forms part of the New Zealand branch's gross income. In other words, this transaction is tax neutral from a New Zealand perspective. Secondly, there are no NRWT implications because this transaction is between two New Zealand tax residents.

(2) **Periodic cash flow (b)/(c).** Australian Finance Company pays interest/dividend to the NZHC pursuant to the terms and conditions of the *hybrid instrument*. For Australian tax purposes, the transaction constitutes interest and therefore Australian NRWT (at 10 per cent) is payable to the Australian Tax Office (ATO). This is the only tax leakage associated with all of the transactions. For New Zealand tax purposes, the payment is recharacterised as a dividend. In view of the subsequent payment by NZHC of a dividend to the Australian Parent Company the conduit tax relief (CTR) provisions apply. This is the key feature of the entire transaction which eliminates all of the New Zealand company tax and New Zealand NRWT associated with the original 'plain vanilla' financing. However, it would be fair to say that the CTR provisions contained in the ITA94 were never intended to be used in this way.

(c) **Periodic cash flow (d).** The final transaction is the payment of a dividend by NZHC to the Australian Parent Company. This transaction is linked to the periodic cash flow (b) / (c) because it is the second stage of the CTR. The original purpose of the CTR provisions were to reduce the amount of New Zealand company tax, and NRWT which is payable associated with International Paper (Inc)'s investment in Carter Holt Harvey Limited who in turn owned forestry investments in Chile and Canada. However, there is nothing in the CTR regime which prevents the relief from New Zealand tax applying to trans Tasman companies.

E *The Tax Saving Associated With a Hybrid Instrument*

Table 6 summarises the New Zealand tax consequences of the periodic cash flows described above in section 7.4. The main purpose of Table 6 is to demonstrate that the original after tax dividend of \$67 (paid by NZHC to Australian Parent Company) has increased to \$90, as discussed in section VII D. This represents an increase of \$23 or 34 per cent in the after New Zealand tax return of the Australian Parent Company. This only occurs because of the CTR regime which effectively enables the New Zealand group to more efficiently utilise the underlying New Zealand company tax

(imputation credits) paid by the NZOC associated with the commercial activities that were originally financed by the Australian Parent Company.

Table 6
The tax saving associated with a *hybrid instrument*

(a) <u>Interest NZOC to Aus Finance Co (NZ Branch)</u>		100
- No liability to deduct NZ NRWT	-	
- NET CASH PAID		100
(b) <u>Hybrid Aus Finance Co (NZ Branch) to NZHC</u>	100	
- Aust NRWT – interest	<u>(10)</u>	
NET CASH		90
(c) <u>FDWP Relief s NG 7 (Hybrid)</u>		
- Net cash	90	
- add Aust NRWT	<u>10</u>	
- Gross dividend	100	
- Foreign Dividend Withholding Payment (FDWP) 33%	33	
Less Aust NRWT	(10)	
Less Underlying Foreign Tax Credit (UFTC)	(Nil)	
Net FDWP	23	
S NH 7(1) Conduit Tax Relief (CTR)	(23)	
NET FDWP	<u>(Nil)</u>	
NET CASH RECEIVED		90
(d) <u>Dividend NZHC to Aus Parent Co</u>		
- Cash	90	
FDWP credits	Nil	
Section LGI conduit tax relief dividend	<u>23</u>	
Gross dividend	123	
NRWT 15%	*NIL	
Net cash paid		<u>90</u>

* Sufficient imputation credits would be attached to the gross dividend of \$123 to eliminate the amount of NRWT which would otherwise be payable, that is, \$61 of imputation credits will ensure a fully imputed dividend.

VIII CONCLUSION

Prior to the enactment of the PRA solution there were no logical reasons why the hypothetical trans-Tasman group of companies outlined in the Discussion Document (and reproduced as Diagram 1) would wish to pay New Zealand company tax. All of the imputation credits created by the New Zealand subsidiary were wasted because they could not be utilised by any of the shareholders.

What then are the key behavioural implications of the recently enacted PRA solution?

The answer depends on the interaction of two variables:

- The ratio of New Zealand to Australian shareholders, and
- The amount of New Zealand and Australian income/company tax paid.

The profile of trans-Tasman companies outlined in Table 2 suggest that the PRA solution will provide the New Zealand individual shareholder with a modest increase in their after tax dividend income. The dilution effect means that most of the New Zealand imputation credits will still continue to be wasted because they will be allocated to the Australian shareholders who cannot offset them against their Australian tax liability.

Accordingly, the PRA solution is unlikely to have a significant impact on the current range of trans-Tasman tax strategies utilised by the major trans-Tasman public companies. The PRA solution is likely to encourage the development of Westpac/ANZ ad hoc solutions, which in substance provide the same taxation benefits as the full streaming alternative.

Alternatively, Australian public companies may simply ignore the PRA solution to the detriment of their New Zealand shareholders.

JURISDICTION TO TAX AND THE CASE FOR THRESHOLD REFORM

KERRIE SADIQ

Kerrie Sadiq is a Senior Lecturer at the TC Beirne School of Law, University of Queensland and a Senior Research Fellow in the Taxation Law and Policy Research Institute at Monash University.

I INTRODUCTION

Currently, before a jurisdiction has the right to tax a multinational entity on a share of the income, a minimum threshold, in the form of residency or permanent establishment, must be established. To ascertain residency or permanent establishment the structure of the multinational entity is examined. A multinational entity may enter a market through foreign direct investment¹ via one of three structures: a subsidiary, a branch, or a representative office.

This paper considers how the recognition of these structural forms is carried through to the current international tax regime. The purpose of examining the different structural forms, and how they are recognised in the international tax regime, is to argue that they do little in distributing the taxing rights between the relevant jurisdictions in an optimal manner according to economic activity. This paper suggests that, while the threshold tests of residency and permanent establishment are a necessary part of the traditional source and transfer pricing regime, they fail to take into account the unique nature of modern multinational entities.

This paper puts forward the notion that the traditional regime for taxing multinational entities is 'one composed of legal concepts and constructs that no longer reflect the economic realities of international business.'² In particular, it is argued that recognising the legal or structural form is the foundation of this lack of recognition of the economic reality of modern multinational entities.³

¹ That is, operating as a multinational entity rather than simply an entity which deals internationally. Foreign direct investment is any investment by an entity over which they have ultimate control, with the activity consisting of four dimensions: a transfer of capital, a control investment, a source of funds for foreign operations, and a balance of payments flow. M V [Eng, A L Francis and L J Mauer, *Global Finance*, \(2nd 1998\) 403.](#)

² Michael J Graetz, 'Taxing International Income: Inadequate Principles, Outdates Concepts, and Unsatisfactory Policies' (2001) 26 *Brooklyn Journal of International Law* 1357, 1417.

³ Ibid 1417. Michael Graetz argues, 'the continuing insistence of the international tax regime in treating different divisions of an integrated multinational business as separate entities, whenever their legal status implies such separation is but one illustration of the problem'—the problem being the legal concepts and constructs which compose the traditional regime.

The purpose of this paper is twofold.⁴ First, it is argued that the threshold tests of residency and permanent establishment are legal tests which have no place in a tax regime designed to allocate income based on economic activity. Second, it is argued that the principles contained in the traditional regime requiring the recognition of the different structures adopted, along with a legal distinction recognising the separate parts of the multinational entity, while inextricably tied to the current source and transfer pricing rules, are unnecessary, and therefore irrelevant, in determining the allocation of taxing rights to multinational entities where that allocation is based on economic activity.⁵

There are four primary parts to this paper. First, the legal formalisms of the traditional legal regime, along with the interaction of the principles of residency and source, are considered. Second, the measurements of jurisdictional presence are examined. In this part of the paper the legal tests of residence and permanent establishment are considered in detail. Third, the conundrum of the component approach is examined to demonstrate first, that physical presence does not equate to economic activity, and second, that national boundaries should not be recognised for tax purposes. Fourth, an economically valid threshold test is considered within the framework of a unitary tax regime.

⁴ A critique of the traditional residency regime is outside the scope of this chapter. There are further arguments for the abandonment of the residency principle. See, eg, John K Sweet, 'Formulating International Tax Laws in the Age of Electronic Commerce: The Possible Ascendancy of Residence-Based Taxation in an Era of Eroding Traditional Income Tax Principles' (1998) 146 *University of Pennsylvania Law Review* 1949, 1995. He states there are four fundamental problems with a residence-based regime: the difficulty in enforcing residence-based taxation on a taxpayer's global income; the risk of 'capital flight'; the reluctance by developing countries to submit to a residency-based regime; and the diminishing applicability of the 'fixed place of business' concept. Sijbren Cnossen suggests, 'In view of the enforcement problems of residence-based capital income taxes, the choice may not be between residence-based and source-based taxation, but between source-based taxation and no tax at all.' Sijbren Cnossen, 'Tax Policy in the European Union: A review of Issues and Options' (2001) *Rotterdam: Erasmus University* 19.

⁵ Despite the inadequacies of the residency model, it must be recognised that there are proponents of such a regime. Through improvement and expansion of the international tax treaty network, a system of residence-based taxation is argued by proponents to be superior to a source-based regime provided international consensus is obtained. See, eg, Robert A Green, 'The Future of Source-Based Taxation of the Income of Multinational Enterprises' (1993) 79 *Cornell Law Review* 18; John K Sweet, 'Formulating International Tax Laws in the Age of Electronic Commerce: The Possible Ascendancy of Residence-Based Taxation in an Era of Eroding Traditional Income Tax Principles' (1998) 146 *University of Pennsylvania Law Review* 1949; Vito Tanzi, 2001, 'The Nature and Effects of Globalization in International Tax Policy Principle Papers Globalization, Technological Developments, and the Work of the Fiscal Termites' (2001) 26 *Brooklyn Journal of International Law* 1261, (who raises the possibility of a more comprehensive treatment of income tax applying a residency-based system on cross-border financial transactions); Asim Bhansali, 'Globalising Consolidated Taxation of United States Multinationals' (1996) 74 *Texas Law Review* 1401. See also Robert J Peroni, 'Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules' (1997) 51 *University of Miami Law Review* 975, who relies on the grounds for the position set out in Hugh J Ault, and David F Bradford, 'Taxing International Income: An Analysis of the U.S. System and its Economic Premises' in Assaf Razin & Joel Slemrod (eds) *Taxation in the Global Economy* (1990) 11, 27. See also Kyrie Thorpe who points out that current tax policy supports an attempt to preserve the permanent establishment concept for electronic commerce. She also supports a modified method of residence-based taxation for electronic commerce: Kyrie E Thorpe, 'International Taxation of Electronic Commerce: Is the Internet Age Rendering the Concept of Permanent Establishment Obsolete?' (1997) 11 *Emory International Law Review* 633, 696.

This paper concludes with a proposal for a unitary regime based on global formulary apportionment for multinational entities. A formulary apportionment regime removes both the need to distinguish between the various structural forms adopted⁶ as well as a threshold test based on physical presence. Changes in multinationals, and the emergence of new types of multinational entities, mean that ‘links between economic activity and a particular location, traditional tax concepts, such as “residence” and “source” become difficult to apply’.⁷ Formulary apportionment is a taxation model that alleviates these problems.

II LEGAL FORMALISMS OF THE TRADITIONAL REGIME

The aim of any international tax regime is to allocate the taxing rights to relevant jurisdictions. While a multinational entity may produce international business income, there is no one set of taxation principles to tax this income at a global level.⁸ Rather, taxation, or more concisely, jurisdiction to tax, is a matter for domestic law.⁹ In this sense, taxpayers have become global, tax authorities have not.¹⁰ At a global level, the international norms,¹¹ or core concepts, which have been developed and embraced by most countries, apply.¹² The two fundamental concepts—the norms of residency and source—which find their origins in a 1923 report submitted to the League of Nations¹³ and have been developed over the decades are the principles that apply to all multinational entities, whether traditional or modern.¹⁴ The effects, however, of globalisation mean that frictions now arise between current developments, such as the

⁶ Monica Brown-Gianni, ‘Transfer Pricing and Formulary Apportionment’ (1996) 74 *Taxes* 169, 180. Although Monica Brown Gianni considers the fact that formulary apportionment ignores the legal structure of the group a disadvantage of the approach.

⁷ Jeffrey Owens, ‘Tax Reform in the 21st Century’ (1997) 14 *Tax Notes International* 583, 593.

⁸ Although there is no such thing as an ‘international tax’. As David Williams explains “‘international tax’ does not make logical or semantic sense, unless we find supranational taxing powers.’ Rather, it is the interactions that arise in respect of transnational aspects of national taxes, that we are concerned about: David Williams, *Trends in International Taxation* (1991) 8.

⁹ Richard Bird and Scott Wilkie suggest that ‘the most fundamental rule of international tax is that there are no rules of international taxation – just domestic rules applied to cross-border flows taking into account (or not) that such flows may be subject to taxation in more than one jurisdiction’. Richard M Bird and J Scott Wilkie, ‘Source- vs. Residence-Based Taxation in the European Union: The Wrong Question?’ in Sijbren Cnossen (ed), *Taxing Income in the European Union – Issues and Options for Reform* (2000) 78, 91.

¹⁰ John F Avery Jones, ‘Are Tax Treaties Necessary’ (1999) 53 *New York University Tax Review* 1 1. Alex Easson questions whether ‘one can properly speak of an “international law of taxation”’. Alex Easson, *Taxation of Foreign Direct Investment* (1999) 145.

¹¹ It is asserted that source and residence taxation are customary norms. See: Nancy H Kaufman, ‘Fairness and the Taxation of International Income’ (1998) 29 *Law and Policy in International Business* 145, 148.

¹² As Richard Bird points out countries could adopt whatever taxing rules it sees fit, nevertheless a certain degree of uniformity does exist. Richard M Bird, ‘Shaping a New International Tax Order’ (1988) 42 *Bulletin for International Fiscal Documentation* 292.

¹³ League of Nations, *Report on Double Taxation* (1923) Doc EFS 73 F 19. See: Reuven S Avi-Yonah, ‘The Structure of International Taxation: A Proposal for Simplification’ (1996) 74 *Texas Law Review* 1301, for a history of the development of the concepts of residency and source.

¹⁴ For a history of the current international tax regime see: Michael J Graetz and Michael M O’Hear, ‘The ‘Original Intent’ of U.S. International Taxation’ (1997) 46 *Duke Law Journal* 1021.

modern multinational entity, and the traditional principles which reflect outdated thinking.¹⁵

The traditional principles are contained in both domestic law¹⁶ and international treaties.¹⁷ The application of these principles of residency and source to multinational enterprises involves a number of legal formalisms.¹⁸

Generally, principles of residency and source are considered to be competing concepts, with the primary right to corporate taxation falling to the source jurisdiction.¹⁹ Each of the traditional concepts turns on the ability to establish a geographical physical presence in a particular country.²⁰ The residual rights generally fall to the residence jurisdiction, with that country providing exemptions or credits for tax paid in the source country in order to avoid double taxation.

¹⁵ Vito Tanzi, 'The Impact of Economic Globalization on Taxation' (1998) 52 *Bulletin for International Fiscal Documentation* 338, 339.

¹⁶ These concepts are first contended with in Division 6 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). This Division provides that 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. See: ITAA97 s 6-5(2). Alternatively, if you are not an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all Australian sources during the income year; and other ordinary income that a provision includes in your assessable income for the income year on some basis other than having an Australian source. See: ITAA97 s 6-5(3). These principles of residency and source apply equally to statutory income and income according to ordinary principles: s 6-5 of the ITAA97 includes 'ordinary income' in the assessable income of the taxpayer, while s 6-10 of the ITAA97 includes 'statutory income' in the assessable income of a taxpayer.

¹⁷ *International Tax Agreements Act 1953* (Cth) s 4. The application of Australian domestic principles, without resort to international agreements, will not always present the optimal taxing result, as there is potential for double taxation or less than single taxation. Consequentially the taxing position acquired through an application of those domestic principles is neither the final or legally correct result. Adjustments to the domestic principles are facilitated by the overriding effect of the ITAA53 which also addresses the key concepts of residency and source. The ITAA53 provides that the *Income Tax Assessment Acts of 1936 and 1997* are incorporated into it and in the case of any inconsistency the former Act will prevail. All of Australia's Double Tax Agreements are contained in Schedules to that Act, thus forming part of Australian domestic law and effecting the taxation position of multinational entities within Australia's taxing jurisdiction. Like most economically sophisticated countries, Australia has entered into numerous comprehensive double tax agreements. The double tax agreements, generally based on the Organisation for Economic Co-Operation and Development (OECD) model treaty, serve two broad purposes: first, to avoid double taxation, and second, to prevent fiscal evasion. The avoidance of double taxation is achieved through mutual agreements as to the specific allocation of income to the jurisdictions, and exemptions or credits for tax paid. At this point it should be again emphasised that this paper is not suggesting that multinational entities are undertaking fiscal evasion. Rather, this paper considers whether the distribution of the right to tax multinational entities across relevant jurisdictions is optimal. Therefore, while the stated aims of the double tax agreements are to prevent fiscal evasion and double taxation, this paper does not examine whether that is, in fact, achieved. Rather this paper considers whether the distribution of taxing rights under the current law, both the ITAA97 and the relevant double tax agreements, achieves an optimal result, or one reflecting economic reality.

¹⁸ Green, above n 5, 24.

¹⁹ Alvin C Warren Jr, 'Alternatives for International Corporate Tax Reform' (1994) 49 *New York University Tax Law Review* 599.

²⁰ Victor Zonana, 'Introduction: International Tax Policy in the New Millennium: Developing an Agenda' (2001) 26 *Brooklyn Journal of International Law* 1253-54.

Table 1 summarises this position for multinational entities operating in Australia.²¹

Table 1- The general division of Tax Obligations under Australian Domestic Law

	Australian Resident	Non-Australian Resident
Australian Source Income	Jurisdiction to Tax	Jurisdiction to Tax
Foreign Source Income	Jurisdiction to Tax	No Jurisdiction to Tax

Residence and permanent establishment also have a secondary role.²² Where a multinational entity is the taxpayer in question, the residency principle is generally a threshold test in determining the right to tax. In this context, where the test of permanent establishment arises, it is essentially an artificial proxy for residency. 'Strictly speaking, the permanent establishment concept establishes a threshold for taxing business profits rather than a source rule for such profits.'²³ Where a multinational entity is deriving active income, these principles provide the threshold test for allowing a jurisdiction to exert their primary taxing right to that active income which is sourced within their boundaries. Under the traditional regime, the right of a jurisdiction to tax 'is based on either formal residence or physical presence in a taxing jurisdiction'.²⁴ In broad terms, the residency requirement, whether it is used for the purposes of granting taxing rights per se, or as a threshold test, looks to the relationship between the taxpayer and the taxing jurisdiction whereby the residency status is dependent on the type of structure adopted by the taxpayer.

A parent-subsidiary relationship involves the establishment of separate enterprises under the domestic laws of the relevant jurisdictions and, as such, subsidiaries have residency. Conversely, a head office-branch type of relationship requires a consideration of the relevant double tax agreement, which is generally conclusive that branches are permanent establishments. Where a permanent establishment is shown to exist in a host country, taxing rights under domestic law may shift from the home jurisdiction to the jurisdiction of the host country with respect to any income connected to that permanent establishment. That is, the presence of a permanent establishment in a foreign jurisdiction, in accordance with the relevant double tax agreement accords that foreign jurisdiction the taxing rights to any income connected to the permanent establishment. This is based on the notion that an enterprise must have a sufficient presence through which it conducts business in the source country before it is subject to taxation in that country.²⁵

²¹ This position is generally adopted globally.

²² Jacques Sasseville suggests that the distinction between a threshold and a source rule is, to a large extent, academic. Jacques Sasseville, 'The Future of the Treaty Rules for Taxing Business Profits' (2000) *2000 World Tax Conference Report* 5:1, 5:3.

²³ Ibid.

²⁴ Reuven S Avi-Yonah, 'International Taxation of Electronic Commerce' (1997) *52 New York University Tax Review* 507, 516.

²⁵ Thorpe, above n 5, 654.

III MEASUREMENTS OF JURISDICTIONAL PRESENCE

In the framework of treaties based on the OECD Model Treaty, the rights of each state to tax the profits from global trading are determined by the presence of an enterprise within a jurisdiction and the extent to which profits are connected with that presence.²⁶

This statement of jurisdictional presence is essentially a statement about the necessary nexus between an enterprise and the taxing jurisdiction that is required for taxing rights to exist. These taxing rights arise where one of two measurements is satisfied. First, the existence of an enterprise of a contracting state according to the provisions of the domestic laws grants taxing rights to the relevant jurisdiction.²⁷ This is simply a test of residency. Second, taxing rights are granted to a jurisdiction in which there is a permanent establishment of an enterprise of another jurisdiction.²⁸ This test of permanent establishment is determined by virtue of the double tax agreements and generally looks for a fixed place of business.

Both of these measurements arise in the case of activities undertaken by multinational entities, as operations are conducted in both branch and subsidiary form. It is generally easy to determine whether the subsidiary is a resident of the relevant jurisdiction, just as it is generally easy to determine whether there are sufficient assets of a branch to determine the existence of a permanent establishment.²⁹ However, issues may arise. For example, a difficulty arises in operations conducted through subsidiaries in determining whether a resident subsidiary is a dependent agent of a foreign subsidiary such that the foreign subsidiary has a permanent establishment in the contracting state.³⁰ As Charles Plambeck explains, in practical terms this is often a distinction without a difference.³¹ However, it adds legal complexity where it is not warranted. Further, these tests are strict legal tests which adopt a form over substance approach.

It is outside the scope of this paper to discuss the merits of the residency requirement and the test of permanent establishment per se. The purpose, therefore, is to consider whether these legal tests allocate the rights to tax income from a multinational entity according to economic activity. Prior to a consideration of why these legal tests fail to allocate according to economic activity, it is necessary to consider what these tests entail. This is done below.

²⁶ Charles H Plambeck, 'The Taxation Implications of Global Trading' (1990) 48 *Tax Notes* 1143, 1149.

²⁷ Ibid.

²⁸ Ibid.

²⁹ Ibid, 1150.

³⁰ Ibid.

³¹ Ibid.

A The Multinational Entity Subsidiary

In the context of multinational entities, the test of residency has two broad implications. First, it is possible that a subsidiary of a foreign entity is also considered a resident in Australia, resulting in dual residence. Secondly, where an Australian entity operates through a subsidiary incorporated in a foreign jurisdiction, thereby ruling out the applicability of the test of incorporation, it is possible that residency occurs through either of the two residual residency tests. Such application of residency tests may result in the possibility of double taxation or less than single taxation through inconsistent application of domestic laws across jurisdictions.

It may be argued that the consequences of these results are twofold. First, unnecessary complexity is added to the regime in attempting to ensure there is not double taxation or less than single taxation. Secondly, and more importantly, splitting the jurisdiction to tax based on residency has little to do with economic activity and more to do with a physical presence. It is acknowledged that while the result under the current regime may be similar to that reached under an alternative tax regime, the process of determining residency and, if there is dual residency providing credits or exemptions to prevent double taxation, is an unnecessary process. Further, being mere legal tests, it is proposed that they fail to take into account the true location of income. If it is the case that economic activity does not marry with physical presence, the test of corporate residency is not an optimal measure of the right to tax. Overall it has been suggested that, 'in the case of corporations ... the idea of residence—an idea central to any discussion of principles and policies relating to international taxation of foreign direct investment—seems both outdated and unstable.'³² Furthermore, flexibility in establishing a corporation's residency is a universal phenomenon,³³ which may be used to a taxpayer's advantage.

The following discussion examines the three legal tests for establishing corporate residency to reveal both the purely legal (as opposed to economic) nature of these tests, along with the unnecessary complexity inherent.

The parent–subsidiary relationship, involves the foreign entity being a company³⁴ in its own right. A resident Australian company is defined as a company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia.³⁵

³² Graetz, above n 2, 1422.

³³ Ibid, 1423.

³⁴ 'Company' is defined in s 995-1 of the ITAA97 as:

- (a) a body corporate; or
 - (b) any other unincorporated association or body of persons;
- but does not include a partnership.

³⁵ Section 6(1) ITAA36: 'resident' or 'resident of Australia' means:

- (a) a company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia;

The ITAA97 defines resident in terms of the definition of resident of Australia in the ITAA36. See: s 995-1 of the ITAA97.

Therefore, for a subsidiary to be considered a resident of Australia it must satisfy one of the three tests of residency.

The first statutory test, that of incorporation, replaces the common law proposition that incorporation is not decisive in the determination of residency of a company.³⁶ By providing that incorporation determines residency it is assumed that the owners of a company generally incorporate in their own place of residence. An Australian subsidiary of a foreign entity will be incorporated in Australia and, as such, will satisfy the first statutory test and be considered an Australian resident company so defined. Consequently, application of the two residual tests will not be necessary to demonstrate that a locally incorporated subsidiary of a foreign entity is an Australian resident for tax purposes. As a resident of Australia, the Australian Taxation Office (ATO) may tax income from all sources earned by the subsidiary. Where another jurisdiction has the right to also tax the income of that subsidiary, resort to exemptions, credits, or double tax agreements are necessary to avoid double taxation.

The remaining two tests of residency are an adaptation of the common law, which provides that a company resides where its real business is carried on and its real business is carried on where its central management and control abides.³⁷ As such, the common law provides valuable guidance when determining the residency of a company, particularly where incorporation is offshore.

The second and third statutory tests are applicable to multinational entities in two circumstances. First, where an Australian subsidiary of a foreign entity may also be considered a resident in the foreign jurisdiction, resulting in dual residence. Second, where an Australian entity operates through a subsidiary incorporated in a foreign jurisdiction, thereby ruling out the applicability of the test of incorporation, but making Australian residency possible through either of the two residual residency tests.

The first of these tests requires that for the company to be considered a resident of Australia, its central management and control must be in Australia. Unique problems may arise where the company in question is a subsidiary, due to the ability of the parent company to manage and control it from the foreign jurisdiction, or in the alternative, an Australian parent company manages and controls the foreign subsidiary. For example, a United States subsidiary of an Australian entity will clearly be a non-resident of Australia for Australian tax purposes through the operation of the statutory test. However, the question arises as to whether the subsidiary is a resident of Australia through the common law test of the place of 'central management and control'. This leads to dual residence which would not occur under a unitary tax regime.

The second statutory test appears to contain two limbs: first, that the company carries on business in Australia; and second, that it has its central management and control in Australia.³⁸ However, if there is proof of the company's central management and

³⁶ *Todd v Egyptian Delta Land Investment Co Ltd* (1929) AC 1.

³⁷ *De Beers Consolidated Mines Ltd v Howe* (1906) AC 455. See also *Cesena Sulphur Co Ltd v Nicholson* (1876) 1 TC 88, *San Paulo (Brazilian) Railway Co v Carter* (1896) AC 31, *American Thread Co v Joyce* (1913) 108 LT 353, and *Egyptian Delta Land & Investment Co Ltd v Todd* (1929) AC 1.

³⁸ *Malayan Shipping Co Ltd v FCT* (1946) 71 CLR 156. The Court in *Malayan Shipping Co Ltd v FCT* held that once it is established that a company's central management and control is in Australia by

control in Australia it is sufficient to satisfy the second residency test. That is, a foreign subsidiary of an Australian entity does not need to be carrying on business in Australia in the strict sense. In determining what constitutes ‘central management and control’ for the purposes of this test, it is prudent to consider the concept of management separately to the concept of control despite historically being considered a single concept.

The distinction between ‘management’ and ‘control’ was discussed—in the context of the transfer pricing provisions of the ITAA36—in *FCT v Commonwealth Aluminum Co Ltd*.³⁹ Legislative history was utilised to indicate that control is the paramount test to determine residency with the court clarifying that ‘the word “controlled”, when used passively, in its ordinary meaning refers to de facto control rather than the capacity to control’.⁴⁰ In these circumstances, de facto control means actual control over the *business* not the capacity to control the company. This type of control—actual control—will usually be in the hands of the directors and management of the company, thereby allowing management and control to be considered a single concept with the place of management and control generally being the place of the meeting of directors. There may be exceptional circumstances where control does not lie with the directors thereby avoiding the application of the second residency test.⁴¹

The necessity of ‘control’ to be de facto control is further supported by the mere existence of the third test of residency, which requires that the company carries on business in Australia and has its voting power controlled by Australian residents. As the third test incorporates the capacity to control, regardless of whether it is actually exercised, then by implication, the second test must be examining a separate issue, namely actual control. The question of what constitutes actual control has been considered in a number of cases dating back as far as 1946, when, in *Malayan Shipping Co Ltd v FCT*⁴² the High Court held that the central management and control of the company in question lay with an Australian resident despite the directors being non-residents and meeting outside Australia.⁴³ The judgment was based on the Australian residents’ power to appoint and remove directors and veto any resolutions made by them as well as the control over company business decisions and finances.⁴⁴

implication it must be carrying on business in Australia, thus reducing the second statutory test to one limb.

³⁹ *FCT v Commonwealth Aluminum Corporation Ltd* (1980) 80 ATC 4371.

⁴⁰ *Ibid* 4371, 4378.

⁴¹ It is suggested in R L Hamilton, RL Deutsch and JC Raneri, *Guidebook to Australian International Taxation*, (6th ed, 1999) 2–16, that control may ‘not abide in the place where the directors meet, for example because they have entered into an agreement that they will vote according to the wishes of another or because they habitually follow the instructions of another without exercising independent judgment’.

⁴² *Malayan Shipping Co Ltd v FCT* (1946) 71 CLR 156.

⁴³ The House of Lords, in *Unit Construction Co Ltd v Bullock* (1959) 38 TC 712, also supported the view that the question of control must be one of actual control. The question arose as to whether subsidiaries of a United Kingdom Company were also residents of the UK. Despite the management and control of the subsidiaries being vested in their directors it was held that the subsidiaries were residents of the UK because of the director’s acquiescence in decisions made by the parent company.

⁴⁴ Although Australia’s most notable case relating to the residency of a company is *Esquire Nominees v FCT* (High Court [1972] 72 ATC 4,076; [1973] 129 CLR 177 [Gibbs J]; Full High Court [1973] ATC 4,114; [1973] 129 CLR 204), where the question arose as to whether Esquire Nominees, a company incorporated and holding its registered office in Norfolk Island, was a resident there for the purposes of

Decisions generally conclude the residence of one jurisdiction or the other. Case law, however, suggests that it is also possible, under this second test of residency, for the central management and control to be split between two jurisdictions resulting in dual residency. In *Koitaki Rubber Estates v FCT*⁴⁵, Dixon J, at first instance, recognised the possibility of dual residency while, at the same time, cautioned against such a finding.

In summary, the second test of residency requires actual control of the company to be located in Australia and allows dual residency to be found where the central management and control exists in more than one jurisdiction. It has been suggested that factors to consider when determining the place of central management and control include the place of physical activities, the place where directors meet, and the place where important decisions are made.⁴⁶

Clearly, under this test a foreign subsidiary of an Australian entity will usually also be a resident of Australia. As such, dual residency arises, as will the need for foreign tax credits or exemptions where there is double taxation. Again, this problem would not arise under a unitary tax regime.

The third test of residency, requiring the company to both carry on business in Australia and have its voting power controlled by persons who are residents of Australia, is a true two-limb test. First, it must be determined whether a business is being carried on for the purposes of Australian taxation law. Various factors influence a decision on whether a company is carrying on business in Australia. Repetition or intended repetition of transactions, continuity, and system in the organisation, commercial significance of activities, and profit motive are suggested as being indicative of a business being carried on in Australia.⁴⁷ The courts have gone so far as to provide that a company, which merely invests in Australia, may be carrying on business in Australia.⁴⁸ A diverging view, and one that does not attract the broad support of the courts, suggests that the dicta of Williams J in *Malayan Shipping Co Ltd*

Australian Taxation. During the period in question, the company had three directors, all of whom were residents of Norfolk Island. Through a complicated share holding structure, consisting of A class shares giving holders the right to predominantly exercise all the voting power of the company, and B Class shares which gave limited voting power to the holders, ownership was split between Norfolk Island residents and Australian residents respectively. The Court held that the taxpayer was not a resident of Australia. The decision in *Esquire Nominees* appears to support an earlier decision of the House of Lords, *Mitchell v Egyptian Hotels Ltd* (1915) AC 1022 at 1041 where it was suggested by Lord Sumner, that 'the level of participation in the company's affairs need not go beyond passive oversight and tacit control'. With recent commentary also applauding Lord Sumner's approach and the decisions of *Esquire Nominees* and *Malayan Shipping* exemplifying the threshold, it is suggested that the test of Lord Sumner is the appropriate test for determining central management and control. See Peter J Gillies, 'Understanding Company Residence: Central Management and Control' (1989) *CCH Journal of Australian Taxation* 52, 57.

⁴⁵ *Koitaki Rubber Estates v FCT* High Court (1941) 64 CLR 15, Full High Court (1941) 64 CLR 241.

⁴⁶ Peter J Gillies, 'Understanding Company Residence: Central Management and Control' (1989) *CCH Journal of Australian Taxation* 52, 59.

⁴⁷ Hamilton et al, above n 41, 2-18.

⁴⁸ *London Australia Investment Co Ltd v FCT* (1977) 77 ATC 4398, *FCT v Total Holdings (Australia) Pty Ltd* (1979) 79 ATC 4279.

*v FCT*⁴⁹ that ‘mere trading’ was not enough to find that a company was a resident, may be influential in the courts’ future interpretation of ‘carrying on business’.⁵⁰ Despite the guidance such decisions provide us with, the fact remains that what constitutes carrying on business in Australia must be determined on a case-by-case basis.⁵¹

Having established that the company is carrying on business in Australia, it is then necessary to satisfy the second limb of the test, that persons who are residents⁵² of Australia control the voting power. It would appear that ‘voting power’ includes not only the voting power attached to shares but also voting power attached to the holding of office.⁵³ As to what constitutes ‘control’, it is suggested that it refers to de facto control of a general meeting rather than the mere capacity to control.⁵⁴ The degree of control needed is that of a mere majority, that is, 50 per cent control over matters dealt with at a general meeting.⁵⁵

Subsidiaries can satisfy one of the three tests of residency to qualify for taxation by the ATO. The obvious problem of dual residency arises for a multinational entity when it is considered that they are a resident of more than one jurisdiction because of conflicting domestic tests of the relevant jurisdictions. This, in turn, leads to the double taxation of the income of the multinational entity.

To address the issue of dual residency and the resultant double taxation, Australia has generally adopted the ‘all or nothing approach’ of the OECD Model Tax Convention (OECD Convention). Based on the general principles of residency, Article 4 of the Convention attributes sole residence to one of the competing jurisdictions. The aim of Article 4 is stated as being ‘to define the meaning of the term “resident of a Contracting

⁴⁹ *Malayan Shipping Co Ltd v FCT* (1946) 71 CLR 156, 159: ‘If, on the other hand, a company incorporated elsewhere is merely trading in Australia and its central management and control is abroad, it does not become a resident of Australia unless its voting power is controlled by shareholders who are residents of Australia.’

⁵⁰ Hamilton et al, above n 41.

⁵¹ J Hill, in *Evans v FC of T* highlighted this need for a close consideration of the facts of the case when he cautioned against the reliance on any one case to establish the carrying on of a business. To this effect he stated that, ‘[t]he question of whether a particular activity constitutes a business is often a difficult one involving as it does questions of fact and degree. Although both parties referred me to comments made in decided cases, each of the cases depends upon its own facts and in the ultimate is unhelpful in the resolution of some other and different fact situations’. *Evans v FCT* 89 ATC 4540, 4554–4555.

⁵² Section 6(1) ITAA36: ‘resident’ or ‘resident of Australia’ means:

- (a) a person, other than a company, who resides in Australia and includes a person:
 - (i) whose domicile is in Australia, unless the Commissioner is satisfied that his permanent place of abode is outside Australia;
 - (ii) who has actually been in Australia, continuously or intermittently, during more than one-half of the year of income, unless the Commissioner is satisfied that his usual place of abode is outside Australia and that he does not intend to take up residence in Australia; or
 - (iii) who is:
 - (A) a member of the superannuation scheme established by deed under the Superannuation Act 1990 ; or
 - (B) an eligible employee for the purposes of the Superannuation Act 1976 ; or
 - (C) the spouse, or a child under 16, of a person covered by sub-subparagraph (A) or (B);

⁵³ *Kolotex Hosiery (Australia) Pty Ltd v FCT* (1975) 75 ATC 4028; 132 CLR 535.

⁵⁴ Hamilton et al, above n 41.

⁵⁵ *Mendes v Commissioner of Probate Duties* (1967) 122 CLR 152.

State”, and to solve cases of double residence’.⁵⁶ While Article 4 considers the residency of both individuals and companies in relation to the residency of multinational entities, only the principles relating to companies are relevant.

The OECD Article, in para 1,⁵⁷ initially requires a consideration of domestic law to establish residency. Australia’s double tax agreements are consistent with the OECD Convention and generally provide that a taxpayer is a resident of a Contracting State for the purposes of the double tax agreement if they are a resident of that State for the purposes of domestic tax law. This, however, does not solve the issue of dual residency.

The problem of dual residency is addressed in Article 4, para 3,⁵⁸ of the OECD Convention. It provides that a company’s residency shall be determined by reference to ‘its effective place of management’, yet no guidance is given as to the meaning of this phrase.⁵⁹

Therefore, according to the general principles of residency in Article 4 of the OECD Convention, where, by application of the respective domestic laws, an entity is a resident of more than one jurisdiction, para 3 of Article 4 declares that entity to be a resident of only the jurisdiction in which its place of effective management is situated. This provision excludes any pro rata allocation of taxation rights and excludes any consideration as to where control of the entity is situated.

It can be seen from the above discussion that residence turns on legal concepts, rather than what could be referred to as the true residence, that is, the location of economic activity. In relation to the two residual tests Michael Graetz points out that:

It is precarious to turn significant ... tax consequences on the status of a corporation as a resident or non-resident, given the difficulty of assessing the ‘true’ residence of corporations, except in the case of closely-held companies where the residence of the owners easily can be determined. Linking corporate

⁵⁶ OECD *Model Tax Convention on Income and on Capital*, (OECD, Paris, 1992), Commentary, (4)-1. Exceptions to the general adoption by Australia of Article 4 of the Convention are the United States and Japan agreements, with neither providing tie-breaker rules for corporations.

⁵⁷ Article 4(1) For the purposes of this Convention the term ‘resident of a Contracting State’ means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term however does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

⁵⁸ Article 4(3) Where by reason of the provisions of para 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated.

⁵⁹ New Zealand’s judicial interpretation of this term ‘effective place of management’ is the ‘practical day to day management, irrespective of where the overriding control is exercised’. Contrary to suggestions by some commentators, this suggests that ‘effective place of management’ is not the same as the domestic concept of ‘central management and control’. It is this author’s view that the two phrases have different meanings as failure to conclude that there is a difference results in the continuing problem of dual residency without resolution. Subsequently, with no guidance from the Australian judiciary as to the meaning of ‘effective place of management’ necessitates acknowledgement of the interpretation offered by the New Zealand judiciary. OECD, *Model Tax Convention on Income and on Capital* (1992) (4)-7.

residence to the residence of its owners simply does not seem practical in the context of multitiered multinationals. On the other hand, insisting that a corporation's residence is the same as that of its managers or officers seems difficult to justify.⁶⁰

The problem of the residency requirement in a modern world can be summarised as follows: 'in the case of corporations, the idea of residence is largely an effort to put flesh into fiction, to find economic and political substance in a world occupied by legal niceties. It is no accident that we call corporations doing business around the world "multinationals"'.⁶¹ Similar issues arise when we consider the proxy for residency in the form of the test of permanent establishment.

B Permanent Establishment and Physical Presence

The permanent establishment concept is crucial to the taxing of multinational entities, as trading is often carried on in branch form⁶² (or through agents). The branch format is now the commonly adopted structure for some multinational entities, for example, multinational banks.⁶³ The permanent establishment concept, contained in the treaty rules for taxing business profits, is also considered the international norm for determining the threshold right to tax,⁶⁴ and therefore generally universally applied.

Double tax agreements introduce the concept of permanent establishment into the taxation of multinational entities, particularly in the context of the taxing rights attaching to them. As such, while the existence of a permanent establishment in a particular jurisdiction is not evidence of residency in the true sense, it is a precondition to the ability of a jurisdiction to tax an entity on certain income. In other words, the concept of the permanent establishment is a threshold test for source-based taxation,⁶⁵ with a permanent establishment⁶⁶ acting as a proxy for residence.⁶⁷ Currently this

⁶⁰ Graetz, above n 2, 1425.

⁶¹ Graetz, above n 2, 1422.

⁶² Leslie B Samuels, and Patricia Brown, 'Observations on the Taxation of Global Securities Trading' (1990) 45 *New York University Tax Law Review* 527, 536.

⁶³ Samuels and Brown, above n 62; Diane M Ring, 'Risk-Shifting Within a Multinational Corporation: The Incoherence of the US Tax Regime' (1997) 38 *Boston College Law Review* 667, 677.

⁶⁴ Sasseville, above n 22, 5:10.

⁶⁵ Avi-Yonah, above n 24.

⁶⁶ OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishment* (2001) 6(2). See: the importance of the permanent establishment concept can be seen from the following extract from para 1 of the Commentary on Article 7 of the OECD Model Tax Convention: 'When an enterprise of a Contracting State carries on business in the other Contracting State, the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 of the OECD Model Tax Convention on Income and Capital (OECD Model Tax Convention) is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with another enterprise of another Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9 of the OECD Model Tax Convention'.

threshold is based on the historical notion that this presence is needed to conduct significant business operations.

The concept of permanent establishment was introduced more than 100 years ago,⁶⁸ with emphasis placed on permanence and physical presence.⁶⁹ The current concept of the permanent establishment dates back to the League of Nations in 1927.⁷⁰ The application of the concept is undertaken through Articles 5 and 7 of the OECD Convention.⁷¹ In understanding its origins, it has been suggested that the concept of the permanent establishment 'has to be understood in the light of the second industrial revolution, which in this respect is characterised by relatively immobile production factors. Business enterprises on a national as well as international level were characterised by investments in fixed capital'.⁷² This emphasis remains today and, as such, a fundamental policy concern in the taxation of branches is whether the application of the traditional regime accurately reflects the economic income arising from the branch's activities.⁷³ The question is then asked whether these rules have become obsolete.⁷⁴ To this extent, Michael McIntyre suggests that, '[t]he current permanent establishment rule is an anachronism, formulated in the heyday of the cross Atlantic steamer'.⁷⁵

When the permanent establishment concept was introduced as a criterion for taxing income in the source jurisdiction the existence of a fixed place of business was seen as evidence of economic allegiance to the taxing jurisdiction.⁷⁶ Increasingly, however, modern multinational entities are providing services and products which allow them to perform economically significant operations of a short duration, and with a flexible location.⁷⁷

As with the concept of residency, the concept of the permanent establishment is one which is inextricably tied to the current source and transfer pricing regime. However, it is one which again it is suggested is not an accurate reflection of the true location of the economic activity giving rise to the income. Further, it is only because of the recognition of the alternative legal structures adopted by multinational entities in the

⁶⁷ Michael J McIntyre, 'The Design of Tax Rules for the North American Free Trade Alliance' (1994) 49 *New York University Tax Review* 769, 780. Michael McIntyre describes the taxation of branches as being on a quasi-residence basis.

⁶⁸ For an historical overview of the permanent establishment concept see Arvid A Skaar, *Permanent Establishment—Erosion of a Tax Treaty Principle* (1991); John F Avery Jones, 'Permanent Establishment: Historical Evolution and Contemporary Relevance' (2000) *2000 World Tax Conference Report* 3:1.

⁶⁹ Skaar, above n 68, 70.

⁷⁰ At the multilateral level, the wording of the various draft conventions has evolved from the League of Nations drafts of 1927, 1933, 1943 and 1946 through to the OECD Model Tax Convention in 1963 and its revision in 1977.

⁷¹ Sasseville, above n 22, 5:3.

⁷² Skaar, above n 68, 69.

⁷³ Fred B Brown, 'Federal Income Taxation of US Branches of Foreign Corporations: Separate Entity or Separate Rules' (1993) 49 *New York University Tax Law Review* 133, 161.

⁷⁴ Sasseville, above n 22, 5:3.

⁷⁵ McIntyre, above n 67, 788.

⁷⁶ Thorpe, above n 5, 654.

⁷⁷ Skaar, above n 68, 70.

current tax regime that the need to consider the existence of a permanent establishment arises.

Australia's Business Profits articles in the double tax agreements to which they are a party generally follow Article 7 of the OECD Model. Paragraph 1 of that article provides:

The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.⁷⁸

There are essentially two ways in which a taxpayer may be declared to have a permanent establishment in a particular jurisdiction: first, by satisfying the test of a presence; and second, by having a dependent agent so defined. It is suggested that the permanent establishment requirement of the double tax agreements may be easily manipulated by multinational entities simply by satisfying or failing to satisfy the legal requirements, depending on which is more beneficial.

1 *The Test of 'Presence'*

Article 5 of the OECD Convention provides the general definition of a permanent establishment. Australia has generally adopted this definition, subject to minor amendments. The Article states that for 'the purposes of this Convention, the term permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on'.⁷⁸ This twofold definition stipulates that in order for there to be a permanent establishment there must be first, an 'enterprise' of a Contracting State, and second, a 'fixed place of business'.⁷⁹

First, as to the requirement that there be an 'enterprise', neither the OECD Model Tax Convention, nor Australia's double tax agreements, provides a definition of 'enterprise'. Rather, it is left to judicial interpretation. The commentary to Article 3 of the OECD Model Tax Convention, containing the definition provisions, expressly excludes a definition of enterprise stating that, 'the question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No definition of the term 'enterprise' has therefore been attempted in this Article'.⁸⁰

In 1990, the High Court of Australia, in *Thiel v FCT*⁸¹, was required to consider the term 'enterprise' for the purposes of Article 7 of the Australia–Switzerland double tax

⁷⁸ OECD, *Model Tax Convention on Income and on Capital* (1992) Article 5(1).

⁷⁹ P Baker, *Double Taxation Conventions and International Tax Law* (1994) 141.

⁸⁰ OECD, *Model Tax Convention on Income and on Capital* (1992) Commentary (3)-2.

⁸¹ *Thiel v FCT* (1990) 90 ATC 4717.

agreement.⁸² The issues before the court were, first, whether Thiel's activities and transactions were an 'enterprise' and second, whether these transactions constituted 'carrying on business'. The High Court held that the expression 'profits of an enterprise carried on by a resident of Switzerland' should be construed to include profits arising out of an isolated commercial transaction and, as such, Article 7 of the double tax agreement protected the profits from taxation in Australia.⁸³

The second requirement of the definition of permanent establishment is that the business is 'fixed'. At the crux of all weaknesses associated with the traditional taxation system is the difficulty associated with the concept of a 'fixed place of business', which has been described as 'the most rooted of all in the physical world'.⁸⁴ The concept of a permanent establishment is based essentially on the presence of a fixed place of business. 'A crucial, perhaps the most crucial, part of the PE [permanent establishment] principle is the requirement of a qualified connection between the enterprise's place of business and the soil ... within the jurisdiction of the tax treaty.'⁸⁵

Article 5 of the OECD Model Tax Convention does not define a 'fixed place of business'. It does however provide examples of what constitutes a permanent establishment. The term permanent establishment includes:

- (a) a place of management;⁸⁶
- (b) a branch;
- (c) an office;
- (d) a factory;
- (e) a workshop; and

⁸² The appeal from the Full Federal Court was before Mason CJ, Brennan, Dawson, Gaudron, and McHugh JJ. The facts of the case, as described in McHugh J's judgement ((1990) 90 ATC 4717 at 4725) involved the taxpayer Gunter Thiel, a resident of Switzerland. Since 1963, Thiel had operated a business in Switzerland as a distributor of earthmoving equipment. In 1983 the taxpayer began investigating the possibility of investing in Australia and in 1984 traveled to Perth at the suggestion of a Mr Kristensen, whom Thiel had known for many years. In January 1984, Thiel acquired an interest in a trust, of which Mr Kristensen was an executive. This acquisition of four units in the trust for a sum of \$50 000 was made because of information provided that the trust was planning to make a public offer, which would create a profit for investors. On 25 May 1984 Thiel acquired a further two units in the trust at a cost of \$100 000. The Trial judge found that one-quarter of the total purchase price of the six units was provided by a Swiss business account while the remainder was provided by way of loan from Thiel's parents. On 22 October 1984, Energy Research Group Australia Ltd was incorporated with Thiel selling his six units to that company on 9 November 1984 at a price of \$300 000. The \$300 000 was satisfied by way of 600 000 fully paid ordinary shares of 50 cents each. Thiel gave instructions to his stockbrokers to sell his shareholding when the company became listed on the Australian Stock Exchange. In a one-month period between 7 February 1985 and 6 March 1985 Thiel sold 252 000 shares for a total of \$566 307.30. The Australian Commissioner of Taxation assessed Thiel on the profits from the sales both of the units in the trust and the shares in the publicly listed company. The Commissioner contended that Thiel had made a profit which was assessable income pursuant to section 26AAA of the ITAA36. Thiel challenged the assessment on the basis that he was not liable to tax on the profits by reason of the Australia-Switzerland Double Tax Agreement. Thiel argued that Article 7 of the Agreement applied and that his activities constituted 'an enterprise carried on by a resident of Switzerland'.

⁸³ This interpretation of 'enterprise carrying on business' eliminates the Federal Court's requirement that an enterprise must involve some level of continuity and permits isolated transactions to constitute an 'enterprise carrying on business'.

⁸⁴ Charles I Kingson, 'Taxing the Future' (1996) 51 *New York University Tax Review* 641, 643.

⁸⁵ Skaar, above n 68, 125.

⁸⁶ OECD, *Model Tax Convention on Income and on Capital* (1992) Commentary (5)-5: A 'place of management' is mentioned separately because it is not necessarily an 'office'.

- (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.⁸⁷

Where a purported ‘fixed place of business’ does not fall within the examples provided it is necessary to consider the two elements of the term itself, ‘place of business’ and ‘fixed’.

First, ‘place of business’ is generally determined by reference to the OECD Model Tax Convention Commentary. This Commentary provides that the term is interpreted broadly to include any premises, facility or installation, where the enterprise carries on business, whether or not that use is exclusive. This broad interpretation means that the facility may be as simple as the provision of space for use, regardless of whether it is owned or rented by the enterprise.⁸⁸ Various authors have suggested that the definition of ‘place of business’ should be more restrictive, including suggestions that a prerequisite to finding a place of business be the ‘production of income’, ‘some degree of entrepreneurial activity’ as a prerequisite to a finding that a facility is a permanent establishment,⁸⁹ or the existence of three characteristics: stability, productivity, and dependence⁹⁰. Despite such suggestions, neither the 1992 OECD Model Tax Convention, nor the 1977 OECD Model Tax Convention has implemented any restrictions on this definition thus accepting the broad interpretation.⁹¹

Arvid Skaar believes that the concept of a ‘place of business’ can be defined as any substantial, physical object which is commercially suitable to serve as a basis of a business activity.⁹² This statement is qualified by the fact that while the term ‘place of business’ also encompasses separate parts of the enterprise such as foreign branches and places of management, an office or similar fixed premises must be presupposed.⁹³ This leads to the second requirement of ‘fixed’.

For a ‘place of business’ to constitute a permanent establishment that place of business must be ‘fixed’. The OECD Commentary provides that this usually means that there is a link between the place of business and a geographical point, that is, the business takes place at one particular site.⁹⁴ Further, there needs to be a degree of permanency with operations being conducted on a regular basis, that is, the place of business must not be of a temporary nature.⁹⁵ However, so long as there is a degree of permanence present it is irrelevant that the permanent establishment only existed for a short period of time.

⁸⁷ Ibid Article 5(2).

⁸⁸ Ibid Commentary (5)-2. The OECD Model Tax Convention provides the example of a pitch in a market place or a permanently used area in a customs depot.

⁸⁹ Hamilton et al, above n 41, 6–10.

⁹⁰ P Baker, *Double Taxation Conventions and International Tax Law* (1994) 142.

⁹¹ OECD, *Model Tax Convention on Income and on Capital* (1992) Commentary (5)-1.

⁹² Skaar, above n 68, 123.

⁹³ Ibid, 123.

⁹⁴ OECD, *Model Tax Convention on Income and on Capital* (1992) Commentary (5)-2.

⁹⁵ Ibid.

2 *The Dependent Agent*

An alteration to the general permanent establishment provision of Article 5(1) is the dependent agents' inclusion in Article 5(5). This is a subordinated alternative to the basic rule, which replaces some but not all of the conditions for permanent establishment under the basic rule.⁹⁶ This alternative is particularly relevant to multinational entities where there is simply a representative or a representative office in a foreign jurisdiction.

It is not necessary for there to be physical presence where there is a dependent agent. Where there is no fixed place of business, and the entity falls outside of Article 5(1), but there is a person acting on behalf of the enterprise and concludes contracts for the enterprise (a dependent agent) it may be deemed to have a permanent establishment for the purposes of a double tax agreement. The Model Tax Convention provides:

Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such a person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.⁹⁷

In essence, para 5 provides that where the enterprise has a person acting on its behalf who has the authority to conclude contracts in the name of the enterprise that enterprise is deemed to have a permanent establishment in respect of any of those activities except for activities excluded by para 4. Such persons, either individuals or corporations, acting on behalf of an enterprise are limited to persons who are not independent agents, that is, they do not fall within the scope of para 6 which specifically excludes brokers, general commission agents or any other agents of independent status.⁹⁸ Therefore, the quintessential requirement in order for Article 5(5) to apply and to deem an entity to be a permanent establishment is the existence of a dependent agent.

The question of what constitutes a dependent agent as compared to an independent one arose in *Case 23/93*.⁹⁹ The issue before the Administrative Appeals Tribunal was

⁹⁶ Skaar, above n 68, 471.

⁹⁷ OECD, *Model Tax Convention on Income and on Capital* (1992) Article 5(5).

⁹⁸ Ibid Article 5(6). This Article provides: 'An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business'.

⁹⁹ *Case 23/93* (1993) 93 ATC 288. This case involved New Zealand husband and wife applicants who carried on the enterprise of share trading in Australia through a dealer. This dealer held the husband's power of attorney, which allowed him to arrange contracts of sale and purchase, and also sign share transfer forms. Further, cash management accounts were opened by the dealer, in the applicants' names which were used for the purposes of holding surplus funds, interest and dividends received. Evidence showed that the husband usually accepted the dealers' advice in relation to purchases or sales, and, when busy, these transactions were executed without the husband's knowledge. The wife's investments were conducted on a more conservative basis, with her personally signing any documents.

whether the Australian dealer was a permanent establishment of the New Zealand taxpayers. The Commissioner argued that there was an enterprise being carried on through a permanent establishment in Australia. Consequentially the income was fully taxable in Australia without the limitations placed on dividends and interest income provided in the withholding tax provisions of the Australia–New Zealand double tax agreement.¹⁰⁰ In support of this argument, the Commissioner relied on Article 4(5)¹⁰¹ of the relevant double tax agreement, while the applicants relied on Article 4(7)¹⁰² to argue that there was no permanent establishment.

The Administrative Appeals Tribunal rejected the applicant’s argument that the dealer was a broker, a general commission agent or any other agent of independent status on the basis that he worked substantially for one principal. On this basis, the Administrative Appeals Tribunal went on to consider whether Article 4(5) applied. In concluding that it did, the Administrative Appeals Tribunal stated, ‘the facts in these applications establish that the dealer habitually exercised in Australia an authority to conclude contracts on behalf of the applicants in their share trading activities. The dealer was little more than the Australian end of the applicants’ share trading enterprises. Although consulted by his principals, he habitually exercises his authority as an attorney and agent to conclude contracts on their behalf. The deeming effect of subsection (5) means that the business structure so created must be regarded as a permanent establishment in Australia’.¹⁰³

Even where a multinational entity has none of the three types of entry present in a jurisdiction the permanent establishment threshold may be met simply by having a representative present in the jurisdiction. Thus, the requirement may go from one of having an arm’s length price for the commissions paid to a sales location, to one where

¹⁰⁰ Article 8:

(1) The Australian tax on dividends, being dividends paid by a company which is a resident of Australia for the purposes of Australian tax, derived and beneficially owned by a New Zealand resident, shall not exceed 15 per centum of the gross amount of the dividends.

(2) The New Zealand tax on dividends, being dividends paid by a company which is resident in New Zealand for the purposes of New Zealand Tax, derived and beneficially owned by an Australian resident, shall not exceed 15 per centum of the gross amount of the dividends.

(3) Paragraphs (1) and (2) of this Article shall not apply if the person who is the beneficial owner of the dividends, being a resident of a Contracting State, has in the other Contracting State a permanent establishment and the holding giving rise to the dividends is effectively connected with that permanent establishment.

Article 9:

(1) The tax of a Contracting State on interest derived and beneficially owned by a resident of the other Contracting State shall not exceed 10 per centum of the gross amount of the interest.

(2) Paragraph (1) of this Article shall not apply if the person who is the beneficial owner of the interest, being a resident of a Contracting State, has in the other Contracting State a *permanent* establishment and the indebtedness giving rise to the interest is effectively connected with that permanent establishment.

¹⁰¹ Article 4(5): A person acting in a Contracting State on behalf of an enterprise of the other Contracting State (other than an agent of independent status to whom paragraph (7) of this Article applies) shall be deemed to be a permanent establishment of that enterprise in the first-mentioned Contracting State if he has, and habitually exercises in that first-mentioned Contracting State, an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise.

¹⁰² Article 4(7): An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on trade or business in that other Contracting State through a broker, a general commission agent or any other agent of independent status, where such a person is acting in the ordinary course of his business as a broker, a general commission agent or other agent of independent status.

¹⁰³ *Case 23/93 (1993) 93 ATC 288, 297.*

there is an agency of permanent establishment with an apportionment of the risk as well.¹⁰⁴

A further issue arises under the question of the agency threshold in the context of multinational entities. That is whether the activities of one enterprise constitute a permanent establishment of another enterprise. The question is, whether there is a dependent agent in existence so as to amount to a permanent establishment. The test for determining an agent's status is whether they have the authority, in substance, to conclude contracts on behalf of the enterprise.¹⁰⁵ Where the enterprise is undertaking business through a broker or agent of independent status there is no permanent establishment.

This issue arises in the following scenario. An enterprise may undertake activities in subsidiary form, with each subsidiary taking on separate roles such as trading activities, marketing activities and booking activities. Locations may then take on activities on another's behalf thereby creating a permanent establishment. As the OECD suggests 'the paradigm then changes from Article 9 to Article 7 (or to a combination of both)'.¹⁰⁶ The result may potentially lead to double taxation because of the permanent establishment jurisdiction claiming a larger share of the tax base, as well as denying a deduction for internal payments.

3 *Preparatory or Auxiliary Activities*

Article 5(4) of the OECD Convention provides that a permanent establishment will not arise in certain circumstances. Two of those circumstances are where the activities are merely preparatory or auxiliary, or they relate to a mere purchase. Of particular interest is what is meant by 'preparatory or auxiliary activities'. The OECD provides that where the activities form an essential and significant part of the activity of the enterprise as a whole then those activities are not considered preparatory or auxiliary.¹⁰⁷ In this context, it has been questioned whether the activities of a branch rise to the level of a permanent establishment and may be taxed in that jurisdiction.¹⁰⁸ It is suggested that the taxpayer may argue that the activities of branches are 'merely preparatory, auxiliary activities' or 'mere purchases performed for another location'.¹⁰⁹

While it may not be possible to argue that a branch is merely performing preparatory or auxiliary tasks it may be possible to argue that a representative office does just that. The final structure by which foreign entities may enter the Australian market, the representative office, will not, under any statutory or common law test, be considered a resident of Australia for taxation purposes. While a representative office is physically located in the foreign jurisdiction, their role is usually one of information gathering and coordinating correspondent relationships. A representative office cannot conduct

¹⁰⁴ Robert White, 'Global Trading – Carving Up the Profit Cake' (1997) 24 *Tax Planning International Review* 21, 21.

¹⁰⁵ OECD, *The Taxation of Global Trading of Financial Instruments* (1998) 57(230).

¹⁰⁶ *Ibid* 57(232).

¹⁰⁷ OECD, *The Taxation of Global Trading of Financial Instruments* (1998) 57(228).

¹⁰⁸ Geoff Hoffman, 'Taxation of Global Trading of Financial Instruments: A Discussion Draft by the OECD' (1997) 8 *Journal of Banking And Finance Law and Practice* 130, 132.

¹⁰⁹ *Ibid* 132.

business directly in the foreign jurisdiction, and as such, may be a precursor to the establishment of either a branch or subsidiary. Therefore, a taxpayer may argue that such a structure is merely preparatory or auxiliary, thereby circumventing its classification as a permanent establishment.

So far, this paper has considered the measurements of jurisdictional presence necessary to establish jurisdiction to tax. The next part of this paper considers the problem with this approach.

IV THE CONUNDRUM OF THE COMPONENT APPROACH

Professor Stanley S Surrey, writing a quarter of a century ago, could devote only two pages discussing what he called 'jurisdictional allocation' issues, i.e. source and residence based taxation, but over forty pages to 'transactional allocation' issues, i.e. those posed by the arm's length method. A shift to a formulary apportionment reverses the importance of the two categories. As US experience has shown, under formulary apportionment jurisdictional issues (in the sense of which state is entitled to how much) dominate and transactional issues are relegated to a relatively minor role.¹¹⁰

The transactional allocation issues, which Professor Stanley Surrey refers to, are the arm's length pricing requirements of the traditional transfer pricing regime. This method of transactional allocation focuses on the characteristics and nature of specific transactions between assumed distinct economic entities, each of which reports its taxable corporate income on a separate accounting basis,¹¹¹ and relies on the traditional jurisdictional allocation principles. There is no attempt to allocate the overall profits of the multinational entity to the separate jurisdictions,¹¹² rather each part of the multinational entity is treated as a separate entity. Hence, the reason why it is necessary to consider both the threshold tests and what is considered a separate entity per se. This paper suggests that this separate entity approach is incongruous with the unique attributes of the modern multinational entity.

It is not disputed that the concepts of residency and permanent establishment, (along with source), are usually easily applied to traditional transactions and designed for multinational entities undertaking these very types of transactions. These traditional concepts are ones that originated out of an era of trade in goods. The question that needs to be addressed is whether these concepts have been, or can be, moulded to adequately distribute the taxing rights among the relevant jurisdictions in the present era of trade in services and intangible goods. Where a traditional multinational entity is involved and there are physical goods being dealt in, identifying the relationship between income and the taxing jurisdiction is a relatively straightforward process. To this extent the traditional regime and international standards developed by the OECD

¹¹⁰ Paul R McDaniel, 'NAFTA and Formulary Apportionment: An Exploration of the Issues' in Herbert H Alpert and Kees Van Raad (eds) *Essays on International Taxation* (1993) 293, 309.

¹¹¹ Richard M Bird, 'The Interjurisdictional Allocation of Income' (1986) 3 (3) *Australian Tax Forum* 333, 337.

¹¹² *Ibid.* It is, however, pointed out that such an allocation in effect results from the application of different rules to different classes of income and expenses.

have been ‘tolerably robust’.¹¹³ The application of the traditional concepts to traditional multinational entities, while not ideal, usually corresponds to some degree with the functions performed by the different parts of the traditional entity. Entities themselves may recognise these distinctions. It is also for this reason that a threshold test requiring physical presence does not appear to lead to a result less than ideal, or that the concept is irrelevant when applied to a traditional multinational entity. In essence, a regime recognising the structural variances of traditional multinational entities is often consistent with the economic rationale of the traditional firm.

However, when these concepts are applied to the modern multinational entity, identifying the relationship between income and jurisdiction becomes increasingly difficult, as does the logic of recognizing the different parts of the one entity under the concepts of residency and permanent establishment. The relevance of these traditional concepts is particularly diminished given the prevalence of modern transactions, which have increased dramatically with the expansion of the services industry and the advancement of technology.

In recognising the separate parts of the multinational entity as a precursor to the allocation of taxing rights, there is the potential for those rights to be allocated in a less than optimal manner. For example, source-based taxation of active income can be avoided by falling under the permanent establishment threshold.¹¹⁴ Alternatively, if a taxpayer wishes to be taxed in a jurisdiction it is simply a case of establishing a permanent establishment so defined within the jurisdictional boundaries.

Yaron Reich uses multinational banking as an example of where this happens. He states that under the current regime ‘[m]any tax systems subject a foreign bank to net income taxation only when the bank has a permanent establishment, or branch, in the taxing jurisdiction. Once this threshold is crossed, these tax systems generally treat the branch as a separate entity for the purposes of determining tax liability’.¹¹⁵ It is suggested that because of the unique nature of modern multinational entities these threshold tests, taking into account the various legal forms adopted, fail to allocate the taxing rights to the relevant jurisdictions according to economic activity.

Vito Tanzi argues that there are fiscal termites gnawing at the very foundations of our tax systems causing a need to assess the ways in which current developments are affecting the traditional tax regime.¹¹⁶ He further proposes that an application of traditional principles may bear very little resemblance to economic realities.¹¹⁷ In this part of the paper, it is argued first, that physical presence is not an accurate measure of economic activity, and second that national boundaries do not need to be recognised in order to tax multinational entity income according to economic activity.

¹¹³ Ian Spence, ‘Globalization of Transnational Business: the Challenge for International Tax Policy’ (1997) 25 (4) *Intertax* 143, 146.

¹¹⁴ Reuven S Avi-Yonah, ‘Making Sense of US International Taxation: Six Steps Towards Simplification’ (2001) 55 *Bulletin for International Fiscal Documentation* 493, 494.

¹¹⁵ Yaron Z Reich, ‘US Federal Income Taxation of U.S. Branches of Foreign Banks’ (1994) 2 *Florida Tax Review* 1, 66.

¹¹⁶ Tanzi, above n5, 1263.

¹¹⁷ *Ibid*, 1278.

A Physical Presence as Opposed to Economic Activity

It has been suggested that 'historical rules based on geographical source of income and nationality of taxpayers, and jurisprudential concepts that emerged in the early twentieth century, are simply not adequate in today's world'.¹¹⁸ The existing rules were designed to divide income between jurisdictions in a fashion that roughly proxied economic activity.¹¹⁹ That is, physical presence in a jurisdiction meant that there was economic activity in the jurisdiction which should be taxed by that jurisdiction. However, today, many multinational entities are unique in the provision of services, potentially acting as intermediaries. Therefore, modern multinational entities do not fall within the traditional category for which the existing rules were designed to deal with. Modern multinational entities are not providing the same kinds of products and services as their traditional counterparts, that is, they do not offer any tangible outputs or acquire parts and supplies to rework into other products.

As such, it should not be taken for granted that these principles are suitable in the current economic climate.¹²⁰ Today, fewer transactions conform to the conventional methods of commerce, which revolved around physical delivery. Further, there are shrinking geographical constraints to business activity generally.¹²¹ Internet businesses and multinational banks are clearly an example of where this is the case. In this sense, 'the links between geography and residence have come unfastened. The integration of economies on a global scale, the mobility of capital and individuals, and new methods of doing business (electronically), make it more difficult to identify the residence of a taxpayer or the source of income'.¹²²

The concepts in the current domestic legislation and international treaties, largely conceived in the days of a 'brick-and-mortar' industrial economy,¹²³ were based on the notion that a physical presence was required to conduct business operations in any substantive manner. This is certainly no longer the case with modern multinational entities. David Tillinghast provides:

While that economy still exists, not only has it evolved such that it is a substantial user of the e-commerce technological advances, as evidenced by the increasing prevalence of business-to-business alliances, in addition, it has been overshadowed by the newer information economy. The rapidly growing information economy is based on the technological revolution in communications and the provision of information. Rules designed to apply to the physical delivery of tangible goods or the provision of physical labour, for example, do not always work well when applied to the delivery of software or on-line services. At the same time, the use of derivative financial instruments to bundle or unbundle

¹¹⁸ Stanford G Ross, 'International Taxation: A 20 Year View' (1992) 57 *Tax Notes* 945, 947.

¹¹⁹ Bird and Wilkie, above n 9, 93.

¹²⁰ Klaus Vogel suggests that: 'It has been taken for granted much too long that income taxes should be based on residence, and, in addition, on source'. Klaus Vogel, 'Worldwide vs. Source Taxation of Income - A Review and Re-evaluation of Arguments (Part 1)' (1988) *Intertax* 216.

¹²¹ Spence, above n 114, 143.

¹²² Zonana, above n 20, 1254.

¹²³ David R Tillinghast, 'Tax Treaty Issues' (1996) 50 *University of Miami Law Review* 455, 456.

economic interests, synthesize securities or confer the economic equivalent of the ownership of property without actually transferring that ownership raises treaty issues that require resolution.¹²⁴

While the test of residency may pose questions as to its suitability as a threshold test, most of the issues lie with the threshold test of permanent establishment due to the capacity for easy manipulation. To this extent, the Australian Treasury Department has expressed concern as to whether the current definition of permanent establishment is still viable. It states:

it may also be necessary to examine the adequacy of the definition of *permanent establishment* in the domestic law, given that financial arrangements enable a significant level of economic activity to occur without creating a permanent establishment as currently defined. The traditional definition of permanent establishment is based on concepts of a fixed geographical place where business is carried on.¹²⁵

Due to this highly mobile nature of services the traditional definition of permanent establishment may not be fulfilled and the ease of conducting significant levels of economic activity without creating a permanent establishment, as currently defined, questions the adequacy of the definition of permanent establishment.¹²⁶ As stated, this is because of the need for a fixed geographical location in order for the definition of the permanent establishment to be satisfied.

The OECD is also clearly concerned about the definition of a permanent establishment. For example, in its 1998 discussion paper on the taxation issues relating to electronic commerce, prepared by the Committee on Fiscal Affairs, this issue was raised. It listed as one of the points of application of tax conventions requiring careful attention was the 'definition of when a permanent establishment exists and what profits should be attributed to it'.¹²⁷

The OECD went on to state:

It has been suggested that the concept of permanent establishment is ill adapted to electronic commerce. Those who take that position have argued that a rule based on physical presence is meaningless in the electronic commerce environment. Particular concerns have been expressed with respect to the allocation of tax revenues between source and residence countries and with respect to the use of tax havens.¹²⁸

It is believed that 'the future is likely to prove that the PE [permanent establishment] principle has lost its force for new and mobile industries, whether tax treaties are renegotiated for this purpose or not. An enterprise's connection to the soil, its PE, is no

¹²⁴ Ibid.

¹²⁵ [Australian Treasury Department, *Taxation of Financial Arrangements – An Issues Paper* \(1996\) 248.](#)

¹²⁶ [Ibid](#) 247.

¹²⁷ OECD, *Electronic Commerce: A Discussion Paper on Taxation Issues* (1998) 23.

¹²⁸ [Ibid](#) 24.

longer a reliable evidence of economic allegiance'.¹²⁹ Further, as Reuven Avi-Yonah explains, 'the identity of multinationals as "domestic" or "foreign" based on their place of incorporation is becoming increasingly irrelevant. Multinationals recruit their executives and employees from a worldwide pool and locate their economic activities on the basis of economic, not national, considerations'.¹³⁰

B The Fallacy of Recognising National Boundaries (and Separate Parts of the One Entity)

It may be argued that where a multinational entity is dealing in modern services the entity itself does not recognise national boundaries. For example, multinational banks act as financial intermediaries negotiating deals between lenders and borrowers. By inserting themselves between the lenders (who deposit money into banks) and the borrowers, banks offer an intermediation service that operates seamlessly across borders, through a web of subsidiaries, branches, and representative offices.¹³¹ Where this is the case, recognising these separate parts for taxation purposes, where the entity in question is a multinational bank, fails to correlate with economic activity. Put simply, 'reliance on geographical jurisdictions is inappropriate for new trading operations that fail to recognize national boundaries in their activities'.¹³²

The consequence of new multinational entities such as the multinational bank is that increasingly the relevance of these rules is being called into question. The reason for this questioning is that the 'high-value intangible property and various manifestations of financial property or money increasingly dominate international economic flows, since the existence and exchange of such property is inherently difficult to tie to national territories either conceptually or in practice'.¹³³

By recognising national boundaries, it is suggested that activities are conducted in one jurisdiction by an entity located in that jurisdiction. Today, this seldom occurs. For example, the basic legal nature of the permanent establishment is that it is commercially separate from the head office, but is still a legally integrated entity of a business enterprise.¹³⁴ The economic reality is somewhat different as it is frequently seen that the permanent establishment is also commercially integrated with head office, and sometimes performs the entire business of the head office.¹³⁵

It can be seen that it is relatively easy for a multinational entity to perform tasks in any location. This mobility then challenges taxing authorities. However, this is further compounded by the fact that these entities are becoming 'more truly multinational in

¹²⁹ Skaar, above n 68, 572.

¹³⁰ Reuven S Avi-Yonah, 'Slicing the Shadow: A Proposal for Updating U.S. International Taxation' (1993) 58 *Tax Notes* 1511, 1512.

¹³¹ Charles T Plambeck, 'Transfer Pricing Analysis of Global Trading Operations and Procedural Alternatives' (1996) *Taxes* 1129, 1131.

¹³² Andrew Snyder, 'Taxation of Global Trading Operations: Use of Advance Pricing Agreements and Profit-Split Methodology' (1995) 48 *The Tax Lawyer* 1057, 1073.

¹³³ Bird and Wilkie, above n 9, 93.

¹³⁴ Skaar, above n 68, 1-2.

¹³⁵ *Ibid.*

their operations and revenue sources—that is, lacking any true “residence” in the traditional sense’.¹³⁶ The consequence of these multinationals being managed as global, integrated enterprises makes attempts to tax them on a nation-by-nation, or subsidiary-by-subsidiary basis increasingly challenging and artificial.¹³⁷

By recognising national boundaries, the current regime requires an investigation into the legal form adopted by the multinational entity. This is done to attribute parts of the entity to those jurisdictions in which the entity has a physical presence. It has been recognised, however, that the tax consequences of the legal form adopted should be neutral.¹³⁸ The current regime attempts to achieve this by essentially equating a subsidiary to a branch. It is suggested that by providing rules that recognise the organisational structure this neutrality is not achieved.

The fact that the tax consequences of the legal form of an entity should be neutral has been recognised in the literature. Klaus Vogel states: ‘The legal form imposed on the partial enterprise, whether it has been made a legally dependent or independent unit, a branch (permanent establishment), or a corporation (subsidiary), is immaterial, because the legal form does not affect the economic consequences’.¹³⁹ As a footnote to this statement he adds that ‘[u]nless the taxation differs according to which legal form has been chosen. In such cases, however, the economic consequences flow from the legislative decision regarding taxation, not from the choice of legal form. It is generally acknowledged that taxation should be neutral with respect to the legal form of an enterprise’.¹⁴⁰

Charles Plambeck, dealing specifically with the taxation of global trading, also makes this point:

Economic efficiency dictates that taxes be applied neutrally regardless of the location of operations (foreign versus domestic), the choice of entity (subsidiary versus branch), the form of intermediation (banking versus securities, for example), or type of financial product (swaps versus futures, for example). A coordinated approach also is necessary to prevent tax avoidance and evasion (such as where a book is passed through a tax haven), and to limit opportunities for tax arbitrage.¹⁴¹

In order to attempt to achieve a neutral result under the traditional regime, an approach is adopted which treats a branch as if it were a hypothetical separate entity, that is, a subsidiary. This model is adopted in both domestic¹⁴² and treaty law,¹⁴³ particularly for the purposes of applying the transfer pricing regime.

¹³⁶ David G Noren, ‘Commentary: The U.S. National Interest in International Tax Policy’ (2001) 54 *New York University Tax Review* 337, 340.

¹³⁷ *Ibid.*

¹³⁸ Klaus Vogel, ‘Worldwide vs Source Taxation of Income - A Review and Re-evaluation of Arguments (Part II)’ (1998) 10 *Intertax* 310; Plambeck, above n 26, 1155.

¹³⁹ Vogel, above n 139, 319.

¹⁴⁰ Vogel, above n 139, 310, fn 128.

¹⁴¹ Plambeck, above n 26, 1155.

¹⁴² *Income Tax Assessment Act 1936 (Cth)* s 160ZZVA.

V AN ECONOMICALLY VALID THRESHOLD TEST

Any alternative proposal for allocating the right to tax the income of multinational entities needs to establish the degree of activity required in a jurisdiction before that jurisdiction can assert a right to tax.¹⁴⁴ As part of a unitary tax regime, based on global formulary apportionment, there is potentially an inherent threshold test built in as the presence of factors in a jurisdiction represent activity in that jurisdiction. As Richard Pomp identifies, '[a] relationship, not always fully appreciated, exists between the development of an apportionment formula and the jurisdictional threshold rules'.¹⁴⁵ In asking the question of whether there needs to be a threshold test at all,¹⁴⁶ there are several reasons why a threshold test of some sort should be maintained:

- it would be unreasonable for a country to tax a business if that business did not have a sufficient link (nexus) with that country;¹⁴⁷
- it may be difficult to ensure proper compliance and collection of tax in the case of a foreign enterprise that does not have a presence in the country;¹⁴⁸
- the development of international trade and investment requires that enterprises that conclude a few isolated transactions in a jurisdiction where they have no business presence should not be overburdened by tax requirements in that jurisdiction; and¹⁴⁹
- the existence of a threshold that makes it relatively easy to determine which income should be taxed in a given country alleviates the fact that clear practical source rules for determining where business profits arise are not readily available.¹⁵⁰

In particular, there is concern with formulary apportionment that there may be an overreaching by jurisdictions where there is insufficient activity to reasonably assert a right to tax.¹⁵¹ Alternatively, the scenario could arise where no jurisdiction has the right to tax.¹⁵² Of course, there is the option of maintaining the permanent

¹⁴³ Article 7 of the *OECD Model Tax Convention on Income and on Capital* and the accompanying documents, for example the *OECD Discussion Draft on the Attribution of Profits to Permanent Establishment*, OECD, Paris, 2001.

¹⁴⁴ McDaniel, above n 111, 301; Paul R McDaniel, 'Formulary Taxation in the North American Free Trade Zone' (1994) 49 *New York University Tax Review* 691, 707.

¹⁴⁵ Richard D Pomp, 'Issues in the Design of Formulary Apportionment in the Context of NAFTA' (1994) 49 *New York University Tax Review* 795, 813.

¹⁴⁶ Sasseville, above n 22, 5:4.

¹⁴⁷ Ibid.

¹⁴⁸ Ibid.

¹⁴⁹ Ibid.

¹⁵⁰ Ibid. See also: Charles E McLure Jr, 'Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment' (2002) 56(12) *Bulletin for International Fiscal Documentation* 586, 590.

¹⁵¹ McDaniel, above n 111, 297.

¹⁵² Ibid 297.

establishment threshold in a formulary apportionment regime.¹⁵³ However, even then, it has been suggested that at the very least, modernisation of the permanent establishment concept seems essential.¹⁵⁴ For example, modernisation could occur along the lines suggested by Michael McIntyre. He puts forward the notion that a corporation should be treated as having a permanent establishment in a country if it has apportionment factors in that country.¹⁵⁵ This would appear to be a radical modernisation, which effectively does away with the permanent establishment concept—an approach which is suggested by this paper.

This paper maintains that the current threshold adds an unnecessary legalistic approach to the taxation of multinational entities and fails to allocate the taxing rights according to economic activity. As such, it is proposed that the concept of permanent establishment, as the threshold that is required for taxing jurisdiction to tax active income on a source basis, should be removed.¹⁵⁶ Hence, the question that needs to be addressed is what should it be replaced with?

There needs to be a minimum threshold of business activity as a prerequisite to source-based taxation of business income.¹⁵⁷ Within the context of the taxation of electronic commerce, Reuven Avi-Yonah suggests that the threshold test should not be linked to physical presence, rather that the threshold could be a *de minimis* amount of sales in a jurisdiction.¹⁵⁸ Michael Graetz suggests that a threshold amount of sales, assets, labour, or research and development within a nation may better serve to establish both the source of business income and as a threshold for the imposition of tax.¹⁵⁹ Where this is the case and source-based taxation is imposed on a uniform formulary apportionment of sales, assets, R & D, and labour costs, the need for the permanent establishment concept is eliminated.¹⁶⁰ This would appear to be the most sound of the proposals. It is logical that a jurisdiction has the right to tax under a formulary apportionment regime where the factors are present.¹⁶¹

Robert Peroni has put forth an alternative proposition. He advocates residency-based taxation, while at the same time arguing that formulary apportionment is superior to the arm's length standard.¹⁶² As Stanley Langbein points out, this is a novel position,¹⁶³

¹⁵³ McDaniel, above n 111, 302; Paul R McDaniel, 'Formulary Taxation in the North American Free Trade Zone' (1994) 49 *New York University Tax Review* 691, 706; Charles E McLure Jr, 'US Federal Use of Formula Apportionment to Tax Income From Intangibles' (1997) 14 *Tax Notes* 109, 111.

¹⁵⁴ Graetz, above n 2, 1421.

¹⁵⁵ McIntyre, above n 67, 789.

¹⁵⁶ Reuven Avi-Yonah proposes that this is the first thing that needs to be changed. Avi-Yonah, above n 24, 510.

¹⁵⁷ Graetz, above n 2, 1421.

¹⁵⁸ Reuven S Avi-Yonah, 'Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) 113 *Harvard Law Review* 1573, 1671; Avi-Yonah, above n 24, 536.

¹⁵⁹ Graetz, above n 2, 1421.

¹⁶⁰ *Ibid*, 1421.

¹⁶¹ Charles E McLure Jr, 'Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment' (2002) 56(12) *Bulletin for International Fiscal Documentation* 586, 590.

¹⁶² Peroni, above n 5.

¹⁶³ Stanley I Langbein, 'The Future of Capital Export Neutrality: A Comment on Robert Peroni's Path to Progressive Reform of the US International Tax Rules' (1997) 51 *University of Miami Law Review* 1019, 1025.

and one not normally adopted. However, he recognises that formulary apportionment does require agreement on the international allocation of jurisdiction to tax.¹⁶⁴ This paper suggests that there are faults in the residency regime, which make it unsuitable as a threshold test.

While the threshold chosen should be big enough to ensure that the tax collected is greater than the compliance costs,¹⁶⁵ a low threshold test avoids the necessity for anti-avoidance techniques.¹⁶⁶ The simplest threshold test to impose under a formulary apportionment regime would simply be that of having formulary factors present in the taxing jurisdiction. No matter what threshold test is chosen, it is essential that there is international consensus in its application.¹⁶⁷

VI CONCLUSION

This paper suggests that the threshold tests of residency and permanent establishment are legal tests which have no place in a tax regime designed to allocate income based on economic activity. Further, it is suggested that the principles contained in the traditional regime requiring the recognition of the different structures adopted, along with a legal distinction recognising the separate parts of the multinational entity, are unnecessary, and therefore irrelevant, in determining the allocation of taxing rights to multinational entities where that allocation is based on economic activity.

If this is correct, then residency rules and the permanent establishment test have very little effect on modern multinational entities and are easily manipulated by these entities simply by establishing residency in a particular jurisdiction.¹⁶⁸ Michael Graetz suggests, '[l]egal constructs, which are largely elective and easily manipulated, play too great a role in determining international tax consequences of business arrangements.'¹⁶⁹ Overall, residency and permanent establishment are legal tests, which would become unnecessary with unitary taxation. As such, this paper concludes that an international tax regime that does not contain either residency requirements, the permanent establishment concept, or the recognition of structural variance, is congruent with an optimal regime.¹⁷⁰ However, with the source and transfer pricing rules, as they currently apply, the principles of structure, residency, and permanent establishment are inextricably linked.

Consequentially, if physical presence is not an accurate measure of economic activity, and national boundaries do not need to be recognised in order to tax multinational entity income according to economic activity, it is proposed that a move towards a

¹⁶⁴ Ibid.

¹⁶⁵ Avi-Yonah, above n 24, 536.

¹⁶⁶ Pomp, above n 146, 815.

¹⁶⁷ Charles E McLure Jr, 'US Federal Use of Formula Apportionment to Tax income From Intangibles' (1997) 14 *Tax Notes* 109, 111.

¹⁶⁸ Graetz, above n 2, 1425.

¹⁶⁹ Ibid, 1417.

¹⁷⁰ Avi-Yonah, above n 159, 1605. As Avi-Yonah states: 'This traditional argument [about imposing the same rate on all income from capital] has led most economists to support residence-based taxation of worldwide income as the optimal tax rule for international taxation because, in the absence of host-country taxes, residence-based taxation maintains CEN.'

regime that encompasses these notions, should be made. Unitary taxation based on formulary apportionment is the suggested regime,¹⁷¹ as the formula unitary system eliminates a boundary that grows ever more difficult to sustain.¹⁷²

The unitary tax model, however, does still require an allocation based on source. Charles McLure asks the question ‘should source countries be allowed to tax income of foreign multinationals only if they have a physical presence in the country?’. Based on the conclusions of this paper it is suggested that the answer is *no*. However, by minimising the tax consequences dependent on an entity’s residence—which is the suggested approach—it is a robust source regime that is needed.¹⁷³ The linkage to source should then be the location of the real economic activity, or factors such as sales, labour, property, and research and development.¹⁷⁴ It was noted above that the current principles are connected in a way that would render a source regime alone ineffective. As such, it is also suggested that the current source regime fails to allocate income according to economic activity. However, the unitary tax regime would allocate based on source, but one that could stand alone and allocate income according to economic activity.

¹⁷¹ Paul McDaniel suggests that ‘[a] formulary system of taxing corporate income ignores entities and concentrates on determining the income of the unitary enterprise. It eliminated the distinction between business and investment income within the unitary enterprise by ignoring the form in which the enterprise is conducted - that is, legal entities and all intercompany payments are disregarded’. Paul McDaniel, ‘Reflections on International Taxation for the 21st Century’ (2000) *2000 World Tax Conference Report* 20:1, 20:4.

¹⁷² Paul McDaniel, ‘Reflections on International Taxation for the 21st Century’ (2000) *2000 World Tax Conference Report* 20:1, 20:4.

¹⁷³ Graetz, above n 2, 1426.

¹⁷⁴ *Ibid.*

DIVIDEND IMPUTATION AND DISTRIBUTIONS OF NON PORTFOLIO FOREIGN SOURCE INCOME: AN EVALUATION OF SOME ALTERNATIVE APPROACHES

C JOHN TAYLOR

*C John Taylor is an Associate Professor in the School of Business Law and Taxation,
The University of New South Wales.*

In its February 2003 Report to the Treasurer on International Taxation, the Board of Taxation recommended that:

- (a) domestic shareholder tax relief should be provided for unfranked dividends paid out of FSI (Foreign Source Income) derived after the commencement date; and
- (b) that the relief should be provided by way of a non-refundable tax credit of 20 per cent and without any requirement to trace foreign tax paid or incurred.¹

When announcing the outcome of the government's review of Australia's international taxation arrangements the Treasurer indicated that the government did not believe that it was appropriate to implement the board's proposals at that time. The Treasurer went on to indicate, however, that the government did not rule out future consideration of the issues examined by the Board.²

This paper begins by identifying the biases in the Australian dividend imputation system that led to these recommendations by the Board of Taxation. It then evaluates a selection of possible approaches to the treatment of foreign source income in an imputation system in terms of international tax policy criteria. Key issues for further research are then identified.

I THE BIASES IN THE DIVIDEND IMPUTATION SYSTEM AGAINST OFFSHORE INVESTMENT

For resident underlying shareholders there is a clear bias in Australia's dividend imputation system against investment in Australian resident companies with significant foreign source income as opposed to investment in either Australian resident companies with only domestic source income, or investment in foreign companies with foreign source income. These biases exist simply because payments of foreign tax on foreign source income do not generate franking credits for Australian resident

¹ Board of Taxation, Commonwealth of Australia, *International Taxation: A Report To The Treasurer, Volume 1 The Board Of Taxation's Recommendations*, (2003) Recommendation 2.1 at 72.

² Treasurer's Press Release, 'No.032 of 2003', (Press Release, 14 May 2003) 2.

companies. Australia's foreign source income exemption and foreign tax credit systems contribute to this bias to the extent that Australian corporate tax is not paid on foreign source income that has been subject to foreign tax. This means that foreign taxes are treated as a pre tax expense for the Australian resident company. At the underlying resident shareholder level the end result of this treatment is equivalent to that obtained under a classical corporate tax system and, in some circumstances, produces national neutrality. By contrast, Australian residents who invest in Australian resident companies with only domestic source income can receive a franking credit for the Australian corporate tax paid by the company and, depending on the level of franking credits allocated to the distribution, the overall level of tax on distributions made to them can represent taxation and their respective marginal rates. Australian residents with portfolio shareholdings in foreign companies obtain a foreign tax credit for any foreign withholding tax paid on any distribution they receive. Because credit is only given for the foreign withholding tax and not for the foreign underlying corporate tax, this treatment produces a result somewhere between national neutrality and capital import/capital export neutrality.³ The effects of the current rules are shown in Examples 1 and 2.

Example 1: Current treatment of resident shareholders in resident company with Australian source income

Australian Company

Taxable Income	\$1000
Australian corporate tax	\$ 300 (generates \$300 of franking credits)
After tax income	\$ 700

If the company decides to distribute all of its after tax income the maximum franking credit that it can allocate to the distribution is \$300. The effects of a distribution of \$700 with a franking credit of \$300 attached, are shown for a 48.5 per cent marginal rate shareholder, a 31.5 per cent marginal rate shareholder, for an Australian corporate shareholder and for a complying superannuation fund shareholder. None of the shareholders are assumed to be in a tax loss position and none of them are assumed to have deductions related to gaining dividend income.

³ Capital export neutrality requires that the country of the taxpayer's residence give a tax treatment to the worldwide investments of its residents which is neutral between investing at home or abroad. In relation to outbound investment capital export neutrality is usually regarded as requiring that international juridical double taxation be relieved through a foreign tax credit. Capital import neutrality requires that the rates of taxation applicable to all investors in a source country be the same irrespective of whether the investment is by domestic or foreign investors. When applied in relation to outbound investment capital import neutrality is usually regarded as requiring that international juridical double taxation be relieved by an exemption for foreign source income. National neutrality seeks to maximize the home country's national income including both tax revenues and the after tax profits of businesses. When applied in relation to outbound investment national neutrality is usually regarded as requiring that foreign taxes be treated as a pre tax expense. The majority view in the economic analysis of these alternatives favours capital export neutrality. For a summary of the economic analysis and arguments see R S Avi-Yonah, 'Globalization, Tax Competition and the Fiscal Crisis of the Welfare State' (2000) 113 *Harvard Law Review* 1573 at 1604-610.

48.5% Marginal rate shareholder

Dividend	\$ 700	
Franking credit		\$ 300
Grossed up dividend	\$1000	
Tax @ 48.5%	\$ 485	
Tax offset	\$ 300	
Net tax payable		\$ 185
After tax dividend	\$ 515	

31.5% Marginal rate shareholder

Dividend	\$ 700	
Franking credit		\$ 300
Grossed up dividend	\$1000	
Tax @ 31.5%	\$ 315	
Tax offset	\$ 300	
Net tax payable		\$ 15
After tax dividend	\$ 685	

Australian corporate shareholder (assumed not to be in a tax loss position and assumed not to have deductions related to gaining dividend income)

Dividend	\$ 700	
Franking credit		\$ 300
Grossed up dividend	\$1000	
Tax @ 30%	\$ 300	
Tax offset	\$ 300	
Net tax payable		\$ Nil
After tax dividend	\$ 700	

Complying superannuation fund shareholder

Dividend	\$ 700	
Franking credit		\$ 300
Grossed up dividend	\$1000	
Tax @ 15%	\$ 150	
Tax offset	\$ 300	
Refund of excess tax offset	\$ 150	
After tax dividend	\$ 850	

Throughout this paper Example 1 will be regarded as a benchmark for whether proposed treatments of payments of foreign tax on the foreign source income of Australian companies produce capital export neutrality.

The current Australian treatment of both foreign source non-portfolio dividends received by resident companies, and foreign branch profits of Australian resident companies, in instances where the *Income Tax Assessment Act 1936* (Cth) (ITAA36) s 23AH and s 23AJ exemptions are applicable, produces capital import neutrality at the

resident company. In instances where foreign tax credits apply at the resident company level, the current Australian treatment produces results somewhere between capital export neutrality and capital import neutrality depending on the effect of limitations on Foreign Tax Credits (FTCs). Once the foreign source corporate income is redistributed to underlying resident shareholders, however, the end result is national neutrality. This is because payments of foreign tax do not generate franking or other credits for underlying shareholders and, hence, are treated as pre tax expenses. Whether the result at the underlying shareholder level in turn produces a bias against offshore investment at the company level is discussed below.

The points made above are illustrated by the following examples.

Example 2: Current treatment of Australian resident shareholders in Australian company with foreign source income

In this example three possible scenarios will be illustrated. First, where the investment is made in a high tax country with an effective tax rate assumed to be 40 per cent. Second, where the investment is made in a middle level tax country with an effective tax rate assumed to be 30 per cent. Third, where the investment is made in a low tax country with the effective tax rate assumed to be 10 per cent. In all cases the foreign source income is assumed to be redistributed to the same shareholders, based on the same assumptions as those in Example 1. In all cases the investment in the foreign country is assumed to have been made via a wholly owned subsidiary.

Example 2(a): Direct investment in high tax country — currently s 23AJ exemption applicable

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 400
After tax income	\$ 600

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 600 (exempt from Australian tax under ITAA36 s 23AJ)
-------------------------	---

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 600
Tax @ 48.5%	\$ 291
After tax dividend	\$ 309

31.5% Marginal rate shareholder

Dividend	\$600
Tax @ 31.5%	\$189
After tax dividend	\$411

Australian corporate shareholder

Dividend	\$600
Tax @ 30%	\$180
After tax dividend	\$420

Complying superannuation fund shareholder

Dividend	\$600
Tax @ 15%	\$ 90
After tax dividend	\$510

Example 2(b): Direct investment in middle level tax country — currently s 23AJ exemption applicable

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 300
After tax income	\$ 700

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 700 (exempt from Australian tax under ITAA36 s 23AJ)
-------------------------	---

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 700
Tax @ 48.5%	\$ 339.50
After tax dividend	\$ 360.50

31.5% Marginal rate shareholder

Dividend	\$700
Tax @ 31.5%	\$220.50
After tax dividend	\$479.50

Australian corporate shareholder

Dividend	\$700
Tax @ 30%	\$210
After tax dividend	\$490

Complying superannuation fund shareholder

Dividend	\$700
Tax @ 15%	\$105
After tax dividend	\$595

Example 2(c): Direct investment in low tax country (currently underlying foreign tax credit applicable)

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 100
After tax income	\$ 900

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 900 (currently taxable but underlying foreign tax credit allowed)
Gross up for foreign tax	\$ 100
Grossed up dividend	\$1000
Australian tax	\$ 300
FTC	\$ 100
Net Australian tax	\$ 200 (generates \$200 of franking credits)
After tax dividend	\$ 700

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1. Assume that the Australian company attaches \$200 of franking credits to the dividend.

48.5% Marginal rate shareholder

Dividend	\$ 700
Franking credit	\$ 200
Grossed up dividend	\$ 900
Tax @ 48.5%	\$ 436.50
Tax offset	\$ 200
Net tax	\$ 236.50
After tax dividend	\$ 463.50

31.5% Marginal rate shareholder

Dividend	\$700
Franking credit	\$200
Grossed up dividend	\$900
Tax @ 31.5%	\$283.50
Tax offset	\$200
Net tax	\$ 83.50
After tax dividend	\$616.50

Australian corporate shareholder

Dividend	\$700
Franking credit	\$200
Grossed up dividend	\$900
Tax @ 30%	\$270
Tax offset	\$200
Net tax	\$ 70
After tax dividend	\$630

Complying superannuation fund shareholder

Dividend	\$700
Franking credit	\$200
Grossed up dividend	\$900
Tax @ 15%	\$135
Tax offset	\$200
Refund of excess offset	\$ 65
After tax dividend	\$765

One of the recommendations of the Board of Taxation on International Taxation that was accepted by the government was to extend the exemption for foreign non-portfolio dividends and foreign branch profits to include, broadly, active income earned through foreign subsidiaries and branches in unlisted (generally low tax) countries.⁴ Following the implementation of this change since 1 July 2004 by the *New International Taxation Arrangements (Participation Exemption And Other Measures) Act 2004* (Cth) the

⁴ Board of Taxation, above n 1, Recommendation 3.9, 102; see also Treasurer's Press Release, above n 2, 1.

treatment of non-portfolio dividends (outside the operation of Australia's foreign accruals tax regimes) sourced in a low tax jurisdiction is as follows:

Example 2(d): Direct investment in low tax country (proposed exemption treatment)

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 100
After tax income	\$ 900

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 900 (exempt)
-------------------------	-----------------

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 900
Tax @ 48.5%	\$ 436.50
After tax dividend	\$ 463.50

31.5% Marginal rate shareholder

Dividend	\$900
Tax @ 31.5%	\$283.50
After tax dividend	\$616.50

Australian corporate shareholder

Dividend	\$900
Tax @ 30%	\$270
After tax dividend	\$630

Complying superannuation fund shareholder

Dividend	\$900
Tax @ 15%	\$135
After tax dividend	\$765

Note that, from Examples 2(c) and 2(d), the proposed changes to the treatment of non-portfolio dividends paid by subsidiaries in unlisted countries from active business income will not affect the overall level of Australian tax payable when both corporate level and shareholder level taxes are taken into account. Under the exemption system no Australian corporate tax will be payable, but additional tax will be payable at the

shareholder level when the income is distributed. The after tax dividend to underlying shareholders from a redistribution of foreign source non-portfolio dividends will remain the same in all cases. The examples highlight the point that it is the failure of payments of foreign tax to generate Australian franking credits that produces the bias against investment in resident companies with foreign source income. The method of international juridical double taxation relief provided does not affect the bias. It would be logical for the extension of the exemption to increase the rate of repatriation of foreign source non-portfolio dividends from unlisted countries (as no Australian corporate tax would be payable on repatriation) but also to increase the retention rate by the resident company (as greater shareholder level tax will be payable on a distribution—assuming that the resident company would prefer not to pay franking deficit tax).

II THE BOARD OF TAXATION'S ASSESSMENT OF THE BIASES IN THE DIVIDEND IMPUTATION SYSTEM

The Board of Taxation accepted that there was a bias against direct investment offshore by resident companies and also a bias against investment by resident shareholders in resident companies with direct offshore investments. Treasury had argued in its *Consultation Paper* that a bias against direct foreign investment at the company level existed only where the foreign country had higher company level taxes than Australia.⁵ The Board concluded that a bias at the company level existed despite the s 23AJ and s 23AH exemptions which, as noted above, produce capital import neutrality. This was because, as argued in submissions to the Board, companies, in making investment decisions, consider the impact on shareholder value which takes into account after tax returns to shareholders. As the value of imputation benefits affects after tax returns, and as Australian companies with significant offshore investments continue to have a disproportionate domestic shareholder base, the biases that exist at the underlying shareholder level were seen as significantly affecting investment decisions at the corporate level.⁶ The Treasury had also considered that it was possible that world capital markets set the pre tax rate of return for small open economies which meant that non-resident investors who do not benefit from dividend imputation on either domestic or offshore investments determine a company's cost of capital.⁷

The Board of Taxation accepted submissions that even if the marginal price-setter for a stock is a non resident or if the cost of capital is lower offshore, a company considering offshore expansion will still consider the effect of the decision on the after tax returns to their existing shareholders.⁸ The Board noted submissions to the effect that Australian investors lean heavily towards holding equities in Australian companies noting that they were consistent with Australian companies having a disproportionate domestic shareholder base. After noting other factors supporting the active involvement of domestic investors in equity raisings by Australian companies, the Board noted that the submissions concluded that as domestic investors represent a major source of funds in new equity raisings, and as the Australian equities market

⁵ Australia, Review of International Taxation Arrangements, *A Consultation Paper Prepared by the Commonwealth Department of the Treasury* (2002) 16.

⁶ Board of Taxation, above n 1, 62.

⁷ Australia, above n 5.

⁸ Board of Taxation, above n 1, 62–63.

clearly values franking credits, there is a domestically determined cost of capital.⁹ Submissions to the Board had cited studies on both the value of imputation credits (generally 40 to 60 per cent of face value), and on the predominance of investment in resident companies by individuals and institutional investors contrary to modern portfolio theory. These were cited as indirect evidence of the effect of the bias at the shareholder level on the cost of capital.¹⁰ The overall conclusion drawn by the Board was that:

there is sufficient evidence to support the view that the Australian capital market significantly affects the cost of capital of Australian firms, and further, that the capacity to frank dividends affects the cost of capital in that market.¹¹

The Treasury *Consultation Paper* had proposed three options to deal with the problem. Option 2.1A was to allow domestic tax relief for unfranked dividends funded out of Foreign Source Income via a non-refundable tax credit of 10 per cent of the dividend.¹² The Board recommended this option with some variations most notably that the tax credit be 20 per cent of the dividend.¹³ This recommendation by the Board is discussed in more detail below. The Treasury's Option 2.1B was to allow dividend streaming so that foreign taxes were streamed to foreign shareholders and imputation credits were streamed to domestic shareholders. While the Board recommended Option 2.1B¹⁴ it recognised that the major impact of Option 2.1B would be on Australian companies with significant levels of foreign shareholders. Given that Australian companies with foreign earnings have a disproportionate level of domestic equity investors, Option 2.1B cannot be a comprehensive solution to the problem. Although the Board noted that Option 2.1B would even up the treatment of dual listed companies, which can already effectively stream foreign and domestic credits,¹⁵ it would also mean that resident companies with foreign source income and high levels of foreign shareholders were in a more favourable position than resident companies with foreign source income and low or no levels of foreign shareholders. As dividend streaming cannot be a comprehensive solution to the problem, at least in the short-term, and as it does involve discrimination in favour of Australian companies with high levels of foreign ownership, it will not be discussed in more detail in this paper.

The Treasury's Option 2.1C was to allow a dividend imputation credit for foreign dividend withholding taxes but not for foreign underlying corporate taxes.¹⁶ A similar option had also been recommended by the Review of Business Taxation.¹⁷ The Board did not recommend Option 2.1C, noting submissions to the effect that it would not effectively address the real issue raised by the underlying bias and that dividend withholding taxes will become much less of an issue under proposed changes to Australia's double tax treaty policy.¹⁸ Under the proposed policy, withholding taxes on

⁹ Ibid, 63–64.

¹⁰ Ibid, 65–66.

¹¹ Ibid, 66.

¹² Australia, above n 5, 18–19; Appendix 2.2, 27–30.

¹³ Board of Taxation, above n 1, 72.

¹⁴ Ibid.

¹⁵ Ibid, 71.

¹⁶ Australia, above n 5, 18, 22–23; Appendix 2.2, 27–30.

¹⁷ Australia, Review Of Business Taxation, *A Tax System Redesigned* Canberra (1999) 627–629.

¹⁸ Board of Taxation, above n 1, 71.

non-portfolio dividends are expected to be 5 per cent with a zero withholding tax applying to 80 per cent or more shareholders. Option 2.1C will not be discussed further in this paper.

III THE 20 PER CENT CREDIT SOLUTION

The principal solution proposed by the Board to the above biases in the dividend imputation system was to allow a 20 per cent non-refundable tax credit at the underlying resident shareholder level for dividends paid by Australian resident companies out of certain foreign source income. To maintain the integrity of the Australian tax system, and to minimise the revenue cost of its proposals, the Board considered that the following conditions should apply to its recommended 20 per cent credit:

- the unfranked dividend would be required to be paid out of non-portfolio dividends out of foreign source profits and foreign branch profits generated after the commencement date of the new measures;
- the relevant FSI would be identified at the company level through an account such as a FDA (Foreign Dividend Account) or FIA (Foreign Income Account);
- distributions of FSI subject to Australian company tax would not generate a 20% credit nor would distributions of untaxed foreign capital gains;
- the same FSI could not give rise to a franking credit and a 20% credit;
- the 20% credit would be able to be offset against the total tax liability of the taxpayer, not merely the tax relating to the FSI (but excess credits would not be refundable); and
- the existing imputation system would continue to apply to Australian taxed income while the 20% credit would apply to unfranked dividends paid out of FSI.¹⁹

The following examples illustrate the effects of the proposed treatment of foreign source unfranked dividends under the recommendations by the Board.

Example 3(a): Assume the facts in Example 2(a) with the variation that a 20% non-refundable credit is given at the shareholder level to the extent that an unfranked dividend is sourced in exempt non-portfolio foreign source dividends or exempt foreign branch profits

¹⁹ Ibid, 70.

3(a) Direct investment in high tax country—currently s 23AJ exemption applicable

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 400
After tax income	\$ 600

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 600 (exempt from Australian tax under ITAA36 s 23AJ)
-------------------------	---

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 600
20% credit	\$120
Grossed up dividend	\$720
Tax @ 48.5%	\$ 349.20
Tax offset	\$120
Net tax	\$229.20
After tax dividend	\$370.80

31.5% Marginal rate shareholder

Dividend	\$600
20% credit	\$120
Grossed up dividend	\$720
Tax @ 31.5%	\$226.80
Tax offset	\$120
Net tax	\$106.80
After tax dividend	\$493.20

Australian corporate shareholder

Dividend	\$600
20% credit	\$120
Grossed up dividend	\$720
Tax @ 30%	\$216
Tax offset	\$120
Net tax	\$ 96
After tax dividend	\$504

Complying superannuation fund shareholder

Dividend	\$600
20% credit	\$120
Grossed up dividend	\$720
Tax @ 15%	\$108
Tax offset	\$120
Excess tax offset	\$ 12*
After tax dividend	\$600

* Can be offset against domestic tax liabilities but is not refundable.

Example 3(b): Assume the facts in Example 2(b) with the variation that a 20% non-refundable credit is given at the shareholder level to the extent that an unfranked dividend is sourced in exempt non-portfolio foreign source dividends or exempt foreign branch profits

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 300
After tax income	\$ 700

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 700 (exempt from Australian tax under ITAA36 s 23AJ)
-------------------------	---

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 700
20% credit	\$140
Grossed up dividend	\$840
Tax @ 48.5%	\$407.40
Tax offset	\$140
Net tax	\$267.40
After tax dividend	\$432.60

31.5% Marginal rate shareholder

Dividend	\$700
20% credit	\$140
Grossed up dividend	\$840
Tax @ 31.5%	\$264.60
Tax offset	\$140
Net tax	\$124.60
After tax dividend	\$575.40

Australian corporate shareholder

Dividend	\$700
20% credit	\$140
Grossed up dividend	\$840
Tax @ 30%	\$252
Tax offset	\$140
Net tax	\$112
After tax dividend	\$588

Complying superannuation fund shareholder

Dividend	\$700
20% credit	\$140
Grossed up dividend	\$840
Tax @ 15%	\$126
Tax offset	\$140
Excess offset	\$ 14*
After tax dividend	\$700

* Can be offset against domestic tax liabilities but is not refundable.

Example 3(c) Assume the facts in Example 2(d) with the variation that a 20% non-refundable credit is given at the shareholder level to the extent that an unfranked dividend is sourced in exempt non-portfolio foreign source dividends or exempt foreign branch profits

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 100
After tax income	\$ 900

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend \$ 900 (exempt)

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 900
20% credit	\$ 180
Grossed up dividend	\$1080
Tax @ 48.5%	\$ 523.80
Tax offset	\$ 180
Net tax	\$ 343.80
After tax dividend	\$ 556.20

31.5% Marginal rate shareholder

Dividend	\$ 900
20% credit	\$ 180
Grossed up dividend	\$1080
Tax @ 31.5%	\$ 340.20
Tax offset	\$ 180
Net tax	\$ 160.20
After tax dividend	\$ 739.80

Australian corporate shareholder

Dividend	\$ 900
20% credit	\$ 180
Grossed up dividend	\$1080
Tax @ 30%	\$ 324
Tax offset	\$ 180
Net tax	\$ 144
After tax dividend	\$ 756

Complying superannuation fund shareholder

Dividend	\$ 900
20% credit	\$ 180
Grossed up dividend	\$1080
Tax @ 15%	\$ 162
Tax offset	\$ 180
Excess offset	\$ 18*
After tax dividend	\$ 900

*Can be offset against domestic tax liabilities but is not refundable.

Note that in none of the above examples does the treatment proposed by the Board produce capital export neutrality at the underlying shareholder level. Note, however, that where the underlying shareholder is a complying superannuation fund the treatment proposed by the Board produces an excess credit. Assuming that the superannuation fund will have sufficient domestic tax liabilities against which the excess credit can be offset, the treatment proposed by the Board would come close to approximating capital export neutrality. Note also the somewhat undesirable result that the 20 per cent credit becomes more valuable to the underlying resident shareholder as the level of foreign tax paid decreases. In extreme cases, such as that shown in Example 3(c), this would mean that the credit would exceed the foreign tax paid.

The ability to offset excess 20 per cent credits against domestic tax liabilities may also be a matter of concern. It appears that rules would need to be developed to ensure that the 20 per cent credit operating in tandem with the dividend imputation system did not produce refunds of excess franking credits where the underlying shareholder had excess 20 per cent credits from a redistribution of foreign source income. The Board noted that the 20 per cent credit proposal would also need to be protected against international tax planning to convert some domestic income (for example, exempt income) to foreign source income to inappropriately access the credit.²⁰ The 20 per cent credit proposal appears to be particularly exposed to planning of this type as it does not involve any tracking of foreign tax paid and, as demonstrated above, the credit becomes more valuable the less foreign tax is paid.

IV THE LIMITED EXEMPTION APPROACH

I have previously proposed that these biases in dividend imputation systems be dealt with by using what I have called a 'limited exemption system'.²¹ If the limited exemption approach were to be restricted to the types of foreign income that the Board's proposal was intended to apply to, then it would be necessary for Australian resident companies to maintain an account (a 'limited exemption account' or LEA) that tracked foreign tax paid (by the company or its foreign affiliate) on income that had benefited from either the non-portfolio dividend exemption or the foreign branch profits exemption. To the extent that a dividend paid by a company was funded from the LEA, a portion of it would be exempt. The exempt portion would be calculated as the foreign tax paid grossed up to reflect after tax income as if tax had been paid at the shareholder's marginal rate. Expressed algebraically the exempt portion would be:

$$t [(1-m)/m]$$

where

t = foreign tax paid

m = the shareholder's marginal rate

²⁰ Board of Taxation, above n 1, 72.

²¹ See C J Taylor, 'Approximating Capital Export Neutrality In Imputation Systems: Proposal For A Limited Exemption Approach' (2003) 57 *Bulletin For International Fiscal Documentation* 135-145.

The taxable portion would be:

$$F-t - [(t - tm)/m]$$

where

F = foreign income

t = foreign tax paid

m = the shareholder's marginal rate

In these circumstances the tax payable on the taxable portion at the shareholder's marginal rate would be:

$$Fm - tm - m[(t - tm)/m] \text{ which becomes } Fm - t$$

This means that the after tax dividend that the taxpayer receives will be:

$$F-t - (Fm - t) \text{ which becomes } F - Fm$$

In other words the algebraic analysis shows that the end result of the system is that the total tax borne by the foreign source dividend has represented tax at the shareholder's marginal rate.

To avoid payments of foreign tax being either refunded (either directly or in tandem with the dividend imputation system), or offset against domestic tax liabilities, the exemption would have an upper limit of $F-t$. Where the approach was limited to dividends funded from s 23AJ and s 23AH exempt income, a proportionate approach to determining which foreign taxed income was being distributed would be the simplest and, on these assumptions, should not result in tax-motivated blending of foreign investments. Under a pooling approach, all foreign taxes in the LEA would be placed in a common pool and regarded as being attached to the dividend in the same proportion that the dividend paid bears to the overall pool of company profits. A similar proportionate approach could also be used to determine the extent to which taxed or LEA income was being distributed.²² To ease compliance burdens at the shareholder level companies could be required to issue one statement to all shareholders advising them of what the exempt portion of the dividend was for various levels of taxable income. For individual shareholders on marginal rates below the top marginal rate, an arbitrary rule of some sort would need to apply for the purposes of determining the appropriate marginal rate.

Previously, I have suggested that to the extent that the dividend was regarded as being paid out of LEA, it would be treated as being received last and the marginal rate used in the formula would either be that applicable to the last dollar of the shareholder's taxable income, or the rate that would have been applicable to the last dollar of the

²² If the s 23AJ and s 23AH exemptions were not to be extended, or if the LEA were to extend to taxable foreign source income, then the proportionate approach would amount to permitting tax-motivated blending of foreign investments. See the discussion in Taylor, above n 21, 140-41. For characterising a dividend as being sourced in taxed or exempt income in these circumstances, however, I have previously argued that a proportionate approach reduces the deferral of Australian shareholder level taxation in closely held companies. See the discussion in Taylor, above n 21, 142-43.

shareholder's taxable income if it had included the LEA portion of the dividend.²³ It would be possible to pass the LEA exemption through a chain of resident companies.

The following examples illustrate the operation of the limited exemption system in relation to unfranked foreign source non-portfolio dividends.

Example 4(a): Assume the facts in Example 2(a) with the variation that the limited exemption approach applies to an unfranked dividend sourced in exempt non-portfolio foreign source dividends or exempt foreign branch profits

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 400
After tax income	\$ 600

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 600 (exempt from Australian tax under ITAA36 s 23AJ)
-------------------------	---

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 600
Exempt portion	\$ 424.74 ($\$400 \times 51.5/48.5$)
Taxable portion	\$ 175.26
Tax @ 48.5%	\$ 85
After tax dividend	\$ 515

31.5% Marginal rate shareholder

Dividend	\$600
Exempt portion	\$600 ($\$400 \times 68.5/31.5 = \869.84 exemption limit applies)
After tax dividend	\$600

Australian corporate shareholder

Dividend	\$600
Exempt portion	\$600 ($\$400 \times 70/30 = \933.33 exemption limit applies)
After tax dividend	\$600

²³ Ibid, 140.

Complying superannuation fund shareholder

Dividend	\$600
Exempt portion	\$600 ($\$400 \times 85/15 = \2266.67 exemption limit applies)

Example 4(b): Assume the facts in Example 2(b) with the variation that the limited exemption approach applies to an unfranked dividend sourced in exempt non-portfolio foreign source dividends or exempt foreign branch profits

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 300
After tax income	\$ 700

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 700 (exempt from Australian tax under ITAA36 s23AJ)
-------------------------	--

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 700
Exempt portion	\$ 318.57 ($51.5/48.5 \times \$300$)
Taxable portion	\$ 381.43
Tax	\$ 185
After tax dividend	\$ 515

31.5% Marginal rate shareholder

Dividend	\$700
Exempt portion	\$652.38 ($\$300 \times 68.5/31.5 = \652.38)
Taxable portion	\$ 47.62
Tax @ 31.5%	\$ 15
After tax dividend	\$685

Australian corporate shareholder

Dividend	\$700
Exempt portion	\$700 ($\$300 \times 70/30 = \700)
After tax dividend	\$700

Complying superannuation fund shareholder

Dividend	\$700
Exempt portion	\$700 ($\$300 \times 85/15 = \1700 ie exemption limit applies)
After tax dividend	\$700

Example 4(c): Assume the facts in Example 2(d) with the variation that the limited exemption approach applies to an unfranked dividend sourced in exempt non-portfolio foreign source dividends or exempt foreign branch profits

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 100
After tax income	\$ 900

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend \$ 900 (exempt)

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 900
Exempt portion	\$ 106.19 ($\$100 \times 51.5/48.5 = \106.19)
Taxable portion	\$ 793.81
Tax @ 48.5%	\$ 385
After tax dividend	\$ 515

31.5% Marginal rate shareholder

Dividend	\$ 900
Exempt portion	\$ 217.46 ($\$100 \times 68.5/31.5 = \217.46)
Taxable portion	\$ 682.54
Tax @ 31.5%	\$ 215
After tax dividend	\$ 685

Australian corporate shareholder

Dividend	\$ 900
Exempt portion	\$ 233.33 ($\$100 \times 70/30 = \233.33)
Taxable portion	\$ 666.67
Tax @ 30%	\$ 200
After tax dividend	\$ 700

Complying superannuation fund shareholder

Dividend	\$ 900
Exempt portion	\$ 566.67 ($\$100 \times 85/15 = \566.67)
Taxable portion	\$ 333.33
Tax @ 15%	\$ 50
After tax dividend	\$ 850

Note that the limited exemption approach will produce capital export neutrality at the underlying shareholder level where F_m exceeds $F-t$. Where $F-t$ equals or exceeds F_m the limited exemption approach will produce capital import neutrality at the underlying resident shareholder level. It would be possible to produce a result closer to capital export neutrality in all cases by not limiting the exemption to $F-t$ and by allowing excess exemptions to be offset against a shareholder's domestic tax liabilities. Such offsetting might be thought to be tantamount to refunding payments of foreign tax and, in conjunction with the dividend imputation system, could actually result in what were, in effect, refunds of payments of foreign tax. It would be possible to develop rules so that the offsetting was only against income other than domestic dividend income and franking credits, but to do so would add to the complexity of the approach at the shareholder level thus undermining one of the key advantages of the limited exemption approach.

The compliance costs of the limited exemption approach and of the Board of Taxation's 20 per cent credit proposal would appear to be roughly equivalent at the non-portfolio corporate investor level. There would be some additional compliance costs at the corporate level associated with calculating the exempt portion of the dividend for different types of shareholder (that is, superannuation fund, resident company, individuals on various marginal rates). As this calculation can be done for all shareholders of a particular type, in one calculation the additional compliance costs are unlikely to be significant. At the underlying shareholder level the limited exemption approach is likely to have lower compliance costs. Having an amount treated as exempt income is a simpler process than allowing a gross up and credit. Moreover, in the limited exemption approach one calculation of the extent of the exemption can be made at the company level for all shareholders of a particular type. By contrast under the 20 per cent credit approach each shareholder needs to make an individual calculation. Under the limited exemption approach, in contrast to the 20 per cent credit approach, the compliance costs are principally located at the company level where it is likely that more resources to cope with additional compliance costs are situated.

The most problematic feature of the limited exemption approach involves determining the extent of the exemption by reference to the underlying shareholder's marginal rate. A degree of arbitrariness would be inherent in pragmatic rules regarding the redistributed dividend as being the last income that the taxpayer received. Regarding the appropriate marginal rate for purposes of calculating the exemption as being the one into which the receipt of the dividend pushed the taxpayer could also produce anomalous results at the boundary.²⁴ These disadvantages, however, need to be kept in

²⁴ Between 1923–28 Australia exempted dividends paid to shareholders whose income including the dividend was taxable at a rate lower than 5 per cent. This exemption proved to be administratively

perspective. The vast majority of shareholders in Australian companies are either superannuation funds or companies or top marginal rate individual taxpayers. Even in the instances where the methods are arbitrary and the results anomalous, it is submitted that the limited exemption approach produces an outcome that is far superior to the present approach and that more nearly approximates capital export neutrality in the majority of cases than does any other system.

Unlike the Board's proposed approach, the limited exemption approach would never produce the result that a taxpayer is given an exemption or a credit that is greater than would be appropriate given the amount of foreign tax paid. Nor would planning involving the conversion of domestic source income to foreign source income be as much of a risk, because foreign tax paid would be tracked and, furthermore, because the limited exemption becomes more valuable as foreign tax paid increases.

V A CORPORATE RATE EXEMPTION SYSTEM

An alternate approach to the problem would be to adapt a proposal made by Professor Alvin Warren of Harvard University as part of his 1993 *Reporter's Study Of Corporate Tax Integration* for the American Law Institute. Within Walvin's study, Proposal 11: Foreign Income states as follows:

A US corporation with foreign income will add to the exempt income account described in Proposal 3(a) an amount equal to its taxable foreign source income, reduced by associated creditable foreign taxes. That addition will be limited to the foreign taxes multiplied by $(1-c)/c$, where c is the US corporate tax rate. The foregoing treatment will be available only as part of a tax treaty.²⁵

The treatment proposed for payments of foreign tax in the Bush Administration's 2003 Dividend Exclusion Proposal (namely, that US taxes offset by FTCs would be treated as US taxes for purposes of determining the proportion of a dividend that was funded from US taxed income and hence exempt) would, if it had proceeded, have amounted to a similar treatment of payments of foreign taxes.²⁶

It would be possible to adapt this proposal to the envisaged Australian system with broader s 23AJ and s 23AH exemptions by making $(1-c)/c$ the fraction by which all foreign taxes in the LEA were multiplied by in order to determine how much of the redistributed LEA income was exempt to resident shareholders. The approach would be similar to the limited exemption approach but one standard limitation would apply for all shareholders. Where the result of multiplying foreign taxes by $(1-c)/c$ exceeded $F-t$ the exemption would again be limited to $F-t$.

cumbersome and produced anomalous results. See the discussion in R W Parsons, 'An Australian View of Corporation Tax' (1967) 14 *British Tax Review* 18 and in C J Taylor, 'Development of and Prospects for Corporate-Shareholder Taxation in Australia' (2003) 57 *Bulletin for International Fiscal Documentation*, 346-48.

²⁵ A C Warren, *Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration*, American Law Institute (1993) 198.

²⁶ See: United States, Department of the Treasury, (Press Release KD-3781, 21 January 2003) 3.

The following examples illustrate the operation of this variation on Warren’s American Law Institute proposal (hereafter referred to as ‘the corporate rate exemption system’) in relation to unfranked foreign source non-portfolio dividends.

Example 5(a): Assume the facts in Example 2(a) with the variation that the corporate rate exemption system applies to an unfranked dividend sourced in exempt non-portfolio foreign source dividends or exempt foreign branch profits

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 400
After tax income	\$ 600

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 600 (exempt from Australian tax under ITAA36 s 23AJ)
Exempt income account	\$ 600 ($\$400 \times 70/30 = \933.33 —exemption limit applies)

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 600
Exempt portion	\$ 600
After tax dividend	\$ 600

31.5% Marginal rate shareholder

Dividend	\$600
Exempt portion	\$600
After tax dividend	\$600

Australian corporate shareholder

Dividend	\$600
Exempt portion	\$600
After tax dividend	\$600

Complying superannuation fund shareholder

Dividend	\$600
Exempt portion	\$600
After tax dividend	\$600

Example 5(b): Assume the facts in Example 2(b) with the variation that the corporate rate exemption system applies to an unfranked dividend sourced in exempt non-portfolio foreign source dividends or exempt foreign branch profits

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 300
After tax income	\$ 700

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 700 (exempt from Australian tax under ITAA36 s 23AJ)
Exempt income account	\$ 700 ($70/30 \times \$300 = \700)

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 700
Exempt portion	\$ 700
After tax dividend	\$ 700

31.5% Marginal rate shareholder

Dividend	\$700
Exempt portion	\$700
After tax dividend	\$700

Australian corporate shareholder

Dividend	\$700
Exempt portion	\$700
After tax dividend	\$700

Complying superannuation fund shareholder

Dividend	\$700
Exempt portion	\$700
After tax dividend	\$700

Example 5(c): Assume the facts in Example 2(d) with the variation that the corporate rate exemption system applies to an unfranked dividend sourced in exempt non-portfolio foreign source dividends or exempt foreign branch profits

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 100
After tax income	\$ 900

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 900 (exempt)
Exempt income account	\$ 233.33

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 900
Exempt portion	\$ 233.33
Taxable portion	\$ 666.67
Tax @ 48.5%	\$ 323.33
After tax dividend	\$ 576.67

31.5% Marginal rate shareholder

Dividend	\$ 900
Exempt portion	\$ 233.33
Taxable portion	\$ 666.67
Tax @ 31.5%	\$ 210
After tax dividend	\$ 690

Australian corporate shareholder

Dividend	\$ 900
Exempt portion	\$ 233.33
Taxable portion	\$ 666.67
Tax @ 30%	\$ 200
After tax dividend	\$ 700

Complying superannuation fund shareholder

Dividend	\$ 900
Exempt portion	\$ 233.33
Taxable portion	\$ 666.67
Tax @ 15%	\$ 100
After tax dividend	\$ 800

Note that where $F-t$ equals or exceeds F_c the corporate rate exemption system produces capital import neutrality at the underlying shareholder level. Where F_c equals or exceeds $F-t$ and F_c equals F_m Warren's approach also produces capital export neutrality at the underlying shareholder level. In other instances where F_c exceeds $F-t$ and F_m exceeds F_c the corporate rate exemption system produces a result for the underlying shareholder that is between capital export neutrality and capital import neutrality. Where F_c exceeds $F-t$ and F_m the corporate rate exemption system produces a result for the underlying shareholder that, for the shareholder, is better than capital import neutrality but not as favourable as capital export neutrality.

As is the case with the limited exemption approach the corporate rate exemption system would require an ordering rule for determining which foreign taxed non-portfolio dividend or foreign branch profits income was being distributed. An ordering rule would also be required to determine whether taxed or exempt foreign source income was being redistributed. For the same reasons as discussed in relation to the limited exemption approach it is submitted that in both cases a proportionate approach is the most appropriate. This approach would be likely to have fewer compliance costs at both the corporate and underlying shareholder levels than would the limited exemption approach. The limitation on the exemption would always be calculated by reference to the domestic corporate rate and the statement issued to all resident shareholders could simply state the portion of the dividend that was exempt from tax at the shareholder level. The limit on the exemption would prevent payments of foreign tax from being refunded through interaction with the dividend imputation system or from being offset against domestic tax liabilities.

VI ALLOWING UNDERLYING SHAREHOLDERS AN INDIRECT TAX CREDIT

The final possible approach that will be considered in this paper is to allow underlying resident shareholders a foreign tax credit for the foreign corporate and withholding taxes paid by the Australian resident company, and its foreign affiliates, on the source of non portfolio dividends and on branch profits.

The following examples illustrate the effects of allowing direct and indirect foreign tax credits at the underlying shareholder level with only an overall limitation in place.

Example 6(a) Assume the facts in Example 2(a) with the variation that an underlying foreign tax credit is granted to an unfranked dividend sourced in exempt non-portfolio foreign source dividends or exempt foreign branch profits

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 400
After tax income	\$ 600

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 600 (exempt from Australian tax under ITAA36 s 23AJ)
-------------------------	---

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 600
Gross up for foreign tax	\$ 400
Grossed up dividend	\$1000
Tax @ 48.5%	\$ 485
FTC	\$ 400
Net Australian tax	\$ 85
After tax dividend	\$ 515

31.5% Marginal rate shareholder

Dividend	\$ 600
Gross up for foreign tax	\$ 400
Grossed up dividend	\$1000
Tax @ 31.5%	\$ 315
FTC	\$ 400
Excess FTC	\$ 85 (Quarantined)
After tax dividend	\$ 600

Australian corporate shareholder

Dividend	\$ 600
Gross up for foreign tax	\$ 400
Grossed up dividend	\$1000
Tax @ 30%	\$ 300
FTC	\$ 400
Excess FTC	\$ 100 (Quarantined)
After tax dividend	\$ 600

Complying superannuation fund shareholder

Dividend	\$ 600
Gross up for foreign tax	\$ 400
Grossed up dividend	\$1000
Tax @ 15%	\$ 150
FTC	\$ 400
Excess FTC	\$ 250 (Quarantined)
After tax dividend	\$ 600

Example 6(b) Assume the facts in Example 2(b) with the variation that an underlying foreign tax credit is granted to an unfranked dividend sourced in exempt non-portfolio foreign source dividends or exempt foreign branch profits

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 300
After tax income	\$ 700

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 700 (exempt from Australian tax under ITAA36 s 23AJ)
-------------------------	---

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 700
Gross up for foreign tax	\$ 300
Grossed up dividend	\$1000
Tax @ 48.5%	\$ 485
FTC	\$ 300
Net tax	\$ 185
After tax dividend	\$ 515

31.5% Marginal rate shareholder

Dividend	\$ 700
Gross up for foreign tax	\$ 300
Grossed up dividend	\$1000
Tax @ 31.5%	\$ 315
FTC	\$ 300
Net tax	\$ 15
After tax dividend	\$ 685

Australian corporate shareholder

Dividend	\$ 700
Gross up for foreign tax	\$ 300
Grossed up dividend	\$1000
Tax @ 30%	\$ 300
FTC	\$ 300
Net tax	\$ 0
After tax dividend	\$ 700

Complying superannuation fund shareholder

Dividend	\$ 700
Gross up for foreign tax	\$ 300
Grossed up dividend	\$1000
Tax @ 15%	\$ 150
FTC	\$ 300
Excess FTC	\$ 150 (Quarantined)
After tax dividend	\$ 700

Example 6(c) Assume the facts in Example 2(d) with the variation that an underlying foreign tax credit is granted to an unfranked dividend sourced in exempt non-portfolio foreign source dividends or exempt foreign branch profits

Foreign subsidiary	
Foreign income	\$1000
Foreign tax	\$ 100
After tax income	\$ 900

Assume that the foreign subsidiary distributes all of its after tax income to its Australian parent.

Australian parent

Foreign source dividend	\$ 900 (exempt)
-------------------------	-----------------

Assume that the Australian company redistributes all of the foreign source dividend to the shareholders shown in Example 1.

48.5% Marginal rate shareholder

Dividend	\$ 900
Gross up for foreign tax	\$ 100
Grossed up dividend	\$1000
Tax @ 48.5%	\$ 485
FTC	\$ 100
Net tax	\$ 385
After tax dividend	\$ 515

31.5% Marginal rate shareholder

Dividend	\$ 900
Gross up for foreign tax	\$ 100
Grossed up dividend	\$1000
Tax @ 31.5%	\$ 315
FTC	\$ 100
Net tax	\$ 215
After tax dividend	\$ 685

Australian corporate shareholder

Dividend	\$ 900
Gross up for foreign tax	\$ 100
Grossed up dividend	\$1000
Tax @ 30%	\$ 300
FTC	\$ 100
Net tax	\$ 200
After tax dividend	\$ 700

Complying superannuation fund shareholder

Dividend	\$ 900
Gross up for foreign tax	\$ 100
Grossed up dividend	\$1000
Tax @ 15%	\$ 150
FTC	\$ 100
Net tax	\$ 50
After tax dividend	\$ 850

Depending on what quarantining rules apply at the underlying shareholder level, allowing underlying shareholders an FTC could essentially produce equivalent results to the limited exemption system. Foreign tax paid and foreign source income would need to be tracked at the corporate level (despite the applicability of the s 23AJ and s 23AH exemptions), and the portion of any distribution that represented a redistribution of foreign source income would need to be identified, as would the amount of foreign tax applicable to the dividend. The main difficulty with this approach is the greater complexity involved at the underlying shareholder level. The portion of the dividend flowing from foreign source income would need to be identified and the usual FTC gross up and credit mechanism would need to be applied. As the FTC would be in

respect of income that was tax exempt at the corporate level limitations on the credit would need to be in place at the underlying shareholder level. At least there would appear to be a need to quarantine excess credits so that they could only be offset against future tax obligations on foreign-source dividends. In closely held companies there may be the risk of tax motivated blending of investments in high and low tax countries instigated by controlling shareholders. If this were a concern then some sort of basket system would be necessary. If a basket system were to apply at all at the underlying shareholder level then it may be difficult to confine it to dividends received from closely held resident companies. All of these considerations are likely to mean that the FTC approach is likely to have the highest compliance costs of any of the approaches considered in this paper—particularly at the underlying shareholder level.

VII CONCLUSIONS AND AREAS FOR RESEARCH

The use of some form of limited exemption approach has the potential to produce capital export neutrality at the underlying shareholder level in many cases and capital import neutrality in all other cases. For all underlying resident shareholders this would amount to a considerable improvement on the present position. Limiting the exemption to F-t would ensure that excess exemptions could not be offset against a shareholder's domestic tax liabilities. This together with the fact that the exemption would become more valuable as foreign tax paid increased would be a structural disincentive for planning to recharacterise domestic income as foreign source in order to obtain the exemption. Using marginal rates in calculating the exempt portion of a distribution would be consistent with vertical equity but would increase compliance costs and could create anomalies at the underlying shareholder level. It is submitted that the compliance costs associated with the limited exemption approach would be likely to be no higher, and quite possibly lower, than those associated with other approaches (other than the corporate rate exemption system) particularly at the underlying shareholder level. The corporate rate exemption system carries with it similar advantages with lower still compliance costs and without possible anomalies. In many instances, however, a corporate rate exemption system will only produce capital import neutrality at the underlying shareholder level.

Assuming that Australia wishes to maintain a dividend imputation system, despite the international trend towards more simple systems of corporate tax integration, several key areas for further research can be identified for evaluating the problems and possible solutions in more detail. These include:

- The need for more direct evidence that the bias at the underlying shareholder level affects the cost of capital to Australian resident companies with offshore income;
- A detailed examination of the revenue implications of the alternative solutions discussed in this paper; and
- A detailed examination of the compliance costs associated with the alternative solutions discussed in this paper.

THE RESIDENT/NON-RESIDENT DICHOTOMY IN NEW ZEALAND'S TAX REGIME: PROPOSALS FOR SOME INTERMEDIATE STEPS?

ANDREW SMITH

Andrew Smith is an Associate Professor in the School of Accounting and Commercial Law, Victoria University, Wellington, New Zealand.

I INTRODUCTION¹

A key feature of New Zealand's international tax regime is the comprehensive taxation of New Zealand residents' worldwide income. This is largely due to the broad controlled foreign company (CFC) and foreign investment fund (FIF) regimes found in the New Zealand tax regime.

Because of this comprehensive residence-based taxation, it is believed that highly skilled migrants are deterred from relocating to New Zealand in favour of other countries. Recognising that tax considerations may be undermining the objectives sought from the government's migration policies to attract highly skilled migrants, the government has released a discussion document, *Reducing Barriers to International Recruitment to New Zealand* (Discussion Document), proposing a limited exemption for some new migrants from the full application of New Zealand's international tax regime.²

The objective of this paper is to review and analyse the proposals outlined in the Discussion Document with respect to the proposed limited exemption for new migrants.

II NEW ZEALAND'S TAX REGIME APPLYING TO RESIDENTS

A The CFC and FIF Rules

In the period 1987–96 New Zealand's international tax regime was radically changed. Extremely comprehensive CFC and FIF regimes were initially introduced in 1988 and substantially reformed in 1992, giving New Zealand one of the broadest resident-based

¹ A later version of this paper has been published. See Smith, Andrew M. C., "New Zealand's International Tax Rules: Proposals For a Temporary Exemption For New Migrants", *Bulletin For International Fiscal Documentation*, 58(7) July 2004, 326-333.

² Policy Advice Division of the Inland Revenue Department, Wellington, *Reducing Barriers to International Recruitment to New Zealand: A Government Discussion Document* (November 2003).

tax regimes in the world.³ While New Zealand's CFC and FIF regimes are very complex,⁴ for the purposes of this paper the salient features of each regime will be outlined.

The New Zealand CFC regime applies if a CFC exists for New Zealand tax purposes. A CFC is a foreign company that either has:

- Five or fewer New Zealand residents whose aggregate *control interests*⁵ are greater than 50 per cent in the company; or
- One New Zealand resident where their *control interest* is 40 per cent or greater; or
- Five or fewer New Zealand residents where they have the power as a group to control the exercise of shareholder decision-making rights in the CFC.

Once a foreign company is deemed to be a CFC, the New Zealand resident shareholders are required to attribute their share of the CFC's income (as determined using New Zealand tax accounting rules) if their *income interest*⁶ is 10 per cent or greater in the CFC on a 'branch-equivalent' (BE) basis.⁷ A credit is allowed against New Zealand tax for the taxpayer's share of foreign tax paid by the CFC. If the CFC subsequently declares a dividend to its New Zealand shareholders (including companies), that dividend is taxable with a credit for taxes already paid on the attributed CFC income. In attributing income to the CFC's shareholders no exemption is made for 'active income' earned by the CFC. New Zealand's CFC regime is unusual in this respect—no active income exemption is offered.

The New Zealand CFC regime contains only one exemption. It is for CFCs located in certain approved countries (known as the 'grey-list') that have been deemed by the New Zealand authorities as having a comprehensive tax regime with effective tax rates similar to New Zealand's. The grey-list currently comprises Australia, Canada, the United States, the United Kingdom, Germany, Norway and Japan.⁸

If the CFC is resident in a 'grey-list' country New Zealand residents are not required to attribute any income in respect of their interests in those CFCs. Instead the income of 'grey-list' CFCs is taxed on a deferred basis when (or if) the CFC pays a dividend to its New Zealand resident shareholders. However, if the shareholder is a New Zealand resident company, a deemed credit is given against any tax payable, so the New Zealand tax is effectively deferred until when the New Zealand company declares a dividend to its shareholders. Therefore, there is a significant difference in the manner

³ See D Dunbar, 'The CFC and FIF Regimes: An Historical Examination of the Conflict Between Taxpayers and the IRD—Are the McLeod Committee Recommendations an Acceptable Solution? Parts I and II', 10 *New Zealand Journal of Taxation Law and Policy* 53–83, 95–129.

⁴ The CFC and FIF regimes are found in subpart CG of the *Income Tax Act 1994* (ITA94). All statutory references are to this Act unless otherwise stated. For a detailed summary of the New Zealand CFC and FIF rules refer to *New Zealand Master Tax Guide 2003*, CCH New Zealand Limited, Auckland, New Zealand 908–35.

⁵ *Control interests* are determined under s CG 4 of ITA94.

⁶ *Income interests* are determined under s CG 5 of ITA94.

⁷ If their *income interest* is below 10 per cent, any income attributable to them from their CFC interest is determined under the FIF rules. (To be covered later in this paper.)

⁸ Part A, Schedule 3 ITA94.

in which New Zealand residents' interests in CFCs are taxed in New Zealand, depending upon where the CFC is located.

The FIF regime is complementary to the CFC regime and was introduced at the same time for that reason, although its operation was delayed until 1992. The FIF regime has been more controversial than the CFC regime, partly because it is more likely to apply to individual taxpayers who have interests in FIFs, such as offshore managed funds, foreign life insurance policies and foreign superannuation schemes. The manner in which income is attributed to New Zealand taxpayers with FIF interests under the FIF regime can be penal in many circumstances and is sometimes interpreted by taxpayers as an effective prohibition upon foreign portfolio equity investment outside 'grey-list' countries.

The FIF regime applies to:

- Interests in CFCs (including unit trusts) where the New Zealand shareholder's income interest is below 10 per cent;
- An entitlement to benefit from foreign life insurance policies where the policy was *not* offered or entered into in New Zealand by a non-resident life insurer; and
- Membership or the right to benefit under a foreign superannuation scheme.

Certain FIF interests are exempt. They include:

- Interests in CFCs required to be accounted for under the CFC rules.
- Interests in foreign entities that are resident in 'grey-list' countries. This exemption does not apply to foreign life insurance policies or superannuation schemes in 'grey-list' countries.
- Certain interests held by natural persons. This applies where the aggregate cost of all CFC interests held by the natural person are below NZ\$50 000. (*De minimis* exemption.)
- Interests in an employment-related foreign superannuation scheme. This is a superannuation scheme entered into by virtue of the taxpayer's employment outside of New Zealand when they were non-resident for tax purposes.
- Interests in foreign entities held by natural persons (where those interests were acquired before they became a New Zealand tax resident), where exchange controls offshore prevents the taxpayer from deriving any income interest or realising the interest for New Zealand currency.
- Interests in foreign life insurance policies and foreign superannuation schemes where these were acquired by natural persons before they became resident in New Zealand for the first four years after they become resident in New Zealand.
- Interests in a 'qualifying foreign private annuity' in respect of benefits derived by a New Zealand resident from a pension or annuity where the consideration provided by the taxpayer for that pension or annuity was provided when the taxpayer was a non-resident.

Where a FIF interest is deemed to arise (taking into account the above exclusions) the taxpayer is required to account for them for New Zealand tax purposes using one of four different methods. These methods are:

- Comparative Value Method. (Income for the income year is determined by aggregating dividends received plus the change in the market value of the interest over the income year. That is, an unrealised capital gains tax.)
- Deemed Rate-of-Return Method. (The income of the taxpayer is determined by applying a deemed rate-of-return to the aggregate cost of the investment.)
- Accounting Profits Method or Earnings Per Share (EPS) Method. (Taxpayers are taxed according to the earnings per share of the company attributable to their interest.)
- Branch Equivalent Method. (This is the same method used to account for interests in CFCs under the CFC regime.)

While it initially appears that taxpayers have an unfettered choice as to what method they can apply to an FIF interest,⁹ this is not so. For example, the Branch Equivalent Method can only be applied where there is an income interest in a CFC below 10 per cent and the taxpayer has access to sufficient information for the CFC's income to be determined using the Branch Equivalent Method.¹⁰ This is likely to occur only if there are other New Zealand shareholders in the CFC with income interests of 10 per cent or greater that are required to apply the Branch Equivalent Method under the CFC regime.

The Accounting Profits Method can only be used where the CFC is a publicly listed entity offshore and the accounts distributed to shareholders meet certain standards.¹¹ Both the Branch Equivalent Method and the Accounting Profits Method can only be used where the interest is a company, and not to life insurance policies or superannuation schemes.¹²

The Comparative Value Method can only be applied where it is practicable to obtain market values for an FIF. The remaining Deemed Rate-of-Return Method is available only as a last resort mainly for interests in foreign life insurance policies and foreign superannuation schemes although it could be applied to portfolio interests in companies.¹³ The problem with this method is that the deemed rate-of-return for most income years since 1992 has been set around 10 per cent, based on the long-term New Zealand Government stock rate plus 4.0 per cent.¹⁴ If the interest has been recently acquired, the deemed rate is likely to be penal while if the interest has been held for a long period of time, the deemed rate could be concessional.

The four options available for accounting for interests in FIFs have attracted much controversy, especially when compared to how domestic equity investments and

⁹ Section CG 17(1) ITA94.

¹⁰ Section CG 17(5) ITA94.

¹¹ Section CG 17(6) ITA94.

¹² Section CG 17(4) ITA94.

¹³ Section CG 17(3) ITA94.

¹⁴ It should be noted that the New Zealand Government has recently released a discussion document titled *Taxation of Non-Controlled Offshore Investment in Equity: An Officials' Issues Paper on Suggested Legislative Amendments*, Policy Advice Division of the Inland Revenue Department/New Zealand Treasury, Wellington (December 2003) [hereafter *Issues Paper*]. It is proposed to tax all offshore portfolio equity interests held by New Zealand residents (including 'grey-list' ones) on a 'risk-free' rate of return basis—being approximately 4.0 per cent pa. Unlike the Deemed Rate-of-Return method in the current FIF rules, it would be applied to the market value of the investment rather than its aggregate cost.

interests in 'grey-list' companies are taxed. As New Zealand does not have a comprehensive capital gains tax, many gains derived from the sale of interests in New Zealand and 'grey-list' companies may not necessarily be subject to tax at all.¹⁵

The FIF rules have given rise to distortions in investment patterns, as the difference in the way interests in 'grey-list' and 'non grey-list' companies are taxed is significant.¹⁶ The FIF rules have encouraged New Zealand investors to invest in 'non grey-list countries' through managed funds located in 'grey-list' countries (some of whom have significantly concessional tax rules for some types of managed funds), placing New Zealand managed funds at a disadvantage.

B The Implications of the New Zealand Tax Regime for Migrants

While New Zealand tax rates on individual incomes are not low, they are more moderate than the effective rates prevailing in many Western European countries.¹⁷ New Zealand does not tax capital gains on a comprehensive basis (as is done in Australia), which may be attractive to potential migrants with investments. No estate duty is imposed in New Zealand either. Apart from the top marginal tax rate of 39 per cent applying from NZ\$60 000 (US\$40 000 approx), New Zealand's tax regime would not necessarily be a huge deterrent for most migrants from OECD countries locating to this country.

Where problems arise, however, is with the CFC and FIF rules. Any interests migrants have in foreign companies will be subject to the CFC regime unless it is located in a 'grey-list' country. Many prospective migrants are likely to have interests in foreign superannuation schemes and foreign life insurance policies that will potentially be caught under the FIF rules.¹⁸ This is especially so given that such investments are sometimes mandatory and/or subject to tax incentives (or preferences) in other countries.

¹⁵ In the case of interests in 'grey-list' and New Zealand companies, whether or not gains upon sale are taxable depends upon whether the transaction falls within the scope of s CD 4 ITA94.

¹⁶ Above n 14. Furthermore, under the proposals in the *Issues Paper*, the 'grey-list' distinction will be removed and all portfolio interests in foreign companies will be taxed on the same basis.

¹⁷ To some extent these more moderate rates are tempered by: the absence of any tax-free threshold for individuals, minimal deductions available for individual taxpayers, and a comprehensive, single-rate GST without any substantial exemptions.

¹⁸ In this respect it is also important to note that New Zealand has a superannuation policy (and tax regime) that is not consistent with those found in most other OECD countries. It is not mandatory for New Zealand employees to contribute to a private superannuation scheme nor is there any requirement for New Zealand employers to offer a superannuation scheme to employees. The taxation of superannuation schemes and employers' contributions to such schemes are not subject to any preferential tax treatment in New Zealand although consideration is being given to changes in this area. Refer to *A Future for Work-Based Savings in New Zealand—Final Report of the Savings Product Working Group*, Wellington, August 2004.

III PROPOSED EXEMPTION

A Background

As part of an agreement signed in 1999 between the Labour and Alliance Parties to form a coalition government, it was agreed that an inquiry would be held into the New Zealand tax regime. Prior to the 1999 election the Alliance Party alleged there were major deficiencies in the New Zealand tax regime that were resulting in major inequities, although no evidence nor details of any kind were given to support this assertion.

The Labour Party (having been responsible for a large part of the reforms to New Zealand's tax regime in the 1980s) did not hold the same view and the agreement to convene an inquiry into the tax system was a compromise between the two parties. In 2000 a committee of review (known as the 'McLeod Committee') was convened with terms of reference to 'review the tax system and advise the government of an appropriate framework for policy'.¹⁹ The McLeod Committee delivered *Tax Review 2001: Final Report* (Final Report) in October 2001.²⁰ The McLeod Committee was of the view that 'radical restructuring is not required' and that the 'broad architecture of the tax system is sound'.²¹

The Final Report contained numerous recommendations for minor changes, a number of which were dismissed by the government.²² One of the McLeod Committee's other recommendations was:

An individual with no previous connection to New Zealand who becomes a resident of New Zealand for tax purposes should only be taxed on their New Zealand-sourced income for the first seven years after they first become resident.²³

In respect of this recommendation the government requested officials in the Inland Revenue Department (IRD) and Treasury to undertake further work on this matter. As a consequence of this work, a discussion document titled *Reducing Barriers to International Recruitment to New Zealand: A Government Discussion Document*²⁴ (Discussion Document) was released for public consultation in November 2003.

¹⁹ McLeod Committee, Wellington, New Zealand, *Tax Review 2001: Final Report* (October 2001), 1. Available from the Treasury's website at <http://www.treasury.govt.nz>. (Hereafter known as the *Tax Review 2001*.)

²⁰ Ibid.

²¹ Ibid, Overview i.

²² A recommendation to tax owner-occupied homes was rejected very quickly due to the likely adverse public reaction. Also rejected was a recommendation to reduce the top individual tax rate and the company tax rate so that they were aligned, and to reduce/eliminate excise taxes with a rise in GST to compensate. Another recommendation to tax NZ companies at a reduced tax rate of 15 per cent if they were non-resident owned was subsequently rejected after a report from officials.

²³ Above n 18, Overview xi.

²⁴ Policy Advice Division of the Inland Revenue Department, Wellington, *Reducing Barriers to International Recruitment to New Zealand: A Government Discussion Document* (November 2003). (Referred to in this paper as the Discussion Document.)

B The Issues

The concept of providing certain new residents with some temporary relief from New Zealand's international tax rules is couched in terms of the impact of those rules on the ability of New Zealand employers to hire skilled employees from outside New Zealand. It is argued that New Zealand businesses may have to offer higher salaries to potential employees from overseas to compensate them for the effects of New Zealand's comprehensive international tax rules²⁵ or that highly skilled persons may be dissuaded from working in New Zealand because of New Zealand's international tax rules. The main benefit of 'the proposed exemption would be to make it cheaper for New Zealand businesses to recruit and retain skilled employees'.²⁶ Because of this objective, the government does not propose to offer a similar exemption to wealthy migrants bringing capital to New Zealand nor to entrepreneurial migrants.²⁷

The decision to offer relief against New Zealand's international tax rules to certain new migrants is briefly discussed in terms of general tax policy such as the need to balance the costs of taxation against the need for tax revenue. The Discussion Document mentions the need of other taxpayers for a perceived fairness in the exemption, which may explain the somewhat tortuous logic to attempt to justify the proposal in terms of existing tax policy settings.

C Proposals in the Discussion Document

The Discussion Document contains a proposal to exempt certain persons, who are recruited to work in New Zealand, from some of New Zealand's international tax rules. The exemption would be offered to persons who have not been resident in New Zealand for tax purposes for 10 years prior to becoming resident. It would be available to both New Zealand and foreign citizens. The Discussion Document does not make it clear whether the 10-year period of non-residency must be determined from a certain age or whether a period of non-residence as a minor will be taken into account when determining eligibility for the exemption.

As well as meeting the above non-residence test for a 10-year period, the persons would also have to meet a 'work test'. This work test would be met if the person earned a certain amount of income from employment in New Zealand or worked full-time in employment in any income year the exemption was claimed. Income earned from a non-family partnership in capacity of a partner would be treated as employment income to enable such partners to qualify for the exemption. If the work test was satisfied by one household member, the resulting exemption would apply to the whole household although the remaining spouse would still have to meet the requirement of not being resident for the previous 10 years. If only one spouse meets the 10-year non-residency test the benefits of the exemption would be limited to that spouse only. That

²⁵ Ibid, para 2.3.

²⁶ Ibid, para 1.10.

²⁷ In order for the exemption to have an anti-avoidance provision, it is proposed that migrants who are employed by a company in which they have a substantial interest will be ineligible for the exemption.

same spouse would also have to meet the work test.²⁸ It is proposed that the exemption would be available to a person only once in their lifetime.

The proposal in the Discussion Document is not final in relation to two key elements—the extent of the exemption and the period of the proposed exemption. The Discussion Document instead contains several options for these two key parts, on which the government is seeking feedback.

IV SCOPE OF THE PROPOSED EXEMPTION

From the government's perspective the ideal exemption should cover only those taxes that are passed on to New Zealand employers of foreign staff who have sensitivity to New Zealand taxes. The proposed exemption would ideally be set to avoid adverse side effects such as the creation of incentives to invest outside New Zealand; making foreign recruits cheaper to employ than equivalent New Zealand residents; and undermining the perceived equity of the New Zealand tax system in the eyes of resident taxpayers.²⁹

Whatever the scope of the proposed exclusion will be, it would not apply to any foreign-sourced income arising from the taxpayer's own services. This is to prevent diversion of employment income derived from services provided in New Zealand to offshore entities. It would also not apply to any income derived from the taxpayer's own services where those services were provided offshore.

With respect to the scope of the exemption, two possible options are outlined in the Discussion Document. They are termed a 'broad' option and a 'narrow' option.

A The 'Broad' Option

Under this option, all eligible persons' foreign-sourced income would be exempt from New Zealand tax. This would include: investments caught within the CFC and FIF rules, any income from other offshore investments (whether equity or debt), rental income derived from any property situated outside New Zealand, and any obligations to deduct Non-Resident Withholding Tax (NRWT), or Approved Issuer Levy (AIL)³⁰ from interest paid to a non-resident lender.

In its favour, the government believes the broad option is more likely to reduce the tax-related costs to New Zealand employers. It would send a strong signal to New Zealand employers and potential foreign recruits and would be easier to understand and comply with. The broad option, however, is likely to create incentives to invest offshore rather than in New Zealand, and potentially into tax havens.³¹ The broader the exemption, the

²⁸ Above n 23, paras 7.22–7.23.

²⁹ Above n 23, para 3.2.

³⁰ The Approved Issuer Levy (AIL) is a 2 per cent stamp duty imposed upon interest paid by New Zealand residents to non-associated, non-resident lenders. Interest payments subject to this AIL are effectively exempt from Non-Resident Withholding Tax (NRWT).

³¹ The incentives to invest in a tax haven for portfolio investment may be overstated. Many countries (other than tax havens) pay interest to arm's length non-residents without any withholding taxes so tax

more likely the proposed exemption will be perceived as 'unfair' by other taxpayers, thus possibly undermining the voluntary compliance that underpins New Zealand's tax administration. Such perceived 'unfairness' could also be politically controversial and may risk a public backlash.

B The 'Narrow' Option

Under this option the exemption would be centred on the part of New Zealand's international tax rules that 'are more comprehensive than the international norm' such as New Zealand CFC and FIF rules.³² In addition, the person would be exempt from NRWT (or AIL) and certain share options and trust income.

A narrow option would reduce perceptions that the proposed exemption is 'unfair' by other New Zealand taxpayers especially since most New Zealanders' understanding of the CFC and FIF rules is very poor. Incentives to invest offshore rather than New Zealand would be reduced because new employees would still be taxed on their foreign-source income under existing rules (apart from the CFC and FIF rules), but there would be increased incentives to invest in CFCs and FIFs over other types of investments (both foreign and New Zealand-based). The effects on the incentive to invest offshore under the 'broad' and 'narrow' options may therefore be similar.

One potential way of dealing with the incentive effects of the broad option would be to limit the exemption to sources of foreign income held at the time the person first settled in New Zealand. This, however, could be costly to administer and to comply with and, for that reason, the government does not propose to distinguish between pre- and post-migration assets³³ except for financial arrangements.³⁴

V LENGTH OF THE EXEMPTION

Another key matter in which the government is uncertain is the length of the proposed exemption and again it seeks input from interested parties. In an early part of the Discussion Document the length of the exemption is discussed in terms of the estimated fiscal cost.³⁵ It is estimated that the broad option, if offered to migrants for three years, would have a similar fiscal cost to the narrow option if it were offered for a seven-year period.

In a later part of the Discussion Document, the length of the exemption is couched in terms that a person's sensitivity to New Zealand tax is likely to become less the longer they are resident in New Zealand. With respect to a seven-year exemption, it was felt that a shorter time period could be desirable because if a person has been resident in

havens do not necessarily have an advantage in that area. With respect to portfolio equity investment, investments made in funds located in tax havens are likely to be ultimately invested in countries that are not tax havens.

³² Above n 23, para 3.4. An interesting admission that New Zealand's international tax rules are in effect not comparable to international tax norms found elsewhere.

³³ *Ibid*, para 5.8.

³⁴ *Ibid*, para 4.39.

³⁵ *Ibid*, para 3.18.

New Zealand for 6–7 years, their sensitivity to New Zealand tax will be considerably less than when they first arrived. Although not mentioned in the Discussion Document, the length of similar exemptions offered in other countries should be considered carefully as New Zealand is likely to be competing for the same type of migrant. The period of the exemption must also be related to the period of non-residency necessary to obtain the exemption.³⁶

VI ELIGIBILITY

It is proposed that both foreign and New Zealand citizens will be eligible for the exemption, the key criteria being that the person was a non-resident for New Zealand tax purposes for 10 years immediately prior to seeking the exemption. It is intended that the period of non-residency to qualify for the exemption be substantially longer than the period of the exemption in order to prevent creating tax incentives for New Zealanders to leave in order to gain a tax advantage when they return. In addition, the government does not want to create incentives for New Zealand employers to hire foreigners over New Zealand citizens. In extending the proposed exemption to both foreigners and New Zealand citizens, it must be noted that a significant number of current New Zealand residents are not New Zealand citizens (around 25 per cent) and a significant number also hold dual nationality (believed to be around 20 per cent).

VII EMPLOYER-PROVIDED SHARE OPTIONS, FINANCIAL ARRANGEMENTS AND TRUSTS

A Employment Related Share Options

In many countries skilled and high-level employees are partly remunerated in the form of share options. It is not a common form of remuneration in New Zealand (apart from business executives), which may be due to the way in which share options are taxed in New Zealand.

The New Zealand rules for taxing employment-related share options are contained in s CH 2 of ITA94.³⁷ As in most countries the amount of income to be taxed from the exercise of employment-related share options is the difference between the exercise price and the market price of the shares at the time when the option is exercised. In New Zealand income arising from such options does not attract any concessional tax treatment, nor is any distinction made between whether or not the taxpayer was a New Zealand resident at the time the options were acquired. In this respect New Zealand taxes options differently from other countries where the options granted prior to becoming resident are not taxed nor are subject to apportionment in respect of the prior period of non-residence.

³⁶ Refer to the next section of the paper.

³⁷ Section CH 2 only applies to share options obtained through employment, and not to share options acquired in the capacity of a shareholder or some other non-employment relationship; refer *CIR v Hannigan*; *CIR v Levet* (1980) 4 NZTC 61,573.

As a consequence migrants to New Zealand who bring unexercised employment-related share options are likely to find the share options taxable in the country where they acquired them as well as in New Zealand. This may render New Zealand an unattractive place to migrate to, especially if the exercise of the options will produce a major gain. It is likely to discourage highly skilled migrants of a type that New Zealand seeks to attract.

The Discussion Document proposes that this issue be dealt with by expanding the scope of the exemption to include gains derived from the exercise of share options acquired by persons prior to becoming resident in New Zealand. There is a risk that the gains from the share options may end up being not taxed in any jurisdiction, possibly creating incentives for persons to relocate to New Zealand for a short period of time. This, however, is perceived to be much less of a risk to the New Zealand revenue, given that prospective migrants can decide when their options are exercised and, in the absence of such an exemption, for share options there is no certainty New Zealand would be able to tax their gains on their share options anyway.

B Financial Arrangements

In New Zealand financial arrangements (being debt and similar types of securities) are comprehensively taxed under the accrual rules in Subpart EH of the ITA94. Under the rules:

- (1) Persons gaining New Zealand tax residency are deemed to have acquired any financial arrangements at the market value on that date and are deemed to have disposed of those arrangements on the day they cease to be resident in New Zealand; and
- (2) Persons with financial arrangements denominated in foreign currencies are required to account for foreign exchange variations arising from those arrangements on an unrealised basis annually.³⁸

Many countries do not tax financial arrangement as comprehensively as New Zealand does. The accrual rules are likely to be of particular concern to migrants who have large deposits or owe money denominated in a foreign currency (for example, a house mortgage over offshore property).

Since under New Zealand law foreign exchange variations on financial arrangements are deemed to be New Zealand-sourced, an exemption for foreign-sourced income would not be adequate to deal with this problem. To isolate new migrants from adverse effects of the accrual rules, it will be necessary to either exempt New Zealand-sourced income arising from financial arrangements if that arrangement was a loan made to the person before they became resident, or to give an exemption from the accrual rules as a whole in respect of arrangements acquired before becoming resident in New Zealand.

Surprisingly, the Discussion Document does not make mention of existing exemptions in the accrual rules for migrants in s EH 46(1) of the ITA94. This section removes the

³⁸ Unless they are a 'cash basis person' where foreign exchange variations arising from a financial arrangement are taxed on a realised basis.

requirement for 'cash basis persons'³⁹ from undertaking a 'base price adjustment'⁴⁰ in respect of financial arrangements they held before becoming resident in New Zealand for up to four years after becoming resident in New Zealand. This existing exemption is more limited, however, than that being proposed in the Discussion Document.

C Trusts

New Zealand taxes trusts according to whether or not the settlor of the trust is a New Zealand resident.⁴¹ The trust tax regime is likely to create extra costs for persons with trusts settled while they were non-residents especially former residents returning to New Zealand. One option being considered is to include trusts within the proposed exemption.

VIII ANALYSIS

The first point to note from the Discussion Document is that the New Zealand Government has identified that the recruitment and retention of highly skilled labour is important to promote economic growth in New Zealand. New Zealand must compete for such labour in a global market and the government has finally recognised that a competitive tax regime will contribute to the country's ability to attract such talent. It is also finally a recognition, after over a decade, that certain aspects of New Zealand's international tax regime (that is, the CFC and FIF rules) are very tough, not consistent with international norms and could be harming New Zealand's wider interests.⁴²

The need to offer new migrants tax concessions may instead be a 'bandaid solution' to more fundamental problems in New Zealand's tax regime that render it uncompetitive by international standards. Apart from the very broad CFC and FIF regimes, the high average and marginal tax rates applying to individual taxpayers⁴³ are particularly unattractive to new migrants. Despite a large budget surplus, the government is opposed on political grounds to reducing individual and corporate tax rates. Reform of the CFC and FIF regimes is particularly difficult unless government is strongly of the view that changes are necessary given a well organised resistance from certain public officials to more balanced CFC and FIF rules.

Ironically, one of the benefactors of the proposed exemption may be the New Zealand Government as an employer. The New Zealand Government is a major employer in

³⁹ Defined in s EH 27 of the ITA94 as a natural person whose total value of financial arrangements on every day in a given income year is below NZ\$1.0 million.

⁴⁰ A 'mop-up' calculation required when a financial arrangement is sold, matures, disposed of or remitted as defined in s EH 47.

⁴¹ J Prebble, 'Taxation of Trusts in New Zealand and Australia: Part 1 New Zealand Trusts in International Tax Planning' (December 2001) 7 *New Zealand Journal of Taxation Law and Policy* 246–264 at 249; 'Settlors in the Minor Beneficiary Regime: Part I' (December 2002) 8 *New Zealand Journal of Taxation Law and Policy* 363–370; 'The Minor Beneficiary Regime: Part Two' (June 2003) 9 *New Zealand Journal of Taxation Law and Policy* 161–181.

⁴² This issue was raised in A M C Smith, 'New FIF and CFC Regime Introduced in New Zealand' (1993) *Intertax* 371–379.

⁴³ The top individual marginal tax rate is 39 per cent which applies above NZ\$60 000 (US\$40 000 approx).

the education and health sectors and both sectors continue to face severe shortages of skilled personnel. The ability of New Zealand to attract skilled migrants to work in these sectors will be improved if New Zealand is able to increase the after-tax incomes of new migrants working in New Zealand.⁴⁴

The proposed exemption contains risks, only some of which are identified in the Discussion Document. There is uncertainty as to how other New Zealand taxpayers may react if it is widely known that some migrants are eligible for tax concessions even though the concessions may be limited to the CFC and FIF regimes. The government has expressed concerns that if other taxpayers perceive the exemption as inequitable the exemption may undermine the voluntary compliance that underpins the whole New Zealand income tax regime.⁴⁵ Whether the proposed exemption will give rise to artificial distortions in investment decisions and labour markets is also uncertain and is likely to depend upon how many migrants are able to benefit from the proposed exemption. This problem is likely to be greater if a large number of migrants have large offshore investments while it could be minor if prospective migrants have only FIF interests, such as superannuation and life insurance policies. It is in this latter area that New Zealand's tax rules are likely to create the greatest problems for migrants, and it may, perhaps, be more important to offer an extensive exemption in this area.

One risk the New Zealand Government has identified is the risk to tax revenue if entrepreneurs and migrants with extensive capital were eligible for the proposed exemption. As the proposed exemption is designed to reduce the overall costs of hiring skilled migrants to New Zealand businesses, the exemption is to be limited to employees. While this argument is correct, it ignores the wider issue of whether other aspects of New Zealand's tax regime are also internationally competitive. Higher than necessary tax rates on capital, for example, may raise the cost of capital in New Zealand with an according reduction in investment in New Zealand. The argument about reducing taxes to reduce the cost of doing business in New Zealand (that is, hiring skilled employees) can also be applied to reducing taxes to reduce the cost of equity capital to New Zealand businesses.

One issue not considered in the Discussion Document is the effects upon trans-Tasman migration. As Australian citizens and permanent residents have full rights of residency in New Zealand, it would be easy for wealthy Australian citizens to relocate to New Zealand for the proposed exemption. As Australia has decided not to proceed with a similar exemption for new migrants,⁴⁶ there is less risk of a 'merry-go-round' of skilled labour moving between the two countries driven by tax considerations.

The proposed exemption is modest by international standards and whether it is sufficient to attract more high-skilled migrants is questionable. It is, at least, a move in the right direction. It will improve New Zealand's competitiveness vis-à-vis Australia in attracting migrants given that Australia has a higher marginal individual tax rate (48

⁴⁴ Skilled staff in the public sector also bore the brunt of the increase in the top individual marginal tax rate from 33–39 per cent in 2000 as they have been unable to be compensated by their employers for the higher tax rate.

⁴⁵ Above n 23, paras 3.9–10.

⁴⁶ Johnathan Rickman, 'Government Scraps Tax Incentive Plan for Foreign Workers' (December 2003) 32:10 *Tax Notes International* 968.

per cent) and does not offer (and is not likely to offer) similar concessions for migrants.⁴⁷ It is probably too modest to improve New Zealand's competitiveness sufficiently vis-a-vis Hong Kong, Singapore and the UK, being countries identified as competitors in the Discussion Document for skilled migrants.

The Discussion Document does not contain a comprehensive analysis of what concessions other countries offer skilled migrants (and expatriates).⁴⁸ While Finland and Belgium warranted a brief mention, the more generous concessions offered elsewhere in Europe were not. As an example, the Netherlands offer foreign experts a 5-year exemption from Dutch tax on any foreign-sourced income along with 30 per cent of income derived from Dutch employment. The 5-year period can be extended for a maximum of 10 years. Similar regimes exist in Belgium and Luxembourg. While New Zealand's proposed exemption is modest in comparison, it could be differentiated on grounds that New Zealand wants to attract skilled migrants to settle permanently. European countries, on the other hand, aim to make their countries attractive places for multinational enterprises to set up facilities, and concessional tax arrangements for inter-company transferees are necessary to meet that wider objective.⁴⁹

IX CONCLUSION

The proposed temporary exemption for new migrants to New Zealand is final recognition that aspects of New Zealand's tax regime are uncompetitive and ultimately undermining New Zealand's economic development. While the proposal is modest, the government is, at least, due credit for finally putting New Zealand's wider economic interests ahead of tax considerations. The proposals will be a useful step towards enhancing New Zealand's attractiveness as a destination for new migrants.

The proposals mask the more fundamental issue that New Zealand needs a more competitive individual and corporate tax regime. This would require a revision of the CFC and particularly the FIF rules along with revised tax scales, especially the 39 per cent individual top marginal tax rate.

⁴⁷ Ibid. Note that Australia has a tax-free threshold for the first A\$6000 of income for residents and a lower rate of GST (with some exemptions).

⁴⁸ The European concessions are usually aimed at expatriates rather than new migrants. The difference is that expatriates are usually inter-company transferees of large multinational companies who may be posted to a foreign country for a limited period of time as opposed to migrants who move to have permanent residency in a new country. In practice the difference is not that significant—both are aimed at newly resident skilled individuals.

⁴⁹ The Netherlands also offers their tax concession to 'foreign experts' being individuals with particular skills that cannot be found within the Netherlands. The objective is to strengthen the competitiveness of Dutch businesses, one very similar to the objective of New Zealand's proposed exemption.

THE GST RECURRENT COMPLIANCE COSTS/BENEFITS OF SMALL BUSINESS IN AUSTRALIA: A CASE STUDY APPROACH

JOHN GLOVER AND BINH TRAN-NAM

John Glover is an Associate Professor in the Faculty of Law at Monash University. Binh Tran-Nam is an Associate Professor, Atax, Faculty of Law, University of New South Wales.

I INTRODUCTION AND BACKGROUND OF THE STUDY

Re-election of the Howard-led Coalition Government in October 1998 with a platform including a substantial new tax was unprecedented in Australian federal history. Governments had previously failed to overcome public resistance to major indirect tax reform in 1975, 1985 and 1993.¹ Central to the government's 1998 tax reform package was a 10 per cent, broad-based consumption tax known as the 'Goods and Services Tax' (GST). GST Bills introduced by the government in December 1998 were amended and passed by the Senate in July 1999. The new tax first became effective in Australia on 1 July 2000.

Prior to the introduction of the GST, the government claimed that its relevant tax reform, described in 'A New Tax System' (ANTS), would bring substantial benefits to Australia.² The claim sharply divided the opinion of tax academics and tax practitioners. Expert witnesses giving evidence before a 1999 Senate inquiry provided equally strong support for and in opposition to the GST.

Now the GST has operated for more than three years. It is opportune to assess ANTS, inter alia, under the simplicity criterion of good tax policy. Two things should be mentioned at the outset. First, all five criteria of good tax policy (equity, efficiency, flexibility and transparency) should be applied simultaneously in the evaluation of the ANTS claims. This paper, then, should not be interpreted as a full evaluation of ANTS. Rather, it should be regarded as an attempt to contribute to a specific aspect of the ongoing assessment of ANTS. Secondly, it is known that from the outset both the government's pre-1998 promise that ANTS will 'collect revenue in a ... simpler ... way',³ and post-1998 claim that the replacement of the Wholesale Sales Tax (WST)

¹ Australian Commonwealth Taxation Review, *Full Report* (1975) Australian Government Publishing Service [AGPS], Canberra; Australia, *Reform of the Australian Tax System (Draft White Paper)* (1985) AGPS, Canberra; Liberal Party of Australia, *Fightback!* (1991, 1992) Liberal-National Parties, Canberra, and the Coalition's loss at the 1993 federal election.

² Australia, *Tax Reform – Not a New Tax a New Tax System* (1998), AGPS, Canberra 9–10.

³ *Ibid.*, 10.

and a range of state taxes by the GST will ‘reduce compliance costs for business’,⁴ were untrue and misleading. It has been argued that the GST imposes not only a substantial transitional compliance cost but also a large increase in the recurrent compliance costs. However, estimates of the GST-induced increase in recurrent compliance costs are prospective, mostly based on the New Zealand experience.⁵

The aim of this paper is to present preliminary results of a study of the recurrent costs/benefits of the GST—confined to the Australian small business sector. Small business is acknowledged to bear a disproportionate burden of tax compliance costs, giving the GST, to a degree, a regressive effect. Unlike larger businesses, small businesses are often logistically and administratively under-equipped to cope with new taxes such as the GST.

This paper evolves from an Australian Research Council (ARC) Linkage project involving: two academic institutions, Atax of UNSW and the Law Faculty of Monash University; and three industry partners, National Farmers’ Federation (NFF), Council of Small Business Organisations of Australia (COSBOA) and Taxpayers Australia (TA). The principal aim of the project is to study the impact of compliance costs/benefits of tax reform on small business, especially those in rural areas. More specifically, the project seeks to examine the simplification impact of ANTS, including the so-called Ralph reform proposals.⁶ A previous paper arising from this project reported on the transitional compliance costs of the GST.⁷

Section II of the paper discusses conceptual issues related to small business and recurrent compliance costs. Difficulties with obtaining reliable estimates are identified and analysed. The rationale and methodology of the case study approach adopted in this study are explained in Section III. Qualitative findings obtained from the case studies are summarised in Section IV. Some preliminary findings on estimates of GST recurrent compliance costs incurred by businesses included in the case study follow in Section V. Section VI makes some tentative comparisons with results obtained in previous studies. Concluding remarks are then given in the final section.

⁴ Australia, *Regulation Impact Statement for the Introduction of a Goods and Services Tax* (1998) 1.

⁵ B Tran-Nam, ‘Assessing the Revenue and Simplification Impacts of the Government’s Tax Reform’ (1999) 2:5 *Journal of Australian Taxation* 329–343; see also A Maples, ‘First Comprehensive “Remedial” Review of New Zealand’s Goods and Services Tax’ (2001) 55 *Bulletin for International Fiscal Documentation* 22.

⁶ Review of Business Taxation, *A Tax System Re-designed: More Certain, Equitable and Durable* (1999), AGPS, Canberra 743–752.

⁷ B Tran-Nam and J Glover, ‘Estimating the Transitional Compliance Costs of the GST in Australia’ (2002) 17:4 *Australian Tax Forum* 497–536.

II CONCEPTUAL ISSUES

A Small Business

Since this study is confined to small business, it seems appropriate to start with a discussion on the meaning, characteristics, identification and measurement of small business. A business is traditionally regarded as small if it has some of the following organisational or management characteristics:

- It is independently owned and operated;
- It is closely controlled by owners/managers who also contribute most, if not all of the working capital; and
- Principal decision-making functions rest with the owners/managers.⁸

Essentially qualitative characteristics such as these are inherently problematic. For practical purposes, small business is often measured in terms of business size—usually the number of employees that a business has, or the size of its turnover. The Australian Bureau of Statistics (ABS) defines small businesses in terms of employment. A non-agricultural, private sector business is small if it is either a non-manufacturing business employing less than 20 employees, or manufacturing business employing less than 100 employees. About 95.9 per cent of total non-agricultural businesses are small pursuant to this definition.⁹ However, the employment size definition is not used by the ABS for the agricultural sector. Instead, a measure called the Estimated Value of Agricultural Operations (EVAO) has been developed, to reflect the area of crops sown, the number of livestock and crops produced/livestock sales during a given year. Some 88 per cent of all private sector agricultural businesses are accordingly said to be small.¹⁰

The Ralph Review, following the Australian Taxation Office (ATO), used a definition of small business based on turnover.¹¹ Businesses with an annual turnover or receipts of less than \$1 million, exclusive of GST, are to be eligible to be taxed under the Simplified Tax System (STS) as small businesses. Over 96 per cent of businesses (representing over 1.075 million businesses in 1999–2000) are said to have an annual turnover of less than \$1 million.¹² In order to facilitate critical comparisons and analysis of the Review, this article will adopt the same turnover definition of small business as the Review. In any case, the ABS employment definition has a comparable sample range.

⁸ House of Representatives Standing Committee on Industry, Science and Technology Report, *Small Business in Australia: Challenges, Problems and Opportunities* (1990) AGPS, Canberra.

⁹ ABS, *1999 Year Book* (1999) derives the ratio $1\ 004\ 200/1\ 046\ 900 = 95.9$ per cent; cf ratio of $894\ 500/929\ 500 = 96.23$ per cent.

¹⁰ ABS, *Small Business in Australia* (1997) 8; Australian Treasury, 'Small Business and Primary Producers to Benefit from the New Business Tax System', (Press Release No 59, 27 September 1999) 1: 99 per cent of primary producers are small.

¹¹ See n 6, Recommendation 17.1 at p 575.

¹² ABS, *Small Business in Australia - Update 1999-2000* (2001) para 1.1.

It is worthwhile to note that there are other practical ways of defining small business. For example, the size of PAYE tax deductions is a possible candidate. Thus, the New Zealand's Inland Revenue Department (IRD) defines a small employer as an employer making gross annual PAYE deductions of less than NZ\$100 000.¹³ It is not difficult to see that the IRD's definition of a small employer encompasses both the number of employees and the wage levels (which tend to vary in proportion to business revenue). Gross annual PAYE deductions of less than \$100 000 is quite compatible with an annual GST-exclusive turnover of less than \$1 million. In this sense, the IRD's definition is perhaps a better way to define the size of business than either number of employees alone or turnover alone.

B *Compliance Costs*

1 *Components of Compliance Costs*

It is appropriate to begin with a universally accepted definition of tax compliance costs. According to a leading authority:¹⁴

Compliance costs are defined as those costs incurred by taxpayers, or third parties, such as businesses, in meeting the requirements laid upon them in complying with a given tax structure.

Although this definition will be further elaborated and refined in the remainder of this section, it will be employed as a useful starting point of analysis.

From the above definition, it can immediately be deduced that compliance costs to business taxpayers typically include:

- The value of time losses by taxpayers, internal staff and unpaid helpers in dealing with business tax affairs;
- The costs of external tax advisers; and
- Any non-labour costs such as specific travel relating to tax compliance activity, the cost of tax publications, stationery, postage, telephone and facsimile, the use of office and equipment such as computers for tax purposes, etc.

Sandford et al also included psychological costs in the definition of tax compliance costs.¹⁵ Psychological costs refer to the stress, anxiety and frustration experienced by taxpayers in dealing with their tax affairs. Psychological costs are extremely difficult, if not impossible, to measure and have not yet figured in empirical studies. They may be highly relevant to tax legislative change during the transitional stage but less so for recurrent compliance costs. Nevertheless, some attempts will be made in this study to assess psychological costs qualitatively.

¹³ Inland Revenue Department [IRD], New Zealand, *Glossary* (November 2003) Wellington. Available at <<http://www.ird.govt.nz/employers/resources/glossary.html>>, accessed on 1 November 2003.

¹⁴ C Sandford, M R Godwin, and P J W Hardwick, *Administrative and Compliance Costs of Taxation* (1989), Fiscal Publications, Bath at 10.

¹⁵ *Ibid*, 16–18.

2 Recurrent Compliance Costs v Transitional Compliance Costs

Sandford et al also distinguished a number of tax compliance cost categories.¹⁶ These include:

- commencement costs;
- temporary costs; and
- regular costs.

Commencement costs are typically referred to as start up costs in the Australian literature, and this practice will be maintained here. For example, a typical start-up compliance cost may be the expenses of initial training of staff to deal with a proposed tax change. A temporary compliance cost may then be the value of additional time required by staff over a period extending after a change commences in order for them to comply and familiarise themselves with new regulations.¹⁷ Regular (or recurrent) costs will correspondingly equal the value of time expended by staff to comply with tax changes with which they are now familiar.

3 Gross Business Compliance Costs v Net Business Compliance Costs

The literature recognises offsets to compliance costs.¹⁸ Under this approach, the term 'gross' business recurrent compliance costs is used to refer to the opportunity costs of resources expended by businesses in their compliance with the new tax after the transition period. The components of the gross business transitional costs are elaborated previously. The term 'net' business transitional costs then refers to the costs incurred by business taxpayers after all offsetting benefits have been taken into account. In the context of the Australian GST, these offsetting benefits include:

- Tax deductions (business compliance cost activities are tax deductible);
- Cash flow benefits (mismatch in timing of when GST is collected by business and when it is remitted to the ATO); and
- Managerial benefits: tax compliance may generate marginal benefits to business taxpayers in the form of improved business decision-making. These benefits may be brought about by the need to have stringent record keeping in order to comply with the requirements of the tax laws. Managerial benefits theoretically exist but are difficult to quantify, and are typically omitted in empirical studies. Important exceptions include Sandford et al¹⁹ and National Audit Office of the UK,²⁰ which suggest that the values of managerial benefits can be quite considerable.

¹⁶ Ibid, 13–14.

¹⁷ This period is known as the 'transitional period'.

¹⁸ Above n 14, 13–14.

¹⁹ C T Sandford, M R Godwin, P J W Hardwick and M I Butterworth, *Costs and Benefits of VAT* (1981).

²⁰ National Audit Office of the UK, *HM Customs and Excise: Cost to Business of Complying with VAT Requirements* (1981) HMSO.

4 Incremental Compliance Costs v Total Compliance Costs

The conceptual framework has so far focussed on total compliance costs. But given the nature of the study, the estimation of prevailing total compliance costs before and after the introduction of the GST may not be as important as knowledge as to whether total compliance costs have either decreased, increased, or remained unchanged in response to the GST. Thus, this paper will focus on incremental costs.

5 Practical Difficulties in Measuring Recurrent Tax Compliance Costs

Recurrent compliance costs are difficult to estimate in practice for a number of empirical reasons:

- Boundaries between recurrent and transitional compliance costs are not always well defined. It may be impossible for business taxpayers to allocate costs to the correct category with confidence.
- Economic inputs are not perfectly divisible. One item of expenditure may satisfy several business purposes. For example, a firm may purchase a new computer for stock control and invoicing as well as handling its GST requirements. How much of the costs of running this computer can be attributed to GST compliance costs? This problematic task of cost allocation is analogous to the well-known accounting-taxation overlap debate in the tax compliance cost literature.
- Many tax changes being implemented over a relatively short time period in Australia. The GST, BAS, Australian Business Number (ABN), Pay As You Go (PAYG), Simplified Tax System (STS) and other measures were all introduced either at the same time, or in quick succession. It is difficult for business taxpayers to ascribe recurrent costs to particular types of tax reform.
- Valuation of the time spent by unpaid helpers is also a problem. The problem also exists, but to a lesser extent, with self-employed persons, such as sole traders or partners.

Practical issues, of which the foregoing are only some, suggest that the study of recurrent compliance costs must be conducted carefully in order to achieve meaningful and reliable results.

III RESEARCH METHODOLOGY

A Scope of the Study

The primary purpose of this paper's study is to obtain a general picture of the recurrent costs incurred by small businesses—especially those located in the rural sector—in complying with the GST. Small business is in practice normally defined in terms of various criteria such as turnover, number of employees, physical characteristics or PAYE tax bill, as discussed above. Using turnover to define small business, it is worthwhile noting that the ATO classifies small businesses as those entities (excluding superannuation funds) with an annual total income of less than \$10 million,²¹ while the

²¹ Above at n. 8: see Australian Taxation Office, Commonwealth of Australia, *Taxation Statistics 1998–99* (2001) 46.

Review of Business Taxation regards businesses with an annual receipt of less than \$1 million, exclusive of GST, as small.²² Since the ultimate objective of this ongoing study is to evaluate the Review, this paper initially adopted the same definition of small business as that in the Review. However, it was soon discovered that for rural businesses, the \$1 million limit is almost always exceeded even though the enterprises in question employed only two or three persons. For future studies, an expansion of the definition of small business to entities with a greater annual receipt may be advisable. The periods under study include the 1999–2000, 2000–01 and 2001–02 financial years.

B Choice of Data Gathering Techniques

Basically, there are two main approaches to studies of this kind:

- large-scale mail surveys; or
- in-depth case studies.

Both of these methods have been employed in the Australian context. For example, the pioneering work on tax compliance costs in Australia by Pope et al²³ used the mail survey method, whereas the case study approach was utilised in another earlier study led by Wallschuzky.²⁴

The main disadvantages of large-scale mail surveys are that:

- they are costly to conduct; and
- the assistance of the ATO is required in order to obtain a random, representative sample of business taxpayers.

The major advantage of the large-scale survey is that the sample data, combined with other information and relevant macro-statistics from the ATO, can be used to generalise to the entire economy. This kind of approach is necessary in evaluating the economy-wide simplification impact of the tax reform. If this method is adopted, ideally, there should have been two surveys, six months before and one year after the introduction of the GST, to capture as much information about the transitional costs as possible.

The case study approach was adopted by the present authors for the following reasons:

- They have limited resources and no access to the ATO's taxpayer files;
- Concern with contemporary events are best explored by the case study method;²⁵ and
- It is more useful to study the same taxpayers over the entire life of the project.

²² Above n 6, 575.

²³ See, for example, J Pope, 'The Compliance Costs of Major Taxes in Australia' in C T Sandford (ed), *Tax Compliance Costs: Measurement and Policy* (1995) Bath at 101–25.

²⁴ I Wallschuzky I and B Gibson, 'Small Business Cost of Tax Compliance' (1993) 10 *Australian Tax Forum* 511–43.

²⁵ See R K Yin, *Case Study Research: Design and Methods* (revised ed, 1984).

The case study approach does not allow the results to be generalised to the entire economy. But it does present the likely scenarios faced by a range of businesses in different circumstances. Further, such an approach is useful in obtaining qualitative data that may identify particular areas where compliance costs imposed on business taxpayers could be reduced.

C Selection of Participants

The participants in this project were supplied by the three industry partners (above). Not surprisingly, it was initially difficult to find suitable participants to cover the wide range of characteristics considered as relevant by the research team.²⁶ Ultimately, a total of 53 business taxpayers agreed to participate in the project (26 primary producers supplied by the NFF, 14 small business participants by COSBOA and 13 by TA). However, since the participants are spread throughout Australia, the study has so far only collected data from 31 of them.

A cross-section of participants were selected from Victoria, NSW, Tasmania, Queensland, the ACT and the Northern Territory. At the time of this paper, twelve businesses had been interviewed from the farming sector and ten from non-farming industries. Farming businesses included dairy, beef, sheep and poultry farmers, graziers, a rice farmer, a citrus fruit farmer and a grape-grower. Those businesses from the non-farming sector included financial advisers, accountants, shopkeepers, a sign writer, an association manager, a furniture re-upholsterer, a bookshop owner, a pharmacist and an artist.

Since conducting the study of transitional costs, one business is now defunct, another has been sold and amalgamated as part of a larger business, and, at the time of the last interview, another farmer was preparing for the sale of his farm. At the time of this report, a little over two-thirds (twenty-two) of the respondents had been interviewed.

D Mail Questionnaire and Interviews

Relevant data was gathered from participants by means of a questionnaire, supplemented by face-to-face and telephone interviews. The questionnaire was extensively discussed within the research team, and subjected to pilot testing before being sent to participants by email and ordinary mail. The joint cost problem discussed earlier was dealt with by researchers during interviews.

The purpose of the follow-up interviews was to verify the quantitative data obtained from the questionnaire and to gather additional qualitative comments. In terms of quantitative data, the issue of joint costs was emphasised and participants were guided to focus only on the recurrent costs of tax reform. As far as qualitative comments were concerned, the emphasis was on how tax reform could be made more 'friendly' to those directly affected.

²⁶ Small business taxpayers, many of them owners or partners, were reluctant to commit their time to a multi-stage project.

IV QUALITATIVE FINDINGS

A Evaluating the Problems of Tax Reform

Nine respondents to the questionnaire reported continuing transitional difficulties with the GST. These respondents were mainly farmers. However, as members of the overall majority of respondents declared that they were sufficiently familiar with GST, the following difficulties can be classed as of a recurrent nature.

1 Lack of Time

Respondents were often unable to keep up-to-date with paperwork. GST tax reform was seen by some small business operators as something preventing them from overseeing day-to-day business affairs. Two non-farming small business proprietors remarked:

We have had a couple of major problems but we have too much work to do in the business to worry about these problems. Like most small business owners we spend too much time working on our business tax matters rather than on our business itself.

Bookshop owner, Caloundra, Qld

The general feeling is that we're just tax collectors. It's really hard at our level. We don't have time to think about what we're doing, we just do it. I think we've been taken away from what we're here for.

Shopkeeper, Yanackie, Vic.

The need to prepare and retain copies of GST compliance paperwork was regarded as onerous by small business operators who did not have easy access to administrative resources.

How do you expect a small business (couple or single) without office staff to have the facility to *do* all of this extra work when they are working in the business. Most of these people do not have a photocopier but we are expected to keep copies of everything!

Farmer, Yinnar, Victoria

Reading and understanding industry-specific GST rulings was also onerous for some respondents. A Victorian farmer observed:

I still get lots of paper from the ATO which clarify which things have GST on them and which don't. I guess I'm expected to read them all but there are too many and I don't have time to read them all. I know it's a drop in the ocean compared with what's out there. It would just be much simpler if everything had GST on it.

Farmer, Illabo, NSW

One small business proprietor said that she chose monthly GST BAS reporting because of its cash-flow advantages. Lack of time prevented her from continuing with this choice.

We changed from monthly to quarterly because of a lack of time to complete the monthly BAS. It was due 3 weeks after the end of the end of the month. There were no extensions and it was too constricting. It was just too short a time to get the paperwork completed.

Poultry farmer and small business accountant, Ellalong, NSW

Accountants as respondents recounted comparable problems experienced by their small business clients.

There's too much to explain to people and my clients just can't take it in. You're asking them to make decisions that in a lot of cases they can't reverse. For example, if you go into the STS and then opt out, you can't go back in for 5 years. That's a far-reaching decision. But people are just overwhelmed and they are unable to think through the consequences.

Accountant, Darwin, NT

2 Increased Stress Levels

A majority of the participants had been uncomfortably stressed as a result of GST tax reform. Stress levels varied from moderate to considerable. In most cases, stress levels were not offset by any personal benefit arising as a result of tax reform. Respondents also reported that stress levels varied throughout the year, increasing around the time of the BAS or when the BAS conflicted with other busy periods, for example, shearing and grain harvesting. Notably, the majority of respondents reported that their stress levels had decreased over the 2002–03 period.

Because I do all the BAS and IAS myself, the stress level is high. Before, the accountant dealt with the ATO. Now I do too—I do my best but there's always a worry that I've got something wrong!

Farmer, Glen Innes, NSW

Part of the stress is trying to convince my husband of what he needs to comply with and be careful about regarding the GST. I try to explain to my husband that if you get one thing wrong and you are audited, you're gone but he'll say 'Oh, they won't know'. 'They have computers', I say, 'linked in with our other information, like our super and worker's comp.' It's the whole 'Big Brother' thing—everything is tied up together—you only have to make one mistake and they can catch you up. I'm really nervous about being audited, my accountant tells me that he's never seen so many audits as he's seen recently.

Farmer, Barraba, NSW

The level of changes that small businesses had to do was immense. GST on its own would have been quite enough. People needed a couple of years to get over it before they brought in all the other changes.

Grape-grower, Denman, NSW

3 Higher Tax Adviser Fees

External tax advisory costs increased for almost all respondents.

Most businesses just aren't big enough to absorb all these external costs . . . generally, the benefits don't outweigh the costs. I've had four clients that have said that it is too hard and shut down. One was a doctor and he said that it just wasn't worth his effort. He's now gone to work interstate as an employee in general practice. He used to work on the outskirts of Darwin and there's no doctor there now. It was purely GST-related. So there's an impact on rural people that can get forgotten.

Accountant, Darwin, NT

Some respondents said that accountants had used the GST as a pretext for charging higher fees. 'My accountant charges like a wounded bull for any advice I ask him for,' one NSW farmer commented.

While I think that some accountant firms did a very good job of educating small businesses about the GST, I think that there are a lot out there that simply made an awful lot of money out of it and I believe that organisations like COSBOA, independent retailers organisation and other small business organisations, would have done a far better job with the money that was available. More money should have been spent on small business organisations. We're not in these groups for money or personal gain. We're in it because we consider the effects on small business. Accountants and their firms, they are in it to make money and that's exactly what they did with the GST.

Store-owner, Myaree, WA

The intention of the GST was that people would be forced to do their own bookkeeping and know more about their businesses. The reality is that the people who were already keeping records are still doing so and the 'shoe-box' people are still sending it all to the accountant. For these people there is no benefit, just an increase in costs. There may be a few farmers who weren't keeping records and have been brought in line by the GST, but I suspect these are few and far between. The VB [shoebox] farmers, on the other hand, have increased costs but their knowledge about their business is no better.

Farmer and bookkeeper, Coolup, WA

Only a single respondent recorded a surprising decrease in accountancy fees following introduction of the GST. This was said to be the result of changing from a Sydney accountant to a locally based firm.

4 ATO Alterations to the BAS Form

Changes in the BAS were of concern to nearly all respondents.

The first two [BASs] were abominations of things but we got used to them. Then the b____s changed them, we got used to that and they changed them again! The critical thing would be to find a formula and stick to it. [The ATO] was the worst organisation to design the BAS form. Many of my clients still use the original version and that's their choice.

Farmer and bookkeeper, Coolup, WA

A small minority (two respondents) suggest further changing the layout of the BAS—but back to the original version.

I think the new form that the ATO adopted is actually more confusing. It doesn't flow as easily as the older one did. The way the old BAS form was structured made it easier to find add up payments and calculate the GST. I think it would be simpler to go back to the old form.

Poultry farmer and small business accountant, Ellalong, NSW

Terminology used in the BAS was sometimes troublesome.

Keep things in English! I can't get my head around all the terms like "payee" and "payer". I have a hard enough time with "employee" and "employer." I don't use that sort of terminology in day-to-day life.

Farmer, Illabo, NSW

5 Other Commercial Decisions Based on New Tax Deadlines

It appears that non-tax entities may be basing unrealistic expectations on their customers' compliance with GST accounting requirements. Small businesses are forced to adhere to the new standards for unrelated commercial reasons. One NSW farmer, for example, said that her bank now, for the first time, expected farm finances to be finalised in July.

The expectation now is that our tax is to be up-to-date to the minute. We wanted to borrow money for a truck in May and the bank wouldn't approve it until we had provided our yearly financial statements. The upshot of this is that we now can't borrow money at the 'wrong' time of year.

Farmer, Gogeldrie, NSW

6 Other Problems

The GST, for example, unequally treats economically equivalent credit arrangements for the acquisition of farm equipment, according to whether it is leased, hire-purchased or hypothecated. Lease and hire arrangements attract proportionally more GST than outright purchase subject to a chattel mortgage.

A NSW grazier recounted problems that he had experienced in dealing with the NSW Wheat Board. Transactions for the purchase of grain from local farmers in NSW are treated as loans until the grain is on-sold to a third party. Or again, on a smaller scale, another small business person was concerned about tax invoices issued on thermal paper which fades over time. ‘Who is responsible when the ATO audit me and find only blank pieces of paper?’

Farming respondents have said that the shape of the GST could have been improved through better consultation with farmers as a ‘grassroots level’:

What the tax office should have done was get a few of the real people from the bush to go through it with them. Then they would have been able to bring about reform in a more appropriate way and earn some mileage with the farming community.

Farmer, Lismore, NSW

There was also some discussion of the perceived new role of small business as being ‘unpaid tax collectors’ for the government. One farmer, in particular, resented what he called the ‘three month loan’ that he considered he was effectively making the ATO.

I’m still very cranky about that. It affects those of us who sell food, although, amazingly, the other growers I’ve spoken to don’t seem to be too upset about it. There’s been very little public comment on it—I’m surprised that the Opposition hasn’t got stuck into it. They seem to have missed it completely.

Farmer, Lismore, NSW

B Respondent Comments on the Benefits of GST Tax Reform

1 Decreased Time Costs of Tax Compliance

Only a small number of participants reported a significant decrease (over 20 hours) in the internal time costs of tax compliance since the introduction of the GST. One of them a Victorian farmer, attributed his reduction in time costs solely to tax reform.

Record keeping requirements are easy now that we have systems that are working and the benefits have been huge . . . I use the accounts system where I transfer the payments and receipts from my GST account directly to the last page. I find this easy and straightforward—many others fill in all of the boxes and if I had to do that I would find it a real chore and far more time consuming. I gratefully acknowledge the ATO’s willingness to allow me to do this.

Farmer, Clunes, Victoria

2 Better Business Decisions

Tax reform had brought about significant managerial benefits for small business, in the view of some respondents.

My overall business is much stronger as a result of my improved knowledge—I spend more time at the computer inputting information which I then find myself inadvertently testing, analysing, making up ‘what if?’ scenarios, etc. We have recently gone through the process of applying for finance to allow our business to expand and have found the level of record keeping extremely beneficial. The fact that everything is up-to-date has made us very nimble—financiers like up-to-date cash flow statements and I can now provide them at the touch of a button. In general, I find the GST and STS combined a far more business friendly situation (given the benefits of compliance requirements) than the old system where I was one to largely leave the bookwork until a ‘rainy day’ in June.

Farmer, Clunes, Victoria

Because I have to kept the cashbook every three months (instead of once a year for four nights in January), I’m getting the benefit of the fact that all the receipts aren’t in a shoebox, they have to be on the computer. [My husband] also likes seeing in black and white how many cattle he’s sold, etc. You can see how much money has actually been made. Most of my friends are saying they’ve never been so organised.

Farmer's wife and bookkeeper, Barraba, NSW

Because of the decision I made to put in the scanning system [directly attributable] to tax reform, I am now getting so much more information.

Mini-mart owner, Margate, WA

All bar one of the respondents who acknowledged a managerial benefit in GST tax reform, were unable to quantify the benefit in dollar terms. The exception was a small business retailer who reported savings for his business in the vicinity of \$100 000. Respondents not experiencing any personal benefits pointed to benefits enjoyed by other local businesses or their clients:

I'm very aware of the fact that it [taxation reform] has helped a lot of micro-businesses. For example, a lot of hairdressers [in our area] took up or upgraded computer systems as a result of the GST. Instead of being just a booking system, it became a financial system. This has improved efficiency in a lot of the salons.

Association Management, Hobart, Tasmania

C Participant Suggestions for Reducing GST Compliance Costs

1 Extension of BAS Deadlines

Several respondents saw the need for greater flexibility in BAS deadlines.

Reconciliation of the BAS is particularly difficult towards the end of the financial year. Not only do you have the end of the financial year where you have to do stocktake and so on, but in Darwin we also have our four-week school holidays because that’s our good weather season. An extra two weeks here would be sufficient.

Accountant, Darwin, NT

Twenty-eight-day deadlines are too tight, particularly with deadlines falling during school holidays or if a clerk or bookkeeper is on leave.

Farmer, Coolup, WA

Postponement of the BAS until after all credit statements had been received was a common practice. This often resulted in tight deadlines. In the words of one small business accountant:

If we had until the fifth of the following month, it would make all the difference.

Accountant, Darwin, NT

Farmers filing BAS statements from remote areas contended with the problems of limited postal access.

Postal delivery to our region [Pinjarra, WA] is once a week and many farmers have little or no access to the Internet. Twenty-eight days is too tight a deadline.

Farmer, Coolup, WA

Farmers noted difficulties with filing BAS statements when deadlines conflicted with seasonal activities such as grain harvesting in January or shearing in April. A farmer from Clunes, Victoria suggested that taxpayers individually should be able to negotiate different quarterly arrangements with the ATO, so as to lessen compliance requirements in months of seasonal high activity.

2 Need for a Comprehensive GST Base

Almost all respondents expressed a preference for a GST without exemptions. However, there was also acknowledgment of the difficulties that a regressive consumption tax would cause disadvantaged Australians.

There would need to be compensation for people on lower-incomes and this would need to be *immediate*. But it would be the best outcome for small businesses.

Shop-owner, Myaree, WA

3 The Ability to Self-Correct Errors in BAS Statements

Taxpayer errors in the BAS were a headache for several participants. One NSW farmer took exception to the fact, as he put it, that the ATO would always contact him when he was a couple of dollars out in his BAS:

Most of the time it's just my computer rounding things up to the highest decimal. I really think they could be focussing on more important things!

Farmer, Illabo, NSW

There should be an option to correct small errors (under \$100) on the BAS form. Perhaps a box to tick to show adjustment of a previous BAS. You shouldn't need to ring the tax office for every small error.

Artist, Langwarrin, Victoria

4 Continuing the Presence of Field Officers

Two respondents advocated more individual assistance to small businesses. A larger number of ATO field officers would assist in educating small businesses about easier systems available to them, for example, the STS.

There needs to be greater face-to-face assistance for small businesses from the ATO. Perhaps a resurgence of the role of the [ATO] field officers. I think parliament overestimated the ability of small businesses to handle reforms. Not in an intellectual sense but in the amount of time small business have and their priorities.

Association Manager, Hobart, Tasmania

One NSW farmer, who remained in contact with one of the ATO field officers, commented on the benefits of ongoing advice:

I phoned her up the other day to find out about the rules and regulations with lime marketing—I wanted to ask her how best to grapple with a particular problem—and once again, she was very helpful. The ATO has gems scattered with people like this [sic] and they are worth their weight in gold.

Farmer, Lismore, NSW

Other suggestions included: freepost envelopes (Artist, Langwarrin, Victoria); more people manning the ATO Hotline, 'It takes far too long to speak to them—I'm better off ringing my accountant', (Farmer, Glen Innes, NSW); and an improved ATO website, 'It's hard to find the information you need' (Farmer, Illabo, NSW).

A final point was made by a retailer who ran a convenience store in Western Australia. He suggested the inclusion of manufacturer-inserted barcodes onto the packaging of retail items—to signal whether or not an item was subject to GST.

V QUANTITATIVE FINDINGS

A Participants' Business Profile

Twenty-two participants sent back their completed questionnaires and/or were interviewed. Their business profile is summarised in Table 1.

Table 1: Participants' business profile

Attribute	Summary Statistics			
Legal form	Sole trader: 5, Partnership: 10, Companies: 5, Trusts: 2			
Location of business	NSW: 8, VIC: 8, QLD: 1, WA: 2, TAS: 1, ACT: 1, NT: 1			
Main business activity	Primary: 12, Secondary: 2, Service: 8			
	Min	Max	Mean	Median
2000–01 Turnover (\$)	5950	1 500 000	414 425	296 000
Estimated taxable income (\$)	0	190 000	55 128	45 000
Number of owners/partners/ directors/trustees	1	2	1.68	2
Number of employees/contractors	0	20	3.50	2
Number of unpaid helpers	0	3	0.27	0

Source: Authors' own survey.

B Participants' Accounting and Taxation Profile

All 22 participants were registered for GST. Among them, 14 (64 per cent) submitted BASs only and the remaining 8 (36 per cent) submitted both BAS and Instalment Activity Statements (IASs). It is found that 20 (91 per cent) of participants submitted their BASs/IASs quarterly and 2 (9 per cent) submitted monthly.

As expected, most of the participants (20 out of 22 or 91 per cent) used a cash accounting system. As far as the use of business financial statements is concerned, more participants considered tax requirements as the most important use of financial statements than other reasons, as indicated in Table 2.

Table 2: Ranking of use of financial statements*

	1	2	3	4
Tax requirements	12	7	2	0
Managerial decision making	8	11	2	0
Use by banks, lenders, etc	3	3	17	0
Other	0	0	0	21

Source: Authors' own survey.

Notes:

* 1 is most important and 4 is least important

One participant ranked all four uses equally and was deleted from Table 2.

Table 2 appears to support the conventional wisdom that most small businesses produce financial statements mainly to satisfy their tax requirements. However, the very high ranking of managerial decision making serves to reinforce the difficulty of the accounting-tax overlap debate in tax compliance cost studies.

C Estimates of Participants' Recurrent Costs/Benefits

The case study approach described in Section 3 yields information on time spent on business tax affairs, fees paid to professional tax advisers, and computer-related costs for 2001–02 and 2002–03. In order to generate estimates of recurrent gross and net business transitional costs, some further information/assumptions are required:

- The external adviser, computer-related and other costs relating to GST compliance are deduced by multiplying the respective external adviser, computer-related and other compliance costs of all taxes by the proportion of time spent on GST over time spent on all taxes;
- Time valuation: to value time, we use the hourly wage rates obtained from the 1997 ATAX study,²⁷ adjusting for inflation. For small businesses, these rates are \$33, \$30, \$20 and \$15 for owners, managers, clerks and unpaid helpers, respectively.
- Marginal tax rate: the marginal tax rate varies depending on the legal form and taxable income of business.
- To calculate cash flow benefits, we assume average cash-flow benefit periods of 5 and 10.5 weeks for monthly and quarterly BAS submission, respectively. The interest is conveniently assumed to be 7 per cent per annum.

The data obtained from the study is combined with the information/assumptions above to generate gross and net participants' recurrent costs as a result of the GST-based tax reform. These results are summarised in Table 3.

Table 3: Estimates of participants' annual recurrent GST compliance costs

Component	Min	Max	Mean	Median
External adviser costs (\$)	0	3327	859	569
Internal wage costs (\$) ^a	0	1080	148	0
Value of time loss (\$) ^b	0	5940	1201	726
Computer-related costs	0	1006	105	0
Other costs	0	1215	167	56
Gross recurrent costs (\$)	0	7856	2481	2443
Tax deductibility benefits ^c			744	
Cash flow benefits ^c			493	
Net recurrent costs (\$)	0		1244	

Source: Authors' own survey

Notes:

^a Internal wages costs refer to wages paid to employees including managers, accountants, programmers and clerks.

^b Value of time loss refers to the opportunity costs of time spent by owners/partners/directors/trustees and unpaid helpers.

^c preliminary only.

Totals may not add up due to rounding off.

²⁷ C Evans, K Ritchie, B Tran-Nam and M Walpole, *A Report into Taxpayer Costs of Compliance* (1997) 37–40.

The recurrent costs in Table 3 (\$2481 (mean) and \$2443 (median)) are much smaller than the transitional costs found in an earlier phase of the project (\$7673 (mean) and \$4500 (median)). Nevertheless, the average gross recurrent costs of the GST are still quite high to small businesses, suggesting that these costs still include some elements of transitional costs. This is consistent with the qualitative finding that some small businesses are still having transitional difficulties with the GST. In other words, the GST system has not fully bedded down and it will take several more years to gain a more accurate measure of GST recurrent costs.

The break down of participants' mean gross recurrent costs is presented in Table 4.

Table 4: Distribution of participants' mean gross recurrent compliance costs

Component	% of total
External adviser costs	35
Internal wages	6
Value of time lost	48
Computer-related costs	4
Other costs	7
Gross recurrent compliance costs	100

Source: Table 3.

As expected, the value of time lost was the most important single category of cost, accounting for about 48 per cent of the total costs. Somewhat surprisingly, the costs of computer and other equipment represented the least important (4 per cent).

VI COMPARISONS WITH PREVIOUS STUDIES

It is important to bear in mind that, for a variety of reasons, strict comparisons between the results here with those obtained in previous studies may not be valid. An obvious reason is that the results obtained here are based on a small number of case studies and cannot be extrapolated to the entire economy.

A Australian Studies

To the best of our knowledge, apart from this study, there are no current researches in recurrent compliance costs of the GST in Australia. It is perhaps too premature to conduct a large-scale mail survey for such a study. In the absence of comparable information and in view of the government's claim about the simplicity of ANTS, it is perhaps worthwhile to compare the recurrent compliance costs of the now abolished WST and the GST. For tax policy purposes, the appropriate concept is gross compliance costs.

In a major study of the compliance costs of the Australian federal tax system by large-scale surveys, an ATAX team lead by Chris Evans estimated the gross compliance costs of the WST to be \$737 million in 1994–95.²⁸ Using an annual cost inflation rate

²⁸ Ibid, 56.

of 5 per cent, the estimate of the gross WST compliance costs would be \$1089 million in 2002–03. In its Impact Regulation Statement accompanying the ANTS Bills, the government estimated the net compliance costs of the state taxes to be abolished at about \$220 million to businesses in 2001–02.²⁹ Assuming that tax deductibility and cash flow benefits are worth half of that total, the gross recurrent compliance costs of the repealed state taxes would be about \$330 million. This is a very plausible estimate because the estimated compliance costs–revenue ratio for state taxes (to be abolished) is similar to that of the WST. Adjusting for 5 per cent annual inflation, the compliance costs of abolished state taxes would translate to about \$346 million in 2001–02. Adding the two corresponding figures together, the repeal of the WST and some state taxes would have saved the Australian economy about \$1435 million in 2002–03.

There are about 1 million separate businesses in Australia corresponding to about 2 million GST registered businesses. If we are willing to extrapolate on the basis of the average gross recurrent compliance costs in Table 3, the gross recurrent compliance costs of the GST in Australia would easily exceed \$2500 million in 2002–03. This figure is at least \$1 billion more than the corresponding compliance costs of the abolished WST and State taxes. However, it should be born in mind that the WST only involved about 75 000 large firms. So \$1.089 billion of costs in the aggregate means an average cost of about \$14 520 per WST registrant. In short, the compliance burden under ANTS is now greater than before reform but it spreads much more widely, that is, ANTS is burden-broadening.

B International Studies on GST and VAT

1 New Zealand Experience

A major and authoritative study of the compliance costs associated with business taxes including the GST in New Zealand by Sandford and Hasseldine was published in 1992. Using the mail questionnaire approach and based on a sample of 2700 respondents, Sandford and Hasseldine estimated the total, gross compliance costs of the GST to be NZ\$453 million or 7.3 per cent of GST net revenue in 1990–91. This translated to an average annual gross compliance cost of about NZ\$1290 (= \$452 957 000/351 236) in 1990–91.³⁰ Since the GST was first introduced in NZ in 1986, it seems reasonable to take this estimate as representing recurrent compliance costs only. Assuming that compliance costs grow by 5 per cent per annum, this would give rise to an average cost of NZ\$2317 in 2002–03. Using average weekly earnings (AWE) data for New Zealand and Australia, it is found that for the period 1991–98, NZ\$1 labour cost in New Zealand translated to A\$0.8842 in Australia.³¹ Based on this relative wage information, an estimate of recurrent GST compliance costs of \$2048 per firm is

²⁹ Australia, Regulation Impact Statement for the Introduction of a Goods and Services Tax, *A New Tax System Bills 1998* (Cth) 8.

³⁰ CT Sandford and J Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (1992) Institute of Policy Studies, Wellington at 62.

³¹ Statistics New Zealand, *Key Statistics*, various issues, ABS Statistics New Zealand, Wellington; and *Key Statistics and Year Book, Australia*, (1991–99), ABS Canberra. The Australian data refers to total AWE of all employees (full-time and part-time) while it is not clear whether the New Zealand data refers to total AWE of all employees or full-time employees only.

obtained for Australia in 2002–03. Considering that the estimate of recurrent compliance costs in Table 3 still contains some transitional elements, there is a broad agreement between the New Zealand study and the present study.

2 UK Experience

The Bath mail-survey study led by Sandford estimated that, in 1986–87, the compliance costs of the UK Value Added Tax (VAT) were about £791 million, accounting for 3.7 per cent of VAT collected (£21.4 billion).³² This compliance costs/revenue ratio appears to be much lower than the same ratio in Australia now. A possible reason is that VAT in 1986–87 was an ‘old’ tax in the UK, so all transitional issues had been resolved. The GST in Australia in 2002–03 was still a very young tax and many GST registered taxpayers are still on their learning curves.

3 The Canadian Experience

In 1992 Plamondon & Associate was commissioned by the Department of Finance to undertake a study of the GST compliance costs for small business in Canada. Utilising the interview approach and based on a sample of 200 participants, Plamondon & Associate derived surprisingly low estimates, ranging from Can\$219 (for business with turnover below Can\$100 000) to Can\$17 659 (for business with turnover from Can\$500 000 to \$999 000) in 1992.³³ The gross compliance costs relative to GST collected were all below 1 per cent for different business sizes. These estimates were too low and incompatible with the results obtained in other countries. This may have arisen as a result of differences in research methodology, in particular the question of how to allocate overall compliance costs to different tax types.

VII SUMMARY CONCLUSION

Australia entered the twenty-first century with a substantially reformed indirect tax system. Prior to the replacement of the WST and some state taxes by the GST on 1 July 2000, there had been a heated debate about the desirability or otherwise of the GST. The community of tax academics and tax experts was divided with strong support both for and against the GST-based tax reform. However, despite the federal government’s assurance of its concern for tax simplification,³⁴ replacement of the WST by the GST substantially raised operating costs, especially tax compliance costs, for Australian small business.

The findings of an ongoing case study sponsored by the ARC with participation from the NFF, COSBOA and TA are as follows. On average, based on 22 case studies, small business incurred gross recurrent costs of \$2481 (mean) or \$2443 (median). These are much smaller than their corresponding transitional costs of \$7673 (mean) and \$4500 (median). Subtracting tax deductibility and cash-flow benefits, the net recurrent compliance costs of the GST for small business was estimated to be \$1244 on average.

³² Above n 23, 75.

³³ Plamondon & Associates, for Department of Finance, Ottawa, *GST Compliance Costs for Small Business in Canada* (1992) 51.

³⁴ Above n 2, 131–52.

The main category of transitional costs was value of time lost, followed by external adviser costs.

In addition to monetary costs, small business taxpayers also appeared to suffer some psychological costs. Broadly speaking, it may be concluded that:

- Small business, especially the farm sector, has not fully come to grips with the GST on a day-to-day basis. Transitional issues still exist.
- Current estimates of the GST recurrent costs are on the high side but should decline over time as business becomes more familiar with it.
- The ATO should consider implementing some of the suggestions from respondents of this study in order to make the GST friendlier to small businesses in their capacity as tax collectors.

HOW SIMPLE CAN TAX LAW BE?: THE INSTRUCTIVE CASE OF HONG KONG

MICHAEL LITTLEWOOD

Michael Littlewood is a Senior Lecturer in the Faculty of Law, The University of Auckland, New Zealand.

INTRODUCTION

Hong Kong is famous for its low rates of tax. The territory's tax system also seems to be well-known for being relatively simple. What seems to be under-appreciated, however, is just how simple it is.

Hong Kong's system of income tax is provided for, still, by the *Inland Revenue Ordinance 1947* (IRO).¹ When it first became law, the Ordinance consisted of 90 sections, and occupied a total of 43 pages in the issue of the *Hong Kong Government Gazette* in which it was published. Since then it has been amended repeatedly (though far less often and far less extensively than the taxing statutes in other jurisdictions). Consequently, it is now much more complex than it was. Even so, it is still only about 200 pages all up—and it contains not only the substantive law but also the machinery for its administration: taxpayers' obligations, the Commissioner's powers, appeals procedures and so on.

It might be supposed that the successful operation of so skeletal a statute must depend upon a correspondingly comprehensive body of case law. It might be supposed, in other words, that the courts must have filled in the gaps left by the legislature. But this is not so. On the contrary, one of the most striking features of the case law which has grown up around the IRO is the number and size of the gaps in it.

The aim of this paper is to examine the law (that is, the IRO and the cases relevant to its interpretation); to examine, in particular, its simplicity; and to examine also the factors which appear to have made this simplicity possible. I explain the operation of the Ordinance as a whole, but concentrate on the taxation of business profits. More particularly still, I examine the way in which Hong Kong law distinguishes between trading profits and capital gains (crucial, because capital gains are not taxable at all) and between Hong Kong profits and offshore profits (also crucial, because offshore profits are likewise not taxable). The reasons for this emphasis are that the taxation of profits is both fiscally and politically important; the taxation of profits poses greater conceptual challenges than the taxation of other forms of income; and firms

¹ Pieces of primary legislation in colonial Hong Kong were called Ordinances, not Acts. This appears to have been the custom in British colonies not possessing responsible government. The practice has survived the return of the territory to Chinese rule in 1997.

(particularly those engaged in cross-border business) are commonly in a position to undertake more sophisticated tax planning measures than individuals. For these reasons, the complexity of most countries' tax law is very largely attributable to the difficulties posed by the taxation of profits. The simplicity of this aspect of Hong Kong's tax system is therefore especially instructive.

The paper is divided into three main parts. The first of these provides an overview of Hong Kong's tax system. Particular attention is paid to a number of important respects in which the simplicity of Hong Kong tax law is almost incomprehensible, judged by the standards prevailing elsewhere in the developed world. The second part examines more closely the taxation of profits in Hong Kong. Again, particular attention is paid to a number of important respects in which Hong Kong tax law is very much simpler than the law of other developed jurisdictions. Finally, in the third part, I seek to explain what it is that has made this extraordinary simplicity possible. I examine a number of possible explanatory factors and conclude that one, the very low rates of tax, is the most important.

I AN OVERVIEW OF HONG KONG'S TAX SYSTEM

A Hong Kong's System of Government and the 'Fiscal Firewall'

It may be useful to begin with a brief account of Hong Kong's system of government and its 'fiscal firewall'. The colonial Hong Kong government was established in accordance with the British Imperial norm in the mid-nineteenth century. The system then established survived not only the following century-and-a-half of colonial rule, but also the return to Chinese rule in 1997; consequently, it remains basically intact today. Curiously, then, the only substantially populated place in the world whose government is still based on the mid-nineteenth century British colonial model is Hong Kong—a small but bustling and economically important corner of an emerging superpower whose central government still professes to be communist.

Since 1997, Hong Kong's constitution has been contained in an instrument called the Basic Law.² The Basic Law is itself subordinate to the Chinese constitution; for this reason, it is sometimes called Hong Kong's 'mini-constitution'. Prior to that date, the colony's constitution was based on Letters Patent and Royal Instructions issued by the British government in the name of the Crown. The head of the government, called the Chief Executive (in the colonial period, the Governor) is effectively appointed by the Chinese Government in Beijing (previously the British Government in London). The incumbent, Tung Chee Hwa, has held the post since 1997. Tung is a multimillionaire shipping magnate. He was originally from Shanghai, was educated at Liverpool University in England, and is a long-term resident of Hong Kong. The members of the legislature (called the Legislative Council) are selected by an electoral process

² See generally Yash Ghai, *Hong Kong's New Constitutional Order: The Resumption of Chinese Sovereignty and the Basic Law* (2nd ed, 1999); Norman Miners, *The Government and Politics of Hong Kong* (updated 5th ed, 1998); Peter Wesley-Smith, *Constitutional and Administrative Law in Hong Kong* (2nd ed, 1994); and Anton Cooray et al, *International Encyclopaedia of Laws: Constitutional Law: Hong Kong* (2004).

especially designed to give the appearance of democracy whilst in fact effectively guaranteeing a body dominated by Beijing-friendly business interests.³

One of the more notable aspects of the Basic Law is that it provides for the complete separation of the tax systems and public finances of Hong Kong and the rest of China. This is sometimes referred to as the 'fiscal firewall'. It is established by Articles 106 and 108 of the Basic Law. Article 106 provides as follows:

The Hong Kong Special Administrative Region shall have independent finances.

The Hong Kong Special Administrative Region shall use its financial revenues exclusively for its own purposes, and they shall not be handed over to the Central People's Government.

The Central People's Government shall not levy taxes in the Hong Kong Special Administrative Region.

Article 108 provides, insofar as is relevant, as follows: 'The Hong Kong Special Administrative Region shall practise an independent taxation system.'

There would appear to be several methods by which the Central People's Government could, if it wished, circumvent the spirit of these provisions without contravening them. For example, it could impose a tax on the exportation of water from the Mainland to Hong Kong, for the territory is heavily dependent on the Mainland for water. Electricity, gas, meat, vegetables and various other goods are also imported from the Mainland in large quantities, and all of these, too, would be reasonably expeditious subjects of taxation. It seems reasonable to suppose that, in the event of serious national need (eg, war over Taiwan?), the fiscal firewall would come down; and that the Central People's Government would cease to deprive itself of the revenues it might raise in Hong Kong. To date, however, the Central People's Government's behaviour has been in this respect exemplary: it appears to have made no attempt whatever to extract revenues from Hong Kong, other than, of course, through normal commercial endeavour.⁴ Thus Hong Kong, by far the richest part of China, is the only part to make no contribution at all to the nation's public finances.

B The History and Basic Structure of Hong Kong's Tax System

Taxes on income were first introduced in Hong Kong by the *War Revenue Ordinance 1940*, as a means of financing a contribution to the British war effort. The colonial government proposed to establish an income tax of the kind it considered 'normal': that is, a single tax on the worldwide incomes of persons resident in the colony and also on income derived from the colony by persons resident elsewhere. But the government was dominated by the colonial business community, which was predictably opposed. Consequently, the system of taxation which was in fact established differed from this norm in two basic respects. First, there was no tax on income, as such, at all. Instead, there was a schedular system of three separate taxes on three different kinds of income:

³ See Ghai, above n 2.

⁴ The Basic Law contains notable Buchananite limitations on the Hong Kong government's authority to levy taxes. See Michael Littlewood, 'The Taxing and Spending Powers' in Cooray et al, above n 2.

property tax was charged on rents derived from land and buildings; salaries tax on income from employment (and on various analogous forms of income, such as directors' fees); and profits tax on the profits of business.⁵ These three taxes were not exhaustive; income of kinds not covered by them was untaxed.⁶ Second, each of these three taxes was confined to income derived from Hong Kong. Offshore income, in other words, was exempt from tax (whether taxed elsewhere or not). This system was revived after the war by the IRO, which remains in force today.⁷

The IRO also added to the system a mechanism called 'personal assessment'. This is essentially a 'normal' income tax—but a voluntary one, to which taxpayers can choose to submit themselves, if they wish, instead of paying the separate taxes on the several components of their incomes. Thus, the IRO gives each taxpayer a choice: she can pay the schedular taxes (property tax, salaries tax and profits tax) on the several components of her income; or she can elect to have them combined, and pay tax on the total.⁸

C The Statute and the Cases

Judged by the standards of other developed jurisdictions, the case law that has grown up around Hong Kong's IRO is disconcertingly incomplete. To provide a comprehensive account of the gaps would be tedious, but some examples might serve to give an idea of their nature and scale.

One illuminating instance is the tax treatment of dividends. The IRO provides that no tax is payable on dividends paid out of profits which have borne tax.⁹ The implication, one might think, is that dividends paid out of *untaxed* profits might be taxable (in some circumstances, at least). Curiously, though, Hong Kong's Inland Revenue Department seems never even to have asserted that this might be so. At least, the law reports contain not a single case in which the department has sought to tax a dividend.¹⁰

⁵ Profits tax was (and is) charged on the profits of both incorporated and unincorporated firms. This is explained further below.

⁶ For example, interest was in some circumstances chargeable to profits tax, and in others not taxable at all. This remains the case today (though the circumstances in which interest is chargeable to profits tax are more extensive than in 1940).

⁷ In 1941, a fourth tax, interest tax, was added to the original three. It remained in force until 1989, when it was abolished. In some circumstances interest is chargeable to profits tax (in particular, when produced by the carrying on of a trade or business); in others it is simply exempt (for example, interest on bank deposits held by individuals). For a brief history of Hong Kong's tax system, see Michael Littlewood, 'Taxation without Representation: The History of Hong Kong's Troublingly Successful Tax System (2002) *British Tax Review* 212.

⁸ A person electing personal assessment is taxed on the same income as would otherwise be chargeable to the schedular taxes (property tax, salaries tax and profits tax). That is, income which escapes the schedular taxes escapes personal assessment also. The difference between personal assessment and the schedular taxes lies not in what income is taxable, but in the method by which liability is calculated. Since personal assessment is elective, it can only decrease a person's liability to tax, not increase it. See below n 40.

⁹ Inland Revenue Ordinance 1947 [IRO] s 26.

¹⁰ Since dividends are invariably not taxable, there is no need of either (1) a definition of 'dividend' or (2) rules providing for the tax treatment of distributions other than dividends.

Taxpayers, too, have been curiously unassertive. Like the department, they have chosen not to take points which (by the standards prevailing elsewhere in the developed world) seem clearly to be worth arguing. For example, the department maintains that neither an employee nor a self-employed person can deduct the cost of clothing.¹¹ In the case of employees, the department's position seems sound (though still debatable).¹² In the case of self-employed persons, however, the authority for the department's position is dubious in the extreme;¹³ yet no-one appears ever to have challenged it.

Thus, the prevailing interpretation of the IRO rests heavily on a kind of consensus, shared by taxpayers and the department and supported by only the sketchiest authority, or none at all. To some extent, this is no doubt true of all tax systems (and, indeed, law generally): some points, whilst arguable, are not worth taking. The point, however, is that the threshold at which an arguable point of tax law becomes one worth arguing seems to be very much higher in Hong Kong than elsewhere.

¹¹ The department accepts that the cost of clothing is deductible if the clothing is of a sort that would not ordinarily be worn other than for the purpose of producing income. Examples include uniforms and costumes. But, the department's position seems to be that clothing that might be worn for purposes other than producing income is not deductible (even if in fact worn exclusively in the course of producing income). The cost of clothing purchased by an employer for an employee, however, would seem to be deductible by the employer and not taxable to the employee, so long as provided to the employee on terms not permitting the benefit to be converted into cash.

¹² Section 12 of the IRO provides that employees can deduct expenditure only if it is 'wholly, exclusively and necessarily' incurred in the production of taxable income. A similarly-worded provision was held by the House of Lords in *Mallalieu v Drummond* (1983) 2 AC 861 not to permit the deduction of expenditure incurred on clothing (conservatively-colored suits, and accoutrements) used by a barrister only when appearing in court. Decisions of the House of Lords are still regarded as highly persuasive in Hong Kong, but they are not binding.

¹³ Section 16 of the IRO provides that a self-employed person can deduct expenditure 'to the extent that' it is incurred in the production of taxable profits. The department's view that this does not permit the deduction of expenditure on clothing seems, again, to be based on *Mallalieu v Drummond* (1983) STC 665 (above n 12). But the theory that *Drummond's Case* is relevant to the interpretation of s 16 seems highly speculative, given the difference in the statutory wording, and in any event is entirely unsupported by authority.

D Property Tax

Property tax is imposed on rental income derived from land and buildings.¹⁴ It is charged at the flat 'standard rate', currently 16 per cent.¹⁵ There are no allowances. Consequently, the flat 16 per cent applies from the first dollar. The tax is imposed on gross rents, less 20 per cent.¹⁶ There is no provision for the deduction of landlords' actual expenditure, which is therefore irrelevant. Thus, the statute effectively assumes that landlords invariably incur deductible expenditure equal to exactly 20 per cent of their rental receipts.¹⁷ Like the other taxes imposed by the IRO, property tax is based on the 'source principle'. It is imposed only on income derived from property 'situate in Hong Kong'.¹⁸ Income derived from offshore property, in other words, is exempt from tax (whether or not taxed in the jurisdiction in which the property is situated). Also, property tax is imposed only on landlords who are natural persons. Corporate landlords are taxed on their rental income, but they pay profits tax, not property tax.¹⁹ Property tax is provided for by Part II of the IRO. Part II is simple in the extreme: it consists of four sections of about half a page each. There is virtually no case law, because there has been virtually no litigation.

¹⁴ IRO s 5 and 5B. For a comprehensive analysis of Hong Kong tax law, see Peter Willoughby and Andrew Halkyard, *Encyclopaedia of Hong Kong Taxation*, Butterworths, Hong Kong, loose leaf, which is the leading work on its subject. Virtually all privately held land in Hong Kong is leasehold. That is, it is held on lease from the government. (The only fee simple is the site on which stands the Anglican Cathedral, St Johns.) Consequently, when people speak of 'land' in Hong Kong, they are generally speaking of leases. This results in some difficulties in terminology. In particular, there is no real property or real estate in the territory (apart from St Johns). The word 'land' is also problematic, since what is in fact meant is generally buildings or parts of buildings.

¹⁵ IRO s 5 and Schedule 1.

¹⁶ IRO s 5.

¹⁷ This is obviously a very rough and ready approach to the taxation of rental income. It seems unlikely that such approximate equity would be tolerable at significantly higher rates of tax. Even at the relatively low rates at which tax is imposed in Hong Kong, the statutory 20 per cent deduction is presumably a significant cause of the notorious parsimony of Hong Kong's landlords (for they get the 20 per cent deduction even if they spend less than that or nothing at all on maintaining their properties). It is worth noting also, however, that the system is simple not only from the landlord's point of view, but from the revenue's, too: since landlords' expenditure is irrelevant, the only item on their tax returns requiring verification is the amount of rent. Once interest is included, landlords' expenditure (in Hong Kong, as elsewhere) very commonly exceeds 20 per cent of rents received. In fact it commonly exceeds 100 per cent of rents. The absence of any provision allowing for the deduction of landlords' actual expenditure can therefore be very harsh. Relief is commonly available, however, in the form of personal assessment. See below.

¹⁸ IRO s 5.

¹⁹ IRO s 2 ('business' defined to include the letting of 'premises' by a corporation), 5 and 25. Profits tax, unlike property tax, makes provision for the deduction of expenditure: IRO s 16. Thus, a corporate landlord can deduct its expenditure (to the extent that it is incurred in producing rents or other assessable profits and is of a revenue nature); and an unincorporated landlord can deduct 20 per cent of her rents, even if she in fact spends nothing. There is consequently very considerable scope for very simple tax planning. That this kind of thing is tolerable seems, again, to be a function of Hong Kong's unusually low rates of tax. It is perhaps worth adding that the rules providing for the deductibility of expenditure for profits tax are almost entirely free of the kinds of restriction which are to be found in other developed jurisdictions. See Willoughby and Halkyard, above n 14.

E *Salaries Tax*

Salaries tax is provided for by Part III of the IRO, which consists of 12 sections, averaging a little under a page each. Salaries tax, then, is somewhat more complex than property tax, but still extraordinarily simple, judged by the standards of the rest of the developed world.

The tax is charged on income from employment, and also on analogous forms of income such as directors' fees.²⁰ There is a system of allowances which effectively exempt from tax the first part of the taxpayer's income.²¹ The rest is taxed at progressive rates, currently 2 per cent, 8 per cent, 14 per cent, and 20 per cent.²² There is also, however, a provision limiting liability to the amount produced by applying the flat standard rate (16 per cent) to the whole of the relevant income, without the benefit of any allowances.²³ There are thus two separate methods of calculating a person's liability to salaries tax. The first is to subtract the allowances to which the individual's circumstances entitle her; and to apply the progressive rates (2 per cent, 8 per cent, 14 per cent and 20 per cent) to the remainder. The second is to apply the flat standard rate to the whole of the assessable income, from the first dollar. The taxpayer gets the benefit of whichever calculation produces the lesser liability. The consequence of this is that incomes *beneath* a certain point (known colloquially as the 'standard rate threshold') are taxed at the progressive rates (because these produce a lower liability than would the flat standard rate); and incomes *above* that point are taxed at the flat standard rate (because, for incomes above the standard rate threshold, the progressive rates, culminating in a maximum of 20 per cent, produce a larger liability than the flat 16 per cent).

Judged by the standards of the rest of the world, the allowances are exceedingly generous: they are so high as to effectively exempt about two thirds of the workforce from tax altogether.²⁴ (Salaries tax is thus aptly named: mere wages are not taxable in Hong Kong.) Moreover, very few taxpayers' incomes exceed the standard rate threshold. Of those who pay tax, therefore, the overwhelming majority are taxed at the progressive rates rather than the flat standard rate; their total liability, in other words, is less than 16 per cent.²⁵

²⁰ IRO s 8(1).

²¹ IRO s 27 to 33.

²² IRO s 13 and 43 and Schedule 2. The first part of the taxpayer's income is effectively exempted by the allowances to which her circumstances entitle her; the next HK\$30 000 is taxable at 2 per cent; the next HK\$30 000 at 8 per cent; the next HK\$30 000 at 14 per cent; and the remainder at 20 per cent.

²³ IRO s 13.

²⁴ For example, a married couple with two children and an ordinary level of expenditure on home-mortgage interest is taxable only on income over

HK\$360 001 (about US\$46 000) per year: Antony Leung (Hong Kong Financial Secretary), 2003/2004 *Budget Speech*, Supplement, Salaries Tax.

²⁵ The standard rate threshold depends on the allowances to which the taxpayer's circumstances entitle her. It therefore varies from taxpayer to taxpayer, depending on marital status, number of children and other dependents, etc. The standard rate threshold for a single person with no dependants is currently HK\$770 000 (about US\$99 000). For a typical Hong Kong household (which, according to the Hong

Salaries tax has given rise to more litigation than property tax. For example, there have been disputes over the distinction between employees (who are liable for salaries tax) and independent contractors (who are liable for profits tax).²⁶ The distinction is significant, because the rules for deductibility for profits tax are far more generous.²⁷ For instance, an independent contractor can deduct entertainment; an employee generally cannot. For present purposes, however, the most notable aspect of this feature of Hong Kong's tax system is not the disputes, but that liability can vary very considerably depending on whether a person is an employee or a contractor. Elsewhere in the world, the legislature has typically resorted to considerable complexity of legislation to eliminate or at least ameliorate such inequities; in Hong Kong it has not.²⁸

Also notable is the tax treatment of persons deriving income from employment from outside Hong Kong. Salaries tax (like property tax and profits tax) is confined to income derived from Hong Kong.²⁹ Offshore income, in other words, is simply not taxable. The IRO contains a number of rules for distinguishing between employment income derived from Hong Kong (which is taxable) and employment income derived from outside Hong Kong (which is not).³⁰ These rules are more important in Hong Kong than similar rules in other jurisdictions, not only because offshore income is simply exempt from tax, but also because it is very common for Hong Kong residents to work both in Hong Kong and elsewhere.³¹ The Board of Review³² has interpreted these in such a way as to favour non-residents;³³ and the Inland Revenue Department administers the IRO in accordance with this interpretation. The practical effect of this seems to be that Hong Kong's tax system favours expatriates and discriminates against Hong Kong Chinese. Any taxpayer aggrieved by this practice would be entitled to appeal—but none has. This curious state of affairs might once have been dismissed as a

Kong government, consists of a married couple plus two children plus two other dependents) it is HK\$1 870 000 (about US\$240 000): Leung, above n 24.

²⁶ See for example Hong Kong Inland Revenue Board of Review Decision no *D 103/96*. (The Board of Review is the tribunal charged with determining disputes between taxpayers and the Inland Revenue Department. Its establishment, membership and procedures are among the matters provided for by the IRO.)

²⁷ Above n 12 and 13.

²⁸ There is a provision, however, aimed at the use of companies to turn a person who would otherwise be an employee into an independent contractor. See IRO s 9A.

²⁹ IRO s 8.

³⁰ IRO s 8.

³¹ There are two main reasons for this. First, many American and European firms maintain their regional Asian headquarters in Hong Kong, and require extensive regional travel of their employees. Secondly, many Hong Kong firms (and Hong Kong subsidiaries of foreign firms) conduct various operations (notably manufacturing) in the Mainland of China, and require their employees to spend substantial periods in the Mainland.

³² Above n 26.

³³ The IRO provides that income derived from services rendered during 'visits' to the territory of less than 60 days is exempt: s 8. The Board of Review (see above n 26) has interpreted this on the basis that a person can 'visit' Hong Kong only if she is not resident there; and, therefore, that residents cannot benefit from this rule. See *D 11/84*. In *D 54/97*, the Board expressed doubt as to this interpretation, but did not rule on the point. The legislature has shown no inclination to intervene.

distasteful relic of colonialism, but seven years after the resumption of Chinese rule this explanation is unconvincing. Rather, it seems that no-one adversely affected has yet found it worthwhile to challenge the Board's very dubious interpretation in the courts. Once more, the unusually low rates of tax are presumably a significant factor in this calculation.

Another important feature of Hong Kong's system of taxing income from employment is that there is no PAYE. That is, employers are not required to deduct at source the tax on the salaries they pay their employees. Instead, persons who are liable for salaries tax are simply required to discharge their liabilities themselves. Generally they are required to pay twice per year; and generally they meet this obligation either by mailing the department a cheque, or by presenting themselves at the department's offices with a pile of banknotes. (The department operates cashiers' booths for the purpose of accepting these payments.)

This aspect of Hong Kong's tax system is especially instructive, because if other developed jurisdictions were to emulate it (that is, if they were to scrap their PAYE systems and require persons in employment to pay their own tax), it seems inevitable that many taxpayers would be unable or unwilling to pay. It seems reasonable to suppose also that the number of defaults would escalate to the point of producing significant losses in revenue. Law-abiding taxpayers would grow resentful of those not paying; and resentful also of the system itself. In short, the result would be chaos. Yet Hong Kong's tax system operates well enough without PAYE. The reasons are that the rates of tax are very low; and the allowances are generous enough to exempt most of the workforce from tax altogether. Also, most of those obliged to pay tax own assets and so are worth suing if they default.

F Profits Tax (an Overview)

Profits tax is of course a tax on profits. It is imposed on both incorporated and unincorporated firms. Profits tax is provided for by Parts IV and VI of the IRO, which consist of about 70 sections in total, averaging a page or so each. Profits tax is thus considerably more complicated than property tax or salaries tax, but still much simpler than the taxes on profits to be found elsewhere in the developed world.

Unincorporated firms (that is, mainly sole proprietorships and partnerships) are charged at the flat standard rate (16 per cent).³⁴ There are no allowances. Consequently, tax is payable at 16 per cent from the first dollar, irrespective of the amount of profits; and irrespective of the personal circumstances of the firm's proprietor or proprietors.³⁵ In the case of a sole proprietor, he or she is of course liable for the whole of the tax. In the case of a partnership, the partners are liable for the tax in the same shares as they are entitled to the profits. No further tax is imposed on distributions.

³⁴ IRO s 14(1).

³⁵ The proprietors of unincorporated firms can commonly reduce their liability by electing personal assessment. See below n 40.

In the case of corporations, profits tax is charged at 17.5 per cent.³⁶ No further tax is imposed on dividends. In other words, dividends are treated as distributions out of a taxed fund, and accordingly exempt. Notably, though, dividends are exempt from tax even if the profits out of which they are paid have not been taxed.³⁷ As with unincorporated firms, the profits tax on corporations is a final liability. It is not subject to adjustment, either upwards or downwards, in light of shareholders' total incomes or other circumstances. Nor is there any system of imputation (or integration): since dividends are simply exempt from tax, there is obviously neither any need nor any room for imputation. One of the more obvious advantages of very low rates of tax is thus that it makes feasible the extremely simple treatment of corporate profits. To put it another way, Hong Kong's tax system appears to demonstrate that the so-called 'problem' of taxing corporate profits is entirely a function of relatively high rates of tax.³⁸

G Personal Assessment

In various common circumstances, Hong Kong's schedular taxes (property tax, salaries tax and profits tax) are inequitable. Relief from some of the grosser inequities is available in the form of 'personal assessment'. This, as I have indicated,³⁹ is like a normal income tax, except that it is optional. Thus, instead of paying the schedular taxes on the separate components of her income (broadly rents, salary and profits), a taxpayer can elect personal assessment, and pay tax on the total. Personal assessment tax is charged at the same rates as salaries tax.⁴⁰ That is, there are two ways of calculating it. The first is to take into account whichever of the allowances the taxpayer's personal circumstances entitle her to; and to apply the progressive rates (2 per cent, 8 per cent, 14 per cent and 20 per cent) to the rest. The other is to apply the flat standard rate (16 per cent) to the taxpayer's total

³⁶ IRO s 14(2) and Schedule 8. A closely held company can generally reduce its liability to tax by employing its shareholders (or their family members). In all normal circumstances, the salaries will be deductible by the company and taxable to the employees, if at all, at a lower rate (and usually a much lower rate) than 17.5 per cent. See above n 20. In other developed jurisdictions, there are typically complex rules designed to restrict this sort of tax minimization. In Hong Kong there are none, other than the basic requirement that a salary is deductible only if incurred in the production of assessable profits; and this is liberally interpreted. See Willoughby and Halkyard, above n 14.

³⁷ See above n 9. There are various common circumstances in which tax might not have been paid on the profit out of which a dividend is paid. For example, the profit might have been derived from outside Hong Kong; or it might be a capital gain. If the department were to assess dividends to tax in such circumstances, it would face issues such as whether a dividend paid out of an offshore profit is derived from the same place from which the profit was derived, or from the place where the company is resident, etc. The point remains that the department has in effect conceded all such arguments.

³⁸ Most developed jurisdictions tax corporate profits at a rate which is lower than the highest rate applicable to personal income. Consequently, they have little choice but to tax dividends—for, if they did not, they would (1) lose very substantial revenues (the difference between the corporate rate and the personal rates on distributed corporate profits); (2) create a substantial inequity (in that corporate income would be taxed less heavily than income of other kinds); and (3) open up an attractive possibility for abuse (in that channelling income through a corporation would reduce the tax on it by the difference between the corporate rate of tax and the highest personal rate).

³⁹ See above n 8.

⁴⁰ IRO s 40B to 43. See also above n 20.

taxable income, without allowances. Liability is determined by whichever of these methods produces the lower figure.

Personal assessment alleviates the inequity of the schedular taxes in the following common circumstances. First, it is only by electing personal assessment that an individual taxpayer can set off a business loss against rental income or income from employment. The reason for this is simply that the schedular taxes make no provision for such set-offs. Second, most landlords and self-employed people gain by electing personal assessment. The reason is that property tax (payable by landlords) and profits tax (payable by self-employed people) are charged at the flat standard rate (16 per cent), without the benefit of any allowances, whereas personal assessment (like salaries tax) provides for generous allowances and is charged at progressive rates (if these result in a lesser liability than would the flat standard rate). Thus, personal assessment generally produces a lesser liability for individuals whose total taxable income is less than the standard rate threshold.⁴¹ Most landlords and self-employed people have incomes below the standard rate threshold; of these, almost all gain by electing personal assessment.⁴² Third, property tax makes no provision for the deduction of mortgage interest by landlords, whereas personal assessment does.⁴³ Landlords commonly make the election for this reason.

H The Unnecessary Complexity of Hong Kong Tax Law

My aim in this paper is to examine the simplicity of Hong Kong tax law. But it is apposite to note also the possibility that it is in fact considerably more complex than it needs to be. The reason is that, as I have explained, there is in Hong Kong no tax on income as such at all but, rather, a schedular system of three separate taxes (property tax, salaries tax and profits tax), plus personal assessment. If, instead of this schedular system, there were a single tax on income as such, the legislation could be simplified considerably. It would likewise seem possible to eliminate various other causes of complexity. For example, the IRO provides for very generous allowances for capital expenditure. In particular, capital expenditure on plant and machinery qualifies for an 'initial allowance' (meaning an immediate write-off) of 60 per cent.⁴⁴ Unsurprisingly, even the Hong Kong Government has found it necessary to add to the legislation rules to restrain the abuse of this provision; and, of course, such rules are necessarily complex. Compared to other jurisdictions' tax systems, then, Hong Kong's is very simple; but it could be simpler still.

⁴¹ Above n 23.

⁴² There are circumstances in which a person whose income is below the standard rate threshold would not gain by electing personal assessment. But such cases are unusual.

⁴³ IRO proviso to s 42(1).

⁴⁴ IRO s 37A.

II PROFITS TAX EXAMINED MORE CLOSELY

A The Charging Provision: Section 14(1)

The legislation providing for profits tax is extremely simple. The charging provision, s 14(1), is worded as follows:

Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate⁴⁵ on every person carrying on a *trade, profession or business* in Hong Kong in respect of his assessable profits *arising in or derived from Hong Kong* for that year from such trade, profession or business (excluding profits arising from the sale of capital assets)⁴⁶ as ascertained in accordance with this Part.⁴⁷

This wording imposes profits tax only where two basic conditions are satisfied. First, there must be a person (which, as will be seen, is defined to include a corporation)⁴⁸ carrying on a 'trade, profession or business'. Second, there must be profits 'arising in or derived from Hong Kong'.⁴⁹ These formulae are thus of fundamental importance. As will be seen, they give rise to some difficult issues. But, as will also be seen, Hong Kong's courts have developed interpretations which, whilst sometimes controversial, have been entirely workable. Moreover, the government has been content to rely on the judicial interpretation of s 14(1); it has not attempted to resolve the difficulties by adding to the legislation or otherwise amending it.

Section 14(1), as recited here,⁵⁰ is in some respects similar to charging provisions contained in the taxing statutes of other jurisdictions, such as Australia and New Zealand. The Hong Kong provision most strongly resembles those used in other British colonies, dominions and other territories in the early and middle years of the twentieth century. More recently, other jurisdictions have revised their wording (not always for the better); but even today the wording of s 14(1) has a very familiar ring to it.

It is necessary to emphasise, however, that in other jurisdictions (such as, again, Australia and New Zealand), basic charging provisions of this sort have commonly,

⁴⁵ The 'standard rate' is currently 16 per cent. See above n 15.

⁴⁶ It might, incidentally, be argued that the words in parentheses imply that capital receipts other than those arising from the sale of capital assets are taxable; but the Inland Revenue Department has never suggested that this might be so. This is another example of the department's unassertive approach to the administration of Hong Kong's tax system. It demonstrates also that imprecision in drafting of a kind that would be problematic in other jurisdictions (where taxes are higher) is satisfactory in Hong Kong.

⁴⁷ IRO s 14(1), emphasis added.

⁴⁸ See below n 53.

⁴⁹ The wording of s 14(1) (see above n 47) requires also, (1) that the person carrying on the trade, profession or business is doing so 'in Hong Kong'; and (2) that the profits are '*from* such trade, profession or business' (emphasis added). Disputes as to whether a firm is carrying on a trade or business are common; but if a firm is carrying on a trade or business at all, it is usually clear whether it is doing so in Hong Kong. Moreover, this issue is significant only if there are profits 'arising in or derived from Hong Kong' (because otherwise there is no liability in any event). The second requirement (that profits are taxable under s 14(1) only if they are 'from' the taxpayer's business) is examined below at n 59.

⁵⁰ Above n 47.

since the early twentieth century, been supported by a complex of ancillary provisions whose function is to bring within the scope of the charging provision (and so render taxable) income which would or might otherwise escape. For example, it is common to find provisions deeming various species of income to be derived from within the taxing jurisdiction—and therefore within the scope of the basic charging provision—and therefore taxable. Hong Kong has some such rules but, as will be seen, they are few in number and rudimentary in the extreme.⁵¹ Equally, in other developed jurisdictions, much of the complexity of the tax legislation is due to the need to provide expressly and in detail for the problems posed by the taxation of corporations. In Hong Kong, again, there are some such rules, but, again, they are rudimentary in the extreme. Consequently, to an extent unparalleled in other developed jurisdictions, the law of Hong Kong really is as simple as the wording of the charging provision—s 14(1)—suggests.

Leaving it to the courts to define the scope of the tax on profits has required of the Hong Kong government a ‘let the chips fall where they may’ approach to the consequences. One of the consequences—perhaps the most important consequence—is of course the amount of money produced by the tax. Given that profits tax is the Hong Kong Government’s largest single source of revenue, the government’s restraint and trust in the judiciary is remarkable. It is very difficult to imagine the government of, say, Australia, entrusting its revenues to the Australian courts to anything like the same degree. And yet, as will be seen, the Hong Kong Government’s trust in the territory’s courts seems to have been well-founded. Of course the government has not agreed with every decision.⁵² And some decisions have provoked extreme dissatisfaction on the part of Hong Kong’s taxpayers and their advisers. The decisions of Hong Kong’s courts are, of course, open to the same kinds of criticism as are levelled against the decisions of the courts in common law jurisdictions generally. But, at the end of the day, Hong Kong’s courts have interpreted s 14(1) in such a way that it works.

B Corporations

The law relating to the taxation of corporate profits in Hong Kong is extraordinarily simple. Section 2 of the IRO defines ‘person’ as including ‘corporation’. Section 14(1), which imposes profits tax on ‘every person carrying on a trade’ etc,⁵³ thus imposes the tax on both incorporated and unincorporated firms. Section 14(2) provides that, in the case of a corporation, profits tax is imposed not at the ‘standard rate’ (that is, currently, 16 per cent),⁵⁴ but at the rate specified in Schedule 8. The rate specified in Schedule 8 is currently 17.5 per cent. Thus, profits tax is imposed on both incorporated and unincorporated firms; but corporations pay at 17.5 per cent and unincorporated firms pay at 16 per cent. The excess is colloquially referred to as the ‘corporate surcharge’. It

⁵¹ Below n 64.

⁵² If the courts *had* agreed with the Commissioner in every case, that might indicate a problem—departure from the rule of law—even more serious than an unexpected shortfall in revenue.

⁵³ Above n 47.

⁵⁴ Above n 15 and 47.

has varied from time to time, but has always been slightly (1–2.5 percentage points) above the standard rate.⁵⁵

And that is all. Other developed jurisdictions' tax statutes generally contain a complex array of rules dealing with the various problems posed by the taxation of corporations. For example, there are rules dealing with dividends; the integration of corporate and shareholder liability to tax; losses; groups; amalgamations; and so on. The Hong Kong Ordinance has virtually nothing of this kind. Dividends, as I have explained, are simply not taxable.⁵⁶ Problems such as determining the consequences of, say, a transaction designed to allow a profit-making company to use a loss suffered by an affiliated company are simply left to be resolved by the Commissioner and the taxpayers concerned on the basis of general rules.⁵⁷ The taxpayer, if dissatisfied with the Commissioner's solution, can of course appeal; but such appeals are uncommon.⁵⁸

C Passive Income: Section 15

The wording of s 14(1) (see above at note 47) is such as to impose tax only in the case of taxpayers 'carrying on a business';⁵⁹ and only on profits 'from' such business. Consequently s 14(1) generally does not cover 'passive' income such as, in particular, interest, royalties and sums received for the use of movable property.⁶⁰

For example, if a person (incorporated or unincorporated) receives interest as a result of carrying on a business (such as a business of money-lending or selling goods on credit), then the interest is taxable under s 14(1). But the mere making of a loan and the receipt

⁵⁵ The corporate surcharge was introduced in 1975 by means of an amendment to s 14 itself. Various subsequent changes to the corporate surcharge were likewise brought into effect by amendment to s 14. Eventually, in 1992, the corporate rate of tax, like the personal rates, was shifted to a schedule at the end of the IRO (Schedule 8), so as not to clutter the charging provisions with the amendments resulting from occasional tinkering with the rates of tax.

⁵⁶ Above n 9.

⁵⁷ That is, mainly, the basic charging provision (s 14(1); see above n 47) and the basic provisions dealing with the deductibility of expenditure (s 16 and 17).

⁵⁸ For further examples of provisions typically regarded as basic and obvious necessities in other jurisdictions, but simply missing in Hong Kong, see below at n 112. The IRO's treatment of trusts is even simpler than its treatment of companies. Indeed the taxation of trusts is not specifically provided for at all (other than that s 2 defines 'person' as including 'trustee'); rather, it is left to taxpayers and the Commissioner, supervised by the courts if necessary, to apply general rules (in particular, the rules relating to profits tax in the case of trading trusts and the rules relating to property tax in the case of property-holding trusts) to income derived by trusts.

⁵⁹ To be precise, s 14(1) imposes tax also in the case of taxpayers carrying on a trade or profession. See above n 47. But for the sake of simplicity I here use the word 'business' to cover trades and professions also.

⁶⁰ Other species of passive income include rents derived from land and dividends. But, as is explained above, rents derived from land are chargeable to property tax (in the case of unincorporated landlords) or profits tax (in the case of incorporated landlords); and the Hong Kong Government apparently does not wish to tax dividends.

of interest typically does not constitute the carrying on of a business.⁶¹ Thus, if a person (or a corporation) not carrying on business at all lends money and receives interest, the interest is generally not taxable under s 14(1). Moreover, even if a person (or corporation) *is* carrying on a business, any interest received by that person (or corporation) is taxable under s 14(1) only if the interest is ‘from’ the business. For example, if a company carrying on a trading business holds surplus funds and lends these at interest, such interest is not ‘from’ the business but merely incidental to it—and therefore not taxable under s 14(1).

Similarly, if a royalty is derived from the taxpayer’s business, it is taxable under s 14(1).⁶² This might be so, for example, in the case of a firm carrying on a business of developing and licensing intellectual property. But the mere licensing of intellectual property and the receipt of royalties typically does not constitute the carrying on of a business. Consequently, such royalties are not taxable under s 14(1). Equally with sums received for the use of movable property (such as plant or machinery). If such a sum is derived from the taxpayer’s business, it is taxable.⁶³ For example, the profits of a company carrying on a business of renting out cars are taxable under s 14(1). But the mere letting of movable property and the receipt of money for its use typically does not constitute the carrying on of a business. Such receipts are therefore not taxable under s 14(1). For example, if the owner of manufacturing plant leases it to a manufacturer, sums received under the lease are not taxable under s 14(1).

Thus interest, royalties and sums received for the use of movable property are generally not taxable under s 14(1). These gaps were obviously substantial. Moreover, they were open to very easy abuse. For example, a closely-held manufacturing company could assign its plant to the shareholders; who could lease it back to the company. Payments made under the lease would be deductible by the company and tax-free to the shareholders. Similarly, a sale and lease back of intellectual property could produce deductible but tax-free royalties. Likewise, financing a business by means of debt could produce deductible but tax-free interest payments.

Lacunae on this scale proved intolerable even by Hong Kong’s standards. Over the years and bit by bit they have been partly (but still only partly) filled by the addition to the IRO of rules dealing specifically with interest, royalties and sums received for the use of movable property. These rules are themselves extraordinarily simple. They are all contained in a single section, s 15. This provides that, in some circumstances, interest, royalties and sums received for the use of movable property are deemed to be ‘derived from Hong Kong from a trade, profession or business carried on in Hong

⁶¹ There is English and other Commonwealth authority to this effect. It is notable, though, that Hong Kong’s Inland Revenue Department has accepted without argument that these cases are determinative of the interpretation of the Hong Kong statute—especially since the result (unlike in the jurisdictions where the cases were decided) was that important categories of income escaped tax altogether. Note too that, even if interest *is* produced by the carrying on of a business, it is taxable under s 14(1) only if, (1) the business is carried on in Hong Kong and (2) the interest is derived from Hong Kong.

⁶² Assuming again that the business is carried on in Hong Kong and that the profit in question is derived from Hong Kong.

⁶³ Assuming once more that the business is carried on in Hong Kong and that the profit in question is derived from Hong Kong.

Kong'.⁶⁴ Thus s 15 effectively brings receipts of these kinds within s 14(1), and so renders them taxable.

It is necessary to mention s 15 because it is difficult otherwise to explain s 14(1). Perhaps too the very rudimentary rules contained in s 15 provide further illustrations of the extreme simplicity of Hong Kong's tax system. But there seems little point in examining these rules any more closely—suffice to say that they are very simple, that the circumstances in which they apply are curiously limited, and that considerable scope for abuse remains.

D *Trading Profits and Capital Gains*

As has been explained, s 14(1) does not tax all profits, but only those produced by the carrying on of a 'trade', a 'profession' or a 'business'.⁶⁵ If a profit is produced by an activity covered by one (or more than one) of these words, it is taxable (assuming that the activity is carried on in Hong Kong; and that the profit produced by it is derived from Hong Kong). Otherwise, it is not. The formula 'trade, profession or business' was copied (indirectly, via various other British colonial taxing statutes) from the 'trade', 'profession' and 'vocation' which have long been central to British income tax legislation. The word 'profession' no doubt humours those who prefer theirs not to be classified as a trade or a business, but is otherwise unimportant.⁶⁶ The word 'vocation' does not appear in Hong Kong's IRO, and so is of no further concern here. The word 'business' was presumably intended to broaden the scope of the Hong Kong statute; as will be seen, however, it has had very little effect. The crucial word, then, is 'trade'.

The word 'trade' has been used in British income tax legislation for over 200 years. It is defined as including 'every adventure ... in the nature of trade'. This wording, too, was adopted in Hong Kong.⁶⁷ As is well-known, there are many cases, both British and from various other Commonwealth jurisdictions, on the meaning of both the word 'trade' and the formula 'adventure in the nature of trade'. Perhaps most importantly, the use of the singular 'adventure' is interpreted as confirming that in some circumstances a one-off transaction amounts to the carrying on of a trade (and, therefore, that any resultant gain is taxable).⁶⁸ Hong Kong's courts have consistently accepted these cases as authoritative.⁶⁹ Thus, by copying the terms of the legislation, Hong Kong received the benefit of the cases also.

⁶⁴ Section 15 contains provisions dealing with various other sorts of income also, but there seems no point in examining these here.

⁶⁵ Above n 47. Or the deemed carrying on of a business, trade or profession under s15: above n 64.

⁶⁶ There is English authority to the effect that there is a distinction between a profession and a trade. See for example *Inland Revenue Commissioners v Marxe* (1919) 12 TC 41. But the issue has never arisen in Hong Kong and it seems doubtful that the English cases are of any modern relevance in the territory.

⁶⁷ See IRO s 2, definition of 'trade'.

⁶⁸ See for example *Leeming v Jones* (1929) 25 TC 333.

⁶⁹ See for example *Beautiland Co Ltd v Commissioner of Inland Revenue* (1991) 1 HKRC 90-053.

Copying what was tried and true was sensible, especially in the circumstances prevailing in Hong Kong in the 1940s. It is necessary to emphasise, though, that the word 'trade' bears a much heavier weight in Hong Kong than it does in the United Kingdom or in other Commonwealth jurisdictions. For example, in some circumstances the buying and selling of land amounts to an adventure in the nature of trade, and therefore to the carrying on of a trade. In other circumstances, it does not. Rather, it is the making and realising of an 'investment'.⁷⁰ In the United Kingdom, if the purchase and sale do not amount to trading, the profit is not chargeable to income tax, but it is generally chargeable to capital gains tax. Even in jurisdictions in which there is no tax on capital gains as such, there are commonly rules extending the definition of income to cover specified kinds of short-term capital gains. An example is New Zealand, where there is no capital gains tax as such, but in some circumstances capital gains on land are treated as income. In Hong Kong, on the other hand, the issue remains straightforward: if the purchase and sale amount to trading, the gain is chargeable to profits tax; conversely, if the purchase and sale do not amount to trading, the gain is not taxable at all. This is so of a private individual buying and selling a small residential apartment, and it is equally so of a large corporation buying and selling a billion-dollar building. Hong Kong has thus preserved a degree of simplicity in its tax legislation which elsewhere was lost long ago.⁷¹

The meaning of 'trade' has been frequently litigated in Hong Kong. Most of the cases concern land,⁷² while almost all the rest are about transactions in securities.⁷³ Given the nature of the problem, and the scale of the revenues at stake, the number of cases is

⁷⁰ The issue of whether or not a person is trading arises not only in the case of the purchase and sale of land but in various other circumstances also. Most importantly, it arises in the case of, (1) the purchase, *redevelopment* and sale of land and (2) the purchase and sale of securities. Whether a particular transaction or series of transactions amounts to trading or not depends on factors traditionally referred to as the 'badges of trade'. The most important of these are: (1) the period of ownership (the quicker the taxpayer sells the property, the more likely she is to be trading); (2) the number of transactions (the more transactions there are, the more likely the taxpayer is to be trading); and (3) the taxpayer's intention (if she purchased with the intention of selling in the short-term at a profit, that is a strong indicator of trade). The word 'investment' is not used in Hong Kong's IRO. Nor is it used in this context in the British legislation. But it is routinely used by the courts in this context. See for example *Marson v Morton* (1986) 1 WLR 1343, 1349: '[W]as the taxpayer investing the money or was he doing a deal?'

⁷¹ From time to time, it has been suggested that it might be desirable to deal with this problem by incorporating a time limit into the IRO. Thus, selling land *within* (say) two years of acquiring it would count as trading (and so any gain would be subject to profits tax); and selling land *after* holding it for two years or more would be treated as the realisation of an investment (and so any gain would be tax-free). But no such amendment has been formally proposed, let alone passed into law. Moreover, this debate seems to have been conducted almost entirely in terms of merely clarifying the law. The idea that it might be desirable to *extend* the tax system to catch short-term capital gains on land (let alone capital gains generally) seems to enjoy virtually no support in Hong Kong. In its administration of the IRO, however, the department generally acts on assumptions such as, for example, the purchase and sale of land does not constitute trading if the period between the buying and the selling is two years or more. Thus, if the taxpayer holds the land for two years or more, the department will generally accept without further questioning that any gain made on the sale is not taxable; whereas if the taxpayer sells the land within two years of buying it, the department is likely to seek further information. Such assumptions are however of no legal effect and are based on no particular authority.

⁷² See for example *Richfield International Land and Investment Co Ltd v Commissioner of Inland Revenue* (1988) 2 HKTC 444; (1989) STC 820.

⁷³ See for example *Commissioner of Inland Revenue v Dr Chiang Liang-Jen* (1977) 1 HKTC 975 and *Commissioner of Inland Revenue v Waylee Investments Ltd* (1989) 3 HKTC 410.

unsurprising. The point, however, is not that the matter has been frequently litigated, but that the legislature has been content to leave it to the courts. Thus, an approach which seems old-fashioned and even quaint when judged by the standards of the rest of the developed world, still works well enough in Hong Kong.

Also requiring comment is the word ‘business’ (for s 14(1), as I have recounted, taxes not only the profits of ‘trade’, but also the profits of ‘business’).⁷⁴ Given the apparent importance of the word ‘business’, one might expect its meaning to have been thoroughly tested. Indeed, given the restricted scope the courts have given ‘trade’, one might expect the Inland Revenue Department to have turned to ‘business’ with enthusiasm. Specifically, one might expect the department to have taken an expansive approach to its interpretation; to have issued assessments to tax accordingly; and, when challenged, to have defended them in court on the basis that the assessee’s activities, if not a trade, were at any rate a business. But it has seldom done so.⁷⁵

Rather, this basic issue has been approached almost exclusively in terms of whether the taxpayer’s activities amount to a *trade*. The reason is simply that the word ‘trade’ was used in the British legislation, and that there was a large body of English case law on its meaning. Consequently, there are many Hong Kong cases on the word ‘trade’; a small number on ‘business’;⁷⁶ and none at all on ‘profession’. There is thus a curious imbalance in the cases defining the basic scope of Hong Kong’s tax system. In particular, it seems probable that the word ‘business’ is capable of a broader meaning than ‘trade’; that the scope of s 14(1) (properly interpreted) is therefore broader than the Inland Revenue Department has asserted; and that the Hong Kong government has consequently always failed (and is still failing) to collect a significant part of the revenue to which it was (and is) entitled. In most other developed jurisdictions, such a state of affairs would be intolerable and, indeed, difficult to imagine. The government of Hong Kong, in contrast, seems unconcerned.

E Source

Most countries tax resident firms on their worldwide profits, meaning both domestic and offshore profits. Hong Kong, however, does not. Rather, as I have mentioned, profits tax, like property tax and salaries tax, is confined to income derived from Hong Kong. In the vernacular, profits tax (like the other two taxes) is ‘based on the source principle’. Offshore profits, in other words, are simply exempt from tax. My purpose here is not to comment on the merits of this policy (though that is an interesting and important topic),⁷⁷ but to examine the legislation by which it is affected.

⁷⁴ Above n 47.

⁷⁵ It is worth noting that Hong Kong’s courts appear never to have been asked to consider the scope of the word ‘profits’ (which seems fundamental to the meaning of s 14(1)—see above n 47). Once more, this is indicative of the level of simplicity achievable at low rates of tax. The comparison with the judicial consideration given to the word ‘income’ in other jurisdictions is striking.

⁷⁶ See for example, *Commissioner of Inland Revenue v Bartica Investment Ltd* (1996) 1 HKRC 90080.

⁷⁷ See Robert E Hall and Alvin Rabushka, *The Flat Tax*, (2nd ed, 1995) for a modern American defense of this approach. The Hall and Rabushka flat tax is, incidentally, structurally similar to Hong Kong’s IRO. This is presumably related to the fact that Alvin Rabushka has long been a student of Hong Kong’s systems of taxation, public finance and government and has written a number of important books about them. See in particular Alvin Rabushka, *Value for Money: The Hong Kong Budgetary Process* (1976).

As will be seen, the simplicity of Hong Kong's IRO is in this respect extreme. Before examining its terms, however, it is necessary to emphasise that the absence of detailed source rules in the IRO is a far more telling measure of its simplicity than would be the case elsewhere. Many other jurisdictions have detailed rules for determining the source of income. But most of these jurisdictions tax residents on their worldwide incomes. Such jurisdictions' source rules are not, therefore, the primary determinant of residents' liability to tax. Rather, their function is, first, to determine the taxability of *non-residents'* income (because non-residents are typically taxable only on income derived from within the taxing jurisdiction); and, secondly, to determine the availability to residents of foreign tax credits (because resident taxpayers are typically entitled to credit for foreign tax paid on offshore income, but they are not entitled to credit for foreign tax paid on income derived from the jurisdiction in which they are resident). Thus, many jurisdictions' tax statutes contain detailed source rules, even though source is *not* the principal determinant of liability. Hong Kong's IRO, on the other hand, contains almost nothing of this kind, even though source *is* the principal determinant of liability (in that profits derived from outside the territory are simply exempt from tax, whether taxed in some other jurisdiction or not).

It is necessary to emphasise also that the source of profits is a far more important issue in Hong Kong than in most other jurisdictions. Indeed, it seems likely that the issue is more important in Hong Kong than anywhere else in the world. This is because the reason for Hong Kong's existence as a separate jurisdiction is to serve as a center for cross-border trade, finance and investment. The territory was colonised by the British in 1842 expressly for this purpose, and has fulfilled it very satisfactorily ever since (apart from the period from 1941–45, when it was occupied by the Japanese). In the beginning, the colony's economy was based on the opium trade, which consisted of foisting Indian opium on Chinese consumers. Later, Hong Kong served as an *entrepot* for international trade in goods generally. After 1945, its economy came to be largely based on manufacturing for export. Then, in the 1970s, Hong Kong became an internationally important financial center. Again, much of this business was of an international nature—that is, it consisted of meeting the needs of lenders and borrowers outside Hong Kong. Later still, in the 1980s, Hong Kong became an important source of investment in the Chinese Mainland. The territory also came to function as a conduit for foreign investment in the Mainland.⁷⁸ For these reasons, the purely domestic part of Hong Kong's economy has always been relatively small; and, since the introduction of taxes on income in 1940, the distinction between domestic profits (which are taxable) and offshore profits (which are not) has been correspondingly crucial.

One might think, then, that if any jurisdiction needs detailed source rules, it would be Hong Kong. In fact, however, the legislation is simple in the extreme. As I have said, s 14(1) of the IRO imposes profits tax only on profits 'arising in or derived from Hong

⁷⁸ An alternative way of looking at Hong Kong's economic history is that the purpose for which the territory was colonized was to serve as a tax haven; that it has fulfilled *that* function very satisfactorily ever since; and that the changing nature of its economy has essentially reflected the evolving needs of those who use tax havens. Thus the handover in 1997 marked the formalization of the process whereby Chinese capital took over from British as the principal beneficiary of the tax advantages offered by the territory.

Kong?—and that is it.⁷⁹ As to what these words might mean, the IRO says almost nothing.

In other jurisdictions, it is common for taxing statutes to contain a whole raft of rules for determining the source of profits produced by specific forms of commercial endeavour. Unsurprisingly, such rules typically serve not merely to clarify the law, but to do so in such a way as to prevent the erosion of the tax base. Most importantly, it is common for taxing statutes to provide that profits produced by carrying on a business within the jurisdiction are derived from the jurisdiction. Thus, if a non-resident carries on business within the jurisdiction, any profit produced by the business is taxable there. This basic approach is commonly both endorsed and limited by treaties based on the OECD Model Tax Treaty, Article 7 of which in effect both (1) confirms the right of a contracting state to tax business profits sourced within its territory, and (2) confines the exercise of the right to cases in which the taxpayer has a permanent establishment there.

In addition to the rule applicable to business profits generally, it is common for taxing statutes to contain more specific rules applicable to more specific forms of income, such as interest; income from land; rentals derived from movable property; royalties; insurance premiums; dividends; and so on. Again, treaties based on the OECD Model commonly both confirm and limit contracting states' rights to tax income of these kinds.

Hong Kong's IRO contains two rules of this nature. First, sums received for the use of intellectual property in Hong Kong (that is, royalties) are deemed to be derived from Hong Kong.⁸⁰ Such sums are, therefore, taxable. Secondly, sums received for the use of movable property in Hong Kong are likewise deemed to be derived from Hong Kong.⁸¹ Again, therefore, such sums are taxable. But that is all; apart from these two rules, the territorial scope of profits tax depends simply on the words 'profits arising in or derived from Hong Kong'.⁸² Most strikingly, the IRO does *not* provide that the profits of a business carried on in Hong Kong are derived from Hong Kong. Thus, the wording of s 14(1) appears to leave open the possibility that a firm carrying on business in Hong Kong, and without a permanent establishment anywhere else, can derive profits from outside Hong Kong; and that such profits are not subject to tax in Hong Kong. Moreover, Hong Kong's courts have confirmed that this interpretation is correct. In other words, Hong Kong's courts have accepted that it is possible for a part (or even the whole) of the profits of a firm carrying on business in Hong Kong and nowhere else

⁷⁹ See above at note 47. The courts have held that there is no significant difference between "arising in" and "derived from". See in particular *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306. Henceforth, for convenience I sometimes use the latter term as covering the former also.

⁸⁰ IRO s 15(1)(a) and (b); see above n 64.

⁸¹ IRO s 15(1)(d). See above n 64.

⁸² Section 2 of the IRO defines the words 'profits arising in or derived from Hong Kong' as including 'all profits from business transacted in Hong Kong, whether directly or through an agent'. The meaning of this definition remains unclear. What is clear, however, is that, whatever its meaning, it has made little difference in practice, for no court has ever based a decision on it. But see *Commissioner of Inland Revenue v Orion Caribbean Ltd (in voluntary liquidation)* (1997) STC 923 for hints that the definition might be important.

to be derived from outside Hong Kong; and that such profits are therefore not taxable in Hong Kong.⁸³

As is mentioned above, the non-taxability of such profits in Hong Kong does not depend on their being taxable elsewhere. In other words, the profit of a firm resident in Hong Kong will go entirely untaxed to the extent that (1) it is derived from outside Hong Kong and (2) it is derived from a jurisdiction that does not tax it (such as a tax haven).⁸⁴ The extent to which Hong Kong firms are able to escape tax as a result of this limit to the scope of the territory's tax system is unknown, because Hong Kong generally does not require its residents even to disclose their offshore income. It seems reasonable to suppose, though, that the extent to which Hong Kong-resident firms enjoy tax-free offshore income is very substantial. In jurisdictions with higher rates of tax, simply to exclude offshore profits (and other offshore income) from tax would result in revenue losses and inequities so severe as to be probably intolerable. In Hong Kong, it is uncontroversial.⁸⁵

That so basic an issue has been left to the courts is in itself instructive. So, too, is the manner in which the courts have tackled it. Despite a more or less continuous stream of litigation, radical uncertainty persists. The taxability of even routine forms of business activity remains unclear. By the standards of the rest of the developed world, the uncertainty prevailing in Hong Kong would be plainly intolerable. In Hong Kong, however, the level of uncertainty, whilst acknowledged as a problem, is not regarded as a serious one. There has occasionally been discussion of reform, but the available cures seem generally to be regarded as worse than the ailment. One reason for this is presumably the lightness of the burden. Uncertainty as to liability is of course undesirable, but there is certainty of another kind: that the worst possible outcome (from the taxpayer's point of view) is tax at 17.5 per cent.

⁸³ See in particular *Commissioner of Inland Revenue v Hang Seng Bank Ltd* (1991) 1 AC 306.

⁸⁴ It is also possible for profits not to be derived from any jurisdiction. See in particular *Commissioner of Inland Revenue v The Hong Kong and Whampoa Dock Co Ltd* (1960) 1 HKTC 85; (1960) HKLR 166, which concerned salvage in international waters.

⁸⁵ That is, the basic policy of not taxing offshore income is uncontroversial. As will be seen in the following section of this paper, since 1940 (when taxes on income were first introduced in Hong Kong) there has been controversy as to where the line should be drawn between taxable domestic income and non-taxable offshore income; and such controversy continues still. But this seems to be universally regarded as a merely technical problem. The idea of extending the tax system to cover offshore income seems to enjoy virtually no support in Hong Kong. Indeed, Hong Kong people seem commonly to be shocked when they learn that other states routinely tax residents on their offshore income.

F The Interpretation of the Source Principle: Traders and Manufacturers

In the late nineteenth century and for the first few decades of the twentieth, most British colonies' tax systems were based on the source principle.⁸⁶ In other words, most colonies did not tax residents on their offshore incomes. This was so in, notably, Australia, New Zealand, India, the Canadian provinces and various British colonies in Africa. As the twentieth century went by, however, these jurisdictions generally withdrew this exemption. That is, they extended their tax systems to catch income derived by residents from outside the jurisdiction (though South Africa did so only in 2001). Thus, by the time Hong Kong adopted its source-based tax system in 1940, source-based tax systems had fallen out of fashion almost everywhere else. Before Britain's other colonies took to taxing offshore income, however, their courts were repeatedly called upon to determine whether particular items of income were derived from within the jurisdiction (and therefore taxable) or from outside it (and therefore not). The Australian case law on the distinction was especially strong, but there were numerous New Zealand, South African, Canadian and Indian cases, too. There was also a series of nine Privy Council decisions.⁸⁷

When Hong Kong's IRO became law in 1947, the territory's new Inland Revenue Department assumed that these cases (which, for convenience, I will refer to collectively as 'the Imperial source cases') applied in the colony. In due course, this view was confirmed by the colony's courts.⁸⁸ As with the cases on the distinction between 'trade' and 'investment',⁸⁹ this was sensible; for the courts of a small and under-developed colony to have attempted to reinvent the wheel would seem to have been at best a waste of effort. The Imperial source cases thus became in effect part of the law of Hong Kong. These cases established a number of rules (or, at least, guidelines) for determining the source of many different kinds of income. There were rules for determining the source of 'trading' profits (that is, profits made by buying and selling things); 'manufacturing' profits (profits made by manufacturing and selling things); interest; dividends; royalties; profits made by rendering services; profits derived from transactions in land; insurance premiums; income from employment; and so on.⁹⁰ For present purposes it is not necessary to examine all of these rules, but those

⁸⁶ I use the word 'colony' in this paper generally to include also dominions and other territories. In United Kingdom tax parlance, the word 'source' has usually been used to denote economic source. In the colonies, it meant geographic source. This ambiguity is unfortunate, especially since it is not purely semantic. The economic source of income is generally situated in the geographic source, but the two are not the same.

⁸⁷ For reviews of these cases, see Willoughby and Halkyard, above n 14, and Jefferson VanderWolk, *The Source of Income: Tax law and Practice in Hong Kong* (3rd ed, 2002). The Privy Council was, and is, the final court of appeal for British colonies (and, in some cases, dominions and other territories). For an analysis of the Privy Council decisions on source, see Michael Littlewood, 'The Privy Council, the Source of Income and *Stare Decisis*' (2004) 121 *British Tax Review*.

⁸⁸ See for example *Commissioner of Inland Revenue v The Hong Kong and Whampoa Dock Co Ltd* (1960) 1 HKTC 85. See also Willoughby and Halkyard, above n 14; and VanderWolk, above n 87.

⁸⁹ See above n 65–76.

⁹⁰ See above n 88. Reviews of these cases can be found in the works referred to there, and also in some of the standard texts on the law of taxation in various jurisdictions including the United Kingdom, Australia, South Africa, etc.

bearing on trading profits and manufacturing profits are of such fundamental importance that it is necessary for even a summary account of Hong Kong's tax system to examine them.⁹¹

As regards trading profits, the Imperial source cases had established that a profit made by buying and selling goods is generally derived from the place where the goods are sold. Thus, if a firm buys goods in jurisdiction A and sells them at a profit in jurisdiction B, the profit is generally derived from jurisdiction B. The profit is therefore not taxable in jurisdiction A (assuming jurisdiction A has a source-based tax system).⁹²

For about thirty years, Hong Kong's Inland Revenue Department administered the IRO in accordance with these rules. Then, in about 1980, the department adopted a more expansive interpretation of s 14(1) (that is, of the words 'profits arising in or derived from Hong Kong').⁹³ Specifically, it took the position that the profits of a business carried on in Hong Kong are generally derived from Hong Kong, unless properly attributable to a permanent establishment outside Hong Kong. Moreover, the department succeeded in persuading the courts (including the Privy Council) to accept this view. Consequently, whilst the legislation remained unchanged (that is, s 14(1) continued to provide for profits tax to be imposed only on 'profits arising in or derived from Hong Kong'), its effective scope was expanded dramatically. Most importantly, in *Commissioner of Inland Revenue v HK-TVB International Ltd*,⁹⁴ the Privy Council established the 'operations' test, according to which a profit is derived from the place where the taxpayer carried out the operations which 'in substance' produced it.⁹⁵ Thus, if a firm carries on business in Hong Kong, and has no permanent establishment anywhere else, its profit will generally be derived from Hong Kong and therefore taxable there. In the same case, the Privy Council observed that it is only in 'rare cases' that a firm carrying on business in Hong Kong can derive profit from outside Hong Kong, unless it has a permanent establishment outside Hong Kong to which it can properly attribute part (or all) of its profit.⁹⁶ This appears to amount to a comprehensive rejection of the earlier decisions.⁹⁷

As regards manufacturing profits, the Imperial source cases had established that a profit made by manufacturing goods in one jurisdiction and selling them in another is derived partly from each. Such a profit is therefore taxable in part in each of the two

⁹¹ Trading and manufacturing are basic, archetypal economic activities. The taxation of trading and manufacturing profits is consequently indicative of the operation of Hong Kong's tax system as a whole. To demonstrate more or less the same dynamics by reference to the taxation of profits of other kinds would be straightforward, but tedious.

⁹² See for example *Commissioners of Taxation v Kirk* (1900) AC 588; *Lovell & Christmas Ltd v Commissioner of Taxes* (1908) AC 46; *Federal Commissioner of Taxation v W Angliss & Co Pty Ltd* (1931) 46 CLR 417; and *The Commissioner of Taxation of Western Australia v D & W Murray Ltd* (1929) 42 CLR 332.

⁹³ Above n 47.

⁹⁴ *Commissioner of Inland Revenue v HK-TVB International Ltd* (1992) 2 AC 397.

⁹⁵ *Ibid* 407.

⁹⁶ *Ibid* 409.

⁹⁷ For an analysis of this reinterpretation see Michael Littlewood, 'The Uncertain Geographical Scope of Hong Kong Profits Tax and the Possibility of Reform (11 October 1999) *Tax Notes International* 1441.

jurisdictions. Thus, if a firm makes a profit by manufacturing goods in jurisdiction C and selling them in jurisdiction D, part of the profit is derived from the place where the goods are manufactured (jurisdiction C) and part from the place where they are sold (jurisdiction D). In such circumstances, source-based tax legislation implicitly requires the apportionment of the profit. That is, jurisdiction C taxes the part of the profit attributable to the manufacturing, and jurisdiction D taxes the part attributable to the selling (assuming that both jurisdictions have source-based tax systems).⁹⁸

This reinterpretation of s 14(1) has had important consequences for the tax treatment of profits generally, including both trading profits and manufacturing profits. The law of Hong Kong is now that a profit made by buying goods in Hong Kong and selling them elsewhere is generally derived entirely from Hong Kong (unless the sales are effected by a permanent establishment outside Hong Kong); and that such a profit is therefore generally taxable in full.⁹⁹ Thus, profits of a kind which the Inland Revenue Department and the courts previously accepted as entirely exempt from tax are now taxable in full. At least, that is what the law seems to be—the cases are still too few and far between to allow a definitive statement.

Similarly, the law of Hong Kong now seems to be that a profit made by manufacturing goods in Hong Kong and selling them outside Hong Kong is derived entirely from Hong Kong and therefore taxable in full (unless, again, the sales are effected by a permanent establishment outside Hong Kong). Thus, profits of a kind which the Department previously accepted as taxable only in part are now taxable in full.

This reinterpretation is especially notable, in that it is based on no direct authority at all—for no Hong Kong court has ever been called upon to determine the source of a manufacturer's profits. The original interpretation was based on manufacturing cases from other jurisdictions, notably Australia.¹⁰⁰ That these cases were applicable in Hong Kong was accepted by the Inland Revenue Department and by all Hong Kong's manufacturers without the point ever being litigated. The current interpretation is based on principles ostensibly derived from Hong Kong cases concerning forms of business having nothing whatever to do with manufacturing (notably banking, film licensing, salvage and trading).¹⁰¹ Again, the applicability of these principles to manufacturing

⁹⁸ See for example *Commissioners of Taxation v Kirk* (1900) AC 588; *Federal Commissioner of Taxation v W Angliss & Co Pty Ltd* (1931) 46 CLR 417; *International Harvester Co of Canada Ltd v Provincial Tax Commission* (1949) AC 36; *Provincial Treasurer of Manitoba v Wm Wrigley Jr Co Ltd* (1950) AC 1; and *The Commissioner of Taxation (New South Wales) v Hillsdon Watts Ltd* (1936–37) 57 CLR 36.

⁹⁹ See in particular *Commissioner of Inland Revenue v HK-TVB International Ltd* (1992) 2 AC 397; *Commissioner of Inland Revenue v Magna Industrial Co Ltd* (1997) HKRC 90-082; and *Commissioner of Inland Revenue v Orion Caribbean Ltd (in voluntary liquidation)* (1997) STC 923.

¹⁰⁰ See *Commissioners of Taxation v Kirk* (1900) AC 588; *Federal Commissioner of Taxation v W Angliss & Co Pty Ltd* (1931) 46 CLR 417; and *The Commissioner of Taxation (New South Wales) v Hillsdon Watts Ltd* (1936–37) 57 CLR 36.

¹⁰¹ See *Commissioner of Inland Revenue v The Hong Kong and Whampoa Dock Co Ltd* (1960) 1 HKTC 85 (salvage); *Commissioner of Inland Revenue v Hang Seng Bank Ltd* (1991) 1 AC 306 (banking); *Commissioner of Inland Revenue v HK-TVB International Ltd* (1992) 2 AC 397 (film licensing); *Commissioner of Inland Revenue v Orion Caribbean Ltd (in voluntary liquidation)* (1997) STC 923 (banking); and *Commissioner of Inland Revenue v Magna Industrial Co Ltd* (1997) HKRC 90-082 (trading).

profits has never been tested in the courts: the Inland Revenue Department simply asserted that it was so, and all of the territory's manufacturers accepted it.¹⁰²

Since 1945, Hong Kong's economy has been heavily dependent on manufacturing for export. It still is, though over the last twenty years or so almost all the actual manufacturing has been shifted across the border into the Chinese Mainland. As will be seen, this has raised new and difficult questions as to the source (and therefore the chargeability to tax) of Hong Kong-based manufacturers' profits. Given the importance of manufacturing to Hong Kong's economy, the fact that the source of manufacturing profits has *never* been litigated is an impressive indicator of the simplicity of its tax system. In other developed jurisdictions, it seems unlikely that such an important principle of law could stand on such a flimsy foundation. To put it another way, the complete lack of cases is powerful evidence of the degree of simplicity achievable at very light levels of taxation. Conversely, it is evidence also of the degree to which the complexity of other tax systems is a product of relatively high rates of tax.

It is difficult to conceive of the government of any other developed jurisdiction taking such a straightforward approach to the important business of defining the basic scope of its tax system. The reasons for this seem clear: if any other developed jurisdiction were to adopt Hong Kong's approach, the consequences would include an intolerable level of uncertainty, an intolerable increase in the volume of litigation and perhaps also an intolerable collapse in revenue. In Hong Kong, there is indeed a high level of uncertainty; there have been numerous disputes as to the meaning of s 14(1); and possibly the government's revenues have suffered as a result. But these difficulties could not by any stretch be called intolerable. The reason seems again to be the very low rates of tax.

G The Taxation of Hong Kong/Mainland Joint Ventures

Over the last twenty years or so, Hong Kong's manufacturing industry has changed dramatically. Indeed, the transformation in manufacturing has transformed Hong Kong's whole economy. Nowadays, almost all of Hong Kong's manufacturers do almost all of their actual manufacturing in the Chinese Mainland. The reason is that land, labour and utilities (electricity, water and so on) are much cheaper in the Mainland than in Hong Kong. Many foreign firms too, of course, are involved in manufacturing operations in the Mainland. The reason, again, is the cheapness of land, labor and utilities. Many of these firms conduct their Mainland manufacturing operations through a Hong Kong subsidiary (for various reasons, including the tax savings to be had).

¹⁰² It is possible that the Department assessed only *new* taxpayers on the basis of its revised interpretation of the law. That is, it might have continued to assess *existing* taxpayers on the basis of its original interpretation. In other words, the Department might have "grandfathered" its treatment of taxpayers already benefiting from the earlier, more generous interpretation. If this is so, it is further evidence of what is achievable at very low rates of tax (because surely it would not be acceptable in, say, Australia to discriminate among taxpayers in this way). The only alternative possibility seems to be that the Department radically increased the extent of the liability of existing taxpayers on the basis of its own reinterpretation of the legislation, unsupported by any direct authority. But if this is so, it, too, is intriguing evidence of what is possible at low rates of tax.

Very commonly, the Hong Kong firm (or the Hong Kong subsidiary of the foreign firm) enters into a joint venture with a Mainland entity.¹⁰³ This often takes the form of what is called a 'processing arrangement', the terms of which are typically as follows. The Mainland entity provides the factory, the workers, and the utilities; and the Hong Kong firm (or the Hong Kong subsidiary of the foreign firm) provides designs, prototypes, management expertise, factory plant, quality control, raw materials, finance and so on. These factors are combined to produce goods in accordance with the Hong Kong firm's specifications. The goods so manufactured are the property of, and are sold by, the Hong Kong firm. Sometimes they are sold to foreign customers (mainly in the United States or Europe), sometimes to customers in Hong Kong, and sometimes to customers in the Mainland. The Hong Kong firm pays the Mainland party a 'processing fee' for its part in the process.¹⁰⁴

Businesses of this type present interesting challenges to Hong Kong's tax system. Take the case of a Hong Kong firm which has entered into a processing arrangement with a Mainland entity to manufacture, say, sports shoes. The Mainland entity contributes a factory and workers; and the Hong Kong firm contributes the machinery to go in the factory. The Hong Kong firm acquires prototype shoes from, say, an American customer, which designs the shoes and controls the brand name to be attached to them. The Hong Kong firm also acquires, perhaps from a Taiwanese firm, the raw materials requisite to manufacture shoes in accordance with the prototype. The materials are shipped from Taiwan to the factory in the Chinese Mainland. At the factory, the materials are made into shoes. The Hong Kong firm pays the Mainland entity a processing fee, and sells the shoes to its American customer. The Hong Kong, American, Mainland and Taiwanese firms might all be independent; alternatively some or all of them might be related.

As a result of these operations, the Hong Kong firm makes a profit. The chargeability of this profit to Hong Kong tax depends on whether it is covered by Hong Kong's IRO. Once more, the Ordinance contains no provision directed specifically at businesses of this kind (even though they account for a very large part of Hong Kong's economy). Consequently, the liability of the firm to Hong Kong tax depends on section 14(1) of the Ordinance. Section 14(1), as has been seen, provides that profits tax is charged on 'profits arising in or derived from Hong Kong.'¹⁰⁵ The question, then, is: is this profit derived from Hong Kong?¹⁰⁶ If so, it is taxable; if not, not. This basic question raises

¹⁰³ It is also possible in some circumstances for Hong Kong firms (and the Hong Kong subsidiaries of foreign firms), after overcoming various bureaucratic hurdles, to operate in the Chinese Mainland either directly themselves or indirectly through a wholly-owned subsidiary. The tax treatment of (and the planning opportunities available to) such firms offer further evidence of the simplicity achievable at low rates of tax, but examining them would inordinately increase the length of this paper. It might be worth noting, though, the well-established tradition of Mainland firms and individuals channelling funds through wholly-owned Hong Kong corporations in order to reinvest them in the Mainland. One reason they do this is so as to qualify for tax incentives offered to 'foreign' investment.

¹⁰⁴ Such processing arrangements are a species of 'contractual' joint venture. Also possible are 'equity' joint ventures, in which an entity is established (typically under Chinese law) with the foreign and Chinese joint-venturers as shareholders. Again, the tax treatment of such arrangements provides compelling evidence of the simplicity achievable at low rates of tax, but examining them would inordinately increase the length of this paper.

¹⁰⁵ See above n 47.

¹⁰⁶ Above n 79.

several subordinate questions. In particular, does the basic question require an all-or-nothing answer? That is, does s 14(1) require that the profit must be either taxable in full or not taxable at all? Or does s 14(1) implicitly require the apportionment of the profit? In other words, does s 14(1) impose tax on the part of the profit attributable to the firm's operations in Hong Kong, but not on the part attributable to its operations outside Hong Kong? Worse: if s 14(1) implicitly requires apportionment, how is this implicitly-required apportionment to be calculated? These are difficult questions. The IRO itself provides no answer to them: s 14(1) provides that tax is charged on 'profits arising in or derived from Hong Kong'—and that is all. It is worth noting, though, that the difficulty is exacerbated by the fact that, no matter how these questions are answered, the answers are virtually certain to prompt responses in taxpayer behavior: if the profits of a particular form of processing arrangement turn out to be taxable, firms will tend to try some other.

It is not unusual for new ways of doing business to pose challenges to taxation (or, depending on one's point of view, opportunities for tax planners). The instance generating much recent interest is of course the Internet. It is necessary to emphasise, though, that the challenge to Hong Kong's tax system posed by Hong Kong firms involving themselves in manufacturing operations in the Chinese Mainland is far greater than that posed by the Internet. The Internet is obviously important. But manufacturing is a core economic activity for Hong Kong, and almost all of the territory's manufacturers have decamped across the border. Firms not previously in the business of manufacturing have taken it up, in the light of the opportunities to be found in the Mainland. And many new firms have been formed for the purpose. From the Hong Kong Government's point of view, the issue is critical.

One response would have been to legislate. But detailed new rules would no doubt have led to new problems; new problems would in turn have led to more new rules; the simplicity of the IRO would have been lost. Also, legislating might have presented political difficulties. So the Hong Kong Government did not suggest legislation. Instead, it left the Inland Revenue Department to deal with the problem. The department's solution was strikingly simple. In 1992, it announced that it would treat the profits of Hong Kong firms engaged in manufacturing operations in the Mainland as 50 per cent taxable.¹⁰⁷ In other words (to give this manifestly pragmatic solution a semblance of orthodox legal justification), the department adopted the view that s 14(1) implicitly requires the apportionment of profits produced in this way; and implicitly requires also that this apportionment be calculated by simply dividing the profit in two.

The only problem was that there was no authority whatever for the department's interpretation of the law—at least, the department offered none.¹⁰⁸ Commentators were

¹⁰⁷ See Commissioner of Inland Revenue, *Departmental Interpretation and Practice Notes No 21: Locality of Profits* (November 1992). It is the practice of the Inland Revenue Department to issue Practice Notes from time to time, stating its view of the law. These notes are not binding, but are generally regarded by taxpayers and their advisors as helpful. The department in fact adopted the practices set out in Practice Note No 21 before it was issued. Practice Note No 21 has been revised since it was issued in 1992, but the revisions are irrelevant for present purposes.

¹⁰⁸ Actually, there was authority, in the form of some old Australian cases, for interpreting source-based income tax legislation as implicitly requiring the 50/50 apportionment of manufacturing profits in some circumstances. See in particular *Federal Commissioner of Taxation v Lewis Berger & Sons (Australia) Ltd* (1927) 39 CLR 468; and *Michell v Federal Commissioner of Taxation* (1927) 46 CLR 413. These

quick to point to the flaws in the department's position. In particular, they pointed out that, according to the department, a profit made by manufacturing goods in Hong Kong is derived entirely from Hong Kong and therefore taxable in full.¹⁰⁹ Thus, the department's position on firms carrying out their manufacturing in Hong Kong seems to be based on the principle that a manufacturer's profits are derived from the place where the manufacturing is carried out, and this seems difficult to reconcile with its view that profits produced by manufacturing goods in the Mainland are even partly derived from Hong Kong. Moreover, complained the critics, the department offered no authority for its view that the correct method of calculating the implicitly-required apportionment is simply to divide the profits in two. Perhaps, too, they went on, the department was wrong to regard the place of sale as altogether irrelevant.¹¹⁰

The complaints were loud, but taxpayers seem to have been amazingly shy about standing by them. The department proceeded to assess firms to tax on the basis of the policy it had announced. Taxpayers complained but, as before, they did not litigate. To date, there is not a single case of a taxpayer objecting to an assessment of this kind. They have complained, but they have paid the tax. Once more, it is difficult to imagine the government of any other developed jurisdiction dealing with a tax problem (any tax problem, let alone one of this magnitude) in this way—that is, by issuing assessments to tax on the basis of a policy with a certain rough and ready justice to it, but based on only the flimsiest legal authority. Equally, it is difficult to imagine the taxpayers of any other developed jurisdiction responding as Hong Kong's have done—by paying the tax, despite the flimsy legal basis of the assessments. Once more, it seems reasonable to suppose that the reason Hong Kong's tax system can operate in this way, while others cannot, is the difference in the rates of tax. In Hong Kong, the rate of tax for corporations is 17.5 per cent. The department's policy of 50/50 apportionment therefore results in an effective rate of 8.75 per cent—a significant cost; and worth complaining about; but not, apparently, worth litigating.¹¹¹

H Provisions Notable for their Absence

The brevity and simplicity of Hong Kong's IRO is largely due to the fact that provisions of kinds regarded as indispensable elsewhere are simply not there. In particular, much of the complexity of other countries' tax statutes is due to the need to prevent avoidance. Hong Kong, in contrast, has evidently not felt the same need. Given that offshore income is generally exempt from tax, there is plainly no place in Hong

cases did not of course deal with the forms of joint venture manufacturing now common in China. In any event, the department did not refer to them in defence of its position. Moreover, these cases (and the simple 50/50 approach to apportionment) appear to have been overruled by subsequent Australian cases requiring a more sophisticated added-value calculation. See in particular *Federal Commissioner of Taxation v W Angliss & Co Pty Ltd* (1931) 46 CLR 417.

¹⁰⁹ See above n 99 and 100.

¹¹⁰ See above n 92 and 94.

¹¹¹ Given that Hong Kong's IRO is unusually generous in most other respects also (deductions, depreciation, transfer-pricing), the amount of profits, as calculated under it, is typically less than it would be under other jurisdictions' tax systems. The effective rate of 8.75 per cent is therefore typically applied to a smaller amount.

Kong's tax system for CFC rules. Therefore, there are none. Nor are there any rules restricting the deductibility of interest incurred by thinly-capitalised companies. There is a provision intended to prevent the abusive pricing of transfers between associates,¹¹² but it consists of only two relatively short sentences, its drafting seems inadequate, and in any event there is no reported case of the department ever invoking it.¹¹³ Similarly, there is a section aimed at restricting the abuse of corporate losses,¹¹⁴ but it, too, is brief and poorly-drafted and has rarely if ever been invoked. The taxation of perks is notably generous. Employer-provided housing is taxed at a small fraction of its actual value, and various other benefits (for example, company cars and interest-free loans) are not taxed at all. Expenditure on such items by employers is in all ordinary circumstances deductible (or depreciable, in the case of expenditure of a capital nature).¹¹⁵ The scope for avoidance is therefore substantial, but this seems not to be regarded by the government as problematic. Indeed, the government is itself a notable provider of tax-effective perks (mainly housing and cars) to its employees. There is a general anti-avoidance provision,¹¹⁶ similar to those of Australia and New Zealand, but Hong Kong's Inland Revenue Department has been relatively reticent about invoking it. Whether the *Ramsay* principle¹¹⁷ applies in Hong Kong remains unclear, because the Inland Revenue Department, in accordance with its generally unhurried approach, has yet to raise the issue.¹¹⁸

Another important cause of complexity in tax law is the attempt to eliminate, or at least ameliorate, inequity. In particular, in most countries, a great deal of complexity is attributable to the attempt to provide as equitably as possible for persons whose incomes are relatively small and to achieve a reasonable degree of integration between the tax system and the system of social welfare. Hong Kong's tax system, as I have explained, simply exempts the poorest two-thirds of the workforce from tax altogether.

¹¹² IRO s 20.

¹¹³ Because taxes are lighter in Hong Kong than in most other places, groups of companies have traditionally set their transfer prices so as to shift income to Hong Kong rather than away from it. The abusive pricing of transfers has therefore generally operated to the advantage of the Hong Kong treasury rather than against it. But even light taxes are worth avoiding, and in recent years it has become very common for Hong Kong firms and individuals to shift income to other jurisdictions. For some years, the jurisdiction of choice has been the British Virgin Islands. The number of Hong Kong-controlled companies established there is rumoured to run to hundreds of thousands—an impressive number, given Hong Kong's total population of about seven million. Hong Kong's Inland Revenue Department has challenged such income-shifting arrangements, but in the only cases to appear in the law reports the department has based its challenge on grounds other than s 20. In some cases it has denied the deductibility of payments made to associates; in others, it has invoked the general anti-avoidance rule contained in s 61A of the IRO.

¹¹⁴ IRO s 61B.

¹¹⁵ See generally Willoughby and Halkyard, above n 14.

¹¹⁶ IRO s 61A.

¹¹⁷ See *W T Ramsay v Inland Revenue Commissioners* (1982) AC 300.

¹¹⁸ The courts have upheld the department's argument that the *Ramsay* principle applies to the interpretation of Hong Kong's *Stamp Duty Ordinance* (*Arrowtown Assets Ltd v Collector of Stamp Duty* (2004) 1 HKLRD 77) and *Estate Duty Ordinance* (*Shiu Wing Ltd v Commissioner of Estate Duty* (2000) HKCFAR 215; (2000) 3 HKLRD 76), but the department has not yet raised the argument in a case under the IRO.

The need to achieve equity among this part of the populace thus does not arise.¹¹⁹ The inequity among the other third is considerable. Indeed, as the Hong Kong government itself has acknowledged (though not recently), the territory's tax system is 'inherently inequitable'.¹²⁰ In particular, some forms of income are taxed (profits, rents and salaries), whereas others are not (interest, offshore income, perks).¹²¹

Moreover, of those forms of income which are subject to tax, some are taxed at different rates from others. For example, rents received by a natural person are taxed at a flat 16 per cent;¹²² rents (and other income) received by a company are taxed at 17.5 per cent;¹²³ and income from employment is taxed at rates varying from 0 per cent to 20 per cent.¹²⁴ Similarly, companies can deduct their actual expenditure incurred in producing rental income; whereas natural persons cannot, but are effectively assumed to have incurred expenditure equal to 20 per cent of rents, irrespective of actual expenditure.¹²⁵ But there are very few complaints about such inequities. Apparently people do not object to the inequitably light contribution required of their neighbors, if their own liability is capped at 16 per cent.

III THE FACILITATION OF SIMPLICITY

What, then, has made it possible for Hong Kong to retain such simplicity in its tax law? It might be said that the place was colonised for the purpose of serving as a tax haven; that it serves that purpose still; and that the rudimentary state of its tax law should therefore come as no surprise. There is considerable truth in this, but it falls far short of a complete explanation, for Hong Kong's is a modern, complex, affluent society. The populace numbers seven million. The government, although not democratic, is mindful of public opinion. It finances a range of public services including a large public housing program, a comprehensive public health service and an expensive public education system. In some respects, Hong Kong's public services are not up to the standard of those to be found in comparably affluent western societies. For example, Hong Kong's public housing is cramped and uncongenial by western standards. In others, they are better. Examples include the public transport system, the financing of the territory's eight universities and the preservation of extensive undeveloped parkland adjacent to urban areas. The simplicity of Hong Kong's tax law cannot, therefore, be so easily written off.

The factors which appear to have made this simplicity possible include the absence of democracy; the fact that the Hong Kong government has generally operated at a

¹¹⁹ At least, the need to achieve *tax* equity does not arise. Whether the Hong Kong Government should do more to redress the gross inequality of incomes to be found in the territory is another question.

¹²⁰ See Michael Littlewood, 'Tax Reform in Hong Kong in the 1970s: Sincere Failure or Successful Charade?', in John Tiley (ed), *Studies in the History of Tax Law* (2004) 385.

¹²¹ See above n 5 to 8.

¹²² See above n 14 to 19.

¹²³ See above n 19 and 36.

¹²⁴ See above n 20 to 25.

¹²⁵ See above n 16 to 19.

surplus; the stability of the tax system over time; perhaps also a Chinese aversion to confrontation and litigation; and, most importantly, the lightness of the burden. Each of these requires comment.

Hong Kong's system of government (outlined briefly above)¹²⁶ is, and always has been, undemocratic and dominated by business interests. That such a government should finance itself by means of a simpler tax system than is to be found in most democracies is unsurprising. It is worth noting, though, that in other jurisdictions, especially the United States, the influence of business interests over tax policy has commonly manifested itself in the form of incentives of various kinds, and that these have tended to entail legislation of considerable complexity. In Hong Kong, in contrast, this had happened hardly at all.¹²⁷

From 1945 (when British rule was restored after the Japanese occupation) until 1997 (when Hong Kong returned to Chinese rule), Hong Kong's financial secretaries were perennially worried that the colony's tax system would fail to raise the revenues required to finance the massive expansion of the public services which, the British and colonial governments had decided, post-war sensitivities required.¹²⁸ But this never happened. Rather, almost every year, despite exponentially increased government spending, the IRO (together with the government's other sources of funds) produced greater revenues than the government required. Consequently, the government almost always operated at a large surplus, and so accumulated large reserves.¹²⁹ It was never short of money, and so could afford not to plug all the gaps in its tax statute.¹³⁰ Ironically, however, as soon as the Hong Kong government took the revenue-producing power of the IRO for granted, in the mid-1990s, the Asian financial crisis struck, and the government found itself having to operate at a deficit. This has not yet, however, led to any compromising of the tax system's simplicity. The government has continued to amend and add to the IRO, but at more or less the same rate as before.

Hong Kong's tax system is also unusually, perhaps uniquely, stable. There has been no basic change in the system since 1947. Hong Kong has thus been spared the kind of complexity that results from repeated changes in policy. This stability is itself of course

¹²⁶ See above n 2.

¹²⁷ Particular industries and commercial sectors have often sought specific tax concessions in Hong Kong, but the government has consistently refused. The allowances for investment in plant and machinery are very generous (see above n 44), but these are not industry-specific and, as the government itself has acknowledged, operate in effect as an across-the-board reduction in the rate of profits tax (thus affecting also a relative shifting of the burden by stealth from business profits to income from employment). For example, these allowances are available not only for manufacturing plants in the traditional sense but also for office fit-outs, company cars, works of art and so on. In recent decades, industry-specific tax provisions have fallen out of favour in most countries. In this respect, world opinion has changed so as to accord with what Hong Kong has been doing consistently since 1940 (when taxes on income were first introduced in the territory).

¹²⁸ In Hong Kong (both in colonial times and since), the Financial Secretary was (and is) roughly equivalent to the Secretary of the Treasury (in the United States) or the Chancellor of the Exchequer (in the United Kingdom).

¹²⁹ See Rabushka, 1976, above n 77; and A J Youngson, *Hong Kong Economic Growth and Policy* (1982).

¹³⁰ See Littlewood, above n 7.

largely attributable to the undemocratic system of government. The return of Hong Kong to Chinese rule in 1997 entailed no discernible change in tax policy. On the contrary, the Basic Law enshrines and gives constitutional status to the tax policy pursued during the colonial period.¹³¹

It is sometimes said that the Chinese people, or at least the Hong Kong Chinese, are generally non-confrontational, non-litigious and law-abiding. Perhaps this is so. The colonial Hong Kong Government, however, appears to have regarded the Hong Kong Chinese as even more prone to tax evasion than the expatriate part of the populace.¹³² The attitudes, beliefs and practices of the Hong Kong people are subjects particularly deserving of research, not least because the populace largely selected itself on the basis of an aversion to Communist rule. (The majority of the population are either immigrants or the children of immigrants from the Mainland.) Much work has been done in this field,¹³³ but it touches hardly at all on their attitudes to taxation. All that can be said, then, is that this is a subject in urgent need of research.¹³⁴ But of all the factors making feasible the extreme simplicity of Hong Kong's tax system, one seems paramount—the exceptional lightness of the burden. To *prove* that the lightness of the burden is a more important causal factor than the others I have mentioned is of course impossible. There are large gaps in the evidence, and, even if these could be filled, the basic problem of demonstrating causation would remain.

Nonetheless, the proposition seems reasonable. More specifically, it seems reasonable to suppose that the exceptional simplicity of Hong Kong tax law could not have been maintained at substantially higher rates of tax. In other words, it seems probable that if the Hong Kong Government had substantially increased the rates of tax, it would have found it necessary also to complicate the IRO with the sorts of provisions which are elsewhere regarded as obvious necessities, but which it currently does not contain. In particular, it would probably be necessary to add rules that would be necessary to: (1)

¹³¹ Basic Law, article 108. See also above at note 2. The interpretation and enforceability of article 108 appear to raise difficult questions which remain as yet wholly unresolved. It is plain, however, that the Chinese Government, the Hong Kong Government and all the major political parties in Hong Kong are determined that the handover should not result in, or permit, any change in basic tax policy.

¹³² See Littlewood, above n 7.

¹³³ See in particular Lau Siu-Kai and Kuan Hsin-Chi, *The Ethos of the Hong Kong Chinese* (1988); and Lau Siu-Kai, *Public Attitudes toward Political Parties in Hong Kong* (1992).

¹³⁴ Such research is needed for several reasons. First, such legitimacy as the Hong Kong government possesses rests on its claim that it governs in the interests of the populace generally. In the absence of democracy, research is therefore needed to determine if the Hong Kong's people's preferences are indeed as claimed by the government. Some of their preferences (for example, their opinions of the Chief Executive) have been the subject of considerable research; but very little has been done on the extent to which they understand and approve of their tax system. Second, Hong Kong's tax system is unusual in a number of important respects (one of these being its simplicity), and consequently of potential theoretical interest. But it is difficult to draw useful conclusions from it without being able to test the government's claim that the territory's people generally approve of both its tax system and its public finances. One powerful piece of evidence, however, is that there is no PAYE in Hong Kong; and that the tax system instead functions satisfactorily on the basis of taxpayer's active compliance. (See above, under the heading Salaries Tax). This gives Hong Kong's tax system a kind of legitimacy that cannot be claimed by the governments of most other developed jurisdictions (because if they abolished PAYE and attempted instead to rely on the active compliance of their taxpayers, their public finances would be reduced to chaos).

to make it at least somewhat more difficult to avoid tax;¹³⁵ and (2) to ameliorate at least the grosser inequities which currently exist in the system.¹³⁶ It seems reasonable also to regard the other factors I have mentioned (the lack of democracy; the surpluses; the tax system's stability; and Chinese cultural norms) as perhaps facilitating simplicity, but not as necessary conditions for it.

IV CONCLUSION

Hong Kong tax law is very simple. The obvious measure of its simplicity is the succinctness of the statute. But the difference between Hong Kong's tax system and those of the rest of the developed world is not merely quantitative; it is not just that other countries' tax law consists of ten times, or a hundred times, as many words as Hong Kong's. Rather, the difference is qualitative too. Hong Kong's IRO is not just a leaner animal, but a different beast. Judged from the perspective of other developed common law jurisdictions, there are gaps which are difficult to fathom. How can it be, for instance, that the taxation of Hong Kong/Mainland joint ventures—one of the territory's most important forms of business—is conducted, and conducted satisfactorily, on the basis of no direct authority? Viewed from outside the territory, the approach of Hong Kong's Inland Revenue Department seems lacking in authority, even illegitimate—yet at the same time puzzlingly benign. It can also be seen, however, as robust, straightforward and sensible. Any taxpayer, at any time, could object to the department's interpretation, and so oblige the department to defend it in court. Perhaps, one day, one will. In the meantime, the system works—and costs much less to run than it would if there were a rule to cover every case, and the courts were called upon to resolve every doubt.

The main reason for studying the simplicity of Hong Kong tax law is that it might be possible to learn from it something of more general application. Specifically, it seems possible that other governments, seeking to redress the appalling complexity of their tax laws, might be able to learn something from Hong Kong. Two lessons might be tentatively suggested.

The first is that the degree of simplicity which very low rates of tax might make possible seems commonly to be underestimated. To suggest that other governments might cut their taxes (and reduce their revenues) so as to facilitate the simplification of their tax laws would not be helpful. On the other hand, any tax reform is likely to be less than optimal if it is based on fallacious assumptions as to the relationship between the weight of the burden and the complexity of the law needed to collect it. In any project of tax reform, it is necessary to consider numerous variables, and one of these is the relationship between the rates of tax and the complexity of the law.

The second lesson which Hong Kong seems to offer is that a legislature might avoid considerable complexity by placing greater trust in the judges. The complexity of most

¹³⁵ As is mentioned above, it is routinely possible in Hong Kong to escape tax by such simple means as remunerating employees in kind rather than in cash (see above n 115) and transferring income to offshore entities (see above n 113).

¹³⁶ As is mentioned above, some forms of income are taxed and others are not, and of those forms which are taxed, some are taxed at different rates from others. See above n 120.

countries' tax laws is very largely due to the perceived need to provide for every conceivable case; and to spell out the rules in advance, so that taxpayers can make commercial decisions with reasonable certainty of the tax consequences to follow. Hong Kong's legislature, however, has promulgated rules of a very general nature, and left it to the courts to interpret them in such a way that the system works. This has meant, most importantly, that it has fallen to the courts to interpret the legislation in such a way as to accord with two basic norms. First, taxation must be in accordance with the law. It must not be, or appear to be, arbitrary or capricious. Second, the law must be interpreted in such a way as not to permit excessive erosion of the government's revenues. Hong Kong's courts seem to have succeeded on both counts.

This, in turn, has been possible only because the legislature produced a statute capable of sustaining a workable interpretation. The best example is the one I have laboured: that Hong Kong profits tax is imposed only on profits 'arising in or derived from Hong Kong'.¹³⁷ What these words mean has been determined by the courts; and the courts have developed a meaning which is adequately principled, adequately respectful of taxpayers' rights and adequately protective of the government's revenues.¹³⁸

It might be said that this is not a function that can satisfactorily be left to the courts. In so general a form, this proposition seems to be false, for the case of Hong Kong disproves it. Perhaps, then, there is something about Hong Kong, or its tax system, which makes it possible for its courts to bear such a burden, even though it would not be possible elsewhere? It is difficult, though, to see what this might be—other than, of course, that the rates of tax in Hong Kong are very low.

¹³⁷ IRO s 14(1); see above n 47.

¹³⁸ As I have also explained, the taxation of Hong Kong/Mainland joint ventures depends on an interpretation of the law devised not by the courts but by the Inland Revenue Department. But the reason no-one has challenged it is presumably that taxpayers think the courts unlikely to interpret the statute any more generously.

PART IVA AND TAX REFORM

TOM DELANY

*Tom Delany is a Senior Lecturer in Taxation Law in the Faculty of Business,
University of Southern Queensland, Toowoomba, Queensland.*

Determining the extent to which the Australian general anti-avoidance tax provisions in Part IVA of the *Income Tax Assessment Act 1936*(ITAA36)¹ apply to particular transactions is a perennial piece of work-in-progress for our tax professionals, tax administrators and the courts. The introduction of new legislation as a result of the tax reforms emanating from the Ralph Review² provides yet another forum to test the application of Part IVA.

The personal services income (PSI) provisions³ (which are part of the tax reform measures) limit the availability of deductions against PSI where the person earning the income cannot satisfy the personal services business tests. A person or entity satisfying the relevant tests is no longer subject to PSI rules but still needs to consider the application of Part IVA to their particular situation⁴.

This paper initially clarifies the concept of PSI and the types of entities that will be either within or outside the operation of the PSI rules. The paper then critically evaluates the likely application of Part IVA to PSI that is not subject to the PSI rules. This evaluation is completed by analysing the existing law in relation to Part IVA as well as any ruling and public pronouncements made by the Commissioner⁵ relevant to this matter. The paper concludes that certain types of entities generating PSI that are outside the PSI rules may be captured by the application of Part IVA.

¹ Sections 177A to 177H of the *Income Tax Assessment Act 1936* (ITAA36).

² On 21 September 1999 the federal government released the *Ralph Review of Business Taxation Report* entitled, *A Tax System Redesigned*. The Federal Government has subsequently introduced a substantial amount of legislation in line with the recommendations of that report.

³ Divisions 84 to 87 of the *Income Tax Assessment Act 1997* (ITAA97). These rules apply from 1 July 2000 with some transitional rules applying to 1 July 2002.

⁴ Section 86-10 of the ITAA97 states that taxpayers not covered by the PSI rules will need to consider the application of Part IVA.

⁵ The Commissioner of Taxation in Australia or the Australian Tax Office.

I INTRODUCTION

The general anti-avoidance rules in Part IVA⁶ apply to all transactions⁷ entered into⁸ that have the dominant⁹ purpose of generating a tax benefit¹⁰. It is recognised that where the conditions of Part IVA are not satisfied¹¹ that the anti-avoidance rules will not apply. Where the rules apply any tax benefit derived from the scheme is cancelled¹² and an amended assessment is issued¹³. Part IVA has been applied by the Commissioner of Taxation¹⁴ to many transactions with some success in relation to existing legislation¹⁵.

⁶ Sections 177A to 177H of the ITAA36.

⁷ Generally Part IVA applies to schemes and a 'scheme' is defined in s 177A(1) to mean, unless the contrary appears: '(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and

(b) any scheme, plan, proposal, action, course of action or course of conduct;'

⁸ After 27 May 1981.

⁹ In its ordinary meaning, 'dominant' indicates that purpose which was the ruling, prevailing, or most influential purpose. *Spotless Services Ltd v FCT* 93 ATC 4397; 96 ATC 5201.

¹⁰ The primary examples of a tax benefit include a situation where:

- an amount is not included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or
- a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out.

¹¹ For example *Mochkin v FC of T* 2002 ATC 4465; 2003 ATC 427; *Essenbourne Pty Ltd v FC of T* 2002 ATC 5201.

¹² Section 177F provides that where a tax benefit has been obtained, or would but for this section be obtained, by a taxpayer in connection with a scheme to which Part IVA applies, the Commissioner may:

'(a) in the case of a tax benefit that is referable to an amount not being included in the assessable income of the taxpayer of a year of income—determine that the whole or a part of that amount shall be included in the assessable income of the taxpayer of that year of income; or

(b) in the case of a tax benefit that is referable to a deduction or a part of a deduction being allowable to the taxpayer in relation to a year of income—determine that the whole or a part of the deduction or of the part of the deduction, as the case may be, shall not be allowable to the taxpayer in relation to that year of income'.

¹³ Section 177G(1) ITAA36 provides that:

Nothing in section 170 prevents the amendment of an assessment at any time before the expiration of 6 years after the date on which tax became due and payable under the assessment if the amendment is for the purposes of giving effect to subsection 177F(1).

¹⁴ In Australia or the Australian Tax Office.

¹⁵ Legislation that was in place at the time that Part IVA was enacted which was on 27 May 1981.

Fresh legislative measures being introduced as a result of the Ralph Review¹⁶ provide us with further opportunities to test the application of Part IVA. One example of this new legislation can be found in the PSI provisions¹⁷. The objective of the PSI rules is to limit the entitlements of individuals or other entities to deductions relating to PSI derived directly or being alienated to other entities¹⁸.

II OVERVIEW OF THE PERSONAL SERVICES INCOME (PSI) RULES

The PSI rules apply only where the income is personal services income. PSI is defined as:¹⁹

Your ordinary income or statutory income, or the ordinary income or statutory income of any other entity, is your personal services income if the income is mainly a reward for your personal efforts or skills (or would mainly be such a reward if it was your income).

It is noted that only individuals can have PSI²⁰ and can include income received for doing work or performing a result²¹. Taxation Ruling TR 2001/7²² provides a very comprehensive discussion of what constitutes PSI and in paragraph 22 of the ruling it is stated:

The phrase “or would mainly be such a reward if it was your income” in subsection 84-5(1) ensures that the character of the income as being mainly a reward for an individual's personal efforts or skills is not altered in those circumstances where it is legally derived by another entity. The phrase requires a determination as to whether the income, if it was derived by an individual, would be mainly a reward for that individual's personal efforts or skills rather than being generated by the use of assets, the sale of goods, or by a business structure. If, as a practical matter, the income is mainly a reward for the individual's efforts or skills, then that amount or item of that entity's ordinary income or statutory income is an individual's personal services income.

The meaning of the word ‘mainly’ is generally understood to be a requirement that at least 50 per cent of the activity that generated the income was from personal exertion. While the concept of PSI is quite wide it does not include income that is mainly:²³

¹⁶ On 21 September 1999 the Federal Government released the Ralph Review of Business Taxation Report entitled, *A Tax System Redesigned*. The federal government has subsequently introduced a substantial amount of legislation in line with the recommendations of that report.

¹⁷ Divisions 84 to 87 of the ITAA97. These rules apply from 1 July 2000 with some transitional rules applying to 1 July 2002.

¹⁸ Division 85 and 86 of the ITAA97.

¹⁹ Section 84-5 of the ITAA97.

²⁰ Section 84-5(2) of the ITAA97.

²¹ Section 84-5(3) of the ITAA97.

²² Published on 31 August 2001.

²³ Paragraph 29 TR 2001/7.

- from an entity supplying goods or granting a right to use property;
- generated by assets an entity holds; or
- generated by the business structure.

Also where the personal services that are provided are ancillary to:²⁴

- (a) the sale or supply of goods;
- (b) the granting of a right to use property;
- (c) the supply and use of assets that have a significant role in the generation of the income; or
- (d) the generation of the income by the business structure.

The income so generated is not personal services income.

Depending on the circumstances, the question of whether the income will be derived mainly from personal exertion or whether it is ancillary to other activities will depend on the nature of the transactions. It will require a consideration of all the facts of the particular case keeping in mind that to be PSI at least 50 per cent of the income must be generated from personal exertion.²⁵

Paragraph 45 of TR 2001/7 provides guidance in clarifying PSI, as follows:

To decide whether an entity's income is your personal services income, assume that it is your income, and ask yourself whether it would mainly be a reward for your personal efforts or skills. If the character of the income is mainly a reward for your personal efforts or skills and is not mainly from the use of assets, sale of goods, or a business structure, it will be personal services income within the meaning of subsection 84-5(1), although it may legally have been derived by the personal services entity.

III IMPACT OF THE PSI RULES APPLYING

There are two methods by which the PSI rules can apply depending on whether the income is derived by an individual directly²⁶ or is alienated to a personal services entity²⁷. Generally where the PSI is generated directly by an individual their deductions are limited to the amount of deductions available to employees. Accordingly expenses for home to work travel are not deductible as these would not be available to employees²⁸. Some expenses that are specifically deductible include expenses of:²⁹

²⁴ Paragraph 30 TR 2001/7.

²⁵ Paragraph 31 TR 2001/7 outlines certain factors to be considered in determining if the income is personal services income.

²⁶ Division 85 ITAA97.

²⁷ Division 86 ITAA97.

²⁸ See *Lunney v FC of T* (1958) 100 CLR 478.

- gaining work; or
- insuring against loss of your income or your income earning capacity; or
- insuring against liability arising from your acts or omissions in the course of earning income; or
- engaging an entity that is not your associate to perform work; or
- engaging your associate to perform work that forms part of the principal work for which you gain or produce your personal services income; or
- contributing to a fund in order to obtain superannuation benefits for yourself or for your dependants in the event of your death (but only to the extent of the Superannuation Guarantee amount where the contribution is for an associate³⁰); or
- meeting your obligations under a workers' compensation law to pay premiums, contributions or similar payments or to make payments to an employee in respect of compensable work-related trauma; or
- meeting your obligations, or exercising your rights, under the GST law.

Note that these rules do not apply where a person is carrying on a personal services business³¹ or where the income is derived in the capacity of an employee³².

Where the PSI is alienated to a personal services entity then Division 86³³ deems the income so alienated as your income and limits the other entity's entitlement to deductions to offset against the amount treated as your income³⁴. The deductions available to the personal services entity are essentially those that would be available to the individual if they incurred them. Deductions available to the personal services entity include:

- Entity maintenance deductions³⁵ which include tax related expenses³⁶;
- Certain car³⁷ expenses³⁸;
- Superannuation³⁹; and

²⁹ Section 85-10(2) ITAA97.

³⁰ Section 85-25(3) ITAA97.

³¹ Division 87 ITAA97 outlines what is a personal services business.

³² Section 85-30 and 85-35 ITAA97.

³³ ITAA97.

³⁴ Section 86-1 ITAA97.

³⁵ Section 86-65 ITAA97.

³⁶ Tax related expenses are deductible under s 25-5 ITAA97.

³⁷ Section 86-70 ITAA97.

³⁸ These expenses are limited to one car where there is private use of the car. Note a deduction is available for fringe benefits tax paid as well.

³⁹ Section 86-75 ITAA97. Note that if the individual performs less than 20 per cent of the entity's principal work and the individual is an associate of another individual whose personal services income is included in the entity's ordinary income or statutory income the superannuation contributions are limited to the Superannuation Guarantee level (currently 9 per cent).

- Salary and wages paid promptly to the person who performs the personal services⁴⁰.

IV STAYING OUTSIDE THE PSI RULES

A taxpayer will be able to stay outside the PSI rules where the income is derived as part of a personal services business⁴¹. There are four tests for determining your eligibility to be outside the PSI rules. Taxation Ruling TR 2001/8 at para 27 states:

You will not be within the alienation measure and can self-assess accordingly if you come within ONE of the following four situations:

- You satisfy the ‘results test’, that is:
 - (a) You work to produce a result(s); and
 - (b) You provide the tools and equipment necessary (if any) to produce the result(s); and
 - (c) You are liable for the cost of rectifying any defective work.

OR

- None of your clients pay you 80% or more of your personal services income in the year of income and you have two or more unrelated clients (who were obtained as a result of you making offers to the public at large or to a section of the public).

OR

- None of your clients pay you 80% or more of your personal services income in the year of income and
 - (d) You engage an individual(s) or an unrelated entity(ies) to perform 20% or more (by market value) of the principal work (ie the work that generates the personal services income) or
 - (e) You employ an apprentice for at least half the year.

OR

- None of your clients pay you 80% or more of your personal services income in the year of income, and you exclusively use business premises that are physically separate from your home, or from the premises of the person for whom you are working.

In addition, if you cannot satisfy any of these four tests and 80 per cent or more of your personal services income comes from one source, you may be able to obtain a Personal Services Business Determination (PSBD) from the Commissioner to establish that you are conducting a personal services business. You can also apply for a PSBD if you are not sure whether you satisfy any of the tests. If the Commissioner is satisfied that you are entitled to a PSBD, you will not be subject to the alienation measure⁴².

⁴⁰ Section 86-80 ITAA97.

⁴¹ Division 87 ITAA97.

⁴² Paragraph 28 TR 2001/8.

V PART IVA RAISES ITS HEAD

For many taxpayers the exclusion from the PSI rules is a welcome relief but this is far from the end of the story as stated in para 32 of Taxation Ruling TR 2001/8:

Note that the general anti-avoidance provisions of Part IVA of the ITAA 1936 may still apply to cases of alienation of personal services income that fall outside the alienation measure: see section 86-10⁴³ of the ITAA 1997.

The Commissioner has issued a fact sheet⁴⁴ on the application of Part IVA to personal services business and in this fact sheet it is stated that:

It is important to remember that a personal services business still earns personal services income and not business income for income tax purposes. Our views on how you should treat that income have been established for some time and have not changed in relation to arrangements that are not affected by the new alienation of personal services income legislation.¹ These views are set out in Taxation Rulings IT 2121, IT 2330 and IT 2503. Consequently, we would apply those views in appropriate cases.

This fact sheet restates the basic principles on which Part IVA will apply and in essence the Part applies if there is a scheme that is entered into or carried out for a dominant purpose of obtaining a tax benefit, and the conclusion about dominant purpose is required to be made on an objective analysis of the facts.

VI WHO ARE THE ATO TARGETS?

It would appear that where the income is derived from the use of business assets or from a business structure there will be no particular issues for taxpayers with the operation of Part IVA. The ATO targets are likely to be entities that satisfy one of the exceptions to the PSI rules. Examples are as follows:

- Professionals providing services to the public; and
- Tradespersons providing services to the public.

The targets will still be deriving income primarily from personal services rather than a business structure.

⁴³ Section 86-10 of the ITAA97 states that taxpayers not covered by the PSI rules will need to consider the application of Part IVA.

⁴⁴ Fact sheet on the application of Part IVA, Commissioner of Taxation, *General Anti-Avoidance Rules and how they May Apply to a Personal Services Business* (September 2003).

VII WHAT IS A BUSINESS STRUCTURE?

As can be seen from the foregoing discussion, if the income is from a business structure (not mainly from personal exertion) then it will not be subject to immediate scrutiny by the Commissioner. Generally the income will be from a business structure where:

- There are a number of arm's length employees or others engaged to perform work;
- There is a presence of goodwill;
- The extent to which income-producing assets are used to derive the income;
- The nature of the activities carried out;
- The size of the operation and the extent to which the income is dependent upon a particular individual's own personal skills, efforts or expertise.

There have been a number of cases that have considered the existence of a business structure. In *Osborne v FC of T*⁴⁵ a taxpayer who was a registered valuer commenced practice as a registered valuer working from home in 1980 and at the same time the business name and business was transferred into a family trust that was already in existence. In 1983 the valuation business was acquired by another family trust and in 1989 the taxpayer ceased valuation work. The primary issues before the court were whether s 260⁴⁶ applied in respect of the 1983–84 year, and Part IVA applied in respect of the 1984–85 to 1988–89 years so that all of the valuation income was assessable to the taxpayer personally in those income years.

The AAT, at first instance held that both s 260 and Part IVA applied, however, the Federal Court subsequently held that while the taxpayer was the registered valuer that enabled the fees to be earned, the fees were actually earned as a result of the contractual arrangements made between the trustee and various clients and so s 260 did not apply. In addition the Court held that Part IVA did not apply because once it was concluded that the trustee derived the income, a subsequent change of trustee meant that the tax benefit was not obtained by the taxpayer but by the beneficiaries of the first trust.

⁴⁵ 95 ATC 4323; (1995) 30 ATR 464.

⁴⁶ ITAA36. Section 260 provides: 'Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly:

- (a) altering the incidence of any income tax;
- (b) relieving any person from liability to pay any income tax or make any return;
- (c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or
- (d) preventing the operation of this Act in any respect,

be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.

This section does not apply to any contract, agreement or arrangement made or entered into after 27 May 1981.'

In coming to its conclusion in relation to s 260 the court stated:⁴⁷

Whilst it may be said that the valuation fees were generated by the personal services of the applicant in the sense that it was his standing as a registered valuer that enabled the fees to be earned, they were earned as a result of contractual arrangements made between Bellatrix and various clients ... The applicant at no time had any personal entitlement to any of the valuation fees paid to Bellatrix other than in accordance with the terms of the trust deed. Nor had the applicant at any antecedent time been employed as a valuer or conducted a business or practice whereby he had applied his professional skill as a valuer for the purpose of earning valuation fees. On the facts as found by the Tribunal the only “arrangement” the applicant made was, in his capacity as a director of Bellatrix, to contract on behalf of Bellatrix with various clients to provide valuations for reward. Neither Bellatrix nor trust no. 1 were set up for the purpose of “diverting” income derived from valuation fees. Both existed well before any such fees were derived. Bellatrix's income was already “diverted” to trust no. 1 well before any income was derived from valuation fees.

Furthermore the court indicated that s 260 was not satisfied:⁴⁸

The respondent's case fails the test expressed by Gibbs CJ in Gulland⁴⁹ namely that the arrangement will be within s 260 “if it alters the incidence of income tax in a case in which the taxpayer is in receipt of income”.

In relation to the application of Part IVA the court stated:⁵⁰

Where a tax benefit has been obtained, or would but for s 177F be obtained, by a taxpayer in connection with a scheme, the Commissioner may, in the case of a tax benefit that is referable to an amount not being included in the assessable income of the taxpayer of a year of income, determine that the whole or part of that amount shall be included in the assessable income of the taxpayer for that year of income (s 177F(1)).

In holding that there was not tax benefit gained by the taxpayer the court stated:⁵¹

Once the position is established that the appellant was not, and had never been, liable to tax on the valuation income derived by Bellatrix as trustee for trust no 1 ... If there was a scheme in connection with which a tax benefit was obtained, it was the beneficiaries of trust no 1 who obtained the tax benefit.

⁴⁷ Olney J at para 4330.

⁴⁸ Olney J at para 4331.

⁴⁹ 83 ATC 4352.

⁵⁰ Olney J at para 4331.

⁵¹ Olney J at para 4332.

The case of *Rippon v FC of T*⁵² also considered whether the income derived was from personal exertion or from a business structure. In that case the taxpayer was an engineer who, following the collapse of his employer in 1976, went into business on his own as a project management consultant. He set up a unit trust and all of the units were held by the trustee of a discretionary family trust. The trustee of the unit trust conducted the consultancy business and engaged consultants on a sub-contract basis and obtained various professional engagements. Initially the taxpayer was employed by the company at a salary of \$18 000 per annum, but this fell dramatically thereafter and bore no relation to the gross fees received by the company.

The Commissioner applied s 260 to strike down the corporate and trust structure so that the taxpayer was liable for tax as though the income were received in his own hands.

The Federal Court however held that s 260 did not apply despite the fact that there was a complex corporate structure because the structure could be explained by reference to the fact that it provided a convenient way to take in partners in the future. In addition, the business structure provided scope for future growth of the business and was an ordinary business and family dealing. The court held that the structure was not put in place to avoid tax.

The court did discuss the issue of reduced salary in later years as follows:⁵³

Fourthly, the salary which the taxpayer received in the earlier years under review was fixed by reference to his previous experience as an employee. Such salary therefore reflected a proper commercial value of the personal service he was to render to the company ... The fact that much less salary was earned in 1980 to 1983 is explicable by the Kordiak problems. ... Absent the Kordiak problems, the reasonable inference is that the taxpayer's salary would have continued without substantial reduction. I do not see that the salary reduction which in fact took place assists the Commissioner's case.

The case of *Liedig v FC of T*⁵⁴ is another example of where the Commissioner failed to convince the court that the relevant income was PSI. In this case the taxpayer was a registered land broker and the taxpayer's parents-in-law sold their land broking business to the taxpayer and his wife on the basis that it would be owned by them in equal shares. The taxpayer carried on the business for himself and his wife in his capacity as trustee. The Commissioner argued that the land broking business was operated by the taxpayer as a sole trader and the taxpayer's wife made no contribution to the running of the land broking business. Thus, the income was the taxpayer's personal exertion income which he could not divert to his wife.

⁵² *Rippon v FC of T* 92 ATC 4186; (1992) 23 ATR 209.

⁵³ *Ibid*, Heerey J, at para 4191.

⁵⁴ *Liedig v FC of T* 94 ATC 4269; (1994) 121 ALR 561; (1994) 28 ATR 141; (1994) 50 FCR 461.

On appeal to the Federal Court against this decision, the taxpayer sought to add to his grounds of objection by arguing that the tribunal should have granted an extension of the grounds of the taxpayer's objections on the basis that it was bound so to do on its own initiative. The court found that the contracts for work entered into by the taxpayer as trustee were, like service contracts with staff, the physical assets and goodwill, assets of the trust estate. Any income was derived as a result of those assets as much as through personal services.

In discussing the law in relation to PSI and the use of trusts, Hill J stated:

[Section] 260 applied and the more recent trilogy of cases in the High Court reported as *FC of T v Gulland*; *Watson v FC of T*; *Pincus v FC of T* 85 ATC 4765; (1985) 160 CLR 55 clearly indicated the application of s. 260 to the use of trusts to derive income which might ordinarily be described as “personal service or personal exertion income”. ... There is no reason to doubt that Part IVA of the present Act, replacing s. 260 in respect of schemes entered into after 27 May 1981, would have the same result where, having regard to the various matters referred to in s. 177D of the Act, a conclusion would be reached that a person who entered into or carried out the scheme or any part of it did so for the purpose of enabling a taxpayer to obtain a tax benefit in connection with that scheme.

In holding that the income was derived from the assets of the trust Hill J stated:⁵⁵

the Deputy President who recognised that there were some trust assets, including goodwill, and that income could be said to flow in part from those assets as well as the skill of Mr Liedig. But the problem is not even as simple as that. A land broker, like a solicitor, may, and probably does, enter into a contract with the client for the performance of work. Ordinarily moneys would not be payable under that contract unless and until the work contracted to be performed had been completed. Those contracts, like the service contracts with staff, the physical assets and goodwill, are all assets of the trust estate...

It can be deduced from the foregoing discussion that the distinction between personal exertion income earned by an individual in their own right and income earned from a business structure where the economic activity is essentially carried on by one person is a difficult task as noted in Hill J's comments above.

A question that could be posed is whether the cases of *Gulland*, *Watson* and *Pincus*,⁵⁶ if considered in the light of the current PSI provisions, would be captured by those rules to deem the income earned to be income of the individuals. It is clear that the taxpayers in those cases should be able to satisfy one of the four personal service business tests.⁵⁷ Based on the facts in those cases it should be possible to satisfy the unrelated client

⁵⁵ At para 4280. See also *Tupicoff v FC of T* 84 ATC 4851; (1984) 56 ALR 151; (1984) 15 ATR 1262; (1984) 4 FCR 505.

⁵⁶ 85 ATC 4765; (1985) 160 CLR 55.

⁵⁷ Section 87-15(2) ITAA 97.

test,⁵⁸ the employment test⁵⁹ or the business premises test⁶⁰ and stay outside the PSI rules. However as pointed out by Hill J, Part IVA is very likely to strike down any tax benefit arising from the alienation of the relevant income.

VIII CURRENT APPROACH BY THE COMMISSIONER

In the fact sheet⁶¹ the ATO has indicated that the following types of arrangements are likely to require closer investigation for a potential application of Part IVA:

- Income is retained in the personal services entity and in addition splitting of income with other family members occurs.
- Husband and wife partnerships deriving income but where one of the partners does the dominant amount of the work but income is shared 50/50.
- Income paid to the principal in the entity where the income is not commensurate with the duties of that individual. An example of this would be where non-commercial salaries are paid to the principal.
- Excessive remuneration paid to a related party, eg spouse. The focus is on non-principal work. Remuneration includes superannuation contributions made – note the provisions governing super contributions are age based rather than salary based.
- Where a personal services business earns income from a few clients rather than from many clients.

In the fact sheet, the Commissioner is not prohibiting a taxpayer from operating through an entity structure. In fact he provides the following guidance:⁶²

Company:

⁵⁸ Section 87-15(2)(b) ITAA 97.

⁵⁹ Section 87-15(2)(c) ITAA 97.

⁶⁰ Section 87-15(2)(d) ITAA 97.

⁶¹ See above n 45.

⁶² Ibid.

If you operate through your company and there is no income splitting and no retention of profits in the company (for example, if the only advantage for income tax purposes is access to greater superannuation benefits) then Part IVA will not apply.

If a bona fide attempt is made to break even, a relatively small amount of taxable income may be returned by the company provided that income is distributed to you by way of a franked dividend in the following year.

Trust:

If you operate through your trust with a corporate trustee the position is the same as for companies.

You should receive income from the trust in relation to the personal services income that is commensurate with your duties and responsibilities, or be the sole beneficiary of the trust in relation to that income.

Partnership:

If you are in business and you conduct that business with your spouse through a genuine partnership then this will be accepted for income tax purposes.

Where the partnership income results from the personal services of one or more of the partners (not from the services of employees or the use of income-producing assets) and where there is splitting of that personal services income which reduces the amount of income tax which might otherwise be payable, then Part IVA may apply to this arrangement.

IX NON-COMMERCIAL REMUNERATION

A question could be asked as to whether the Commissioner can attack non-commercial remuneration. The primary issue here is if the Commissioner can, firstly, determine what a commercial remuneration is for a principal in a personal services entity, and, secondly, whether he or she can require an entity to pay that level of remuneration to the principal? Note that in the absence of the specific PSI rules discussed already there is no specific provision giving the Commissioner this power. Accordingly, it would appear that the Commissioner would be required to consider Part IVA. If the Commissioner can succeed with applying a non-commercial remuneration argument through the application of Part IVA this would substantially reduce the ability for income splitting.

The Commissioner has discussed commercial remuneration in Taxation Ruling IT 2330 as follows:⁶³

the payment of a salary to the former proprietor considerably lower than the profits which he or she formerly derived from the business, accompanied by a corresponding diversion of income to family members, would require examination. There may be good and valid reasons for the particular level of salary, e.g. reduction in duties and responsibilities, contraction in business activities, payment that adequately enough compensates for the work that is done, participation by beneficiaries in the business activities, etc. As a general proposition the level of salary paid to the former proprietor should be no less than commensurate with his or her continuing duties and responsibilities.

Of course the Commissioner's analysis here relies on there being a former business or former employment. If there are no precedent activities it may be more difficult for the Commissioner to determine a commercial salary.

In relation to remuneration paid to family members Taxation Ruling IT 2330 provides that:

a taxpayer in business may employ family members in the business - provided the employment is bona fide and the wages reasonable in amount, an income tax deduction is allowable for the wages.

⁶³ Paragraph 29 of Taxation Ruling IT 2330.

On the subject of remuneration it would appear that, irrespective of whether the remuneration is to the principal or family members, the remuneration should be commensurate with the level of responsibilities in consideration of normal remuneration in the particular industry. Of course there will be many situations where it is not easy to determine exactly the correct commercial remuneration but it would certainly be possible to determine a range within which a person should be remunerated. If the actual remuneration were clearly outside that range then further investigation would be required.

Of course the Commissioner may take a more direct approach to determining commercial remuneration in a particular situation involving PSI. For example, rather than determine industry comparatives, the Commissioner may take the approach that if the primary income from the activity is derived from the services of one individual then all income reduced by allowable deductions should be the relevant remuneration amount. This may be seen as a harsh approach, and in many respects it is very similar to the outcome achieved when the PSI⁶⁴ rules apply.

X WHY PAY A LOW SALARY?

It appears that the Commissioner's initial reaction to the payment of a low level of salary is that there is a tax avoidance purpose. This may not always be the case as there can be other considerations, including:

- Profits may be retained to purchase business assets.
- Profits may be retained to retire debt incurred in acquiring the business.
- Profits may be retained to provide working capital for the business and retain a satisfactory level of liquidity.
- A low salary may be paid to reduce salary on-costs such as work cover, payroll tax and SGC.
- Retaining profits may assist in boosting the value of the business for future sales.

It would appear that the Commissioner considers that any retention of profits may give rise to a consideration of Part IVA. Taxation Ruling IT 2503 discusses this matter in relation to practice entities:⁶⁵

The retention of profits in the practice company is generally not acceptable. Where profits are retained, salary payments and, therefore, superannuation contributions will be reduced accordingly. Although at times the tax rates on the salary in the hands of the professional and the profits in the company may be the same, the purported main object of the incorporation, obtaining superannuation, will be frustrated. In effect, any retained profits will put in doubt the very basis on which the arrangements have been put forward and accepted, viz., the provision of superannuation benefits.

⁶⁴ Divisions 84 to 87 ITAA97.

⁶⁵ Taxation Ruling IT 2503 para 10.

This ruling does consider a situation where there are profits retained but provides that any retention should be merely temporary as follows:⁶⁶

However, where a bona fide attempt has been made to break even but the practice company returns a relatively small taxable income because of the above or similar difficulties, the company should distribute all its taxable income, to the professional person by way of franked dividend, in the following year.

The ruling goes on to discuss the potential application of Part IVA where all profits are not distributed as follows:⁶⁷

On the other hand, a practice company that makes little or no attempt to distribute the whole of its income to the professional person by way of salary prior to the end of its financial year, or retains income in the company, will not be taken to have made a bona fide attempt to comply with the guidelines. ... In cases of this sort the income from the practice should be treated as that of the professional practitioner involved and reliance placed on Part IVA.

XI WHAT IF THE USE OF AN ENTITY IS FORCED UPON THE TAXPAYER?

In many cases taxpayers are required by service recipients to offer their services through an entity and accordingly it may be open to these taxpayers to argue that the use of the entity is not for a tax related purpose. The Commissioner in the fact sheet⁶⁸ discussed this situation as follows:

Even if you have to provide your services through an interposed entity in order to obtain the relevant service contract Part IVA may still apply if you use that entity to split your income or retain profits.

In essence the Commissioner's comments are suggesting that the mere fact of using an entity to provide services may be fine but you cannot seek to derive tax benefits from the use of the entity. This issue was discussed at length in *Case W58*.⁶⁹ In that case the taxpayer was required to provide his services through a company in order to work as a consultant. He acquired a shelf company to act as his family company and, acting on professional advice, created a discretionary family trust the trustee of which was the family company. Consulting fees paid to the trustee company were retained to pay any debts or expenses of the family company, partly paid to the taxpayer as salary and partly distributed as trust income to members of the taxpayer's immediate family as beneficiaries under the family trust.

⁶⁶ Ibid para 11.

⁶⁷ Ibid para 12.

⁶⁸ See above n 45.

⁶⁹ *Case W58* 89 ATC 524.

The Commissioner, relying on s 177F, included in the taxpayer's assessable income part of the consultancy fees distributed by the family trust as trust income. The Commissioner contended that the whole arrangements entered into by the taxpayer constituted a 'scheme' for the purposes of Pt IVA, whereby surplus income of the family company was distributed to others, resulting in the taxpayer obtaining a tax benefit which should be cancelled.

The tribunal, in agreeing with the Commissioner's argument, initially discussed the non-commercial nature of the salary paid to the taxpayer:⁷⁰

I accept that the distribution occurred in the way set out in Exhibit 12 and I accept that the income received by the taxpayer bears no relationship to the services provided by him to the X Company through the TFC ...

Clearly the payment of a non-commercial salary to the taxpayer influenced the tribunal in coming to the finding that Part IVA applied. The tribunal went on to discuss the requirement to form a company to undertake the income earning activity but was satisfied that there was no need to form a family trust in order to earn assessable income. The tribunal went on to discuss the entity structure as follows:⁷¹

The form of a corporate vehicle which employed the taxpayer and controlled the trust belies the real substance of that arrangement which essentially allowed the taxpayer to act in such a way as to attract to himself a lower incidence of personal income tax. The taxpayer, and his wife, were always in control of the income "coming in" and merely acted in such a way as to generate as small a liability to income tax as possible.

And further:⁷²

I am satisfied, on the balance of probabilities, that having regard to the matters listed in sec. 177D para. (b) that the purpose of the taxpayer when he entered into and carried out the scheme was to obtain a tax benefit. It is not sufficient that this situation be described as a normal family arrangement. The ramifications of Pt IVA on a particular set of facts will always be judged on a case by case basis and no assistance will be gained from the establishment of broad categories such as "normal family arrangement".

It is interesting to note that there is very little discussion in *Case W58* about the question of whether the income earned by the taxpayer was business income or income from a business structure. This has been discussed earlier in this paper but the comments of the Commissioner in Taxation Ruling IT 2121⁷³ put the Commissioner's position beyond doubt:

⁷⁰ At para 532.

⁷¹ At para 536.

⁷² At para 537.

⁷³ Taxation Ruling IT 2121, Income Tax: Family Companies and Trusts in relation to income from personal exertion.

Moreover, looking at the substance of these arrangements, the interposed entity is not itself carrying on a business. The income [from] which it purports to derive comes wholly, or almost wholly, from the work done by the taxpayer and that work is largely confined to work for the employing firm. In a practical sense, to say nothing else, the taxpayer works as an employee of the former employer.

The ruling goes on to further criticise these arrangements:⁷⁴

In the view of this office all of these arrangements may be characterised as arrangements entered into primarily or principally or predominantly to avoid liability for income tax by means of the splitting of income. They are not explicable as ordinary business or family dealings. ... The tax benefit arising out of arrangements entered into on or after 28 May 1981 will be removed through the application of Part IVA. ... the practical result will be that the taxpayer doing the work will be liable to tax on the amount paid by the former employer to the interposed entity.

In situations where there is an interposed entity the Commissioner is more likely to apply Part IVA where upon the formation of the entity:⁷⁵

- (a) The taxpayer performs the same tasks as employees might ordinarily perform and generally works under the same physical conditions as other employees.
- (b) The taxpayer attends throughout normal business hours the premises of the firm for which personal services are rendered through the interposed entity.
- (c) The basis of payment of the income is akin to that normally paid for the personal services.
- (d) In the performance of the duties the taxpayer is subject to a measure of control by the firm for which personal services are rendered.
- (e) The firm has the right to dismiss the taxpayer.

The ambit of the Commissioner's attack is clarified by the following comments:⁷⁶

[Part IVA applies] to any arrangement for the splitting of income and consequent avoidance of liability for income tax where:

- (a) the income involved is income arising from a taxpayer's personal exertions; and
- (b) the arrangements operate solely in respect of that income.

The question of course is whether the Commissioner is aiming to extend the application of Part IVA to situations where income is not earned from personal exertion but from business assets. The following comments are relevant to set the scene:⁷⁷

⁷⁴ IT 2121 para 11.

⁷⁵ IT 2121 para 15.

⁷⁶ IT 2121 para 16.

⁷⁷ IT 2121 para 18.

Taking up a point of contrast, in a true business situation, whether it be that of a sole trader or an individual professional practice, there will be many cases where arrangements are made to conduct the business or practice for the benefit of family members. The assets of the business, e.g. plant and machinery, trading stock, goodwill etc., will be transferred to a family company or trust and the business will be carried on thereafter for the benefit of family members.

However the Commissioner falls short of fully clarifying his position on the application of Part IVA to businesses as follows:

Whether or not the transfer of the income producing assets of a business to a trust and the subsequent conduct of the business for the benefit of family members is affected by section 260 or Part IVA can only be determined in the light of the circumstances of each case. Accordingly that matter is not addressed in this ruling. It should be remembered there is no inherent reason to deny that a business undertaking, be it carried on by an individual, partnership or company can be made the subject of a trust.

There is established authority on whether the transfer of business assets by means of sale or genuine gift to a family trust is an acceptable practice and not likely to be caught by Part IVA. The case of *Tupicoff v FC of T*⁷⁸ discussed this matter as follows:⁷⁹

The taxpayer further argues that the reasoning in Purcell's case (DFC of T v Purcell (1921) 29 CLR 464) demonstrates that sec. 260 cannot apply here. But that was a case of an out and out gift of a portion of certain property to members of the taxpayer's family under a declaration of trust. The beneficial interest in the property passed absolutely, and, despite the retention of wide powers of management, it was possible to characterise the transaction as no more than an "ordinary family dealing" (cf. Hollyock, supra, at ATC p 4205; CLR p 655). However, in the present case, there is no such absolute gift.

This analysis appears to provide some element of certainty that Part IVA will not apply where there is a transfer of property and income subsequently derived from that property can be distributed in accordance with the terms of a trust. *Case W58* by contrast appears to provide guidance that Part IVA will apply where an interposed entity has been used to split personal service income.

The more recent case of *FC of T v MacArthur*⁸⁰ provides a further example of the application of Part IVA in what was essentially a PSI case. In that case the taxpayer had previously been employed by the Department of Mains Roads (DMR) in Queensland as a civil engineer for ten years up to 1982. After his resignation he and his wife worked overseas until 1986. Upon returning to Australia in 1986 the taxpayer and his wife used a company to provide engineering services and to enable the taxpayer and his spouse to get access to superannuation.

⁷⁸ *Tupicoff v FC of T* 84 ATC 4851.

⁷⁹ *Ibid* para 4863.

⁸⁰ *FC of T v MacArthur* 2003 ATC 4826.

In 1988 the company contracted to provide the services of the taxpayer to DMR and other parties. Many of the contracts specified an hourly rate and the taxpayer being nominated as the person to perform the actual work. The Commissioner considered that the income received by the company was the taxpayer's assessable income on the basis that the consulting services arrangement was a scheme to which Pt IVA applied.

The Federal Court, in agreeing with the Commissioner, considered that the arrangement was one to which Part IVA applied. It is noted that while the contracts were performed by the taxpayer for DMR his behaviour was very similar to the behaviour exhibited by an employee of DMR including such things as the completion of timesheets signed by the taxpayer and submitted by the company.

The court concluded that the taxpayer was legally not an employee of DMR even though he exhibited similar behaviour to an employee and the fact that the taxpayer was not an employee since 1982 clearly weighed in the favour of the taxpayer arguing that Part IVA did not apply because of the period of time since the earlier employment. The court addressed a broader question of whether the taxpayer would have received (or it was reasonable to expect that he would have received) assessable income in the absence of the scheme and stated it thus:⁸¹

In other words, the proper inquiry is as to what may have occurred had the scheme not been adopted and as to any amount which might, in those circumstances have been included in the taxpayer's assessable income. In the present case, the contracts with the Main Roads Department were identified as aspects of the scheme, but the relevant tax benefits need not have been tied to notional contracts that the taxpayer may have entered in to with the Department. The Commissioner might well have postulated that the taxpayer would have continued to practise his profession in his own name, deriving income from retainers received from various unidentified entities, possibly, but not necessarily including the Main Roads Department.

The court in concluding that Part IVA may apply agreed that, in the absence of the scheme, the taxpayer would have received assessable income:⁸²

There was every reason to expect that in the absence of the company, the taxpayer would have continued to practise his profession in his own name. It was quite possible that in so doing, he would have entered into contracts with the Department. The Tribunal's failure to deal with this possibility suggests to me that it misunderstood the appropriate question for consideration.

⁸¹ Ibid, Dowsett J at para 4834.

⁸² Ibid, para 4835.

XII ARE THERE SITUATIONS WHERE PART IVA WILL NOT APPLY?

You could be forgiven at this stage of this paper for perceiving the Commissioner as having the 'whip hand' in applying Part IVA to all transactions involving the alienation of PSI to an interposed entity. The case of *FC of T v Mochkin*⁸³ provides evidence that where the other requirements of Part IVA are not satisfied the existence of a tax benefit from channelling income through an interposed entity will not be sufficient to strike down the arrangement.

In 1987 the taxpayer entered into a commission-sharing arrangement with a firm of stockbrokers who subsequently sued the taxpayer for losses that arose from defaults by the taxpayer's clients. The stockbroking firm was successful in its claim for damages. At about the time of the court case for damages, the taxpayer commenced trading through a family trust (and subsequently through another family trust). The objective of the taxpayer was to limit his personal liability from the likelihood of being sued in the case of future client defaults.

The Commissioner argued, firstly, that the income derived by the family trusts should be included in the assessable income of the taxpayer, and, secondly, that the use of the trusts was a scheme to reduce the tax otherwise payable by the taxpayer. As with most schemes that require consideration there are commercial objectives as well as tax objectives. The question, of course, is whether the tax benefits merely come about as a result of affecting the scheme in a commercial manner, or whether steps in the scheme were added to enable the tax benefits to be achieved. This analysis must be completed in recognition of what the dominant purpose of the taxpayer is in affecting the trust structure. The Full Federal Court agreed with the Primary Judge as follows:⁸⁴

his Honour considered that the manner in which the scheme was entered into or carried out pointed to other purposes having actuated the Taxpayer. The most obvious was to immunise the Taxpayer personally, as well as the separate assets of himself and Daccar, from liability for client defaults or other debts or obligations of the business. Another purpose was to allow the business to build up goodwill, which could be detached from the Taxpayer's personality and continued participation in the business ...

The Full Court in balancing the commercial and tax objectives observed:⁸⁵

It can readily be concluded that the Taxpayer had tax advantages in mind in choosing a discretionary tax structure as the means of carrying out the scheme. Doubtless, there were other ways in which he could have chosen to conduct the stockbroking business and to immunise himself from personal liability. ... [T]he question is whether, in view of the matters identified in s 177D(b) it is reasonable to conclude that the Taxpayer's ruling, prevailing or most influential purpose in entering into or carrying out the scheme was to obtain the tax benefit identified by the Commissioner. In my respectful opinion, the primary Judge

⁸³ *FC of T v Mochkin* 2003 ATC 4272.

⁸⁴ *Ibid* para 4283.

⁸⁵ *Ibid* para 4290.

was correct in finding that a reasonable person would conclude that the tax advantages of the scheme were subsidiary to the commercial objectives. The Taxpayer has therefore established that a reasonable person would not conclude that he entered into or carried out the scheme for the dominant purpose of obtaining a tax benefit in connection therewith.

The foregoing analysis indicates that Part IVA will not apply where the normal requirements for its application are not satisfied. However it would appear that the avenues of defence against the application of Part IVA appear limited in relation to the determination of the existence of a tax benefit. The mere fact of operating through an entity and not paying all income to the person performing the personal services appears sufficient for the courts to find that there is a tax benefit present. The eight factors in s 177D that need to be considered in order to conclude that there exists a dominant tax purpose appear more difficult than the tax benefit test to apply in PSI cases.

The requirement to set up an entity to limit personal liability in the *Mochkin Case* appears in some respects similar to the need in *Case W58* to set up a company in order to be able to provide personal services. As the tribunal in *Case W58* concluded, the mere formation of a company was not enough in itself to be caught by Part IVA, it was the manner in which the company as corporate trustee split the income with family members that was the determining factor. The Commissioner endeavoured to argue this point in *Mochkin* as well:

The Commissioner attempted to meet this formidable difficulty by asserting that, even if a corporate entity had carried on the business, that entity would have paid or distributed to the Taxpayer the income that in fact was distributed to the beneficiaries through the No 2 Trust. However, this submission seems to assume, contrary to the primary Judge's findings, that the commission income was generated solely by the Taxpayer's own efforts and that the so-called Ledger team was (in Mr Maxwell's words) "largely ephemeral".

It would appear that the Full Court is stating that the income derived by the trust was not really personal services income (as it was in *Case W58*) but was being generated from the services of a number of employees. As the income was not PSI then Part IVA was not applied as it was in *Case W58*. The Full Court did recognise, however, that the taxpayer should have been remunerated appropriately for his services:⁸⁶

In view of the findings made by the primary Judge, it is difficult to see why, assuming the Ledger scheme had not been entered into or carried out, the net commission income derived by the hypothetical corporation substituted for Ledger, would have found its way to the Taxpayer. It might have been expected that some of that income would have come to the Taxpayer, in the form of a fair reward for the services he would have provided to the corporation. But the primary Judge was not asked to and did not make a finding as to what a fair salary might have been for the Taxpayer, if his salary was to reflect his contributions to Ledger or to a hypothetical corporation conducting the business.

⁸⁶ Ibid para 4290.

As noted in this extract the Commissioner did not ask the court to make a determination as to what may be reasonable remuneration for the services of Mr Mochkin. If the Court did have to consider this matter the result may have been interesting but as the matter was not fully addressed we will have to wait until a further opportunity arises.⁸⁷

XIII INCOME FROM A BUSINESS STRUCTURE IS FINE BUT...

The analysis in this paper appears to indicate that if you earn income from a business structure Part IVA will not have immediate application, while income from personal exertion channelled through another entity will be captured. This raises the question of whether there are some types of activities more likely to be captured by Part IVA than others. Clearly where an economic activity earns income mainly from the sale of goods then this income will not be PSI and is thus less at risk from Part IVA where it is split with parties other than the taxpayer. This has the potential to create an inequity between different types of taxpayers. For example, taxpayers primarily providing personal services will be disadvantaged compared to taxpayers earning income from a business structure and the use or sale of assets. In addition, certain businesses in their early years may be more likely to derive PSI, whereas in later years the income may be mainly from the business structure or from the services of employees.

XIV USE OF SERVICE TRUSTS: PSI AND PART IVA

There may be an option to set up a service trust to provide administration services either directly to a personal service provider or indirectly to a personal services entity. The question of course is whether this is caught by Part IVA—in other words, assuming that the personal service provider is outside of the PSI rules, can the person use a service trust to provide administrative services and not be impacted by Part IVA? It would appear that the service trust would need to satisfy the normal Part IVA rules as they apply to it or otherwise any tax benefit may be struck down.

The use of service trusts has been very common since the case of *Phillips v FC of T*.⁸⁸ The Commissioner appears to sanction the use of services trusts⁸⁹ in his following comments:

Given the view of the facts which the court adopted, that is, a re-arrangement of business affairs for commercial reasons and realistic charges not in excess of commercial rates, the decision to allow a deduction must be accepted as

⁸⁷ There were two issues in the Mochkin case that the Commissioner sought to apply Part IVA to. This paper discusses only one; the Commissioner was successful in applying Part IVA to the other transaction which essentially involved the taxpayer attempting to divert income that he had already derived to a family trust.

⁸⁸ *Phillips v FC of T* 77 ATC 4169.

⁸⁹ Taxation Ruling IT 276 para 4.

reasonable. Accordingly, the decision is not seen as requiring any alteration to existing policy concerning payments of this nature.

It would appear that, based on these comments, the use of a service trust is fine provided that the relevant charges are set at commercial levels. The following are some key issues in defending a service trust from attack by Part IVA:

- The dominant purpose for setting up the trust cannot be to obtain a tax benefit. It needs to be asset protection and the relief of the principals from the administrative burden of running the administration side of the business. To ensure that the argument of asset protection is defensible, then, as many assets as possible should be transferred out of the practice entity to the service trust.
- If the service trust is to provide services of added value to the practice entity then the service trust must deliver tangible managerial services—the employment of a professional manager is evidence of this.
- It would appear best that all non-professional staff should be employed by the service trust.
- Clearly principals of the practice entity should not be employed by the service trust. Non-principal professional staff should not be employed on a long-term basis by the service trust.
- All agreements between the service trust and the practice entity should be fully documented. Also, where such agreements exist, the actual practices of the entities should be in accordance with those agreements.
- The service arrangements should be reviewed regularly and necessary amendments undertaken.
- All fees charged should be commercially realistic including full documentation of how the fee was established.
- Avoid doubling up of charges by ensuring that if the labour component is already marked-up then services performed by those staff should not be marked-up.
- The issue of tax invoices, the payment of fees, and the collection of debts must be done on commercial terms. Apply wherever appropriate an ‘arm’s length’ principle in dealings.
- As the two entities are separate it is appropriate that each entity has its own set of accounts, own bank accounts; the principals of the practice entity do not treat the assets of the service trust as their assets.

XV CONCLUSION

This paper has analysed the potential operation of the general anti-avoidance provisions in Part IVA to income that is earned by personal service entities where one of the personal services business tests is satisfied and the PSI rules do not apply. The paper discusses the concept of PSI and distinguishes this income from income that is derived from a business structure. The paper concludes that it would appear that there is a considerable body of authority supporting the potential application of Part IVA to PSI derived by an entity where that income is not paid to the individual who is performing the services that generated that income.

AN HISTORICAL ANALYSIS OF FAMILY PAYMENTS IN AUSTRALIA: ARE THEY FAIR OR SIMPLE?

AN ANALYSIS OF TRANSFER PAYMENTS TO AUSTRALIAN FAMILIES
APPLYING THE CRITERIA OF EQUITY AND SIMPLICITY

HELEN HODGSON

Helen Hodgson is a Senior Lecturer, Atax, Faculty of Law, University of New South Wales.

The Australian taxation system has a tradition of providing for a certain amount of equity for families by allowing concessions for families in the calculation of income tax payable.

Unlike the UK system, which did not adopt individuals as the unit of taxation until 1990, in Australia income tax is levied on individuals, rather than on family units. The *Asprey Report* considered this issue, without making any recommendations to change the system:

From the beginning, personal income tax in Australia has been based on individual incomes; along with Canada and New Zealand, Australia is one of the few countries still making this selection. This is not, of course, to assert that in our tax system (or in others with this basic unit) no regard whatever is paid to the family situation of the individual taxpayer. There are allowances for various dependants and numerous concessional deductions applying not only to the taxpayer's expenditure upon himself but also to that made on behalf of family members. It is, however, true that the allowances provided are generally rather small in relation to the total expenditure that the individual will normally make upon his or her family.¹

Under this system family tax concessions have been available as deductions, rebates or offsets that reduce the tax payable by the family, rather than through marginal tax scales. There is still considerable debate over the use of business entities to effectively reduce family income tax through the use of income splitting, which utilises marginal tax rates to reduce tax payable by the overall family unit.²

An alternative method of providing family assistance is through the welfare system, with amounts being paid directly to the family concerned. With recent reforms to family transfer payments direct payment is becoming more prevalent—with consequential problems arising where these benefits are means tested.

¹ Commonwealth Taxation Review Committee (Asprey Committee), *Asprey Report*, 1975 published at <<http://setis.library.usyd.edu.au/oztexts/parsons.html>> para 10.2.

² However discussion of income splitting is beyond the scope of this paper.

The *Asprey Report* went on further to acknowledge the issues that arise where the welfare and taxation system overlap:

Still more important is the point that cash transfers to individuals, the whole class of social service payments of every kind, are inextricably bound up with the equity of the taxation system. The Committee certainly does not regard itself as qualified to advise upon the details of the social services, and is aware of other inquiries at work in this area. But some consideration of cash grants, taxable or otherwise, is essential in the design of an optimal tax system.³

In this paper I consider some of the issues that arise under the current system of family transfer payments, including:

- Whether payments are more effective and equitable if paid as direct payments or as an offset against income tax payable;
- Are the current payments appropriately targeted at families in need;
- Has the current Family Tax Benefit simplified the regime when compared with previous regimes; and
- Do governments use such payments as an equity measure, or are there other policy considerations affecting the structure of such payments.

I OVERVIEW OF HISTORY

A Current System

With effect from 1 July 2000 the Howard government introduced the Family Tax Benefit (FTB), which was designed to replace the tax and welfare benefits that were available to families.

The Explanatory Memorandum stated that:

As part of the Government's plan for a new tax system, the structure and administration of family assistance is being simplified with effect from 1 July 2000. Twelve forms of assistance, currently available under the tax and social security systems, will be reduced to three.⁴

The three benefits that are now available are the Family Tax Benefit Part A and B and the Child Care Benefit. The maternity allowance was also continued and moved into the Family Tax Assistance Legislation.

³ Above n 1 para 3.4

⁴ Explanatory Memorandum, A New Tax System (Family Assistance) Bill 1999; Explanatory Memorandum, A New Tax System (Family Assistance) (Consequential And Related Measures) Bill (No 1) 1999.

The Family Tax Benefit Part A is designed to provide assistance to low and middle income families. It is a means tested payment, available as a direct payment from the Family Assistance Office (fortnightly or as a lump sum) or as a tax offset.

Family Tax Benefit Part B replaced the former spouse rebate that was allowed as a tax offset. It is available to families that are dependant on one primary income earner. As with the Family Tax Benefit Part A it is available fortnightly or as a tax offset.

The Child Care Benefit replaced former child care assistance and rebates that were available to assist parents who placed their children in child care. These were paid outside the taxation system, but were in part a response to the legal principle that denies a person a deduction for the cost of child care while the parent is at work.^{5 6} Eligibility for the revised Child Care Benefit is dependent on conditions that must be met by the care giver as well as by the parent, but are linked to FTB eligibility. Payments are made either by instalments directly to the child care provider, or as a lump sum reimbursement.

However on closer examination, there are a number of additional entitlements that have been rolled into the new system, which raises the question as to whether the system has in fact been simplified at all. Combination of benefits does not necessarily result in the simplification of benefits. The following table compares the old benefit with the corresponding concession in the new system.

⁵ *Lodge v FC of T* High Court 72 ATC 4174.

⁶ Acknowledged by the Minister for Human Services and Health, Hansard, 9 May 1995, 113.

Old Benefit		New Benefit
Family allowance	Means tested payment to family with children. Supplementary payment available for low income families.	FTB Part A
Family tax payment Parts A and B	Tax-free thresholds were modified where a taxpayer had children. For each child the tax threshold was raised by a prescribed amount, and an additional allowance was made if the taxpayer had a child under five years of age. The modified thresholds were means tested.	FTB
Family tax assistance Parts A and B	Where a family did not have a high enough taxable income to benefit from the changes through the taxation system, direct payments were made fortnightly through the welfare system.	FTB
Dependent spouse rebate (with children)	Spouse rebate was claimed as an income tax offset. From 1982 the amount that could be claimed in respect of a dependant spouse was increased if the taxpayer also had a dependant child or student. From 1994 the entitlement was reduced by the amount of any parenting payment.	FTB Part B: means tested against income of lower earning parent
Basic parenting payment	A payment to a person who stayed at home to care for children—largely replaced dependant spouse rebate.	FTB Part B
Sole parent rebate	A taxpayer who had the sole care of a dependant child or student was entitled to a tax offset.	FTB Part B: not means tested
Child care cash rebate	Subject to a work test. Paid to families where a sole parent or both parents are working, studying, training or looking for work as recognition that child care is a cost of work.	Child Care Benefit
Child care assistance	Paid to low and middle income families on the basis of a family income and assets test.	Child Care Benefit

B *Income Tax*

1 *Concessional Deductions and Rebates: Pre/Post 1975*

Prior to 1975, concessional deductions were available to taxpayers, depending on their personal circumstances. This has been expressed as follows:

Concessional Deductions help to restore horizontal equity between individuals on a particular income level who differ with respect to characteristics such as marriage, children and health and who therefore incur different amounts of the associated “unavoidable” expenditure.⁷

Some of the criticisms explored by the committee in relation to a system of deductions related to the lack of equity inherent in deductions within a progressive tax scale. In particular the following two issues were identified:

- A poor man’s wife is worth less than a rich man’s;⁸
- In any case the deduction was not enough.

In 1976 these concessional deductions were replaced by a system of rebates, under which a set rebate amount was available in respect of a spouse. The original recommendation was that the amount would be reduced by income that the spouse earned, with the rebate being dissipated just below the point at which the spouse would become liable to pay tax personally. The advantage of the rebate is that it had the same dollar value to each recipient, without reference to the marginal tax rate of the taxpayer. The spouse rebate under this system was related to supporting a spouse, rather than whether children were a part of the family.

The concerns about deductions for children were addressed by removing a direct concession in relation to dependent children. Child Endowment was renamed Family Allowance and increased. Children were retained as a notional rebate for the calculation of the zone rebate, which is in itself a horizontal equity measure. This notional rebate is taken into account for each student under 25 or child under 16 who does not have a significant personal income.

In 1982 the spouse rebate was modified to allow an increased amount where a dependent spouse was caring for children or students, where a notional rebate would have been available. This reintroduced the concept of a family as parents with children in determining the quantum of the rebate entitlement.

It was at this time that the rebates began to be indexed automatically to allow for inflation instead of being reviewed periodically.

As a side issue, it was not until 1990 that the Income Tax Assessment Act was reviewed to remove the traditional values inherent in family policy. In reading the

⁷ CCH Editors, ‘The Asprey Report: An Analysis’ CCH (1975) para 1200.

⁸ Above n 1 para 12.3.

literature that accompanies the legislation providing family support, it was usual to see the assumption that the main breadwinner of the household was the male partner, with the spouse being the secondary earner. It is also from that year that the definition of spouse includes a defacto spouse, at least for taxation purposes.

2 Home Child Care Allowance

In 1994 family concessions were moved further out of the taxation system through the introduction of the Home Child Care Allowance (later to be renamed the Basic Parenting Payment). This benefit was paid directly to a parent who chose not to work, and was intended to replace the dependant spouse rebate (with child). There was a slightly higher rate paid when compared to the rebate but, importantly, it was paid directly to the parent at home instead of to the taxpaying spouse.

The dependant spouse rebate (with child) was not repealed at this time, but it was effectively replaced as any payment received as a direct benefit reduced the amount that the taxpayer could claim.

3 Family Tax Payment

The next significant change in recognising families in the calculation of tax payable was made following the election of the Howard Liberal Government at the 1996 election.

The Family Tax Payment increased the tax threshold for families with the care of children under the age of 16, or students under the age of 18 by an additional \$1000 for each dependent child. As this was an increase in the tax threshold, it was effectively a rebate of an amount equal to the tax rate applicable at the lowest level, that is, 20 per cent x \$1000 = \$200 per child. However, it was means tested so that parents earning more than \$70 000 per annum (increased by \$3000 for each child) were not entitled to the full amount.

There was a second component to this initiative that applied when a family had at least one child under five years of age. A means test, linked to the income levels for the parenting payment, applied to the income of the secondary earning spouse and a further threshold applied to the family income.

The extra threshold available was an amount of \$2500, which effectively amounted to \$500 reduction in tax, that is, 20 per cent x \$2500. This was available in addition to the first component. The spouse rebate was also available in relation to low income spouses.

As it was acknowledged that some low income earners did not earn sufficient to claim the benefit through the taxations system, low income earners were able to claim the equivalent of the income tax rebate as a social security benefit called Family Tax Assistance.

In August 1998 the Liberal Party announced an increase in these thresholds as part of its tax reform package, to take effect from 1 July 2000. However, these increases were overtaken by the FTB.

4 Family Tax Benefit

As discussed previously, the FTB was supposed to simplify the range of benefits available to families. It is made up of several components, and elements of the former tax allowances can be seen in the way in which the benefits are calculated. The FTB is administered through the Family Assistance Office, and can be claimed through one of three methods:

- Direct payment from the Family Assistance Office. If a person is eligible for rent assistance or a Health Care Card they must claim the benefit as a direct payment
- As a tax offset
- As a lump sum from the Family Assistance Office

The FTB is officially made up of two parts including the following.

5 Family Tax Benefit Part A

Part A is available to families with children, where the family income is below certain thresholds. The rates are based on the number of children and the age of each child, who must not be receiving youth allowance. A child over 16 but under 25 is only eligible if a full-time student, and is means tested based on the income of the dependant.

- The family adjusted taxable income (ATI) is the sum of: taxable income; rental property losses included in taxable income; fringe benefits received; exempt pensions; certain foreign income and maintenance payments.
- If family ATI exceeds the threshold (currently \$82 052), the base benefit is subject to shading out provisions.

Family Tax Benefit Part A also includes an additional component for low income families, in relation to children under 16. This additional amount is also subject to shading out provisions where income exceeds the threshold for the additional component (currently \$31 755).

Further allowances available and paid on top of the FTB Part A include the 'large family allowance' where the claimant has more than three children, and the multiple birth allowance where three or more children are born together.

6 Family Tax Benefit Part B

Part B of the FTB is designed to assist single income families. This benefit replaced the sole parent rebate and the spouse rebate (with dependant child) from 1 July 2000.

Eligibility depends on the following criteria:

- There must be at least one child. A child must be under 18, and if over 15 must be studying full time.
- The benefit is based on the age of one child, with a higher rate available if the family includes at least one child under the age of five.
- Where a parent is a sole parent, there are no income tests applied to determine eligibility.
- Where the claimant has a spouse the benefit is based on the Adjusted Taxable Income of the lower income earner. The benefit is reduced by 30 cents for every dollar that the spouse earns over the threshold, currently \$1824.

The interaction between the FTB and the existing dependent rebates⁹ was changed by the introduction of the FTB. If a taxpayer is eligible for the Part B benefit, it precludes eligibility for a number of the dependent tax rebates that may have formerly been available. The rebates that are affected are the 'with child' rate that can be claimed in relation to a dependant spouse¹⁰, child-housekeeper¹¹ or housekeeper¹², and the sole parent rebate¹³ which has been completely superseded.

There are still issues in relation to the remaining rebates. The income tests are different between the rebate and the FTB, as is the concept of a dependant child. As a rule of thumb, if a person has children the FTB will generally be available, and at a higher rate than the corresponding rebate as the income thresholds are higher, as can be seen in the following table.

Eligibility	Family Tax Benefit Part B	Rebate
Child < 16	Dependent if income < \$8613	Notional only. Dependent if income < \$1409
Student 5 – 25	Dependent if income < \$8613 Must not be receiving government allowance	Notional only. Dependent if income < \$1785
Spouse	Must have dependent child or student If child < 5 benefit = \$2920 Spouse income < \$11 557 Child/student > 5 benefit = \$2036.70 Spouse income < \$8613	No dependent child = \$1535 If dependent child = \$1841 Spouse income < \$7641 Entitlement doesn't vary with age of child

⁹ *Income Tax Assessment Act 1936* subdivision A of division 17.

¹⁰ *Income Tax Assessment Act 1936* [ITAA36] s 159J.

¹¹ ITAA36 s 159J.

¹² ITAA36 s 159L.

¹³ ITAA36 s 159K.

There are, however, still some circumstances where there is a mismatch between eligibility requirements for the two offsets. For example, the FTB is based on the annual income of the spouse for the entire year, even if they would not be classified as a dependent for income tax purposes for this whole period. Under the income tax rebate, there must be a spouse relationship (legal or de facto) for the spouse income to be taken into account. If a person with a child entered a spouse relationship during the year, and the new spouse gave up employment to care for the child, the income test under the income tax legislation would be based on earnings after the date that the spouse arrangement commenced but under the FTB legislation the full income for the year would be taken into account.¹⁴

In addition, income for these tests is defined differently. Separate Net Income¹⁵ is defined for tax purposes as income less all expenses incurred in earning that income. This allows a deduction for work related expenses that cannot be claimed in calculating taxable income, for example, child care and travel to work are not excluded. Separate net income does, however, include exempt income. There are also some statutory additions, such as net capital gains.

Adjusted Taxable Income is defined differently under the *Family Assistance Act*.¹⁶ It is based on taxable income, but includes certain pensions and benefits that would be exempt under the *Income Tax Assessment Act*. It also includes reportable fringe benefits, rental property losses are added back, and deductions that may be allowed in calculating SNI are not deducted if they are not allowable as income tax deductions.

C Baby Bonus

The most recent incentive for families has been provided through the First Child Tax Rebate, commonly referred to as the 'Baby Bonus'.¹⁷

The main elements of the Baby Bonus are:

- It is available to parents following the birth, adoption or taking legal responsibility for the first child after 1 July 2001;
- It is an income tested offset of up to \$2500 pa until the child turns five years of age;
- Low income earners (earning less than \$25 000 in the claim year) have a minimum entitlement of \$500 pa;
- It is prorated to take account of the number of days that the parent has the responsibility for the child;
- It may be claimed through the tax system, by direct claim from the ATO, or transferred to a spouse.

¹⁴ Schedule 3 of the *Family Assistance Act 1999* addresses death or separation during the year but does not address a couple that is formed during the year.

¹⁵ ITAA36 s 159J(6).

¹⁶ *Family Assistance Act 1999* Schedule 3.

¹⁷ *Income Tax Assessment Act 1997* [ITAA97] subdivision 61-I.

The maximum entitlement is 20 per cent of the tax liability in the 'Base Year', that is, the year that the person became responsible for the child or the preceding year. The selection of the base year is fundamental to the claim. Either year is available, as the date of the child event will affect the date that work ceases, and therefore income and tax paid by the claimant:

It is usually beneficial for the primary person to elect as the base year the income year which has the higher taxable income. This will provide a higher basic income tax liability, and therefore maximise their entitlement. The base year will generally be the income year before the event year, as there is usually a period of absence from the workforce in the event year which will reduce the primary person's basic income tax liability for that year.

In some cases it may be more beneficial for the primary person to choose the event year as the base year. This will occur where the child event happens towards the end of the income year, or where the primary person has a lower basic income tax liability in the income year before the event year.¹⁸

This is then reduced by reference to the taxable income in the year of the claim.¹⁹ There must be a reduction in income for the offset to be available, with a minimum amount of \$500 being available where a person's income in the claim year is less than \$25 000.

D Social Security Payments

The origins of the FTB can be traced through the evolution of benefits formerly payable to families.

Benefits have been directly payable to Australian families since the introduction of Child Endowment in 1941. Child Endowment rates varied depending on the number of children in the family, but were not income or asset tested. It was payable to the mother. In 1976, when the tax deductions were removed, Child Endowment was renamed Family Allowance and substantially increased.

In 1983 a Family Income Supplement was introduced to assist low income working families not already receiving social security benefits. Originally the supplement was paid to the head of the household, but the following year it became payable to the person entitled to receive family allowance. Eligibility was pegged to the income test used for access to the disadvantaged persons' health care scheme available at the time.

Since 1978, Family Allowance had been progressively restricted where the child was receiving certain government benefits. Income testing for Family Allowance was introduced in 1986 in relation to 16- and 17-year-olds, (the entitlement for children over that age had been removed the previous year), and in 1987 for all recipients.

¹⁸ Explanatory Memorandum, Taxation Laws Amendment (Baby Bonus) Bill 2002, para 3.16–3.17.

¹⁹ ITAA97 s.61–420.

Under the income test the full rate of Family Allowance was payable if family income was up to \$50 000, plus \$2500 per child. The benefit was shaded out after that point by \$.25 for each extra dollar earned. The shading out remained until 1991 after which the allowance cut out as soon as the threshold was reached. The asset test, which remained until 2000, was introduced about this time.

The Family Allowance was renamed the Basic Family Payment in 1993. Over this period indexation of the amounts paid and the thresholds were adopted, and the income thresholds started to include foreign income and fringe benefits.

The Family Income Supplement was renamed the Family Allowance Supplement in 1987, but remained separate from Family Allowance until 1996 although they were paid together. The entitlements were increased, but shading out of entitlements for Family Allowance Supplement was introduced, at \$.50 for each dollar over the threshold and an assets test at which the benefit cut out was introduced in 1988. In 1993 the supplement was renamed the Additional Family Payment, and merged with the additional pension or benefit available to a social security recipient. This amount became payable to the principal carer not the social security recipient.

In 1996 the Basic Family Payment and the Additional Family Payment were merged to become the Family Payment, only to be renamed 'Family Allowance' in 1998, partly because the community had not adopted the new name.²⁰

Therefore the complexity of the FTB that was introduced in 2000, and to a lesser extent the Family Tax Allowance before it, can be traced directly to the original Family Allowance and Family Allowance Supplement.

The Family Allowance was originally a universal benefit, available to assist all families with the cost of raising their children. This became affluence tested, that is, the most affluent families were no longer able to access the allowance.

Simultaneously an additional benefit was available to those families requiring income support—the Family Allowance Supplement. This was always income tested. When the two benefits were merged, both goals were incorporated into the one payment—thus resulting in the application of two different thresholds and different age limits for children within the same benefit, now FTB Part A.

It is worth noting that the income thresholds applied at the commencement of the FTB, and when adjusted for inflation, are not significantly different from the thresholds originally applied to the Family Allowance.

²⁰ Philip Ruddock, Minister for Immigration and Multicultural Affairs, *Social Security Legislation Amendment (Parenting And Other Measures) Bill 1997*, 2nd reading speech, 2 October 1997, Hansard, 9120.

II FAMILY POLICY GOALS

There are a number of different policy objectives that can be achieved through family policy. These include:

- Equity—ensuring that families bear an appropriate tax burden incorporating horizontal equity, which recognises that families have additional costs;
- Safety Net—ensuring that families have sufficient income to meet necessary expenses such as food, clothing, shelter and education costs;
- Workforce participation—women are still the primary carers for families, and therefore family policy (including access to personal income) affects the choices that women make in relation to the extent to which they participate in the workforce;
- Fertility rates – the current debate is focussing on the falling birth rate, and how transfer payments may be used to encourage women to choose to have more children.

A Equity

Equity is a theoretical goal that economists and politicians alike strive to achieve. It can be traced back to Adam Smith, who said:

The subjects of every state ought to contribute towards the support of the state, as nearly as possible, in proportion to their respective abilities; that is in proportion to the revenue they enjoy under the protection of the state.²¹

The *Asprey Report*²² discussed the principle of equity as one of the goals of a good taxation system:

It is usually taken for granted that the best available measure of an individual's 'well-being' is his income. The 'burden of taxation' is thought of primarily in terms of the proportion of a man's income that goes in paying taxes, whether they be taxes levied formally on that income or indirectly by elements of tax in the price of the goods and services he buys. Horizontal equity is then taken to require that two persons with the same income pay the same taxes (at least in the first place and 'other things being equal'), while vertical equity would require that, of two individuals with different incomes, the one with the larger should pay more by some correct amount.²³

²¹ Adam Smith, *The Wealth of Nations* (1937 [first published in 1776]) 777–78.

²² Above n 1.

²³ Ibid para 3.9.

In the context of family support policies, it is generally acknowledged that equity principles dictate that a person supporting a family is not in the same position as a person on the same income with no dependents. Therefore, if horizontal equity is the goal, then the mere fact of having children should entitle a person to the relevant payment or tax concession, as they are in a different position from another person earning the same income by virtue of that fact. The current FTB is not universally available, as affluent families do not have access to the benefit. Accordingly it could be argued that the equity test is not met.

However it can equally be argued that an affluent person can afford to pay for the cost of raising their children and does not need government assistance. In fact an application of the benefit principle would suggest that the person with the family is receiving more benefit from the taxes that they do pay as a family accesses more government services than an individual, and therefore they should not receive tax concessions.

B Safety Nets

Safety nets are clearly designed for policy objectives other than achieving horizontal equity. While tax equity considers the amount that a person should contribute to general revenue, this is a form of redistribution of wealth, which draws on general revenue to assist families in need.

The classic illustration of the safety net theory is the comment made by The Hon R J Hawke in 1987, when he promised that by 1990 'no Australian child will live in poverty'.²⁴ This statement was made when he announced the Family Income Supplement that was introduced for low income families.

This supplement followed changes that had been introduced by the government following the Economic Statement of May 1987. Among the cost cutting measures introduced at that time was a measure to means test access to the Family Allowance, consistent with tests applied to other social security measures.

The notion of limiting support to those families that need it can be seen in the means testing that has applied to the various benefits available at different times. This can be described as 'affluence testing' as the thresholds allow access to benefits for all except the most well-off families. While the spouse rebate available through the taxation system and the FTB Part B are based on the earnings of the secondary income earner, other benefits, such as the FTB Part A or Family Tax Incentive, were based on family income levels.

There are clearly issues that need to be addressed in determining the income levels at which such support is needed, however such discussion is beyond the scope of this paper.

²⁴ ALP Election Policy launch (23 June 1987).

C Workforce Participation

Access to child care arrangements has been seen as the major barrier to the participation in the workforce by women, as women have traditionally taken the major responsibility for caring for children.

The issue of participation in the workforce by women is a question that has been around since before World War II, but it became a major factor in government policy as men returned from the war. The men resumed jobs that had been held by women who had joined the workforce to keep the home front operating while their men were serving overseas.

Women in the workforce at this time (Second World War) were seen as absolutely necessary to the war effort ... but they did have childcare provided. Once the war was finished and the men returned, the women were quickly sent back from whence they came, and the childcare facilities were closed down. We would not see the provision of workplace childcare again until the 1970's.²⁵

Under income tax law there has been no availability of deductions for child care as a cost of work. In *Lodge v FC of T*²⁶ the High Court held that the cost, while work related, was of a character that precluded tax deductibility:

the expenditure was incurred for the purpose of earning assessable income, and it was an essential prerequisite of the derivation of that income. Nevertheless its character as nursery fees for the appellant's child was neither relevant nor incidental to the preparation of bills of cost, the activities or operations by which the appellant gained or produced assessable income.²⁷

An alternative approach was more successful in *Ruth Nancy Coleman v F C of T*²⁸. Senator Coleman relied on the concessional deduction provisions (subsequently re-enacted as a rebate) to claim a tax deduction for the cost of a housekeeper engaged to care for herself, her husband and her five-year-old son while she fulfilled her parliamentary duties. Such a deduction was only available to married persons in special circumstances. The majority of the Board of Review found that special circumstances existed:

In our opinion the extremely busy public life of the taxpayer and the need to maintain through the housekeeper a continuity of stable home life for the taxpayer's son constituted special circumstances because of which it is just to allow the deduction.²⁹

²⁵ Judy Uren, 'Women in the Workplace: Is it One Step Forward and Three Steps Backwards?' *Proceedings of International Conference: Expanding Choices for Women*, J M Barker (ed), (1997) 95.

²⁶ *Lodge v FC of T* High Court 72 ATC 4174.

²⁷ *Ibid* (Mason J), 4176.

²⁸ *Case J70: Ruth Nancy Coleman v FC of T* (public hearing) 77 ATC 579.

²⁹ *Ibid*, R K Todd and L C Voumard at 583.

An appeal to the Supreme Court by the Commissioner of Taxation was not upheld on the basis that the decision of the board did not involve a question of law³⁰.

A similar result arose in *Case M83 80 ATC 613*, where the housekeeper was caring for a severely disabled child. These cases, however, have not changed the Commissioner's practice, of limiting special circumstances to circumstances where the person is not cohabiting with their spouse.³¹

It should also be noted that the amount that can be claimed as the deduction/offset is capped under the relevant legislation, and would not come at all close to the cost of such arrangements.

1 *Child Care Subsidies*

The Women's Electoral Lobby (WEL) and other feminist economic organisations argue that child care is a prerequisite for many women to be able to work, and this needs to be recognised through appropriate funding for women using childcare:

WEL urges governments to support the provision of quality childcare that is accessible on an equitable basis, the costs of which should be shared by parents, governments, employers and other stakeholders.³²

The introduction of child care subsidies progressively from 1984 recognised that child care is a cost of working, although it is not recognised as such in the taxation system.

As I have said, it is a work related deduction, like many others. The government will always have the right and retain the right to make adjustments to any of those deductions. We at least recognise that, in order to work, women and families need decent child care, decent income support, a proper industrial relations environment and appropriate deductions for the cost of their employment, amongst which I would number that particular allowance.³³

Child care subsidies have been retained in various forms since their introduction in 1984, when they were limited to not-for-profit day care centres. In 1990 this was extended to include commercial centres, and by 1994 it was re-enacted as the Childcare Cash Rebate.

These child care subsidies were not originally means tested as they were seen as an entry cost to the workforce, however, means testing has since been introduced. Under the current system, introduced with the FTB, eligibility for the Child Care Benefit depends on both the claimant (who must be eligible for the FTB), and the child care centre (which must meet certain requirements). There may also be limits on the number of hours per week for which a person can claim child care.

The Hon Dr Carmen Lawrence stated in 1997:

³⁰ *FC of T v Coleman*, 78 ATC 4355.

³¹ See ATO ID 2002/281.

³² Women's Electoral Lobby, National Policies, (December 2000) at <www.wel.org.au>

³³ Carmen Lawrence, Minister for Human Services and Health, Hansard 7 February 1995, 584.

In the same way, for instance, that the tools of trade are tax deductible, so women requiring decent child care in order to work should have it recognised as a non means tested cost of employment. Means testing the childcare cash rebate has signalled that the government believes that women's work related expenses are to be treated differently to men's, despite the observation by the Minister responsible for women's interests that child care is a genuine work related expense.³⁴

There are clearly two competing principles at work here: should child care be subsidised as a cost of employment, or is it a benefit that should be restricted to those who need assistance with the cost of child care?

(a) *Baby Bonus*

The baby bonus was an initiative of the Liberal Party, which was taken to the 2001 election. Documents issued at the time indicated that the incentive was available to assist families experiencing a drop in income after the birth of their child:

Recognising the family experiences a fluctuating income where the mother leaves the workforce to look after a child the coalition will introduce a system which effectively averages income over 5 years and allows a mother to claim back the tax paid on her income in the year prior to the birth of her child.³⁵

The form of this offset breaches the principle of vertical equity, as the offset is based on the amount of tax that the claimant has paid in the base year. Clearly a person on a higher income will have paid more tax, and therefore, over a five year period, will benefit more from the tax offset.³⁶ While the minimum and maximum claims go some way to addressing this issue, it is possible for a high income earner who leaves work, and does not return to work before the child's fifth birthday, to receive \$12 500 through the offset; while a low income earner may receive as little as \$2500. Although the rebate is available for the first child born after introduction of the offset, in circumstances where a person has left the workforce following the birth of a previous child the offset is of less value as the claimant may only qualify for the base rate of \$500.

It is still too early to see the effect that the offset will have on the working patterns of women. The ATO has indicated that the budget estimates for the take up of the baby bonus have been revised down by \$105 million in the 2002–03 and 2003–04 financial years³⁷. The ATO was unable to say how much of the lower than expected take up rate was due to women choosing to remain in the workforce, and thus losing eligibility for the offset due to the operation of the income test.

³⁴ C Lawrence, 'Public Policy and the Status of Women in Society' *Proceedings of International Conference: Expanding Choices for Women* J M Barker (ed) (1997) 5.

³⁵ Liberal Party of Australia, *The First Child Tax Refund, Election Policy* (2001).

³⁶ Senate Estimates Committee hearings, 22 February 2002.

³⁷ Senate Estimates Committee hearings, June 2003.

Note that the maternity allowance (a lump sum payment of currently \$833.52 to a mother on the birth of her child to assist with the cost of a new baby) was not removed with the introduction of the baby bonus. The maternity allowance was reintroduced in 1997, two decades years after the former maternity allowance was removed.

2 Maternity Leave

There has been much debate recently in relation to a system of paid maternity leave that will give women the security of a guaranteed job following a decision to take time out of the work force.³⁸ Part of the debate is over whether such a scheme should be funded by the public purse or by employers, and the extent of the support that should be provided from each.

At this stage the federal government has not shown any will to proceed with such a scheme.

D Fertility Rates

A public policy area that is receiving much attention at the moment is the declining birthrate in Australia, as in most other Western countries. The birthrate has been declining during the last three decades and, at 1.75 in 2000, is currently below the replacement rate.

This has significant implications in relation to the future economic policies of the nation. As the population ages, it has implications for health and welfare spending and the taxation burden on the next generation will be increased.

Therefore the focus of family policy is moving away from equity for families with children, to encouraging people to take on the responsibilities of having more children. This is reflected in the introduction of the baby bonus and the current debate on maternity leave.

A paper published recently by the Menzies Institute argues that the best way to increase the fertility rate in Australia is to use a combination of gender equity measures and strategies that encourage a male breadwinner model to ensure that women have the choice to withdraw from the work force to care for children.³⁹

E Income Distribution within the Family

A further policy consideration that is reflected in the evolution of family payments is ensuring that the benefit is received in the hands of the person with primary care of the family. It has long been argued by feminist economists that it is not appropriate for payments relating to children to be paid through the taxation system, as this places control of the money in the hands of the primary income earner who receives the tax concessions—and this is frequently not the primary carer.

³⁸ Sex Discrimination Commissioner, *Paid Maternity Leave: A Time to Value* (11 December 2002); see also the Workplace Relations Amendment (Paid Maternity Leave) Bill 2002, a Private Members Bill introduced to the Senate by Senator Stott Despoja.

³⁹ Lucy Sullivan, *The Influence of Income Equity on the Total Fertility Rate* The Menzies Research Centre Ltd, (2003).

This was noted by The Hon Justice KW Asprey J in the following reservation to the *Asprey Report*:

In my opinion, in the world of today a married woman should be treated both under the general law and in the taxation system as an individual in her own right and, in relation to the income which is both morally and legally her own, she should pay no more and no less tax than if she were a single person.⁴⁰

A recent British study found that there are still issues related to the distribution of income in households, with women being seen as primarily responsible for the costs of raising children. Factors that influence the distribution of income within the household include whether the income is paid to the woman and whether the couple perceived the breadwinner role to be held by the man.⁴¹

For many years there has been an acknowledgement of this principle in family support payments. The partners of people receiving welfare payments have been entitled in their own right to a separate payment, and from 1994 the Home Child Care Allowance /Parenting Payment transferred entitlement from the taxpayer to the non-earning spouse. In the most recent tax benefit, the baby bonus, it is reflected in the methods of claim that are available to the claimant. The baby bonus can be claimed as a direct refund, or transferred to the working spouse as an offset.

III SIMPLIFICATION

Simplification is not achieved merely by reducing the number of benefits and rolling them into a single entitlement.

It is clear from the discussion so far that the family transfer payment system is anything but simple. The major complications relate to the overlap between the welfare and taxation system, with corresponding differences between the eligibility requirements for each.

In 1975, while in discussion about the deductions available in respect of dependent children, the Asprey Committee made the following observation:

It is untidy to have two instruments of policy for the same purpose. The Committee sees advantages in the suggestion made in the Interim Report of the Commission of Inquiry into Poverty (1974) that the dependent child allowance be abolished and child endowment correspondingly increased.⁴²

It would be interesting to see what the authors would say about the system that is in place today.

⁴⁰ Above n 1, Chapter 10, K W Asprey Reservation appended to *Asprey Report*.

⁴¹ Joseph Rowntree Foundation, *Distribution of Income Within Families Receiving Benefits* (April 1998).

⁴² Above n 1, para 12.14.

The system is further complicated when the various methods of payment are taken into account:

- Tax offsets are of limited value where families are not earning sufficient income to claim the full amount of the offset.
- Direct payments are useful in meeting the ongoing expenses of a family, but carry an inherent risk as the amount paid must be reconciled back to the income earned during the full year. I note here that under the previous arrangements a family could obtain the benefit of fortnightly reductions in tax if they were claiming a spouse rebate. Although there were instances where a taxpayer had to repay the credit previously allowed, for example due to spouse earnings, the issue of underestimating income did not have the impact that it has had under the FTB arrangements.
- Direct payments can be directed to the primary carer, assisting the appropriate distribution of income within a household.

A further complication arises in determining whether a benefit should be available to all families as a horizontal equity measure, or whether it should be limited to families in need, for example by means testing family income. FTB Part A is an effective example of how complex the formulas can become when benefits are combined. FTB Part A was supposed to simplify the system, but incorporates two different income levels, with shading in, to determine entitlement, and is based on four different age bands for the children—two age bands apply for each of the two income tests. These do not match up at all with the age or income requirements for the FTB Part B.

The issue that has caused most public outcry in relation to the FTB has arisen due to the administration of the income tests. The problem is that FTB entitlements are based on family adjusted taxable income, which is calculated on an annual basis. However, direct payments are made fortnightly based on an estimate of income, and if the estimate is inaccurate it can result in a significant debt that needs to be repaid.

The four areas where the income test arrangements are most likely to result in an overpayment are:

- Low income families claiming the additional Part A payment where income cannot be reliably estimated. Given that many families at this income level are in casual employment, it may be very difficult to make reliable estimates.
- Families claiming FTB Part B where the secondary income earner earns more than is estimated. Again the secondary income earner is often receiving income irregularly, which causes problems in estimating income.
- Cases where maintenance from a former spouse is received in a lump sum or increased during the year.
- Where a child leaves full-time education and enters the workforce, or receives government benefits, disqualifying them from being classified as a dependant for FTB purposes.

In the first year of operation of the FTB, such debts were written off if they were less than \$1000, however, the problem has continued to be of such magnitude that the Commonwealth Ombudsman has conducted an inquiry into the administration of the FTB.⁴³ In the period from 1 July 2000 – 3 September 2002 there were 1855 complaints to the ombudsman in relation to the assessment of FTB, including overpayments and debt recovery issues.⁴⁴

The major issues identified by the ombudsman relate to the difficulty in estimating adjusted taxable income where income is irregular, or there is a substantial change during the year, or where maintenance payments from a former partner were involved. The method of recovering debts was seen as being arbitrary, in that claimants were not informed of the amount of any overpayment until an expected tax refund was reduced by the amount of the overpayment. Finally, the system requires a tax return to be lodged by the end of the following financial year to allow the FTB entitlement to be reconciled. Where tax returns were lodged late—even with extensions being formally granted to the tax agent—the FTB was denied.

Although the ombudsman did make a number of recommendations, the report acknowledges the inherent difficulties in income reconciliation:

the analysis suggests that, even if my recommendations are adopted in full, the scheme is likely to continue to result [in] significant numbers of unavoidable debts for families.⁴⁵

There have been some administrative changes announced by the government⁴⁶ which allow a number of options when claiming FTB fortnightly:

- Payments for the rest of the year may be reduced if an overpayment based on revised income details is likely;
- Part payment may be deferred and claimed at the end of the year—eg, FTB Part B may be deferred with Part A being claimed, or the base rate may be claimed with the additional amount for low income families being deferred until the end of the year;
- Where the income of older children is uncertain, the benefit for those children may be deferred and claimed in a lump sum when earnings for that child are known.

There has been discussion internationally of the Australian system of reconciling estimates of income to annual earnings. The UK government in particular argues that

⁴³ Commonwealth Ombudsman, *Own Motion Investigation into Family Assistance Administration and Impacts on Family Assistance Office Customers* (2003).

⁴⁴ *Ibid*, para 7.

⁴⁵ *Ibid*, para 34.

⁴⁶ Minister for Family and Community Services, 'FTB Fine Tuning - More Choice and Flexibility for Families', (Press Release, 17 September 2002).

when designing its new Tax Credit system it has learned from the Australian experience.⁴⁷

IV THE POLITICS OF FAMILY PAYMENTS

Finally, while examining the evolution of family transfer payments it has been impossible to avoid seeing the link between historical developments in the system and federal elections. Most of the major changes in the system over the past 20 years can be linked to a federal election.

Just prior to the 2001 federal election the WEL summarised the differences between the positions of the political parties as follows:

The Coalition has a very traditional view of families, ie two parents, mothers at home, men at work. The recent attempt to pay a little baby bonus was a badly designed ideological exercise. The ALP has too often used families as a mantra, but not as cynically in this election as the Coalition. The Democrats and Greens are offering real alternatives to support all families, such as paid maternity leave. The Greens and the Democrats also take a stand for *all* families including gay or lesbian, Indigenous or refugee families.⁴⁸

The following table matches federal elections with changes in family policy.

⁴⁷ Peter White, Michael Mendelson and Jane Millar, 'Timing it Right: Tax Credits and How to Respond to Income Changes' Joseph Rowntree Foundation 2003.

⁴⁸ Women's Electoral Lobby, Federal Election Campaign (2001) at <<http://www.wel.org.au/election2001/vote/guide1.shtml>>

Year	Elected	Family Policy Initiatives
2001	Howard: Lib	Baby Bonus—effective from 1 July 2000 ALP policy addressed working families, including child care issues and support for low income families
1998	Howard: Lib	Family Tax Benefit—in conjunction with A New Tax System The ALP promised improved child care and a Tax Credit for Working Families, for families earning less than \$70 000 based on the number of children in the household.
1996	Howard: Lib	Family Tax Incentive introduced, increasing tax threshold for families with dependent children
1993	Keating: ALP	Home Child Care Allowance and Parenting (Home Child Care) Allowance introduced allowance payable to person caring for children at home Child Cash Care Rebate—increased availability of child care assistance Coalition Fightback! package promised increases to family allowance (means tested), tax benefits for child care paid, and Dependant Spouse Rebate
1990	Hawke: ALP	Extensions to Child Care Fee Relief to include private child care Liberals promised tax rebates for children, and child care rebates extended to private child care
1987	Hawke: ALP	Family Allowance Supplement introduced—the source of the statement ‘By 1990 no Australian child will live in poverty’
1984	Hawke: ALP	Child Care Subsidies introduced Note that if elected the coalition promised to introduce a measure of income splitting in calculation of tax payable

A review of the current position also shows a clear policy distinction between the objectives of the two major political parties. ALP policy in the most recent elections has focussed on working families through child care incentives, industrial relations and the working families’ tax credit.

On the other hand, coalition policy emphasises choice, and provides incentives for women to leave the workforce, as demonstrated through the Baby Bonus and the tightening—during their first term of office—of access to child care benefits.

However, there are many other factors that influence a parent when deciding whether to work or stay at home with their family, and government support for families is only a minor contribution toward the cost of raising children. While family policy is becoming a significant issue in elections, it still ranks behind the economy, health and education for most voters.⁴⁹

⁴⁹ Newspoll, *Political Trend Data: Importance of Federal Issues*, at <<http://.Newspoll.com.au>>

V CONCLUSIONS

If there are two conclusions that must be drawn from this analysis, they must be that the current system of transfer payments to families fails the tests of both equity and simplicity.

There is always a problem in determining whether a concession is equitable, as the concepts of vertical and horizontal equity carry inherent tensions: is it more important to ensure all families have the same access to a concession, or should the concession be targeted at families in need.

If we consider the traditional test of horizontal equity, all families should receive some level of government support to assist in the cost of raising children. Using this measure, the FTB is inequitable as not all families are able to access the benefit; however, the current design of the Baby Bonus, which is available regardless of income level, would meet this test.

Most people would, however, argue that more affluent taxpayers do not require taxpayer support, in which case the FTB would be seen as equitable. By extension, the Baby Bonus would be perceived as inequitable as higher benefits are paid to those who are in higher income brackets.

The equity argument can be seen most clearly in relation to child care benefits. Is the purpose of the benefit to acknowledge that child care is a cost of going to work, or is it a subsidy to assist those parents who cannot afford appropriate care for their children? If it is a cost of working, would it be more appropriately incorporated into taxation laws, rather than paid as a subsidy?

No-one who has had to grapple with the FTB system would argue that it is simple. As it has evolved, different tests have been incorporated for different purposes and it seems that there has been little attempt to make these tests consistent. This has resulted in the confusion discussed previously. It also disempowers taxpayers as they are unable to determine their own entitlements and, by default, leave matters in the hands of the Family Assistance Office.

The literature suggests that it is more appropriate to make sure that family payments are paid to the primary carer, and Australia has progressively adopted this principle for many years. However, we must acknowledge that this adds to the complexity of the system as alternative payment methods lead to problems such as those experienced when reconciling estimated and actual income.

There are currently at least three parliamentary inquiries under way that overlap to the extent that they all consider issues that are relevant in family policy. These inquiries include:

- Structure and Distributive Effects of the Australian Taxation System—Senate Economics Committee
- Poverty and Financial Hardship—Senate Community Affairs References Committee
- Inquiry into Improving Children’s Health and Well Being—House of Representatives Standing Committee on Family and Community Affairs

There are also a number of other inquiries being conducted at departmental level, including the paper on paid maternity leave released by the Federal Sex Discrimination Commissioner,⁵⁰ and the ombudsman’s report into the administration of the FTB.⁵¹

This suggests that there is widespread dissatisfaction with the system as it currently exists.

The final word on these issues belongs to those who are regularly using the system, as shown in these two extracts from Senate Committee hearings:

The family payments proposal that we make about a single payment for children as opposed to the three payments—or more than three payments now because there is the baby bonus and all the others as well—is based on those principles of recognising the number of dependants and of treating all families equitably, neutrally, so that payments go to everybody regardless of whether they use child care or not or whether they have a partner who is in unpaid employment or not. We have discovered, particularly through talking to our members, that there is a huge number of families who, while they all get Family Tax Benefit part A, miss out on either of the other two major payments, that is, Family Tax Benefit part B and the child-care benefit.⁵²

League members believe there is urgent need to arrange family incentives and rebates through the tax system where applicable, rather than relying on complex welfare payments that are expensive to administer. I have a heap of literature here, and you almost need a degree to plough through it—it is a real maze.⁵³

⁵⁰ Above n 38, Paid Maternity Leave: A Time to Value.

⁵¹ Ibid.

⁵² Evidence to Community Affairs References Committee: Poverty and Financial Hardship, Sydney, 27 May 2003, (Mrs Beard).

⁵³ Evidence to Community Affairs References Committee: Poverty and Financial Hardship, Hobart, 2 May 2003, (Mrs Roberts; Dr Gartlan; Mrs Gartlan representing Catholic Women’s League Tasmania).

STOCK-IN-TRADE VALUATION FOR UK TAXATION PURPOSES 1925–71: HAS IT ALL BEEN THE ACCOUNTANTS' WAY?

DAVID M SMITH

David M Smith is a Senior Fellow at the Taxation Law and Policy Research Institute, Monash University. He was formerly a Lecturer in the School of Law, Deakin University, Geelong.

I INTRODUCTION

The valuation of stock-in-trade stock might not, in itself, appear to be a very important question. However, the valuation method chosen could have a significant impact on both the profit and loss and thus the tax payable as well as the balance sheet of the enterprise.¹ This paper considers in detail the court decisions dealing with the valuation of stock-in-trade for income tax purposes and then analyses these decisions in the context of contemporary accounting practices of the time and poses the question: have these decisions all gone the accountants' way?

II BACKGROUND

In the United Kingdom the profits (income) derived from carrying on a business have been taxed since the introduction of income tax in 1799. The *Income Tax Act 1799* (ITA1799)² required a general return to be made. A major change was instituted with the introduction of the *Income Tax Act 1803* (ITA1803), which required that returns be made for various classes of income derived by a taxpayer. From that time on income tax, being a tax charged on 'any profession, trade or vocation' carried on by the

¹ Despite this fact little been written in the last 50 years on the valuation of stock-in-trade for taxation purposes, as the following list indicates: A F Bessemer-Clark, 'Notes on Recent Cases: The Valuation of Stock-in-Trade' (1971) 5 *British Tax Review* 318–319; H C Edey, 'Income and the Valuation of Stock-in-trade' (May–June 1962) *British Tax Review* 164–172; A D W Pardoe, "'Cost or Market Value, Whichever is the Lower": Valuation of Stock-in-trade' (1972) 3 *British Tax Review* 195–200; J E Talbot, 'Tax Aspects of Stock Valuation' (September 1957) *British Tax Review*, 229–40; 'Notes on Recent Cases: The Valuation of Stock-in-trade' (1970) 1 *British Tax Review* 65–69; 'Profits and Stock Valuation' (April 1970) *Taxation in Australia* 533–34, reprinted from *Taxation* (UK) (February 1970); 'Stock-in-Trade: Valuation for Tax Purposes' (February 1970) *Taxation in Australia* 425–29, reprinted from *The Accountant* (UK) (1 January 1970); 'Stock Valuation', (May 1968) *Taxation in Australia* 507–510, reprinted from *Taxation* (UK) (17 February 1968); 'Valuing Trading Stock', (February 1970) *Taxation in Australia* 429–30, (reprinted from *The Accountant* (UK) (29 January 1970).

² The Bill for this Act was introduced as the Income Tax Bill by William Pitt (the younger) on 3 December 1798.

taxpayer, has been levied under Case I of Schedule D of the Act. The top rate set by the ITA1799 was 10 per cent for incomes £200 and upwards, with a graduated scale for incomes between £60 and £200. The ITA1803 was amended, but not so as to affect the question under discussion in 1805 and 1806, and became the *Income Tax Act 1806* (ITA1806). After the end of the Napoleonic War, the income tax legislation was repealed. Income tax was not reintroduced in the United Kingdom until the *Income Tax Act 1842* (ITA1842). The ITA1842 was for all intents and purposes a reprint of the ITA1806. The ITA1842 and subsequent amending Acts were later consolidated into the *Income Tax Act 1918* (ITA1918).

As pointed out above, Case I of Schedule D specifically deals with taxpayers carrying on any trade.³ None of the pre-1900 Acts expressly referred to the necessity to take into account the value of stock-in-trade in-hand at the beginning and end of the year of income when ascertaining the 'balance of profits and gains' of a taxpayer.

While income tax was an annual tax, the liability was not calculated with reference to the current year's income alone. A trader's liability under Case I of Schedule D of the ITA was calculated on the basis of the average of the preceding three years' income.⁴ From the point of view of the Board of Inland Revenue the valuation of stock was not a serious issue 'because it was felt in the long run it would rectify itself'.⁵ This follows from the fact that one would expect that in the normal course of events the stock-in-trade would be realised in the following year. The effect of the three years' average was to minimise the effect of any undervaluation of stock-in-trade in any one year. This is because the undervaluations in years one and two would normally be brought in to account as higher profits in years two and three respectively.

The Board of Inland Revenue believed that the abandonment of the three years' average and the use of the lower of cost or market rule 'would enable ... [the taxpayer] to work his profits advantageously'.⁶ A different interpretation on the effect of the use of the three years' average was expressed by W L Gough:⁷

There can be no doubt that it would be much more simple to make the assessment on the profits of the preceding year, but the average of three years is

³ Case IV charged annual profit or gains not charged under any other Schedule.

⁴ Other classes of income were charged on different bases: collieries on a five years' average; manorial estates on a seven years' average; with railways and gas companies charged on the year preceding the assessment. The change from three years' average to assessment on a single year was recommended in the *Report of the Royal Commission on the Income Tax*, HMSO (1920) section VII: Basis of Assessment under Schedule D.

⁵ Evidence to The Royal Commission on Taxation on the Income Tax, HMSO, *Minutes of Evidence* (1920) para 12 488, 422 (E Stanford, Board of Inland Revenue).

⁶ *Ibid* para 12 425, 620.

⁷ W L Gough, 'Income Tax' (28 March 1885) *The Accountant* 8–10, at 8.

clearly in the interest of the taxpayer.⁸ It may so happen that a heavy loss is sustained in a given year and moderate profits made in the following years.

III DOES THE VALUATION OF STOCK-IN-TRADE HAVE TO BE BASED UPON AN ACTUAL PHYSICAL STOCK-TAKE?

It may seem trite but the question as to whether an actual stock-take is necessary can have a significant impact. For instance, would it be permissible to simply rely upon a perpetual inventory system, which has been tested and shown to have a high degree of accuracy? Is it permissible to undertake the stock-take some days or weeks prior to closing of the book and make adjustments for later transactions—a procedure which is common in practice? Two of the earliest decisions affecting the valuation of stock-in-trade for income tax purposes are relevant to these questions: *The James Cycle Co Ltd v The Commissioners of Inland Revenue*⁹ and *John Marston Ltd v the Commissioners of Inland Revenue*.¹⁰ The facts of both cases are almost identical.

Both companies had taken a physical stock-take each year on 31 August and not on the dates required for preparation of Excess Profits Duty returns. The books of both companies were balanced at the appropriate dates and adjustments made from the audited stock-takes to bring into account sales and purchases during the period to estimate the volume and value of stock on hand for Excess Profits Duty purposes. In both cases the Commissioners for Income Tax found that as an actual stock-take had not taken place, the accounts did not disclose the profit for the quarter, but merely spread the profit for the year over the quarters of the year. In the *James Cycle Co Case* the Commissioners for Income Tax stated that:¹¹

the profit for each quarter shown in the said quarterly accounts was not the profit for that quarter, but merely the profit for the year distributed over the quarter of the year, and that, it was impossible from books kept as those of the Appellant Company were, and from such quarterly accounts, to ascertain readily or indeed to ascertain at all with any approach to accuracy the profits of such quarters without either actually taking stock *or without the keeping of elaborate and accurate stock accounts.*

⁸ Comment: this is an advantage because it smooths the income figure upon which tax is levied, and smooths tax burden as a result. If progressive rates of tax are used or a surcharge is payable above a certain amount, this would increase the benefit of being able to average income.

⁹ *The James Cycle Co Ltd v The Commissioners of Inland Revenue* (1919) 12 TC 98.

¹⁰ *John Marston Ltd v the Commissioners of Inland Revenue* (1919) 12 TC 106.

¹¹ *The James Cycle Co Ltd v The Commissioners of Inland Revenue* (1919) 12 TC 98, 101. Emphasis added.

Rowlatt J, the judge at first instance, and the Court of Appeal, dismissed the taxpayer's appeal as the issue raised by the appeal was clearly a question of fact for the Commissioners to determine.¹² In the *Marston Case* L J Rowlatt LJ commented that:¹³

No doubt the books if looked at by persons with the necessary knowledge contained the materials for finding out the profits for those months, but the books had not been made up within the meaning of this Section. ... Adding up a book is not making it up for this purpose because you make it up in order that the profits may be readily ascertained from the making up, *which means something more than adding up and something more than entering.*

And later referring to the accounts which had been prepared by the taxpayer that:

I have no doubt they did it with very substantial accuracy, but they *did not do it really properly*, because, of course, they did not have and could not have, now that the time had gone by, a stocktaking on the 31st July to which they had transferred the end of the year, but *they got at it by reasoning from the state of affairs which existed on the 31st August.*

The taxpayer decided not to pursue their appeal given the decision in *James Cycle Co.*

These two cases indicate that an actual stock-take is necessary to comply with the requirements to properly value stock-in-trade. However it is less than clear if it would be permissible to take stock on the weekend before balance date, so as to avoid disruption to business, and adjusting the physical quantities through careful record keeping and then applying the stock values of the balance day to the figures so calculated.

There is clear evidence in the accounting literature that an actual stock-take was not always undertaken for the preparation of accounts.¹⁴ That taking a physical stock-take was not always the case is demonstrated by J Rhodes who notes that taking stock 'is not generally looked upon as a *sine qua non*'.¹⁵ He goes on to point out that some taxpayers need only take stock every three years because of the three years' average. Unfortunately, he does not further explain this intriguing comment.¹⁶

Adam Murray and Roger N Carter make an obtuse comment on the valuation of stock-in-trade, suggesting that 'stock has been analysed, and the amount of it appertaining to

¹² Ibid, Rowlatt J, TC 98, 103; M R Sterndale, MR105; Atkin, LJ 105; and L J Younger LJ agreeing, at 105.

¹³ *John Marston Ltd v the Commissioners of Inland Revenue* (1919) 12 TC 106, 112. Emphasis added.

¹⁴ There are numerous comments in *The Accountant* to the effect that it was very common not to get a value for stock-in-trade until all the other information had been tabulated.

¹⁵ The 'indispensable condition or qualification'.

¹⁶ J Rhodes, *Income Tax Assessments: A Practical Guide* (1889-90) 13, 12.

each item at the beginning and end of each year has been taken into account' and that this has the same effect as doing a stock-take and using the figures ascertained as the opening and closing figures for stock-in-trade.¹⁷ They also point out that one of the common errors made by taxpayers who keep accounts for cash transactions only, is to forget that any increases and decreases in the value of stock-in-trade have to be taken into account to determine income for the period.¹⁸ This clearly shows that a physical stock-take was not contemplated.

Another example showing that doing a physical stock-take was not the normal practice follows from a question raised by an 'Enquirer'.¹⁹ The problem involved a retail ironmonger whose stock-in-trade consisted of 'thousands of articles'. The taxpayer had only taken stock 'every two or ... three years' due to the tremendous amount of work involved.

Similarly an editorial note in *The Accountant* discusses the case of a timber merchant who had not taken stock for over ten years. Income (profits) had to be calculated by deducting purchases from gross sales. Due to the actions of the Timber Controller, it was impossible to purchase any timber during the current year, therefore, all sales were out of the prior years' purchases. As a result the current year's assessment was 'unduly inflated'. It was asked by 'FCB', if this could be avoided. The tax editor responded as follows:²⁰

Rule I to Case I of Schedule D only charges the "balance of the profits or gains", and it was laid down in *inter alia Usher's* case that profits for income-tax must be computed on ordinary commercial principles, provided that where there is a specific provision in the Income Tax Acts disallowing a particular expense, that provision must be followed. ... The income-tax is only an annual tax ... an income-tax assessment for one year has no effect whatever on that of a subsequent year ... The position is, therefore, that ... profits for [each year] ... have to be ascertained on commercial principles quite separately and independently of what has been adopted [previously]. Now, as there are no stock figures, the profits must be estimated by estimating the difference in stocks. ... [T]he 1917 accounts do not give the "profits" without taking stock into account ... These accounts are incorrect by their incompleteness in not containing debits and

¹⁷ Adam Murray, and Roger N Carter, (Chartered Accountants Manchester) *A Guide to Income-Tax Practice* (Gee and Co, London, 1895) 74, explaining the figures in an example of a trading account. See also: (2nd ed, Gee and Co, London, 1899) 97; (4th ed, London, 1905) 125 and 284 respectively; (5th ed, London, 1908) 126–27 and 301 respectively; by the late Adam Murray and Roger N Carter, (6th ed, Gee and Co, London, 1911) at 156 and 362 respectively; (7th ed, London, 1915) 177–78 (the second point is not referred to in this edition); (9th ed, 1921) 165 and 388 respectively; (10th ed, 1924) 193–94 and 431 respectively; (11th ed, 1927) at 157 and 316 respectively.

¹⁸ *Ibid*, Murray and Carter 1895, at 152; 2nd ed 1899, at 217.

¹⁹ 'Enquirer' (anon), 'Stocktaking for Retail Accounts', letter to the editor (30 October 1909) *The Accountant* 547.

²⁰ Editor, 'Stock' (22 February 1919) *The Accountant*, 138.

credits for stock, so that without insertion of estimates for stock it would be a direct violation of Rule I to Case I to treat the profit at present shown as being the profit for income-tax.

It is clear from the above discussion that there was some disagreement in the accounting profession as to the need for an actual stock-take to be undertaken or whether estimates could be used.

IV CONSISTENCY AND THE VALUATION OF STOCK-IN-TRADE FOR INCOME TAX PURPOSES

Consistency is a very important factor to be taken into account where there are competing accepted accounting methods (see full discussion below, particularly in relation to *Duple Motor Bodies Ltd v Commissioners of Inland Revenue*). In the United Kingdom consistency involves a consistent use of a particular method by a taxpayer, and may give rise to a form of estoppel against the Revenue. This approach can be traced to the case of *Bombay Commissioner of Income Tax v Ahmedabad New Cotton Mills Co Ltd*,²¹ where it was stated that where an incorrect method of accounting had been used it could not be corrected for the closing balance only: the opening balance must also be adjusted. Later cases have however cast doubts over the scope and application of this rule. In *Patrick (HM Inspector of Taxes) v Broadstone Mills Ltd*, for example, the United Kingdom courts have made the taxpayer change its method of valuing stock-in-trade when that method was found not to produce the true profit for taxation purposes, despite the fact that it had been used constantly between 1920 and 1949. The expert evidence clearly showed that the method in question, the base stock method, was accepted as appropriate throughout the industry as the method for valuing stock-in-trade.²² Another case in point is *BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)*²³ where only Lord Reid, in his dissenting judgment, would have allowed the appeal in the present case, mainly based on the acceptance of the Revenue of the company's use of the method for such a long period. However he was of the opinion that the Revenue could prevent the adoption of this method by companies who had not been using it for a substantial number of years²⁴ as the method adopted by the company was 'stretching unduly the concession to taxpayers involved in 'cost or market value, whichever is the lower'. However, the crux of his Lordship's decision was that the Revenue had only sought to change the values of stock-in-trade for the current year, and not earlier periods.²⁵

²¹ *Bombay Commissioner of Income Tax v Ahmedabad New Cotton Mills Co Ltd* (1930) 46 TLR 68.

²² *Patrick (HM Inspector of Taxes) v Broadstone Mills Ltd* (1953) 35 TC 44.

²³ *BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)* (1972) AC 544.

²⁴ [1971] 2 WLR 1313, at 1317.

²⁵ His Lordship was relying on *Bombay Commissioner of Income Tax v Ahmedabad New Cotton Mills Co Ltd* (1929) 46 TLR 68.

*Steel Barrel Co Ltd v Osborne (No 2)*²⁶ is another case where the consistency doctrine has been greatly limited. Somervell LJ observed that:

Sir Roland argued the case on the merits. With his main submission agree [sic]. He said normally, in dealing with a particular year of assessment, the opening figure which you take in respect of stock must be arrived at on the same basis as the closing figure. With that, as a general principle, nobody would quarrel; but, for the reasons I have sought to give, in the facts of this case, you have to analyse the position, and analysing it, as I have attempted to do, it seems to me plain that the Inspector of Taxes was right in saying that as a result of what had happened when the agreement was come to, this adjustment must be made in this year, and the adjustment is made by deducting the figure of £4,848 at the beginning of the year as if this old stock was still there, deducting nothing on the assumption that it was all sold.

For these reasons, as it seems to me, the learned Judge was right, though I think I have analysed it perhaps rather more fully than he did. I agree with the conclusion which he reached and also with the conclusions of the Commissioners.

Consistency in valuation methods has always been important in the valuing of stock-in-trade for accounting purposes. The introductory paragraph of Recommendation X of the Institute of Chartered Accountants in England and Wales states that:²⁷

No particular basis of valuation is suitable for all types of business but, whatever the basis adopted, *it should be applied consistently ...*

And later that:

(C) *Inconsistency in method* may have a very material effect on the valuation of a business based on earning capacity though not necessarily of importance in itself at any balance sheet date.

And

(6) Whatever basis is adopted for ascertaining cost or calculating market value, it should be such as will not distort the view of the real trend of trading results and *should be applied consistently* regardless of the amount of profits available or losses sustained.

Similarly, Recommendation N22 states that:²⁸

Circumstances vary so widely that no one basis of arriving at the amount is suitable for all types of business nor even for all undertakings within a particular

²⁶ *Steel Barrel Co Ltd v Osborne (No 2)* (1948) 30 TC 73, 78. The facts are discussed below.

²⁷ Published in *The Accountant* (16 June 1945) 302–03. The emphasis is added

²⁸ Recommendation N22: Treatment of Stock-in-Trade and Work in Progress in Financial Accounts (16 November 1960) Institute of Chartered Accountants in England and Wales. The emphasis is added.

trade or, industry. Unless the basis adopted is appropriate to the circumstances of the particular undertaking and *used consistently from period to period ...*

The following comments by F R M de Paula give a reasonable reflection of the accounting approach. Throughout his discussion he emphasised the 'great importance' of applying a consistent basis of valuation to stock-in-trade from year to year. If the basis of valuation is changed:²⁹

the trend of the operating results for the year will be distorted. In my view, it is of the utmost importance that the proprietors of a business should be given a clear view as to the trend of the normal earnings of the concern. If, therefore, the basis of inventory valuation has been altered and the amounts involved are material in amount, then, in my opinion, this fact and the amount involved should be made clear to the proprietors of the business.

Thus it can be seen that the courts have been concerned with finding the actual value of the stock-in-trade in question, whereas the accounting profession seems more concerned with consistency in use of valuation methods. The virtue in being consistently wrong has always escaped the current author.

V OPENING VALUE IS SAME AS CLOSING VALUE OF PRIOR YEAR

It is a basic premise of double entry bookkeeping that the closing value for one year will be the opening value for the next succeeding year. This may seem a trite observation but the following comment by Mr E Stanford of the Board of Inland Revenue before the 1920 UK Royal Commission on Taxation when questioned by one of the member of the Royal Commission gave evidence that:³⁰

even before the Excess Profits Duty it is not uncommon to find that stocks were being unduly written down; in fact, *I was very much mused*, on one occasion, to find that the taxpayer invariably wrote 10 per cent off his stock at the end of each year, and quite reasonably so, *but he carried it forward into the next year at the unreduced figure*. 12,489. That is not really a stock evasion; that is imply changing the figures? As a matter of fact, he was perfectly innocent. *He did not know what he was doing, although he had accumulated a reserve by that means of several thousand pounds, and he did not know where his money had come from, so he said*, and I believe he was right.

There is little direct judicial authority on this point, although the doctrine of consistency discussed above gives some insight as to why this should be the case. In the *Osborne Case*³¹ problems arose from an agreement between the revenue authorities and the

²⁹ F R M de Paula, 'The Valuation of Stock-in-Trade or Inventories' (a paper delivered before the Chartered Accountant Students' Society of London on 10 February 1937) in *Developments in Accounting* (1948), 43–50, 50.

³⁰ Above n 5, 622. Emphasis added.

³¹ *Steel Barrel Co Ltd v Osborne (No 2)* (1948) 30 TC 73, 78.

taxpayer for the 1933 to 1939 years inclusive, arising out of an previous income tax dispute.³² By that agreement the opening and closing stock figures were reduced for 1933 to 1939. However due to oversight the Inland Revenue opening stock figure for the 1938 year was not reduced so as to correspond with the closing figure of stock as at 31 December 1937. The taxpayer objected to the amended assessment which reduced the opening stock figure for the 1938 year as per the agreement. Judge Macnaghten, the judge at first instance, held that.³³

It is plain that the figure taken for the opening figure on 1st January must be the same as the figure for the valuation of the stock on the previous day.

On appeal all the judges agreed on this point. Vaisy J saying that once a³⁴

figure having been fixed ... as the closing [stock] figure at the end of 1937, it would, in my judgment, of necessity also be the opening [stock] figure for the year 1938.

Tucker J agreed noting that.³⁵

the closing figure for stock for 1937 should be treated, as it would normally be, as the opening figure of the stock for 1938.

Somervell LJ agreed that the primary judge had come to the correct conclusion.³⁶

VI VALUATION AND SUBSEQUENT KNOWLEDGE

Generally if during the preparation of accounts it is discovered that after the balance date, but before the accounts are finalised, there is a deficiency which was present at the balance date then that deficiency would be reflected in the accounts. The question arises: can the deterioration in the value of stock-in-trade which is present on the balance date, but which is not discovered until after the balance date, be taken into account at the balance date for taxation purposes. This issue was considered in *Brigg Neumann & Co v Commissioners of Inland Revenue*.³⁷ The taxpayer company had 268 pieces of cloth from Messrs Harper which were still 'in the grey' or were still at the dyers, and had not yet been found to be defective.³⁸ The Commissioners for the Special

³² *Osborne v Steel Barrel Ltd* (1941–42) 24 TC 293. Discussed below.

³³ *Steel Barrel Co Ltd v Osborne (No 2)* (1948) 30 TC 73, 78. The case follows from agreement reached in *Osborne v Steel Barrel Ltd* (1941–42) 24 TC 293 which is discussed below.

³⁴ *Ibid*, the *Osborne Case* (1948) 30 TC 73, 81.

³⁵ *Ibid* 82.

³⁶ *Ibid* 81.

³⁷ *Brigg Neumann & Co v Commissioners of Inland Revenue* (1928) 12 TC 1191.

³⁸ *Ibid* 1205–06. However, '40 other pieces of the same weaving had come back from the dyers and had been examined and were all found to have one similar defect running through them'.

Purposes of Income Tax held that these pieces should be at the 'value the said goods at 31st March, 1921, at the *current market value of perfect goods* of the same description (market value being lower than cost price)'.³⁹ Rowlatt J held that:

I think the Commissioners were right in saying "We must treat these 268 pieces of goods merely on the same footing as perfect goods which they appeared to be at the time." Therefore I think both the appeals fail, with costs.

Thus it is clear that only knowledge at the balance date can be taken into account in valuing stock-in-trade for income tax purposes.⁴⁰

VII THE UNDERLYING ASSUMPTION OF THE COMMON LAW: THE 'LOWER OF COST OR MARKET RULE'

The fundamental basis for the valuation of stock-in-trade adopted by the United Kingdom courts under the Income Tax Acts, is the use of the 'cost or market price, whichever is the lower' rule. It is common for writers in this area to refer to the often-quoted words of Lord President Clyde who described the situation as follows in *Whimster & Co v Commissioners of Inland Revenue*:⁴¹

the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business during such year ... and the expenditure laid out to earn those receipts the account ... must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the *Income Tax Act* For example, the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade at the beginning and at the end of the period covered by the account should be entered at cost or market price, whichever is the lower; although there is nothing about this in the taxing statute.

Lord Sands observed in the same case that:⁴²

The consideration of how it would be prudent for a trader to act does not solve the question here presented to us as one of revenue law. Under this law the profits are the profits realised in the course of the year. What seems an exception is recognised where a trader purchased and still holds goods or stocks

³⁹ Ibid 1199. Emphasis is added.

⁴⁰ See also discussion of *Hinchcliffe (HM Inspector of Taxes) v Crabtree* (1970) 47 TC 419. Discussed below.

⁴¹ *Whimster & Co v Commissioners of Inland Revenue* (1925) 12 TC 81, 823. It is interesting to note, though no doubt totally irrelevant, that in this case there was, by the time it reached the courts, no longer any question of stock-in-trade involved, as the taxpayer had withdrawn any such claim, being a shipping company. Note the other members of the court made similar observations.

⁴² Ibid 827.

which have fallen in value. No loss has been realised. Loss may not occur. Nevertheless, at the close of the year he is permitted to treat these goods or stocks as of their market value.

The overriding consideration, in Lord President Clyde's view, is conformity with the provisions contained in the relevant legislation. In *Commissioners of Inland Revenue v Marshall* his Lordship expressed the following view of the function of the court when considering the appropriateness of stock-in-trade valuation methods:⁴³

It is not for this Court to fix principles of valuation, for a principle of valuation is not a part of the law universal at all, but of course it is necessary sometimes to ask this Court whether a particular principle of valuation, if adopted, would or would not accord with the prescription of the Income Tax Acts which requires the balance of profits and gains to be duly ascertained.

Lord Guest made the point most forcefully in *Duple Motor Bodies Ltd v Commissioners of Inland Revenue* that:⁴⁴

It can never rest with the taxpayer [or anyone else for that matter] to decide upon what principle his income is assessed for tax purposes. The directors' [or anyone else's] decision can never be decisive of the matter for income tax purposes The Assessment, in addition to being consistent with normal accounting practice, must be made according to the provisions of the Income Tax Acts.

Later in the same case Lord Reid commented as follows:⁴⁵

Normally a court attaches great weight to the view of the accountancy profession, though the Court must always have the last word.

Similarly, Lord Carmont in *Commissioners of Inland Revenue v Broomhouse Brick Co Ltd*, commented that:⁴⁶

it must not be left out of account that the approach to the question is not whether any given expenditure would be treated by a chartered accountant in a perfect system of book-keeping as an appropriate deduction in the ascertainment of a taxpayer's true profits, but whether the scheme of the Income Tax Acts permits of the given expenditure being treated as a deduction.

Singleton J, in *Patrick (HM Inspector of Taxes) v Broadstone Mills Ltd* described the attributes of an acceptable valuation method as follows:⁴⁷

⁴³ *Commissioners of Inland Revenue v Marshall* (1927) 14 TC 319, 322.

⁴⁴ *Duple Motor Bodies Ltd v Commissioners of Inland Revenue* (1959-61) 39 TC 537, 573-74.

⁴⁵ *Ibid* 570-71.

⁴⁶ *Commissioners of Inland Revenue v Broomhouse Brick Co Ltd* (1952) 34 TC 1, 10.

The [method] ... which shows most accurately the position between the Revenue on the one hand and the taxpayer on the other hand is the one which ought to be adopted ... *it is not sufficient to say that a particular system of accounting is a well recognised system of accounting and all right during normal times*, if the contention on the other side is that the system does not give a true result for the particular year, the accounting year.

The author endorses the above approach as being the only rational one that can be adopted in the valuation of stock-in-trade. Singleton J enunciated the following general rule:⁴⁸

(1) You cannot arrive at the profits of the year without taking into account the value of the stock ... (2) the figures for stock are just as important as any other figures. Values may have to be estimated when market price is taken, but any departure from accuracy is reflected in the trading account; (3) stock should be taken either at cost price or at market price, whichever is the lower.

One hopes Salmon LJ, in *B S C Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)*, was not being completely serious when making the following comment with respect to the valuation of stock-in-trade:⁴⁹

Much turns upon accountancy practice. Although this may appear elaborate and artificial to a lawyer [or for that matter the man in the street] ... it is aimed, almost always successfully, at arriving at an aspect of the truth.

Tables 1 and 2 summarise the views expressed in books, articles and letters to the editor of *The Accountant* during the period 1921 to 1925. From this it is clear that while the use of the lower of cost or market rule was popular with the accounting profession it certainly could not said to be the established practice for valuing stock-in-trade. Many of the authors who referred to it did not use it for all purposes. This is reinforced by the discussion below.

⁴⁷ *Patrick (HM Inspector of Taxes) v Broadstone Mills Ltd* (1953) 35 TC 44, 64. The emphasis is added.

⁴⁸ *Ibid* 68.

⁴⁹ *B S C Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)* (1971) Ch 427, 436.

TABLE 1 VALUATION OF STOCK-IN-TRADE 1921–25: NET OF MULTIPLE AUTHORS

Valuation methods referred to	Number		%	
The lower of cost or market rule	24		30.0	
Cost	16		20.0	
Cost or below	6		7.5	
Below cost	1	23	1.3	28.8
Base stock	3		3.8	
Retail inventory	3		3.8	
Realisable value	3		3.8	
Net realisable value	2		2.5	
Replacement cost or price	2		2.5	
Market value or price	10		12.5	
Value	3		3.8	
Other methods	7		8.8	
Total valuation methods referred to	80			

TABLE 2 VALUATION OF STOCK-IN-TRADE 1921–25: NET OF MULTIPLE AUTHORS

Valuation methods referred to	Number		%	
The lower of cost or market rule	24		61.5	
Cost	16		41.0	
Cost or below	6		15.4	
Below cost	1	23	2.6	59.0
Base stock	3		7.7	
Retail inventory	3		7.7	
Realisable value	3		7.7	
Net realisable value	2		5.1	
Replacement cost or price	2		5.1	
Market value or price	10		25.6	
Value	3		7.7	
Other methods	7		17.9	
Number of books, articles, letters to the editor, etc.	39			

F R M de Paula opens his extensive discussion of the valuation of stock-in-trade by saying that he has for ‘many years ... been disturbed’ by the ‘so many different’ methods that are used to value stock-in-trade. A matter of particular concern was ‘that there is not an accepted basic principle’ for valuing stock-in-trade.⁵⁰

⁵⁰ Above n 29, 50.

J H Burton identified the following methods used for valuing stock-in-trade that were in current use about this time. They included the following:⁵¹

1. Actual cost.
2. Market value.
3. Average purchase price during a period.
4. Market or selling price, less a percentage to bring the value down to cost.
5. Standard cost based on the values in a normal period.
6. Estimated cost of reproduction.
7. Scrap or forced sale value in the case of obsolete or excess stock.

All these methods are *based on theories* which in *particular circumstances* are *commercially sound*. [Emphasis added.]

More significantly it is noted that:⁵²

Many methods are adopted ... in valuing stock and stores, *which contravene the popular maxim of "cost or market value, whichever is the lower."*†

For instance, there is the use of the 'base stock' method under which stock-in-trade 'may be priced at a minimum figure, as these materials represent the smallest quantity of stock absolutely essential to the conduct of the concern'.⁵³ The consequences of over and under valuation of stock-in-trade are that there will be:⁵⁴

an understatement of the total net expenditure for the period, or a big disparity between the cost accounts and the financial books.

Under-valuing causes an over-statement of total expenditure and a similar discrepancy.

Many other authors in the accounting literature referred to inconsistent or different methods.⁵⁵

⁵¹ J H Burton, *Stores Accounts and Store Management* (first published 1929, second ed, 1930) 61–62; third edition, (3rd ed, 1937) at 60. The emphasis is added. See also J H Burton, 'Practical Problems In Stocktaking And Stores Accounts' (30 August 1924) *The Accountant* 309–17, 316, where the same comment is made. It should be noted that the fourth edition published in 1947 contains the same list at pages 59–60. Thus, these practices survived after the issuing of Recommendation X.

⁵² *Ibid*, Burton 1929, 62. The emphasis is added.

⁵³ *Ibid* 62.

⁵⁴ *Ibid* 62.

⁵⁵ See for example: Stanley W Rowland, and Lawrence R Dicksee, *Auditing a Practical Manual For Auditors* (15th ed, 1933) 205–06; Lester A Boddington, *Financial Statements: Their Treatment and Interpretation* (1938) 160; L Cuthbert Cropper, and Cuthbert, *Book-keeping and Accounts - A Text Book for Students* (eleventh ed, 1925) 128; fourteenth edition, 1927; fifteenth edition, 1929, at page 128 in each and Cropper, L Cuthbert, *Higher Book-keeping and Accounts*, Macdonald and Evans, London, 1927; third edition, 1929, pages 23–24 in each; Hughes-Onslow, H. (the late), and Rowland, Stanley W, A

It is clear from the discussion above that there were many methods of valuing stock-in-trade in use other than the lower of cost or market value rule.

A report in *The Accountant* shows that the use of the lower of cost or market rule was not the only way to reduce income tax liability. Nor was it the most effective one. The report was as follows:⁵⁶

A question has been asked in The House of Commons if relief can be given from demands of Surveyors of Taxes that, for Income-tax and Excess Profits Duty, stocks should be taken at cost or market value, whichever was the lower. It was urged that this acted unfairly, as many traders had been in the habit of taking their stocks below cost or market value, and that traders should be allowed to charge against present profits sums necessary to reinstate stocks to pre-war level.

The opinion of *The Accountant* was that:

It is impossible to lay down a general rule for treatment of stocks, but, on stock depreciating in a particular year, the above method [the lower of cost or market rule] gives a full allowance in that year by the credit for stock being reduced.

In 1920 E W Newman noted that often the valuation of stock is not based upon any method but rather the ‘sole consideration’ is the amount wished to be declared as profit to the Inland Revenue.⁵⁷ He notes, not in the context of tax, that:⁵⁸

one finds that many different methods are adopted in valuing stock-in-trade. Some of these methods contravene the popular maxim of “cost or market value.” All of them are based upon theories which in particular circumstances

Lawyer’s Manual of Book-keeping, 1934, at page 110; Dicksee, Lawrence R., *Advanced Accounting and Bookkeeping for Accountant Students*, second edition, Gee and Co, London, 1897; Pixley, Francis W, (editor), *The Accountants Dictionary*, in two volumes, Waverly Publishing Company Ltd, London, 1922; second edition, The New Era Publishing Co Ltd, 1927/1926, also published by Sir Isaac Pitman & Sons Ltd, London, 1926; third edition, The New Era Publishing Co Ltd, [c1930], at pages [W] 50, 50 and 55 respectively and Pixley, Francis W. (editor), *The Accountants Dictionary*, in two volumes, Waverly Publishing Company Ltd, London, 1922; second edition, The New Era Publishing Co Ltd, 1927/1926, also published by Sir Isaac Pitman & Sons Ltd, London, 1926; third edition, The New Era Publishing Co Ltd, [c1930], at pages 79 [SIP] 79, 79 and 85 respectively; Raffety, Frank Walter (editor), *Modern Business Practice: A Comprehensive Guide and Work for Office Warehouse Exchange and Market* Vol VII (1913) 141; Stanley W Rowland, and Brian Magee, *Accounting (Part I)*, Gee and Company (Publishers) Ltd, London, 1934; second edition 1936; third edition 1938: at page 287, 297 and 303 respectively.

⁵⁶ The editor, ‘Stock’ editorial note (9 June 1917) *The Accountant* 544.

⁵⁷ E W Newman, ‘The Ascertainment of Profit’ (18 December 1920) *The Accountant*, 665–68, 665. (A lecture delivered at a meeting of the Midland Branch of the Institute of Cost and Works Accountants, 5 November 1920.)

⁵⁸ E W Newman, ‘The Ascertainment of Profit’ (18 December 1920) *The Accountant* 665–68, 666. (A lecture delivered at a meeting of the Midland Branch of the Institute of Cost and Works Accountants, Friday 5 November 1920.)

are commercially sound. ... [T]he fundamental principle of all may be broadly stated in this way – that no profits should be anticipated and that all known losses, whether actual or contingent, should be provided against.

And furthermore, significantly, '[w]e may grant that cost price is the proper basis for stock valuations in ordinary cases'.⁵⁹

Before the 1920 Royal Commission Mr E Stanford London, of the Board of Inland Revenue, was questioned extensively on the proper way to value stock-in-trade for income tax purposes. He gave evidence that the practice of the Inland Revenue was to accept accounts drawn up on the basis of *the rule*, and that the Inland Revenue usually requested signed statements from taxpayers stating the value of stock-in-trade and how it was valued.⁶⁰ The lower of cost or market rule was only accepted by the Board of Inland Revenue because of its (assumed/claimed) long use in business, despite the inconsistencies in its application and its lack of logic. He described the use of lower of cost or market rule as 'an unsatisfactory practice'.⁶¹ He indicated that accounts which were based upon current values⁶² of closing stock-in-trade would be acceptable for income tax purposes, as would be accounts based upon historical cost values alone. Neither of these methods would lead to the types of manipulations and inconsistencies which were associated with the use of lower of cost or market rule. He gave evidence that prior to the war and the introduction of the Excess Profits Duty, the Inland Revenue did not worry about stock certificates and the value of stock-in-trade because 'it was felt that in the long run it would rectify itself'.⁶³

Mr London, when questioned by commission member Mr William McLintock, gave evidence that undervaluation of stock-in-trade was quite common, either by creating a fixed 'reserve' which did not vary from year to year, or by reducing the closing figure by a percentage of say 10 per cent, and using the original cost of the stock for the opening figure the following year.⁶⁴ Further evidence of such practices brought out by Dr Josiah Charles Stamp's questioning of Mr London, where he reported that large reserves (arbitrary write-downs in stock values) had been made in the cotton boom of 1910 by a number of taxpayers.⁶⁵ Mr London believed it would be a far more

⁵⁹ Ibid.

⁶⁰ These statements were called stock certificates and are discussed below. For examples of two different types of certificates see APPENDIX 5-6. It is to be noted that one type of certificate referred to did not require that any particular method of valuing stock-in-trade be used see APPENDIX 5-4.

⁶¹ Minutes of Evidence, The Royal Commission on The Income Tax, HMSO, 1920, at 622. At 628 he agrees with the statement that 'the matter has only become acute by reason of the rise in rates during the war and the very rapid rise in prices'.

⁶² The words 'current market values' could mean either replacement market or selling market. The meaning is not apparent from the text.

⁶³ Above n 5, para 12 488, 622.

⁶⁴ Ibid paras 12 484–489, 622.

⁶⁵ Above n 5, para 12 631, 628. See also paras 12, 410–12, 412 under questioning by Lord Colwyn and paragraphs 12, 566-12569 questions by Mr Walker Clark at 625.

satisfactory state of affairs if the method of valuation of stock-in-trade were specifically dealt with in the Income Tax Legislation.

The lower of cost or market rule's place in tax accounting practice can also be questioned by the following comments in the 1950s. Evidence to the Tucker Committee⁶⁶ indicated that there was the belief that stock-in-trade should be valued according to the custom in the trade. Mr Frank Bower⁶⁷ in answer to a question from the chairman is reported as saying that:⁶⁸

each industry had its own method of valuation and it should be left to them to establish a suitable basis. Some fences had to be put up and it was suggested that they could and should be reduced to three. Firstly, the method adopted should be in accordance with the custom of the trade. Secondly, it should be applied consistently from year to year. Thirdly, it must be such as to result in a fair view of the profits or losses of the period, even if this involved some degree of departure from the second proviso.

Mr B M Berry advocated the use of the base stock method⁶⁹ while Mr K A Lacey recommended the use of a replacement reserve technique which would 'iron out booms and slumps'.⁷⁰ Mr T B Robson noted that 'on the whole a lack of rules had worked reasonably well in relation to stock valuations'⁷¹ and Mr E G Turner felt that 'the main difficulties had been in arriving at facts rather than principles'.⁷²

The Report of the Royal Commission on Taxation in 1955 also recommended giving substantial choice to the taxpayer for valuing their stock-in-trade.⁷³

A How is the 'Lower of Cost or Market Rule' to be Applied?

Given that Lord Clyde, and the other judges quoted above, specifically approved the use of the lower of cost or market rule, it is important to point out in the strongest terms that the 'lower of cost or market' rule is not of itself a valuation method. It is merely a decision matrix which is used to decide which of two valuation methods is the one to be used for a particular item in a particular case.

⁶⁶ Committee on Taxation of Trading Profits, The 'Tucker Committee'.

⁶⁷ Frank Bower was representing Federation of British Industry and the Association of British Chambers of Commerce.

⁶⁸ 'Taxation of Profits - Foreign Profits; Stock Valuations; Group Accounts - Tucker Committee's Fourth Public Hearing' (1 April 1950) reported in *The Accountant* 355-58, 355.

⁶⁹ *Ibid*, for the International Chemical Co Ltd, 358.

⁷⁰ *Ibid*, Lacey 358.

⁷¹ For the Institute of Chartered Accountants, *The Accountant* (8 April 1950) 384-87, 385.

⁷² *Ibid*.

⁷³ See 'The Royal Commission Report: Stock Valuation' (18 June 1955) *The Accountant* 691-92.

The case of *Commissioners of Inland Revenue v Cock Russell & Co Ltd*⁷⁴ established an important principle with respect to the application of the lower of cost or market rule. The company was incorporated to acquire a partnership which carried on the business of wholesale wine and spirit merchants, operating under the same name. The firm had purchased, just prior to the outbreak of war, a quantity of port for the price of £3486. In late October 1945 a large quantity of port became available on the market at substantially lower prices. The two remaining pipes of port for which the firm had paid £1620 could then be purchased for a price between £1280 and £1360, and by January the following year for a price of between £ 1200 and £ 1340.

For the year ending 31 December 1945, the company valued this port, after allowing for shortages due to evaporation at £ 1182/15/-, that is, at its present market price. The rest of the company's stock was valued at cost, which was lower than the current market price. The company, and the firm before it, had always valued each item of stock separately, after having tasted them, using the lower of cost or market price for each. The Commissioners of Inland Revenue objected to the application of the lower of cost or market rule in such a way, with only two items being valued at current market value, the remainder of which had values in excess of cost however being shown at cost.

The evidence given by Mr Cock, the company's Managing Director, to the Commissioners for the General Purposes of Income Tax for the City of London, showed the firm had written down wines in the past when their value fell below cost. The last time this had occurred was after the 1914–1918 war, and since then the prices had been continually rising. Additional evidence was given by Mr R G Barrett, the Managing Director of another firm of wine and spirit merchants, James L Denman & Co Ltd. This firm used the same practice when valuing their stock.

Two chartered accountants also gave evidence, Mr Francis Feather of Harper, Feather and Paterson, and Mr G G P Goldney of A C Palmer & Co, both of whom said the company's application of the lower of cost or market rule was the appropriate method of valuing their stock to allow for both deterioration of the stock and also for falls in the market price of the stock. Mr Goldney also produced Recommendation X of the Institute of Chartered Accountants in England and Wales,⁷⁵ and the Commissioner quoted this part of the recommendation:⁷⁶

on the other hand, a more prudent and equally proper course is to take each item of stock or each category group, and value it on the basis of the lower of its own cost or market value.

⁷⁴ *Commissioners of Inland Revenue v Cock Russell & Co Ltd* (1949) 29 TC 387 [1949] 2 All ER 889.

⁷⁵ Published in *The Accountant* (16 June 1945) 302–03. The extract is from para 4 of the Recommendation, 303.

⁷⁶ *Commissioners of Inland Revenue v Cock Russell & Co Ltd* (1949) 29 TC 387, 389.

The Commissioners for the General Purposes of Income Tax of the City of London held the method used by the company was the practice of the trade and they were justified in using it.⁷⁷ The Commissioners of Inland Revenue were dissatisfied with their findings and appealed.

The case was argued before Croom-Johnson J, who pointed out the evidence in this case all pointed the one way, supporting the method adopted by the company.⁷⁸ His Honour was not impressed with the method of applying the lower of cost or market rule contended for by the Revenue which would, if adopted by the company, 'not entitle [them] to go through that "stock-in-trade" item by item and look to see what in truth was the position'.⁷⁹ After reviewing the applicable case law⁸⁰ his Honour found there had been no misapplication of these general principles and the Special Commissioners had directed themselves accurately and properly, and their decision was supported by all the evidence put before them. Croom-Johnson J, indicated that during the argument of the case he had given several illustrations of the 'unjust results which might follow' by applying the lower of cost or market rule in the manner argued by the Crown. Consequently the appeal was dismissed.⁸¹

As such, it is argued that to properly apply the lower of cost or market rule, it should, at a minimum, be done class by class, if not item by item, as the lower of the total cost or total market value may well exceed the value ascertained using the approach approved of by Croom-Johnson J. Such an approach is also common sense. Clearly in most instances it will not be possible to value each item of stock item by item, due to the cost involved. Thus it will be up to the professional judgment of the accountant to determine how the stock is divided into appropriate classes for valuation purposes.

The case of *Worthington (HM Inspector of Taxes) v Oceana Development Company Ltd*⁸² is another instance where the Revenue tried to apply the lower of cost or market rule globally. By consent of the Inland Revenue, judgment was entered for the taxpayer by Croom-Johnson J, on the basis that the law had been clearly determined in the *Cock Russell Case* (above).

⁷⁷ Ibid 390.

⁷⁸ Ibid 392.

⁷⁹ Ibid 391.

⁸⁰ Ibid 392–94. See also *Whimster & Co v Commissioners of Inland Revenue* (1925) 12 TC 81; *Edward Collins & Sons Ltd v Commissioners of Inland Revenue* (1925) SC 15 1; 12 TC 773; *JJ H Young & Co v Commissioners of Inland Revenue* (1925) SC 30; 12 TC 827; *Absalom v Talbot* (1944) 26 TC 166, 197.

⁸¹ *Commissioners of Inland Revenue v Cock Russell & Co Ltd* (1949) 29 TC 387, 394.

⁸² *Worthington (HM Inspector of Taxes) v Oceana Development Company Ltd* (1949) 65 Times LR 726. A number of books and articles by accountants cite this case rather than *Commissioners of Inland Revenue v Cock Russell & Co Ltd*, this intriguing anomaly has not yet been explained by the author's research.

VIII 'MARKET VALUE' WHICH MARKET: BUYING OR SELLING?

A Introduction

The question of the meaning of market price has been considered in several cases, the first being the *Brigg Neumann Case*.⁸³ Rowlatt J enunciated the general principle for determining the market value of stock-in-trade as follows:⁸⁴

Prima facie I take it when there is cloth to be valued at a cloth merchant's the question to be answered simply is: "What is this cloth worth here to-day that is on these shelves?". That involves the contemplation of some market, because it is not to be supposed that you would value and it would not be right, of course, to, do so-the cloth at a figure which you could get by having a break-up sale, or a forced sale, or anything of that sort.

Thus, he interprets market value as meaning realisable value. This point becomes clearer when Rowlatt J considers the market value of the actual stock-in-trade held by the taxpayer.

The taxpayer company was a trader in textiles, purchasing woollen goods 'in grey' from weavers and sending them out to be dyed by dyers. If any defects were to be found in the cloth, they would only become apparent after the dyeing process had been carried out. There were three types of agreements that the company had with its weavers which governed the question of defective cloth. Under the first, the defective goods were returned to the weavers for a credit of the original cost. Under the second, the goods were either returned for credit or sold and the difference in the price received—from that which perfect cloth would have brought—debited to the supplier's account. The third type of agreement had no specific provisions, however the goods were, in practice, sold for the best price obtainable, and the weaver was debited for the difference between the contracted price plus the cost of dyeing and the price which had been realised on the sale.

There were two different agreements with the dyers. Under the first type of agreement, where there was a fault in the dyeing, the piece was sold for what it would fetch in the market, and the dyer debited with the difference between the cost price of the piece plus the cost of dyeing and the price realised. In the second situation, the pieces were charged to the dyers at the cost of the piece plus the cost of the dyeing, and one presumed that they then became the owners of the cloth.

The company valued the imperfect cloth still on hand at the actual sale price of the imperfect cloth and did not include the amounts which they were to receive from the spinners or dyers. The Commissioners of Special Purposes valued these spoiled goods that were subject to these special arrangements at the market-selling prices for perfect goods, as this was the amount the company would actually receive, and not the amount

⁸³ *Brigg Neumann and Co v Commissioners of Inland Revenue* (1928) 12 TC 1191.

⁸⁴ *Ibid* 1202.

which would be received by way of sale alone. Rowlatt J upheld the Commissioners' method, justifying it as follows:⁸⁵

What they have got to get back in some way or another is the price they have paid for the goods and for the dyeing of them. If the goods sell for more they will not have to ask the weavers for so much; if the goods sell for less they will have to ask the weavers for more, but the amount that they will recoup themselves from one or the other, the manufacturer or the weaver, is the amount of the cost price plus the cost of dyeing by which they have been out of pocket. I do not think that affects it. I think the Commissioners are right.

Rowlatt J decided that the effect of these provisions in the contracts was that the condition of the cloth did not matter. The taxpayer would either sell it as perfect cloth in the market and gain the market price, or it would be returned to the manufacturer and perfect cloth substituted, or the imperfect cloth would be sold and the loss on the sale debited to the manufacturer's account. As such, it did not matter to them if the cloth was perfect or not, because the imperfect goods would be exchanged, or the difference in sales price would be made up by the manufacturers. Furthermore:⁸⁶

in either case they get back their purchase price ... If the goods are defective and there also has been a great fall in the market, it follows that Messrs Brigg Neumann will themselves get back from their weavers not only the shortage in value which is attributable per se to the defects in the goods, but they will also get back that which is attributable to the general fall in the market; so that it was better [if the cloth] ... should turn out defective ...

The same considerations applied to cloth which had been defectively dyed. A substantial amount of stock on hand at the balance date had subsequently been found to be imperfect, and this had been valued by the company at its imperfect value. Rowlatt J held that it should be valued in the condition it was known to be in, at that date, that is, as perfect goods, and the Commissioners were correct on this point.⁸⁷

We must treat these ... on the same footing as perfect goods which they appeared to be at the time. Therefore I think both the appeals fail, with costs.

Two points are clear as a result of this case. First, the relevant market price under the lower of cost or market rule, is the market in which the company usually sells. Secondly, where goods are subject to a special arrangement, that is, there is an indemnity or signed contract for sale, then it is the actual price to be received under the arrangement and not the general market price, which is relevant: for this is the amount which will actually be received.

C J Allan Macleod reports that he read with 'growing amazement' about the use of net realisable value for market value in Recommendation X. He says he was relieved 'to

⁸⁵ Ibid 1206.

⁸⁶ Ibid 1204–05.

⁸⁷ Ibid 1207.

find that up to the King's Bench Division the Inland Revenue are still bound by *Brigg Neumann & Co.* (1191, TC, Vol. 12) of which your Council may be unaware'.⁸⁸ He then claims to quote from the case that '[m]arket value is the price at which the appellants could purchase the goods in the market'.⁸⁹

It is claimed that '[o]ur predecessors in this profession maintained' that stock-in-trade was valued using the lower of cost and market rule and that by 'market value they meant the lowest buying price in the best market open to the buyer'.⁹⁰ He would be pleased to see 'these unfortunate recommendations withdrawn'.⁹¹ This is a clear misrepresentation of the case. The only place where the two terms are used together is when Rowlatt J is describing how the taxpayer referred to replacement cost as market value, that is, where Rowlatt J says:⁹²

they say: "If in fact there is no spot market"; but at any rate the case proceeded upon the footing that there was no market. You could not simply value those goods as things you could take out and sell there and then, or anything of that sort, and so they had recourse to cost price, but they distinguished, in not very happy language, between two forms of cost price. One form is: What have you actually given for these goods? That is the cost price in the normal sense. But the other cost price they have described in a phrase which they have used again for this purpose, namely, the phrase "market value" in paragraph 28 of the Case, meaning by that the price at which Messrs. Brigg Neumann & Company could purchase in the market.

The editor of *The Accountant* notes immediately under the letter of C J Allan Macleod that fiscal rules have nothing to do with accounting or auditing practice. The formulation of the Recommendations 'aim simply at formulating a guide to the "best practice" in publishing accounts'. The editor points out that the *Brigg Neumann Case* decision was based on 'on special facts relating to the treatment of damaged goods'.⁹³

⁸⁸ C J Allan, 'The Institute and the Valuation of Stock-in-Trade' (1 September 1945) letter to the editor *The Accountant* 107–08, 107.

⁸⁹ This is not the case at all. Replacement cost was only used as a surrogate for cost, which was inapplicable in the circumstances to some stock of the total stock in question. Rowlatt J held that market value meant realisable value. A computer text scan and word search of the judgment was unable to find this supposed quote. This a clear misrepresentation of the findings and reasoning of Rowlatt J's judgment. A report (*Brigg, Neumann & Co v Commissioners of Inland Revenue*) in *The Accountant Tax Supplement* (14th July 1928) 361–62, at 362, gives a misleading impression by referring to the findings of the General Commissioners for Income Tax stating that market value meant replacement cost without pointing out that this approach was rejected by Rowlatt J.

⁹⁰ Above n 91, 107.

⁹¹ *Ibid* 108.

⁹² *Brigg Neumann and Co v Commissioners of Inland Revenue* (1928) 12 TC 1191, 1202–03.

⁹³ The editor, 'The Institute and the Valuation of Stock-in-Trade' (1 September 1945) *The Accountant* 107–08, at 107. This is a note to C J Allan Macleod's letter. It to be noted that in *Brigg Neumann* it was perfect cloth which had replacement cost attached to it and the imperfect cloth realisable values. The correct citation is *Brigg Neumann & Co v Commissioners of Inland Revenue* (1928) 12 TC 1191.

This a misrepresentation of the facts, as it was used as a surrogate for the cost of the undamaged goods as is shown above. Damaged goods were valued at realisable values under the supply contracts.

The view expressed by C J Allan Macleod is not isolated. J H Burton discusses several income tax cases in relation to the valuation of stock-in-trade.⁹⁴ However, for some reason he omits vital facts in his discussion of *Brigg Neumann*. Whilst correctly stating that it was held that replacement cost means the cost one would have to pay in order to have the stock on hand at the end of the tax year he fails to point out that it was being used as a surrogate for cost because there was no 'spot' selling market at the time and thus the realisable value could not be ascertained. He also misrepresents how goods known to be imperfect should be valued. He does not point out that the discussion was based upon how much they would in fact receive for the particular goods in the normal course of their business.

The Report of the case in *The Accountant* concluded as follows:⁹⁵

The Special Commissioners held that the market value ought to *be the price at which the appellants could buy cloth in the open market*, and if, in fact, there was no spot market enabling the market value at 31st March to be readily ascertained, then the value ought to be the price which ruled at the time when contracts for delivery at 31st March were entered into.

The appellants appealed. There was also a cross appeal by the Crown as to the valuation to be put on the 268 pieces of cloth, which were, in fact, defective but had not been discovered to be so at 31st March 1921 as was found by the Commissioners.

Held, dismissing both appeals with costs, (1) *that the Commissioners had ascertained the correct basis for arriving at the market value of the cloth brought into stock*; (2) *that as regards all defective cloth other than defective cloth purchased from P. & Co., and the 268 pieces purchased from H., Ltd., the Commissioners were right in holding that such cloth should have been valued at its cost price as the appellants had a claim for reimbursement from the weavers*; (3) *that the decision of the Commissioners as regards the value to be placed on the 268 pieces purchased from H., Ltd., was correct.*

This is a clear misrepresentation of the findings of Rowlatt J. Similarly, in an article which appeared in 1941, it is asserted that.⁹⁶

⁹⁴ J H Burton, *Costing for Control* (1948) 46–47. The cases are *Brigg Neumann & Co v Commissioners of Inland Revenue* (1928) 12 TC 1191; *Ahmedabad New Cotton Mills v Bombay Commissioners* (1930) 8 ATC 575; *Craig (Kilmarnock) Ltd v Cowperthwaite* (1914) 13 TC 627; *Huntly & Palmers Ltd v Commissioners of Inland Revenue* (1928) 12 TC1209; *Osborne v Steel Barrel Ltd* (1941–42) 24 TC 293; *Greene v Inland Revenue Commissioners* (1926) 6 ATTC 461 and *Smith & Son v Commissioners of Inland Revenue* (1928) 7 ATC 135.

⁹⁵ *The Accountant Tax Supplement* (14 July 1928) 361–62, 362. The emphasis is added.

⁹⁶ 'Valuation of Stock for Income Tax', (22 November 1941) *The Accountant Tax Supplement* 293–95, 293–94. The emphasis is added.

The Special Commissioners held, however, and their decision was affirmed in the High Court, that the correct method of valuation was to compute the price which would have been paid had the goods been actually delivered on 31st March, 1921, that is to say, had they been ordered on 31st December, 1920. As regards that part of the stock which was defective, the Court decided that where defects had not been discovered before 31st March, the goods could be valued at the current market value (being below cost price) at that date, i.e. *the price at which they could be purchased in the market*.

Max England says that:⁹⁷

With regard to market price the position is not quite clear. Generally, it is taken as the estimated *realizable value* of the stock in its existing condition after taking into account expenditure incurred before disposal. In *Brigg Neumann & Co v CIR* (7 ATC 269; 12 TC 1191), however, it was defined as the price at which the goods *could be purchased* by the trader in the market. Where there is no spot market a notional cost price to the trader of the goods on the day of valuation is to be taken.

There are many similar comments to be found in the literature.⁹⁸ These comments are hard to understand given Rowlatt J's explicit comments that market value meant realisable value. Having reread the case many times, the current author could find no such comment. Even scanning the judgment and doing a word search produced no guide as to how the mistake could have happened. It is as if these authors had not in fact read Rowlatt J's judgment. In para 28 of the findings of the General Commissioners for Income Tax they conclude that:⁹⁹

We hold that the correct method of stock valuation at 31st March, 1921, is cost price or market value whichever is the lower. *By market value* we mean the price at which Brigg Neumann & Co *could purchase the goods in the market*. If in fact there is no spot market for goods of the same description as the goods dealt with by Brigg Neumann & Co. enabling market value at 31st March, 1921, to be readily ascertained, then market value at 31st March, 1921, will be the price which ruled at the time when contracts for delivery at 31st March, 1921, were entered into.

⁹⁷ Max England, 'Stock Valuation' (28 January 1956) *The Accountant* 80–82, 80. The emphasis is added.

⁹⁸ John E Talbot, 'Tax Aspects of Stock Valuation' (September 1957) *British Tax Review*, September 1957, pages 229-240, at page 236; Willott, Robert, *Current Accounting Law & Practice*, Sweet & Maxwell, London, 1976, at page 74; Viscount Simon (general editor), *Simon's Income Tax*, Butterworth & Co (Publishers) Ltd, London, 1949, at page 137; *Simon's Taxes - Income Tax, Corporations Tax, Capital Gains Tax*, 3rd revised edition (issue 74), Butterworths, London, 1983, at page 2001; Shaw, John Houldsworth and Baker, T. Macdonald, *The Law of Income Tax*, Butterworth & Co (Publishers) Ltd, London, 1937, at page 152; Hughes, Percy F., and Cooper, J.M., *Taxation Manual*, 12th edition, Taxation Publishing Company, London, at page 137.

⁹⁹ *Brigg Neumann and Co v Commissioners of Inland Revenue* (1928) 12 TC 1191, 1200.

This finding is also included in the head-note to the case.¹⁰⁰ When read in conjunction with the head-note— ‘Held, *that the decision of the Special Commissioners was right in all respects*’— the situation becomes abundantly clear. In other words, these authors have read the head-note only, and have not read Rowlatt J’s judgment.

The case of *Freeman, Hardy & Willis Ltd (now BSC Footwear Ltd) v Ridgway (H M Inspector of Taxes)* also considered the issue of the meaning of market value in the lower of cost or market rule.¹⁰¹ Cross J, the judge at first instance, rejected such an interpretation, as follows:¹⁰²

I cannot treat it as authority for the proposition for which the taxpayers are contending, namely that a retailer can value his unsold stock by reference to the wholesale or replacement value, if less than cost, even though the price which he could obtain for it on a retail sale would be above cost.

His Honour rejected their contention that because the Court had accepted the accountant’s rule of the lower of cost or market and that therefore ‘Its meaning must be determined by reference to the practice of accountants’¹⁰³ those views might well have had weight in determining what ‘cost’ means. However, the question of determining the meaning of the term ‘market value’ was quite a different matter. His Honour concluded:¹⁰⁴

... the words ‘market value’ prima facie connote the price which can be obtained for the article in question in the market which offers the best price.

Russell LJ in the Court of Appeal made the following comment with respect to the meaning of the word ‘market’ in the lower of cost or market rule:¹⁰⁵

I must say ... that I have always thought that in this context market value meant the price at which the stock could be expected in due course to be sold in the market in which the trade of selling by the taxpayer was conducted. And after extensive argument I am not persuaded that my original assumption was wrong.

For a retailer this value was the retail sales price expected to be realised in the due course of that business and ‘[t]he trader’s market is the retail market, and while that market exists for the goods I see no justification for turning to any other market’.¹⁰⁶

¹⁰⁰ Ibid 1192.

¹⁰¹ *Freeman, Hardy & Willis Ltd (now BSC Footwear Ltd) v Ridgway (H M Inspector of Taxes)* (1969) 1 WLR 1488; [1971] Ch 427 (CA) and [1971] 2 WLR. 1313 (HL); (1971) 47 TC 495.

¹⁰² Ibid [1969] 1495.

¹⁰³ Ibid 1196.

¹⁰⁴ Ibid.

¹⁰⁵ *BSC Footwear Ltd v Ridgway (Inspector of Taxes)* [1971] Ch 427, 434.

¹⁰⁶ Ibid.

Megaw LJ also agreed that it was the market in which the company would actually sell the shoes which was relevant in this case. The company was involved in the retail trade and as such 'the wholesale market is not relevant'.¹⁰⁷

In the House of Lords, Lord Pearson was of the opinion that where a company is a retailer his stock should normally be valued in the retail market, which is the one in which he expects to sell and the wholesale market in such a case will probably be irrelevant as:¹⁰⁸

He is not vitally concerned with the wholesale price at which he might buy more of the goods, because he does not need to buy more of them and probably does not wish to do so.

Lord Morris of Borth-y-Gest, concluded that the decision of Rowlatt J, in *Brigg Neumann*, merely indicated that:¹⁰⁹

there may be some cases in which the wholesale market value may be taken as the appropriate market value the case does not establish that a retailer who on a retail sale will sell at a price above what it cost him to buy may value his unsold stock-in-hand by reference to the wholesale or replacement value if that is less than what it cost him.

Lord Guest agreed it was the market in which the company actually sold its stock which was relevant under the lower of cost or market rule, and it was not permissible to use replacement cost.¹¹⁰

In *Hinchcliffe (HM Inspector of Taxes) v Crabtree*¹¹¹ the question arose whether the actual market price of quoted shares truly reflected their value. In this case confidential preliminary negotiations had commenced for the takeover of a company. However, a firm intention to enter into negotiations did not take place until some months after the relevant date. It was held unanimously by the Court of Appeal and the House of Lords that it was the quoted market price on the relevant date which was the value of the shares. No special circumstances existed which would permit a higher value under s 44 of *The Finance Act 1965* which would have increased the cost base of the shares for capital gains purposes. The same considerations would appear to apply with respect to the valuation of shares that are stock-in-trade.

¹⁰⁷ Ibid 440.

¹⁰⁸ *BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)* [1971] 2 WLR 1313, 1333.

¹⁰⁹ Ibid 1323.

¹¹⁰ Ibid 1325.

¹¹¹ *Hinchcliffe (HM Inspector of Taxes) v Crabtree* (1970) 47 TC 419.

Tables 3 and 4¹¹² are drawn from the accounting books, journal article and letters to the editor of *The Accountant*. Looking at Tables 3 and 4 it is clear that the majority of the accounting profession at the time of *Brigg Neumann* would have considered ‘market value’ to mean ‘replacement cost’ and not ‘realisable value’.

**TABLE 3 THE LOWER OF COST OR MARKET RULE:
THE MEANING OF ‘MARKET VALUE’
1921–25: NET OF MULTIPLE AUTHORS**

	Number	%
Realisable value	7	29.2
Net realisable value	0	0.0
Replacement cost or price	9	37.5
Market value or price	18	75.0
Lower of replacement price and realisable value	1	4.2
Lower of replacement price and net realisable value	1	4.2
Number of authors using the Lower of Cost and Market	24	

X REPLACEMENT COST

The case of *Brigg Neumann & Co. v Commissioners of Inland Revenue*¹¹³ also raises the question of the use of replacement cost to value stock-in-trade. As seen above, the company was a trader in textiles, purchasing woollen goods ‘in grey’ from weavers and sending them out to be dyed by dyers. It was admitted in the facts, and accepted by the Commissioners for Special Purposes, and Rowlatt J, that at the relevant time there was no selling price for the appellant’s stock-in-trade, as there was no spot market. The company, however, wished to value their stock at market price, as there had been a considerable fall in the prices in the market since they had purchased their stock and, therefore, actual ‘cost’ was not a measure of the value of the stock at the balance date.

Rowlatt J considered there were two possible surrogates for the market (selling) value, those being the actual cost of the stock and the notional cost for which the stock could have been bought, whichever of the two were lower. His Honour was forced to rule out actual cost as a surrogate because the facts clearly showed there had been a substantial drop in the value of the cloth since it was purchased.¹¹⁴

In the special circumstances of the case his Honour found the appropriate value to use as a surrogate was the notional cost of replacement. This cost was to be calculated by using the estimated contracted price for the goods which could have actually been delivered at the balance date, and not the cost of goods contracted to be bought on the

¹¹² Table 4 is in Appendix 1.

¹¹³ *Brigg Neumann and Co v Commissioners of Inland Revenue* (1928) 12 TC 1191.

¹¹⁴ *Ibid* 1203.

balance date as was the practice in the trade, where goods were to be delivered in three months time, as:¹¹⁵

When one is seeking to get what in building or engineering is called the constructional value ... based upon current prices three months ago of a building, it is the price that you have to pay which will give you the building here now, not the price that you have to pay now to give you a building at some future time.

It should be noted, however, that prima facie it is the actual cost which should be used under the 'lower of cost or market' rule. It is only in exceptional cases, such as the instant one, where replacement cost can be used as a surrogate for the market value of the stock under the lower of cost or market rule.

In *Watson Bros v Hornby (HM Inspector of Taxes)*,¹¹⁶ Macnaghten J found that 'market value' for a taxpayer who sold the same items in two markets, the relevant market was the market in which those goods, as a matter of course, would be sold.

In the case of *Craddock (HM Inspector of Taxes) v Zevo Finance Co Ltd*, Viscount Simon made the following comment in the House of Lords, where it was held that replacement cost could not be used as an alternative to actual cost at the time of acquisition:¹¹⁷

To put the matter in its simplest form, the profit or loss to a trader in dealing with his stock-in-trade is arrived at for Income Tax purposes by comparing what his stock in fact cost him with what he in fact realised on resale. It is unsound to substitute alleged market [purchasing] values for what it in fact cost him.

This extract and the discussion in the next section of this paper, reinforces the inappropriateness of using replacement prices for the valuation of stock-in-trade for income tax purposes despite the clear evidence shown in Tables 3 and 4 that the majority of accountants would have interpreted 'market value' as meaning replacement cost.

¹¹⁵ Ibid 1204.

¹¹⁶ *Watson Bros v Hornby (HM Inspector of Taxes)* (1942) 24 TC 506. The facts of this case are discussed further in this paper when considering the meaning of the word 'cost'.

¹¹⁷ *Craddock (HM Inspector of Taxes) v Zevo Finance Co Ltd* (1946) 27 TC 267, 287.

XI REPLACEMENT COST ESTIMATED BY THE 'RETAIL INVENTORY METHOD',¹¹⁸

The 'retail inventory method' is used to estimate the price at which the company would be willing to pay for stock, given the company's current selling price. This is achieved by taking stock at their selling price and reducing the selling price by the standard mark up used for the particular line of goods. This reduces the selling price to the amount which the item would have cost. This method is also referred to as the 'adjusted selling price' method. There are no decided cases on the use of this method, however a variant was discussed in the case of *Freeman, Hardy & Willis Ltd (now BSC Footwear Ltd) v Ridgway (HM Inspector of Taxes)*.¹¹⁹

This case dealt with the question of the acceptability of the use of what would appear to be the 'retail inventory method' of determining cost. However the method was not being used to calculate actual cost but, rather, the cost price at which the company would be willing to purchase such stock, given the current ticketed selling prices, where a substantial amount of the company's stock had been marked down. The case also considered, with respect to the stock on hand, the question of the use of a variant of the 'net realisable value' method for valuing stock-in-trade under the lower of cost or market rule, which was also argued as an alternative method of valuation. The case has usually been discussed in the context of the latter issue, although both issues were of equal importance.

The stock-in-trade in this case consisted of shoes, the selling price of which had been reduced at the end of the season in order to sell them off. The company's pricing policy was to fix the selling price of the shoes by the use of a standard mark up on the actual cost price of the shoes. To value the stock on hand a reverse calculation was used, that is, the standard mark up was deducted from the marked prices of the shoes, including those whose prices had been marked down. This amount represented the price at which the company's buyers would have been prepared to pay for the shoes, given the company's current selling price for them. The underlying reason for the company's use of this method was to enable it to show a normal mark up (that is, gross profit) on the shoes in the next year, or whenever they were sold.

The company had consistently adopted this method¹²⁰ for valuing its stock for many years, and had done so since at least 1940. The Inland Revenue had accepted their accounts drawn up on this basis until 1959. The company justified the use of this method, relying on the comments of Rowlatt J in *Brigg Neumann* whereby he suggested that in certain circumstances it was possible to use replacement cost as a surrogate for actual cost. That is, the company should be permitted to value its stock at

¹¹⁸ This method is also referred to as the 'adjusted selling price' method.

¹¹⁹ *Freeman, Hardy & Willis Ltd (now BSC Footwear Ltd) v Ridgway (HM Inspector of Taxes)* [1969] 1 WLR 1488; [1971] Ch 427 (CA) and [1971] 2 WLR 1313 (HL); (1971) 47 TC 495.

¹²⁰ Referred to in the judgment as 'replacement value'.

the wholesale market value (at which it would be willing to buy), which was less than actual cost, but higher than the retail market value of the stock.

Cross J, the judge at first instance, rejected such an interpretation, as follows:¹²¹

I cannot treat it as authority for the proposition for which the taxpayers are contending, namely that a retailer can value his unsold stock by reference to the wholesale or replacement value, if less than cost, even though the price which he could obtain for it on a retail sale would be above cost.

His Honour rejected their contention that as the Court had accepted the accountant's rule of the lower of cost or market therefore 'Its meaning must be determined by reference to the practice of accountants',¹²² and that, furthermore, those views might well have had weight in determining what 'cost' meant. However, the question of determining the meaning of the term 'market value' was quite a different matter. His Honour concluded:¹²³

the words 'market value' prima facie connote the price which can be obtained for the article in question in the market which offers the best price.

The case came before the Court of Appeal in the *BSC Footwear Case*,¹²⁴ which upheld the judgment of Cross J.

Russell LJ made the following comment with respect to the meaning of the word 'market' in the lower of cost or market rule:¹²⁵

I must say ... that I have always thought that in this context market value meant the price at which the stock could be expected in due course to be sold in the market in which the trade of selling by the taxpayer was conducted. And after extensive argument I am not persuaded that my original assumption was wrong.

For a retailer this value was the retail sales price expected to be realised in the due course of that business and '[t]he trader's market is the retail market, and while that market exists for the goods I see no justification for turning to any other market'.¹²⁶ This value, according to Russell LJ was the retail market 'price' for the shoes in question.

¹²¹ *Freeman, Hardy & Willis Ltd (now BSC Footwear Ltd) v Ridgway (HM Inspector of Taxes)* [1969] 1 WLR 1488 1495.

¹²² *Ibid* 1196.

¹²³ *Ibid*.

¹²⁴ Before Russell, Salmon and Megaw LJ *BSC Footwear Ltd v Ridgway (Inspector of Taxes)* [1971] Ch 427.

¹²⁵ *Ibid* 434.

¹²⁶ *Ibid*.

Salmon LJ was not at all impressed with the action of the Revenue in seeking to force a change of method from the one which the company had been allowed to use for such a long period of time. While feeling it might well be acceptable for accounting and commercial purposes, to use a method which over a period of years showed the real profit of a business, though with distortions in some individual years, the Court had to look to the requirements of the relevant legislation. Therefore the question was whether or not the taxpayer's system, taking the 1959 year alone, showed the actual profit for the particular year for income tax purposes.

Salmon LJ felt there were good reasons to change the method of accounting, which more than outweighed the problems of the transitional years:¹²⁷

because the method ... does not for the year ... accurately reproduce the profits or gains ... [It] must, for tax purposes, be not only consistent ... but must produce the full profits or gains for each year.

Secondly, for the purposes of the income tax legislation, was the method employed by the taxpayer which had the effect of pushing income (profit) from one year to later years, an acceptable method of accounting? Salmon LJ answered this question as follows:¹²⁸

It has never yet been held that the taxpayer may anticipate in year A a diminution of the profits which he may have hoped to make in year B on the closing stock for year A by writing down his closing stock for that year below its cost price ...

Later Salmon LJ makes the following observation about the company's argument that they should be permitted to value stock-in-trade in order to obtain a fixed margin of profit in following years on the stock-in-trade in question. He suggests that their¹²⁹

contention that they may ... enter their closing stock in their accounts below cost price at a market price which would show them a gross profit of 37.19 per cent is beset with difficulties ... there was certainly no market in which they could have acquired the goods at such a price.... [they] could not have been bought from manufacturers or wholesalers at such a price.

Similarly, neither the company, nor any other retail shoe seller, would have been prepared to sell their stock at such a price when they could sell it in their own shops at a higher price.

Megaw LJ also agreed that it was the market in which the company would actually sell the shoes which was relevant in this case. The company was involved in the retail trade

¹²⁷ Ibid 437.

¹²⁸ Ibid 438.

¹²⁹ Ibid 439.

and as such ‘the wholesale market is not relevant’.¹³⁰ They were trying to sell the shoes and were not interested in buying them.

The case was heard on appeal in the House of Lords by Viscount Dilhorne and Lords Morris of Borth-y-Gest, Reid, Guest, and Pearson.¹³¹ Lord Reid, though he would have allowed the appeal in the present case, mainly based on the acceptance of the Revenue of the company’s use of the method for such a long period, was of the opinion that the Revenue could prevent the adoption of this method by companies who had not been using it for a substantial number of years.¹³² His Lordship felt the method adopted by the company was ‘stretching unduly the concession to taxpayers involved in “cost or market value, whichever is the lower”’. However the crux of his Lordship’s decision was that the Revenue had only sought to change the values of stock-in-trade for the current year, and not earlier periods.¹³³

Lord Pearson felt, given the special facts of this case, that Revenue could only force the company to change its method of valuing stock-in-trade if the company’s method produced values which were ‘seriously and substantially incorrect’ leading to a distortion of the profits and gains of the company during the tax year.¹³⁴ In this context, his Lordship applied the taxpayer’s system to the profits and gains for the year in question, by the use of several examples. One of the examples will be more than sufficient to indicate the results that followed from the use of such a method:¹³⁵

The total of the original retail selling prices was £3,668,087. The total of cost ... was £2,303,925. The reduced total of expected retail selling prices was £3,246,272. Thus the valuation at cost was nearly £1 million below the total of expected retail selling prices. And yet according to the appellants’ system the valuation at cost was reduced to £2,038,843, being approximately £1.2 million below the total of expected retail selling prices. ...

[Even] when all due allowance is made for the expectations involved in “expected retail selling prices” being some times frustrated, these figures still demonstrate that the appellants’ system produces valuations of stock which are seriously and substantially incorrect.

¹³⁰ Ibid 440.

¹³¹ *BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)* [1972] AC 544.

¹³² *BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)* [1971] 2 WLR 1313, 1317.

¹³³ His Lordship was relying on *Bombay Commissioner of Income Tax v Ahmedabad New Cotton Mills Co Ltd* (1929) 46 TLR 68. Later cases have cast doubts over the scope and application of the case.

¹³⁴ *BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)* [1971] 2 WLR 1331, 1331.

¹³⁵ Ibid 1332.

His Lordship was of the opinion that where a company is a retailer his stock should normally be valued in the retail market, which is the one in which he expects to sell. The wholesale market in such a case will probably be irrelevant because:¹³⁶

He is not vitally concerned with the wholesale price at which he might buy more of the goods, because he does not need to buy more of them and probably does not wish to do so.

Lord Morris of Borth-y-Gest, being unable to find any authority which could throw weight behind the company's contention, concluded Cross J was correct in his evaluation of the decision of Rowlatt J in *Brigg Neumann* as merely indicating:¹³⁷

there may be some cases in which the wholesale market value may be taken as the appropriate market value the case does not establish that a retailer who on a retail sale will sell at a price above what it cost him to buy may value his unsold stock-in-hand by reference to the wholesale or replacement value if that is less than what it cost him.

Lord Guest, in a short judgment, felt the company's 'replacement value' was open to serious objection, as it did not 'claim to represent the price at which the appellants would replace the shoes' and it was totally artificial. The use of such a method 'would make it possible for a taxpayer to control his profits for tax purposes by a calculation at his own hand'.¹³⁸ His Lordship agreed it was the market in which the company actually sold its stock that was relevant under the lower of cost or market rule, and it was not permissible to use replacement cost.

After a brief discussion of the Court's recognition of the lower of cost or market rule Lord Guest concluded:¹³⁹

Market value in this context appears to me to signify real value, the value that the goods have on the accounting day.... Cross J said ... the words 'market value' prima facie connote the price which can be obtained in the market which offers the best price. That usually will be the price at which the goods are sold to the public, but surely it cannot be right to value goods in the possession of a manufacturer or wholesaler at a higher price than they can obtain in the course of their trade, to attribute to their stock the price it would fetch if sold in the best market, the retail market. ... I therefore think that in making the valuation some regard must be paid to the nature of the trade carried on.

With all respect Cross J made no general observation, he was at all times referring to a company carrying on a retail trade, which is what the taxpayer was doing in this case.

¹³⁶ Ibid 1333.

¹³⁷ Ibid 1323.

¹³⁸ Ibid 1325.

¹³⁹ Ibid 1328–329.

His Lordship's last comment is correct,¹⁴⁰ however the judgment is very confusing in all its aspects. His Lordship clearly rejected the use of replacement cost as a method of determining market value, and concluded that the term 'market value' denotes an exit value.

Reference should also be made in this context to the case of *Watson Bros v Hornby (HM Inspector of Taxes)*,¹⁴¹ where Macnaghten J found that where a taxpayer sold in two markets, the relevant market was the market in which those goods, as a matter of course, would be sold. However, in that case, his Honour was more interested in determining their cost for another business carried on by the taxpayer.

XII NET REALISABLE VALUE

Having established that it is the selling market in which the company actually sells its goods which is relevant under the lower of cost or market rule, the question arises whether it is possible to use the net realisable value method of valuing stock-in-trade. It was not until *BSC Footwear*,¹⁴² which first came before the courts in 1969, that it was suggested that anything approaching the use of net realisable value might be used by a trader to value his stock-in-trade. It is to be remembered that the taxpayer in that case had estimated the 'replacement cost' of its stock-in-trade by the use of the 'retail inventory' method. This method was rejected by the courts and as a consequence the courts were placed in the situation of having to accept the Revenue's method of valuing the stock-in-trade, which was to take the gross sales values expected (that is, the marked prices) less an allowance for the salesmen's commissions. This method was throughout referred to as the 'net realisable value' method of valuing the stock. The Revenue were not prepared to allow any other deductions to be made. As Viscount Dilhorne in the House of Lords pointed out:¹⁴³

I think that perhaps some of the difficulties in this case have arisen from the appellants labelling the figure arrived at after making the deduction of the mark-up as the replacement value when it might equally have been called the net realisable value.

The same comment, though in reverse, could be made with respect to the Revenue's use of the term 'net realisable value' in a non-conventional manner.

¹⁴⁰ See *Brigg Neumann & Co v Commissioners of Inland Revenue* (1928) 12 TC 1191.

¹⁴¹ *Watson Bros v Hornby (HM Inspector of Taxes)* (1942) 24 TC 506. The facts of this case are discussed in this paper when considering the meaning of the word 'cost'.

¹⁴² *BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)* [1969] 1 WLR 1488; [1971] Ch 427 (CA) and [1972] AC 544; (1971) 47 TC 495.

¹⁴³ *BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)* (1971) 2 WLR 1313, 1330.

Nowhere during the progression of the case was it argued why it was permissible to make any such deduction from the realisable value. Nor was it argued what, if any, other deductions might legitimately be made to ascertain the net realisable value of stock-in-trade. The reader should therefore take great care when reading the case, as the judges, when referring to this method, meant, unless the contrary intention is indicated, realisable value, with the only deduction being that of the salesman's commission. As such, this does not conform with any of the normal meanings associated with the words 'net realisable value' as used by accountants.

Cross J, the judge at first instance, having rejected the company's method had no option other than to accept the method suggested by the Revenue, and made this important comment upon which there had been no argument:¹⁴⁴

I am expressing no view on the question what, if any, anticipated expenses can be deducted from the anticipated retail selling price in arriving at market value.

In the Court of Appeal Russell LJ also rejected the company's method and thus had no alternative to accepting the Revenue's method, which included the deduction of a salesman's commission. This follows from the fact that there had been no argument as to whether or not it is permissible to make a deduction. His Lordship tries to justify this method using the following spurious analogy:¹⁴⁵

... it seems to me logical and reasonable to look for the money expected to reach the till as a result of sales: in effect the salesman's commission does not reach the till, though in practice he does not abstract it from money handed over the counter.

However his Lordship clearly indicates it is not possible, under the lower of cost or market rule, to use a method which deducts an amount sufficient to enable a normal profit to be made when the stock is actually sold. He states:¹⁴⁶

But if it is estimated that on sale it will not contribute to the gross profit of the second period ... the shortfall is to be regarded in the course of stock valuation as irrecoverable and may properly be treated as a loss incurred in the first period. This I believe to be the basis of the principle ... market value ... may be taken as the value of stock-in-hand. The principle relates to loss of all gross profit and more, and not to diminution.

Salmon LJ, as noted above, approached the question as follows, that it is permissible to enter stock-in-trade at less than cost price:¹⁴⁷

¹⁴⁴ *BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)* [1969] 2 WLR 1488, 1498.

¹⁴⁵ *BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)* [1971] Ch 427, 435.

¹⁴⁶ *Ibid* 435.

¹⁴⁷ *Ibid* 439.

... only if its net realisable resale price is less than its cost price. The question as to what items (if any) of indirect selling costs can properly be deducted ... to arrive at the net realisable resale price of the closing stock was not fully explored before the Commissioners, nor was it argued before the judge or in this court. Therefore, like the judge, I express no view upon this point ...

Later Salmon LJ makes the following observation on the company's argument that they should be permitted to value stock-in-trade in order to obtain a fixed margin of profit in following years on the stock-in-trade in question, suggesting that their:¹⁴⁸

contention that they may ... enter their closing stock in their accounts below cost price at a market price which would show them a gross profit of 37.19 per cent is beset with difficulties.... there was certainly no market in which they could have acquired the goods at such a price.... [they] could not have been bought from manufacturers or wholesalers at such a price.

It is to be noted once again that Salmon LJ merely accepts that it is permissible to deduct the salesman's commission, for the reasons outlined by the author above.

Megaw LJ was not impressed with the Revenue's method, though preferring it to the method suggested by the company, and made the following point with respect to this matter:¹⁴⁹

I do not see any really acceptable or logical basis for a differentiation being drawn between the salesman's commission and the other overhead expenses. The latter, I think, were rightly disregarded. But the Crown has made this concession.

It appears his Lordship, if given the opportunity to do so, would have concluded that no costs should be deducted from the amount actually realised.

In the House of Lords, Lord Reid, contrary to the evidence, felt that there was no market in the normal sense of the word for the goods, and therefore:¹⁵⁰

If there is not then we must look for the next best way of estimating their value. It is here that we should have regard to commercial accounting practice. The last word must always be with the court. ... If there is a uniform accounting practice it should not be rejected without good reason. If there is not the court must choose which version appears to give the fairest and most reasonable result in the particular case.

¹⁴⁸ Ibid 39.

¹⁴⁹ Ibid 442.

¹⁵⁰ *BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)* [1971] 2 WLR 1313, 1316.

For some reason Lord Reid thought the expert price setters employed by the company would not mark down the shoes to a price at which they would be sold, and therefore there would be expenses incurred in keeping large quantities of this marked down stock on hand. His Lordship seems to confuse shoes that are out of fashion or last year's fashions with shoes that are obsolete, or unsaleable.¹⁵¹ As a result, his Lordship felt some deduction must be made from the market selling price, by taking off a 'fair estimate' of the total cost involved in selling the shoes, in order to estimate their value. His Lordship felt the allowance made by the Revenue was unrealistic, but he could 'see objections to the appellants' method of taking what they call replacement value' and he thought their method was 'stretching unduly the concession to taxpayers involved in "cost or market value, whichever is the lower"'.¹⁵² The crux of the matter was that the Revenue had only sought to change the method for the year in question and not to adjust prior years.¹⁵³

Viscount Dilhorne's dissenting judgment is difficult to follow in many respects, however, he was also concerned about the lack of argument as to what, if anything, should be deducted from the amount expected to be realised on sale. He expressed his concern as follows:¹⁵⁴

Little argument was directed to the question whether ... it is right only to deduct expenses directly referable to the sale. ... I am unable to see any valid ground for deducting one kind of expense and not another from the retail price when one is endeavouring to ascertain the value of stock. ... To arrive at the net realisable value ... it appears to me that one should deduct not only the profit element, not only the salesmen's commission but also the other expenses referable to the sale from the retail price, in other words, the mark up. If this is done, the net realisable value and the appellants' replacement value are the same.

His Lordship's discussion was based on the assumption that the Revenue were proposing the use of the 'net realisable value' method as commonly used by accountants. This was not, however, what they were advocating, which was a 'net value after salesman's commission'. It does not necessarily follow that his Lordship would conclude the 'net realisable value' method was preferable to 'gross realisable values', particularly as these points were not argued at any stage of the proceedings.¹⁵⁵

¹⁵¹ Ibid 1316.

¹⁵² Ibid 1317.

¹⁵³ For a detailed discussion of this matter see above.

¹⁵⁴ *BSC Footwear Ltd (formerly Freeman, Hardy & Willis Ltd) v Ridgway (Inspector of Taxes)* (1971) 2 WLR 1313, 1327.

¹⁵⁵ Ibid 1330. His Lordship made this comment at 1330, which may help with understanding the reasoning applied: 'I must confess that I cannot bring myself to accept the proposition that where a trader has to reduce the price of goods in order to sell them, those goods are still worth what it cost to buy them when it was hoped to sell them at the price originally fixed and that they only become worth less than cost when the reduced selling price less the deduction of directly referable expenses is below cost.'

Lord Pearson rejected the use of 'net values' strongly, in the following terms:¹⁵⁶

the correct principle is that goods should not be written down below cost price unless there really is a loss actual or prospective. So long as the fall in prevailing prices is only such as to reduce the prospective profit the initial valuation at cost should be retained.

As Lord Morris of Borth-y-Gest points out 'our concern must be to consider whether the method required by the Crown is better'¹⁵⁷ than the taxpayer's method, as such, not necessarily the best of all methods. His Lordship also pointed out that the expert evidence presented in the case was completely contradictory, and later that:¹⁵⁸

the Crown accept ... the figure of expected retail selling price (if lower than cost) may be taken ... there may in certain cases be deducted the known or anticipated direct selling cost (salesman's commission) ...

Lord Guest in a short judgment evaluated the Revenue's method as follows:¹⁵⁹

The Revenue have [made this concession] ... I cannot think that it is necessary or appropriate to make a further deduction on a pro rata basis of overhead expense ... in another type of case some such deduction [may] have to be made. But the failure to make such an allowance does not, in my view, invalidate the basis of valuation suggested by the Crown.

His Lordship concluded that the Crown's method 'more fairly and reasonably' represented the profits of the company's business.¹⁶⁰

It is clear from the above discussion that this case cannot be used to support the use of the 'net realisable value' method for the valuation of stock-in-trade. The most that can be said is that the Revenue were content to concede the deduction of salesmen's commission for this particular taxpayer for the income tax years in question, without any argument on the acceptability of such a deduction. Thus, the judges had no option but to accept such a deduction.

XIII HOW IS COST TO BE CALCULATED?

There are two central issues in determining the cost of an item of stock-in-trade. The first is what costs are to be included. The second issue is to determine what stock remains on-hand and its cost.

¹⁵⁶ Ibid 1332.

¹⁵⁷ Ibid 1319.

¹⁵⁸ Ibid 1320.

¹⁵⁹ Ibid 1324-325.

¹⁶⁰ Ibid 1325.

A How Wide is the Word 'Cost'?

There are a number of court decisions which have specifically dealt with the question of what is to be included in the cost of the stock-in-trade and these will be considered in chronological order.

In *J and M Craig (Kilmarnock) Ltd v Cowperthwaite (Surveyor of Taxes)*¹⁶¹ the taxpayer company had taken over several of the businesses previously carried on by J and M Craig Ltd. The consideration for the purchase of the assets was at 'the reduced upset price of £25,000'.¹⁶² In addition to these assets the new company also took over some contingent liabilities.¹⁶³ No stocktake took place at the time of the sale nor immediately prior to the sale. The £25 000 was not apportioned at the time of sale. The initial entry in books of the taxpayer was as follows:¹⁶⁴

4 Hillhead Brickworks—Buildings A/c	£2,500	0	0	
8 Hillhead Colliery Buildings and Land A/c.	7,600	0	0	
12 Hillhead Brickworks—Plant A/c. ...	2,380	0	0	
16 Hillhead Colliery—Plant A/c. ...	1,750	0	0	
28 Hillhead Brickworks—Office Furniture A/c.	45	0	0	
40 Longpark Pottery—Buildings A/c....	2,700	0	0	
44 Longpark Pottery—Plant A/c. ...	2,390	0	0	
52 Longpark Pottery—Office Furniture A/c.	10	0	0	
				£19,375 0 0
20 Hillhead Brickworks—Stock A/c. ...	1,500	0	0	
24 Hillhead Colliery—Stock A/c. ...	180	0	0	
48 Longpark Pottery—Stock A/c. ...	3,464	0	8	
60 Edinburgh Branch Stock and Plant A/c. (value of <i>Plant</i> stated to be nominal)	480	19	4	
				5,625 0 0
Total Purchase Price				£25,000 0 0

¹⁶¹ *J and M Craig (Kilmarnock) Ltd v Cowperthwaite (Surveyor of Taxes)* (1913) 13 TC 627.

¹⁶² *Ibid* 628.

¹⁶³ *Ibid* 629.

¹⁶⁴ *Ibid* 629.

At the same time a valuation of stock-in-trade was made of £12 789 1s 4d. The difference between these two amounts was entered into a 'stock suspense account'. This amount in effect could be said to be an allowance for the value of the contingent liabilities taken over. The contemporary discussion of this case is quite misleading. The facts are not fully described, in particular no reference is made to the contingent liabilities.¹⁶⁵

In computing their income tax liability the latter amount was used for the value of opening stock, not the former amount. The Survey of Taxes assessed them on the basis that the opening stock was £5625 as per the original book entry. The Special Commissioners also rejected taxpayer's argument. On appeal by the taxpayer The Lord President (Strathclyde) noted that:¹⁶⁶

Of all the assets purchased by the Company from the liquidator the market value of one alone was susceptible of definite ascertainment. It is agreed that for the stock-in-trade there was always a considerable demand and that its true market value at any given time was susceptible of ascertainment. The Appellants straightway proceeded to ascertain the value of their stock-in-trade and valuing it *on the basis of ordinary stock-taking* the figure of £12,798.

And furthermore that:¹⁶⁷

Now, it is apparent that the £5,625 thus reached [after valuing all items except stock-in-trade and the contingent liabilities] does not represent the true value of the stock-in-trade, nor indeed does it represent the price which they paid for the stock-in-trade to the selling Company. If this be so, then plainly the trading period to which I have referred cannot commence with a stock-in-trade of £5,625, and, if not, there is one and one only alternative offered – £12,798. If we take the £12,798, therefore, as the appropriate value of the stock-in-trade at the commencement of the trading period, *ascertained as I have described on an ordinary stock-taking basis*, it follows inevitably that the profits of the Appellants for that period were £2,911.

Lord Johnston noted that assets taken over were at a 'price very much below their book value',¹⁶⁸ and that:¹⁶⁹

¹⁶⁵ The case of *Craig (Kilmarnock) Ltd v Cowperthwaite* (1914) 13 TC 627 was discussed in 'Income Tax' (21 February 1914) *The Accountant* 248; and a similar situation discussed in 'Value of Stock' (29 May 1915) *The Accountant* 715–16, 716.

¹⁶⁶ *J and M Craig (Kilmarnock) Ltd v Cowperthwaite (Surveyor of Taxes)* (1913) 13 TC 627, TC665. The emphasis is added.

¹⁶⁷ *Ibid* 666. The emphasis is added.

¹⁶⁸ *Ibid* 668.

¹⁶⁹ *Ibid* 669.

The Inland Revenue are not entitled as matter of course to hold the Company to entries made in their books for purely book-keeping purposes, and these entries may in many cases be wholly disregarded, and that for two reasons: the first, a general reason, viz., that the Revenue cannot have it both ways; they cannot accept entries in a company's books when they find them to be to the advantage of the fisc and discard them when they are to its disadvantage. They invariably set aside, and rightly so, entries which would favour a company, but which do not give the real results of their business. And I do not think that they can be allowed to hold a company to entries which favour the Revenue but equally do not show the real results of their business. The second, a special reason, that the Revenue authorities cannot be allowed to pick and choose their figures, taking those that suit them and rejecting others.

And later that:¹⁷⁰

If the Appellant Company were not to show fictitious results and delude their shareholders, it was necessary that they should begin their business operations on a true and not a fictitious valuation of these assets. They could never reach correct figures for these assets if they simply took, as the Inland Revenue maintain that they did take, and irrevocably take, the gross price paid, and, having attributed empirical values to the fixed or capital assets, simply attributed the balance whatever it might be, less or more, to the working stock in their trading and profit and loss accounts. *I think that the Appellants took the proper course and revalued the working stock on a basis of stock-taking, with the result that whereas on the empirical division of the £25,000, the sum left for the working stock was £5,625, the revaluation made on stocktaking basis was £12,798.* And with this latter sum distributed over its different departments the Company commenced its trading accounts.

Lord Salvesen agreed that the only proper course was to make an allowance for the contingent liabilities taken over¹⁷¹ and noted that:¹⁷²

After their acquisition of these assets the Appellants allocated the price for bookkeeping purposes. They apportioned £19,375 to all the assets other than the stock-in-trade, leaving £5,625 as the assumed value of the latter. At the same time they had the stock-in-trade separately valued *on the basis of ordinary stock-taking* and this valuation brought out a sum of £12,798 1s. 4d.

And later that:¹⁷³

¹⁷⁰ Ibid 670. The emphasis is added.

¹⁷¹ Ibid 673.

¹⁷² Ibid 672. The emphasis is added.

¹⁷³ Ibid 673.

The mere fact that the Appellants had estimated the total value of the assets which they acquired at a higher figure than the cash purchase price would have been no ground for treating the difference as part of the profits earned; and that even if the appreciation had not merely been assumed, but was capable of accurate ascertainment by the end of the year and there had been no indefinite liabilities to set against it. An appreciation of capital value is not the subject of taxation under the Income Tax Acts; although if it is actual it may be reflected in the profits of succeeding years.

The other judges were of the same opinion.¹⁷⁴ From this case it is clear that it is not only the cash consideration that is taken into account in determining the cost of stock-in-trade, it is all the consideration expended and that consideration includes taking over liabilities even if they are contingent. The contemporary accounting literature and later published works rarely refer to the taking over of the contingent liabilities and thus misrepresent the facts underlying the decision.¹⁷⁵

In *John Smith & Son v Moore (HM Inspector of Taxes)*,¹⁷⁶ which was heard in Second Division Court of Session by the Lord Justice Clerk (Scott Dickson), Lords Dundas, Salvesen, and Guthrie, Lord Salvesen made some interesting comments with respect to the sum of £30 000 paid to the executors of the estate of the deceased, for the assignment of contracts for the delivery of coal upon very favourable terms.¹⁷⁷ His Lordship could not see why the firm should have to pay tax on this £30 000, which would be the effect of the exclusion of this amount from the cost of the coal delivered to them under the contracts. His Lordship summed up his finding as follows:¹⁷⁸

In my opinion the case would be exactly the same if the coals had all been delivered and lay in the vendor's yard but he had refused to sell them unless he got £30,000 more than he had himself paid for the coals.

The majority, the Lord Justice Clerk (Scott Dickson), and Lords Dundas and Guthrie, however, were of the opinion that the £30 000 was outlaid for the purchase which was of a capital nature, made at the commencement of business by the firm, and it was not

¹⁷⁴ Lord Dundas, *J and M Craig (Kilmarnock) Ltd v Cowperthwaite (Surveyor of Taxes)* (1913) 13 TC 627, at 667; Lord Mackenzie at 674; Lord Guthrie at 674; and Lord Skerrington at 675.

¹⁷⁵ Above n 169, 'Income Tax' and 'Value of Stock'. See also J H Burton, *Costing for Control* (1948) 98, where he contrasts the decision to that in *Commissioners of Inland Revenue v Huntly & Palmers Ltd* (1928) 12 TC 1209. The latter case is also discussed in this paper.

See the discussion in *The Accountant, Income Tax*, 21st February 1914, page 248 and the similar situation discussed in *Value of Stock, The Accountant*, 29th May 1915, pages 715-716, at page 716. J H. Burton, *Gee and Company (Publishers) Limited*, 1948, at page 98, where he contrasts the decision to that in *Commissioners of Inland Revenue v Huntly & Palmers Ltd*, (1928) 12 TC 1209.

¹⁷⁶ *John Smith & Son v Moore (HM Inspector of Taxes)* (1921) 12 TC 266.

¹⁷⁷ *Ibid* 278.

¹⁷⁸ *Ibid*.

made in respect of the purchase of their stock-in-trade. Rather, it was paid in order to secure future supplies of coal at a favourable price, and not for the coal itself.

The firm appealed from this decision to the House of Lords.¹⁷⁹ Viscount Haldane was of the opinion that though the contracts were of a short duration 'they were none the less part of his fixed capital'.¹⁸⁰ It was irrelevant that the £30 000 had been paid for the contracts.

Viscount Cave considered the problem as follows:¹⁸¹

those contracts belonged to the firm from the time when they were entered into. The £30,000 was not paid by the firm for coal, nor was it paid by the trading firm as such for coal contracts; it was paid by John Rose Smith out of his private pocket as part of an overhead transaction under which the business with its assets and future profits passed into his hands, and it left the trading profits of the firm unaltered.

This is a line of argument that the present author finds tenuous to say the least. Lord Sumner justified his decision as follows. The firm, being merely middlemen, never actually saw the coal, it was delivered directly from the mine to the final purchaser and the firm 'need never have any stock-in-trade'.¹⁸² The firm bought no coal from the estate, it had none to sell and, furthermore:¹⁸³

He did not pay this sum as the consideration for an assignment of the benefit of these contracts to himself; he took no assignment. The contracts were presumably in the firm's name and were part of its assets. ... £30,000 was the value of an important part of the subject matter of the business, to use a neutral term. It is an accident that the last of the contracts expired during the accounting period.

Viscount Finlay in his dissenting judgment felt a deduction had to be made from the gross profit of all the expenses incurred by the 'owner for the time being' for the purposes of earning the profits as:¹⁸⁴

The profits are not fruits yielded by a tree spontaneously. They are the result of operations carried on by the owner of the business for the time being and of the ability which he brings to bear upon it.

¹⁷⁹ Ibid, before Lord Sumner, Viscounts Haldane, Finlay and Cave, 280.

¹⁸⁰ Ibid 293.

¹⁸¹ Ibid 293–94.

¹⁸² Ibid 295.

¹⁸³ Ibid 295–96.

¹⁸⁴ Ibid 286.

The change in ownership had altered the situation. The appellant was bound by the settlement made by his father which required him to pay the values shown in the balance sheet for these contracts, that is £30 000. It was the only way in which the benefit of the contracts, for the supply of the coal in question, could be transferred to the taxpayer's business. It was with this coal that the appellants carried on their business.¹⁸⁵

The profits must be computed in the usual way by comparing the amount got by the sale of the coal with the amount which it cost the owner for the time being to acquire it. Lord Salvesen ... points out with great force to what absurdities the argument for the Crown would lead.

This statement was made by his Lordship at the conclusion of his judgment. His Lordship reinforced the point that all the contracts had expired during the period and covered only stock acquired by the taxpayer for the year in question. His Lordship continued:¹⁸⁶

If the amount of coal which they [the contracts] represented had been in stock in yards belonging to the coal dealer it could not have been disputed that the price paid for it would have been a proper deduction as against the price realised by the re-sale. It can make no difference for this purpose that the coal dealer followed the more convenient practice of having contracts with the collieries and despatching it from the pit's mouth straight to his customers. ... [T]he distinction between 'goods' and 'choses in action', such as contracts for coal ... seems ... untenable.

The contracts had given the taxpayer the means of obtaining the coal in question at an advantageous price, and logically there can be no difference between 'having coal stored in your yard and having a contract which enables you to get'¹⁸⁷ the coal as and when it is required. His Lordship pointed out that this had been conceded by the Lord Advocate when Lord Haldane had specifically asked him the question. His Lordship concluded:¹⁸⁸

If the Crown is entitled to disallow what the appellant had to pay for these contracts, it would be equally entitled to disallow as a deduction the price paid for coal actually in stock.

The author finds his Lordship's argument a strong one indeed when, even though not a direct cost of stock-in-trade, it was made in relation to the purchase of the stock-in-trade of the taxpayer, and was not of a capital nature. Thus, the majority were of the

¹⁸⁵ Ibid 297.

¹⁸⁶ Ibid 288–89.

¹⁸⁷ Ibid 289.

¹⁸⁸ Ibid.

opinion that the expenditure of the £30 000 was not deductible as it was of a capital nature.

There are many other cases which consider the issue of whether payment for the right to gain stock-in-trade should be included as part of their cost by the courts. In nearly all these cases the amount has been found to be capital in nature (as in the *John Smith case*), usually because they were for the acquisition of a *profit à prendre*, that is, the right to take or mine something from another's land.¹⁸⁹

The facts surrounding the case of *Commissioners of Inland Revenue v Huntly & Palmers Ltd*, are quite unusual.¹⁹⁰ The company was a biscuit manufacturer who purchased their supplies of tin boxes in which they packaged their biscuits from an associated company, Huntly, Borne & Stevens Ltd, which had been a wholly owned subsidiary since 1918. This associated company was in financial difficulties and in order to 'save' it from liquidation, and thereby ensure the supply of tins essential to their business, the company 'bought' from Huntly, Borne & Stevens Ltd all the stock which they held of the tins used by the company at twice their market value,¹⁹¹ as well as the stock of partially completed tins and (printed) tin plate.

It is important to note that Huntly, Borne & Stevens Ltd had made similar agreements with its other customers, and as such this was not an isolated transaction. However, this extraordinary fact was ignored in the judgments.¹⁹²

The questions to be settled in this case were: for what reason had the expenditure been incurred, and consequent upon that, what was the nature of the expenditure? The Commissioners for the General Purposes of Income Tax were of the opinion that the amounts paid were not expended in respect to the acquisition of stock-in-trade, but rather:¹⁹³

¹⁸⁹ These cases include: *Old Silkstone Collieries v Marsh (HM Inspector of Taxes)* (1941) 24 TC 25, at 34; *Golden Horse Shoe (New) Ltd v Thurgood (HM Inspector of Taxes)* (1934) 18 TC 280; *Stow Bardolph Gravel Co, Ltd v Poole (HM Inspector of Taxes)* (1954) 35 TC 459; *The Commissioners of Inland Revenue v Broomhouse Brick Company, Ltd* (1952) 34 TC 1; *Stratford (HM Inspector of Taxes) v Mole & Lea* (1941) 24 TC 25, 10–25, 31–33; *Kauri Timber Co Ltd v Commissioner of Taxes* [1913] AC 771 (a decision of the Privy Council on appeal from the New Zealand Court of Appeal); *Hood Barrs v The Commissioners of Inland Revenue (No 2)* (1954–57) 37 TC 188; *Coates v Holker Estates* (1961) 40 TC 75; *Mohania Hargovind of Jubbuipore v Commissioner of Income Tax, Central Provinces and Berar, Nagpur*, (Privy Council) [1949] AC 521, [1949] 2 All ER 652; *H J Rorke Ltd v Inland Revenue Commissioners* (1960) 39 TC 194, [1960] 3 All ER 359; *Hopwood (HM Inspectors of Taxes) v C N Spence Ltd* (1964) 42 TC 169; *Murray v Commissioners of Inland Revenue* (1951) 32 TC 238; *Craigenlow Quarries v Commissioners of Inland Revenue* (1951) 32 TC 326; *Hughes (HM Inspectors of Taxes) v The British Burmah Petroleum Co Ltd* (1932) 17 TC 288. Many of these cases relied on, or considered, the criminal trespass case of *Marshall v Green* (1875) 1 CPD 35. The discussion of these cases has been removed from this version of the paper for the sake of brevity.

¹⁹⁰ *Commissioners of Inland Revenue v Huntly & Palmers Ltd* (1928) 12 TC 1209.

¹⁹¹ They were invoiced to the taxpayer at their cost to Huntly, Borne & Stevens Ltd plus 10 per cent.

¹⁹² *Commissioners of Inland Revenue v Huntly & Palmers Ltd* (1928) 12 TC 1209, TC1213.

¹⁹³ *Ibid* 1219.

to ensure the supply of tins essential to their trade, and we upheld the inclusion of the whole of the claim as a necessary expense of their business ...

From this comment it is certainly clear that the Commissioners for the General Purposes of Income Tax thought the expenditure was of a revenue nature, but there is nothing in their discussion of the case or in their findings to indicate why they considered the expenditure to have been incurred for the acquisition of stock-in-trade.

Rowlatt J agreed with the Special Commissioners' conclusions with respect to the purpose of these inflated payments 'which was to 'make good' the deficiency which was arising in Huntly, Borne & Stevens Ltd and thus 'get them out of their difficulties'. On this basis:¹⁹⁴

for one company to make a purchase of goods from another at double the value in order that that the other company may not come to grief, so stated that does not describe an item which may be brought in to diminish the profits. ... this is money put into another business or thrown into another business without any security, or with some possible security by way of goods, or something of that sort, but it is thrown into another business in order to keep that business alive, and that is a capital risk ...

Thus, the expenditure being of a capital nature it was not deductible, even if it were made in relation to the acquisition of the stock-in-trade. It is clear, therefore, that at common law the courts will look to the real purpose of the payments being made, and the consequent nature of the expenditure, that is, whether it is of a capital or revenue nature.

Another unusual case dealt with the ascertainment of the cost of a particular piece of land which had been purchased for the purpose of re-sale at a profit. The land in question was acquired by a partnership from the father of one of the partners, with the purchase price being stated to be £15 000. At the time of signing the contract for the purchase of the land, the partners, other than the son, agreed in writing to pay a further amount of £25 000 'as and when they resold the property' to the son, Mr Worskett (Jnr).

The question which arose was at what opening figure the land should be shown: the £15 000 specified in the contract for the sale of the land, or the total consideration of £40 000 agreed upon by the parties in the two agreements? The question was resolved by Lawrence J in *Bennett, Oswald & Worskett v Bennet (HM Inspector of Taxes)*,¹⁹⁵ where his Honour concluded that while the matter was one involving some difficulty the £15 000 was not 'the true cost of the property' as the arrangement had to be looked at as a whole and the arrangement included.¹⁹⁶

¹⁹⁴ Ibid 1221–222.

¹⁹⁵ *Bennett, Oswald & Worskett v Bennet (HM Inspector of Taxes)* (1937) 21 TC 209.

¹⁹⁶ Ibid 219.

an obligation which was owed by Mr Bennett and Mr Oswald to Mr Worskett, Senior, that they should undertake to pay to Mr Worskett, Junior, a minimum price of £25,000 when they re-sold the property. That obligation was a valuable obligation, and constituted ... a part of the cost of the property. They did not get the property for £15,000, but ... for £15,000 plus that obligation. I think, therefore, that that figure being a minimum figure, it ought to be taken at its face value as a part of the cost price of this property, and that the true figure ... ought to be £40,000.

Thus Lawrence J found one must look to the entire arrangement to determine what consideration was agreed upon to be paid for the stock-in-trade and of what it consisted.

In *Steel Barrel Co Ltd v Osborne (HM Inspector of Taxes)*¹⁹⁷ one Mr Hood Barrs had entered into a contract to purchase a business being carried on by an insolvent company, for £10 500. Having done so Mr Hood Barrs incorporated a new company, The Steel Barrel Co (of Uxbridge) Ltd.¹⁹⁸ This newly incorporated company in turn purchased the business from Mr Hood Barrs for a consideration, which consisted of the £10 500 he had outlaid to buy the business along with an additional consideration of 29 997 fully paid shares of £1 each in the company. Various evidence was given as to the value of the stock-in-trade at the time of the transfer; for example, independent valuation and the stamp duty paid on the transfer. The question to be determined was, what was the appropriate cost of the stock-in-trade acquired by the company?

Macnaghten J, who heard the case at first instance, concluded that the issue of the shares had cost the company nothing and as such could not form part of the price of the stock-in-trade. The judgment upon the company's appeal was delivered by Lord Greene MR (with him du Parcq LJ and Singleton J) which reversed this strange finding by Macnaghten J.

There were two questions to be answered by the court: first, did the issue of the shares by the company form part of the consideration for the purchase of the business; and consequent upon that, what was the value attributable to the purchase of the stock-in-trade. His Lordship was of the opinion that when shares are 'properly issued' for consideration consisting of other than cash, such consideration must be 'at least equal in value to the par value of the shares' and be based upon an 'honest estimate' made by the company's directors of the value of the assets acquired. He continued by saying the description 'nominal value of shares issued' was a 'slovenly and inaccurate expression' used to describe the value of the assets acquired by the company in return for the issue of the shares. A more accurate description was the 'value of [the] rights acquired by the company under the contract'.¹⁹⁹

¹⁹⁷ *Steel Barrel Co Ltd v Osborne (HM Inspector of Taxes)* (1941–42) 24 TC 293.

¹⁹⁸ It would appear that the company had at some time prior to the commencement of the action changed its name to its present title.

¹⁹⁹ *Steel Barrel Co Ltd v Osborne (HM Inspector of Taxes)* (1941–42) 24 TC 293, 307.

It was not to the point that the company later wrote down these assets on re-evaluation, as they were perfectly entitled to do, and such an action had no effect on the value arrived at the time of acquisition; that is the £29 997 for shares issued to Mr Hood Barrs plus the £10 500 in cash.²⁰⁰

Lord Greene MR summed up the Court's findings as follows:²⁰¹

it cannot, we think, be open to doubt that as a general rule stock acquired by a trader must be brought in at the price which he paid for it in order to calculate the profit which he makes by its sale. ... In our opinion, what had to be found in the present case was the price paid for the stock. Now as this price was cash plus shares, it is necessary in the first instance to ascertain what payment in cash was represented by the issue of the fully paid shares. In our opinion, on the facts of the present case it must be taken as a sum of cash equal to the par value of the shares.

Thus, it is all the consideration given by the company, as in *Craig's Case* (above),²⁰² which must be taken into account in determining the cost of stock acquired by a company. Thus, where part of the consideration is shares in the company itself, the par value of the shares is to be included in the total acquisition cost. Clearly, if the shares were issued at a premium, the amount of the premium would also form part of the consideration.

In *Watson Bros v Hornby (HM Inspector of Taxes)*²⁰³ the taxpayers carried on the business of poultry dealers and breeders. This involved them in carrying on both the production of eggs and the operation of a hatchery, which produced chickens primarily for sale as 'day-old chicks'. The two businesses carried on by Watson Bros were liable for tax under different Schedules of the income tax legislation. As a result the question arose, at what value should the chicks be transferred from the hatchery to the farm. Was it the cost of production of 7d, or the price at which the chicks could have been bought or sold, on the open market, which was 4d? The answer to this question would have a significant affect on the value of the taxpayer's stock-in-trade.

The taxpayer sold its chicks to the public at their catalogue prices, and those which could not be sold at the catalogue price to the public were either auctioned off or transferred to the –'brooder house'. The average price the taxpayer received at auction was 4d each and this is the figure at which they wished to transfer the 'chicks' to the 'brooding house'. The Revenue contended, however, they should use the actual cost of production which was 7d each. The Commissioners for the General Purposes of Income Tax had decided the cost of production should be taken as the value of the chicks.

²⁰⁰ Ibid.

²⁰¹ Ibid.

²⁰² *J and M Craig (Kilmarnock) Ltd v Cowperthwaite (Surveyor of Taxes)* (1913) 13 TC 627. Discussed above.

²⁰³ *Watson Bros v Hornby (HM Inspector of Taxes)* (1942) 24 TC 505.

The case came before Macnaghten J in the Kings Bench Division, and his Honour came to his decision as follows:²⁰⁴

I have no doubt that in this notional sale between the hatchery and the farm the rule laid down in s 8 of the *Sale of Goods Act 1893*, ought to be followed and that the Commissioners ought to have ascertained what was a reasonable price for the day old chicks in view of the circumstances of the case ... But it appears that the Commissioners never considered what, in view of the circumstances, was a reasonable price. ... that is, reasonable as between the hatchery on the one hand and the farm on the other ...

His Honour therefore concluded the decision of the Commissioners was 'erroneous in law' and that:²⁰⁵

The cost of the production of an article ... might no doubt happen to be its reasonable price, but there is no ground for saying that in the absence of any agreement it should be taken as the reasonable price. On the contrary, the market price would as a general rule be the reasonable price.

Thus, the cost price to the 'brooder house' was the price which they could reasonably expect to pay for the chicks, and the relevant price was to be determined by the ruling market price in the market in which they would have been bought, that is, the spot auction market. Consequently, the appropriate cost was 4d for each chick. Presumably, this would also be the value of any stock on hand, at the balance date of the hatchery. In the instant case, however, there were no chicks in the hatchery at the balance date.

In the unusual case of *Julius Bendit Ltd v Commissioners of Inland Revenue*,²⁰⁶ the company was incorporated in England in 1936 by a German Jew, who was carrying on the business of a textile exporter in Germany where he lived. He owned all the shares in the company. To move his wealth from Germany to England he entered into contracts with the company to sell textiles at substantially less than normal market prices. The company contended that the figure which should be transferred to the profit and loss account was not the actual purchase price (that is, their actual cost) but rather the market value of the textiles at the time of the transactions. This would have had the effect of reducing the profits of the company significantly.

The Commissioners for the General Purposes of Income Tax concluded the 'real bargain' between the company and Mr Bendit was, as follows. He would sell the textiles at the price stated on the invoices 'which were deliberately fixed at less than the market value' and which would have the effect of enabling the company to realise a larger profit than would normally be the case. This bargain was in fact carried out by

²⁰⁴ Ibid 509–10.

²⁰⁵ Ibid 510.

²⁰⁶ *Julius Bendit Ltd v Commissioners of Inland Revenue* (1945) 27 TC 44.

the parties and therefore ‘these prices represented the true cost to the Company’ of the textiles.²⁰⁷

The company appealed against this decision of the Commissioners for the General Purposes of Income Tax, and the case was heard by Macnaghten J, who dismissed the appeal as follows:²⁰⁸

I have listened with interest and pleasure to Mr King grappling with the difficulties of [the company’s] ... contention, but it seems to me that not only was there ample evidence on which the Commissioners could find the facts as they have found them. ... The result, therefore, is that the appeal must be dismissed ...

As a result of this case, it is clear one must look to the actual bargain made, and not what the instigators of the bargain seek to achieve, if the two do not coincide, and this is the vital difference between this case and the *Huntly & Palmers Case*.²⁰⁹ It should be noted that there was no substantive argument put forward by the company as to why the market value at the time of purchase should be substituted for the actual cost of the textiles, other than the possibility of considering the whole arrangement as a sham, entered into to achieve the transfer of Mr Bendit’s wealth from Germany to England.

A case with similar issue to that considered in the *Osborne Case*²¹⁰ came before the court in *Craddock (HM Inspector of Taxes) v Zevo Finance Co Ltd*.²¹¹ In this case the company had been formed from the reorganisation of an existing company. Under this reorganisation the company ‘acquired’ all the speculative investments of the original company at their book value. The shares in question were valued in the books of Zevo Syndicate Ltd at their original acquisition cost, however, since the time of their purchase there had been a significant drop in their market value. The consideration which the company gave for these shares to Zevo Syndicate Ltd consisted of the issue of fully paid shares in the company, and in addition to these shares Zevo Finance Co Ltd assumed the responsibility for debenture liabilities of Zevo Syndicate Ltd.

The Revenue contended that in such a case the correct method for calculating the cost of the company’s stock-in-trade (that is, the shares), was to treat the shares issued by the company to Zevo Syndicate Ltd as not having been fully paid shares, but instead they should be treated as being issued at an amount equal to the market price (value) of the shares at the time of the transfer. These shares had been issued fully paid. The

²⁰⁷ Ibid 49.

²⁰⁸ Ibid 51.

²⁰⁹ *Commissioners of Inland Revenue v Huntly & Palmers Ltd* (1928) 12 TC 1209. See above.

²¹⁰ *Steel Barrel Co Ltd v Osborne (HM Inspector of Taxes)* (1941–42) 24 TC 293, 307. See above.

²¹¹ *Craddock (HM Inspector of Taxes) v Zevo Finance Co Ltd* (1946) 27 TC 267.

Commissioners for the General Purposes of Income Tax found that the cost included the full value of the shares issued to acquire the stock-in-trade.²¹²

Macnaghten J, the judge at first instance, countered the Revenue's argument as follows:²¹³

the contention of the Crown amounts to an allegation that the Respondent issued shares at a discount and I do not see how, in the absence of fraud, such an allegation could be sustained in a case where a company took over property at the value which was properly placed upon it by the vendor.

Macnaghten J misses the point that in this case the companies were not acting at arm's length in relation to the transaction in question.

In the Court of Appeal, Lord Greene MR said that prima facie where a company makes an issue of fully paid shares in return for property acquired, the value of the property is the nominal value of those shares. The onus was in this case on the Revenue to displace this presumption, which they had failed to do.

MacKinnon LJ agreed with the judgment of the Master of the Rolls, while Luxmoore LJ dissented on the basis that there was no 'sale', there being merely a transfer of ownership on the reconstruction of the former company, and thus, the value of the shares at the time of the transaction should be used as the cost of the shares.

The Revenue, being dissatisfied, appealed to the House of Lords.²¹⁴ Viscount Simon agreed with the reasons given by Lord Greene MR in the Court of Appeal and summarised the situation as follows:²¹⁵

To put the matter in its simplest form, the profit or loss to a trader in dealing with his stock-in-trade is arrived at for income tax purposes by comparing what his stock in fact cost him with what he in fact realised on resale. It is unsound to substitute alleged market [purchasing] values for what it in fact cost him.

Lord Thankerton found that the arguments of the appellant had been fully addressed by Lord Greene MR and therefore dismissed the appeal. Lord Wright pointed out that the matter was beyond doubt in this case. The construction of the contract was unambiguous and entered into in the 'ordinary course of a reconstruction' of the original company, the consideration for the assets acquired being clearly specified. This agreement was 'unimpeachable', and that:²¹⁶

²¹² Ibid 272.

²¹³ Ibid 274.

²¹⁴ Ibid 284. Before Viscount Simon, Lords Thankerton, Wright, Parker and Simonds.

²¹⁵ Ibid 287.

²¹⁶ Ibid 289.

It is well established that the issue of shares at a discount is illegal. It has also been held that, if the consideration for the issue of shares is a sum of money which is less than the nominal value of the shares, the shares will be treated as issued at a discount. If, on the other hand, the shares are issued for something other than a money consideration, the position is different because the Court does not enquire into the adequacy of the consideration so long as the transaction is a genuine and honest agreement deliberately entered into between ... [the parties]. These rules are clearly established by many cases ... [the Revenue] seem to disregard the obligation which was assumed by the Respondent to discharge the debentures and interest, and simply compare £620,030 with £360,000. The bargain, however, in any case, would have to be looked at as a whole.

His Lordship fully approved the judgment of Lord Greene MR in the Court of Appeal.²¹⁷

Lord Porter dismissed the appeal as the Revenue had not proved the contracts to be 'colourable'.²¹⁸ Lord Simonds also agreed with the reasoning of Lord Greene MR and dismissed the appeal as the transaction had not been impeached. There were no grounds to find the shares had been issued at a discount and he concluded:²¹⁹

I cannot distinguish between consideration and purchase price, and (using again the language of the Master of the Rolls) I find that, acquiring the investments "under a bona fide and unchangeable contract", they paid the price which that contract required, a price which, whether too high or low according to the views of third parties, was the price upon which these parties agreed.

As in *Osborne*,²²⁰ the Court took the view that the cost of the stock-in-trade included the cost of the shares issued to acquire it, as the revenue had failed to impeach the 'purchase agreement'.

In *Ryan (HM Inspector of Taxes) v Asia Mills Ltd*,²²¹ the courts were once again faced with the question of what should be included in the cost of the company's stock-in-trade. The company were cotton spinners, and the question at issue was how the sum of £55 087, paid by the company to the Cotton Controller in respect of its stock of cotton, should be treated for taxation purposes. This represented the amount they were required to pay to the Cotton Controller to reflect the upward movement in the price for cotton which they held and which was in excess of their contracted needs. Should the £55 087 be included in the current year's profit and loss account as a period cost or should it be included as part of the cost of the cotton purchased by the company?

²¹⁷ Ibid 290.

²¹⁸ Ibid 293.

²¹⁹ Ibid 294–95, and 295.

²²⁰ *Steel Barrel Co Ltd v Osborne (HM Inspector of Taxes)* (1941–42) 24 TC 29. Discussed above.

²²¹ *Ryan (HM Inspector of Taxes) v Asia Mills Ltd* (1951) 32 TC 275.

The cotton in question had been purchased by the company under fixed price contracts. The Commissioners for the General Purposes of Income Tax in their decision agreed with the taxpayer, finding that the cost of the cotton was the invoice price for the cotton purchased under those fixed price contracts and the £55 087 was not part of the cost of the cotton. Consequently the payments made to the Cotton Controller had been properly treated by the company as period costs.²²²

Croom-Johnson J, the judge at first instance, and the members of the Court of Appeal (Tucker, Singleton and Jenkins LJ) decided the £55 087 formed part of the cost of the taxpayer's stock-in-trade. The following extracts, from the judgment of Jenkins J in the Court, of Appeal is indicative of the reasoning applied by the other members of the Court and Croom-Johnson J, with respect to the company's arguments as being:²²³

too narrow a meaning on the term "cost" for the present purposes ... the cost with which we are here concerned is not merely the contract price and incidental expenses paid for the stock in order to get it, but must also take into account any payments the appellants became liable to make or entitled to receive which had the effect of adding to or reducing the total outlay attributable to their stock as a whole ...

This was so, whether it was attributable to the company's stock as a whole, or merely to the amount of stock in excess of the amount required to meet their existing orders, and consequently:²²⁴

the "difference" payment of £55,087 7s 4d made by the Appellants was in the relevant sense an addition to the cost of the stock, since it had to be paid under the agreement with the Controller ...

The payments were directly attributable to the stock which the company held, although not calculated with respect to the total of the company's stock. It was calculated on their 'excess stock' at the relevant dates. If the price of the cotton had fallen rather than risen and the company had received payments from the Cotton Controller then:²²⁵

Conversely, I think a 'difference' payment received by a spinner who was 'long' at the date of a reduction in price would properly be treated as a reduction in the cost of his stock.

The company, not unexpectedly, was dissatisfied with this decision and the appeal was heard by Lords Porter, Reid, Radcliffe, Normand and Oaksey in the House of Lords. Their Lordships differed from the opinions expressed in the Court of Appeal and

²²² Ibid 278.

²²³ Ibid 291.

²²⁴ Ibid 291.

²²⁵ Ibid 292.

Croom-Johnson J at first instance, deciding the amounts paid by the company to the Cotton Controller were 'ordinary' business expenses and did not form a part of the cost of the company's stock-in-trade.

Lord Porter expresses his opinion on the matter succinctly:²²⁶

My Lords, to my mind the payment is not an increase in the cost of the cotton. It is a global payment in respect of a holding of cotton in excess of that required to fulfil the appellants' contracts.

His Lordship concluded that to include these payments as part of the cost of the company's stock-in-trade was 'to extend unduly the meaning of the word "cost"' and although the payments were undoubtedly part of 'the expenses incurred ... in carrying on their business' they did not, however, form part of the cost of the company's stock-in-trade.²²⁷

Lord Reid was of the opinion that if these payments could have been classified as an 'adjustment of price' then they would have to be included in the cost of the stock-in-trade, but this clearly was not the situation in the present case. With respect to the Solicitor-General's argument, relying on the judgment of Jenkins J in the Court of Appeal which was discussed above, that while these payments did not form part of the price they 'had the effect of adding to or reducing the total outlay attributable to their stock as a whole.'²²⁸ His Lordship concluded:²²⁹

I cannot agree that every payment or receipt which has that effect must come in to the cost of the stock. If a trader keeps perishable stock for a considerable time he may have to incur large expense in keeping it in proper condition-expense which he would not have incurred if he had not been carrying the stock. ... But I do not think that it was seriously argued that such expense incurred after the stock has been acquired and delivered to the trader must go to swell the cost of the stock for income tax purposes.

Whilst Lord Radcliffe put the matter succinctly that:²³⁰

after everything has been said it remains the fact that monies paid under it were not paid as part of the consideration for acquiring stock, but as a contribution to the Controller's pool.

His Lordship felt that this did not 'necessarily prevent such a payment being treated as an element of cost' but one had to look to the agreement under which the payments

²²⁶ Ibid 296.

²²⁷ Ibid 297.

²²⁸ Ibid 298.

²²⁹ Ibid 298-99.

²³⁰ Ibid 300.

were made, and it was the legal effect of the agreement which the Commissioners for the General Purposes of Income Tax had to take into account.²³¹ Consequently his Lordship could find nothing to detract from their finding that the payments did not form part of the cost of the company's stock. Similarly, there was no evidence presented to the Commissioners to show the appropriate method of accounting was to include the payments as a part of the cost of the company's stock-in-trade, and that.²³²

If there were such evidence, uncontradicted, it might well have been the Commissioners' duty to act on it, for if the law guides itself by the principle of accountancy as to cost or market price, whichever be the lower, it must I think guide itself also by any of its principles which determine how cost is made up.

Yet, in this case there was no such evidence available which showed the accounting practice was to include such payments as being part of the cost of a company's stock-in-trade.

As a result of this case, it is suggested that holding costs of stock-in-trade should not be included in determining its cost, but should be treated as an expense in the profit and loss account. It should be noted, however, that the stock-in-trade in question consisted of raw materials of a manufacturing concern. The question was never raised as to whether any part of the £55 087 paid to the Cotton Controller should or should not be included in the cost of the manufactured goods which were made from those raw materials, and which formed part of the company's stock-in-trade at the close of the year.

1 *Direct v Absorption Cost*

The use of direct, versus absorption costing, was dealt with in the case of *Duple Motor Bodies Ltd v Ostime; Duple Motor Bodies Ltd v Inland Revenue Commissioners*.²³³ The appellant was a coach builder, building bodies on various kinds of vehicles. It built only on an order basis, often building bodies on the chassis supplied to it.²³⁴ The most accurate description of its business was that of a contract jobber, with almost all of the bodies being built to the specifications of the purchaser. It was not, therefore, involved in 'mass production' or production line activities. During the relevant period most of the company's work was concerned with the building of bus bodies to order.

The appellant, and its predecessor in title, had always used for income tax purposes what was described as the 'direct cost' method to ascertain the cost of stock-in-trade at the end of each relevant period. It did not in fact use a full direct costing method, as it only included direct labour costs and the material actually used, and did not include

²³¹ Ibid 300.

²³² Ibid 301.

²³³ *Duple Motor Bodies Ltd v Ostime; Duple Motor Bodies Ltd v Inland Revenue Commissioners* (1961) 39 TC 537.

²³⁴ Ibid 544.

other direct costs. For example, unused labour and electric power were charged directly to the profit and loss account, as well as other direct expenses.

At the end of the year in question nearly all the stock on hand consisted of work in progress, and there was no selling market for the unfinished buses; and consequently the only relevant valuation method for stock on hand was cost. A complicating factor was that the appellant had for some years been experiencing a downturn in its activities, and it was not therefore operating at full capacity.

By the time the case was heard the appellant had admitted many of the overheads that had been charged directly to the profit and loss account to be in fact direct costs, and this issue was settled by the Commissioners for Special Purposes. The appellant, however, was dissatisfied with the Commissioners' conclusion which 'confirmed in our view that "on-cost" [full absorption costing] is really, in this kind of case, the better method to follow by the recommendations of the Institute of Chartered Accountants'.²³⁵

The case was heard by Vaisey J, at first instance, who allowed the appeal on the basis that it was the directors who had the right to choose between the two alternative methods of valuation:²³⁶

I can come to no conclusion other than that the directors have elected to use the direct cost method of arriving at the value for income tax purposes of work in progress ... I am not here to tell the directors what it would be good for them to decide.

This remarkable statement seems unjustifiable, and it was squarely put to rest by the Master of the Rolls, Lord Evershed, on appeal, who said that, when considering such matters for the purposes of income tax law,²³⁷

[Y]ou cannot say: 'Well, it is a matter for the directors. If the directors had decided to adopt ... the direct cost method, that concludes it for income tax purposes'. The duty of the directors is to make their decision on this matter in the best interests of the company, looking at it as a business entity; and quite plainly it could not be said that their conclusion ... was decisive of the matter for income tax purposes.

Lord Evershed then considered the effect in the relevant years, where the business of the company was contracting, of the adoption of the direct cost method. He observed in regard to those years, 'for these particular years and in relation to this particular company' the on-cost (absorption cost) method was shown to produce, on the face of it, 'an unfair result' but he pointed out that he was 'in no way affirming the view as a matter of principle'.²³⁸

²³⁵ Ibid 544.

²³⁶ Ibid 554.

²³⁷ Ibid 560.

²³⁸ Ibid 562.

Pearce LJ agreed that in this particular case, where the court was required to choose between these two competing methods, it would be wrong to lay down a general rule as if it were a rule of substantive law. It was a question of fact in each case to ascertain the true profit. His Lordship agreed with the Master of the Rolls, Lord Evershed, that in these circumstances, where the factory was idle and unprofitable.²³⁹

[T]he costing of the work in progress is inflated by the fact that it has, under the on-cost method, to bear an abnormally high proportion of the overheads during an uneconomic period. As a result, the profits are notionally increased, whereas in fact there are no true profits to justify that increase. In such a case, an actual loss could be converted on paper into a theoretical and untrue profit. Both theories rest ultimately on the fact that cost is a guide to value.

Harman LJ agreed with the reasons given by the Master of the Rolls and Pearce LJ, and in the course of a very short judgment he made this comment:²⁴⁰

This case has been a good illustration of the sometimes forgotten fact that an English law suit is not a moot or a debate, but an attempt to arrive at a result on the facts before the Court. Broad academic arguments are quite unsuited to the processes of the English law.

The Revenue was dissatisfied with the decision of the Court of Appeal and appealed to the House of Lords, the decision of which was given by Viscount Simonds, Lord Reid (with Lord Tucker and Lord Hodson agreeing) and Lord Guest.

Lord Guest agreed with the Master of the Rolls' comments in the Court of Appeal on the reasoning of Vaisey J:²⁴¹

It can never rest with the taxpayer to decide upon what principle his income is assessed for tax purposes. The directors' decision can never be decisive of the matter for income tax purposes (see *Patrick v Broadstone Mills Ltd*²⁴²).

As the Court had found on the facts and figures before it that the on-cost method produced an unfair result in these particular circumstances and that the direct cost method was the correct one to apply, the burden was stated by Lord Guest to be therefore on the Crown to show that the direct cost method was not in accordance with the requirement of the Income Tax Acts. Lord Guest noted that the House of Lords had been informed that the Crown had for a period of 50 years accepted the direct cost method and that this was the first time they had attempted to oppose the use of the direct cost method. Consequently the burden on the Crown was a particularly heavy one.

²³⁹ Ibid.

²⁴⁰ Ibid 563.

²⁴¹ Ibid 573–74.

²⁴² *Patrick v Broadstone Mills Ltd* (1953) 35 TC 44.

Lord Guest dismissed the Crown's claim to apply the on-cost method.²⁴³

[W]hen trade is slack the trader's profit on the goods sold will be low as his expenses are high, but his profit in respect of work in progress will be increased. I cannot think that a method which leads to these absurd results is in accordance with the principles of income tax law or, I may add, with common sense. ... The direct cost method ascertains the amount which the production of work in progress has actually cost. In his Lordship's view the Crown had failed to show that the on-cost method was of universal application. The accountancy profession was divided in its opinion on the matter, and the Crown had also failed to show that the direct cost method did not comply with the test enunciated by Lord Clyde in the *Whimster & Co* case.²⁴⁴

Viscount Simonds believed the company should not be exposed to the risk of being charged with a higher amount of profit than could be reasonably determined, and he said that he would, if he had to choose between two vaguely defined methods, 'choose the direct cost method as the less likely to violate the taxing Statute'.²⁴⁵ He added that if under the direct cost method the cost were to be put too low the error would be made good in the 'following year'—by this one must presume that he meant when the stock was sold. He found that any method was remote from common sense if, when used for taxing purposes (or any other), it resulted in inflated stock-in-trade or work in progress valuations because 'a slump in trade has reduced the articles between which overhead costs can be apportioned'.²⁴⁶ He rejected the imposition of any such method upon the taxpayer, and added the following observation:²⁴⁷

But I will add, in order to show how impossible it is to lay down any universal or even general rule, that it may be equally open to the taxpayer in special circumstances to show that something less than the cost of material and wages should be taken as the value of work in progress or stock-in-trade.

Lord Reid, with whom Lords Tucker and Hodson agreed, approached the problem in a most appropriate way. His Lordship first referred to the finding of the Commissioners for Special Purposes that the accountancy profession was satisfied that either method would produce a true profit figure for income tax purposes. He then continued:²⁴⁸

²⁴³ *Duple Motor Bodies Ltd v Ostime; Duple Motor Bodies Ltd v Inland Revenue Commissioners* (1961) 39 TC 537, 575–76.

²⁴⁴ *Whimster & Co* (1925) 12 TC 813.

²⁴⁵ *Duple Motor Bodies Ltd v Ostime; Duple Motor Bodies Ltd v Inland Revenue Commissioners* (1961) 39 TC 537, TC 568.

²⁴⁶ *Ibid.*

²⁴⁷ *Ibid* 569.

²⁴⁸ *Ibid* 570.

This cannot mean that, taking a particular business in a single year, either method will produce a true figure: the methods will produce very different figures of profit and both cannot be true figures of profit for the same year.

Rather, it means that if either method is consistently used over a number of years it will produce the same aggregate profit. His Lordship went on to state as to the finding of the Commissioners that 'it may mean that one or other method will produce a true figure depending on the nature of the business, and that seems to accord with the 'Recommendations' of the Institute'.²⁴⁹ It is submitted in this article that these views of Lord Reid are entirely correct.

Lord Reid then pointed out that while the courts usually attach a great weight to the views of the accountancy profession, the courts, of necessity, must always have the last word on the question. However, the problem for the Court in the present case was made far more difficult because this assistance was not available, as both methods were acceptable to the members of the accounting profession. As a result the courts were called upon to choose, as were the Commissioners, between these two competing methods of determining cost for the determination of the taxpayer's liability for income tax in the years in question. He continued by saying, 'I find that very difficult: if the accountancy profession cannot do that I do not see how I can'; and he added that the most that he could do was to try to bring common sense into the consideration of the problem, on the basis that 'common sense is the same for lawyers as for accountants'.²⁵⁰

Lord Reid then pointed out that it had long been accepted with respect to the Income Tax Acts that it was permissible to deduct expenses whether or not they were attributable to the production of goods during the relevant year. It did not matter if such expenditure might be 'abortive' or spent with the view of producing income in future years, and have no relationship to the production during the year. It is part of 'the whole general expenditure during the period, and it can only be said to have been spent to earn the profits of that year in the sense that it was all spent during that year to keep the business going'.²⁵¹ The question to answer therefore is what expenditure can properly be excluded from the expense account by setting it off against a figure representing work in progress and stock-in-trade: 'You must justify what you seek to exclude in this way as being properly attributable to, and properly represented by, those articles'.²⁵²

His Lordship found that it was impossible as a matter of principle to say which overheads must be brought into account and which left out, in determining cost under the on-cost method, and he continued:²⁵³

²⁴⁹ Ibid.

²⁵⁰ Ibid 571.

²⁵¹ Ibid.

²⁵² Ibid.

²⁵³ Ibid 572.

One thing clearly emerges as approved by the accountancy profession - whatever method is followed, it must be applied consistently. I accept that the real question is, what method best fits the circumstances of a particular business. And if a method has been applied consistently in the past ... it should not be changed unless there is good reason for the change ...

Lord Reid's subsequent observation has more than passing significance. His Lordship specifically stated that:²⁵⁴

I would not go so far as to say that this consideration condemns the on-cost method in every case. No doubt all these methods have their weak points. But this does, to my mind, make it more than ever necessary to find good reason for adopting the on-cost method in any particular case.

Thus it can be seen that there were a number of crucial factors in this case. First, the Revenue had accepted the company's income tax return for many years, in which it had valued its stock on hand using a limited version of the direct cost method, and therefore it was necessary for the Revenue to have very good reasons for compelling the company to change its method of accounting for income tax purposes. Secondly, there were the peculiar facts of the case, which were attributable to the fact that the company's business was contracting due to the economic conditions of the time. Thirdly, the company was a contract jobber. And fourthly, the lower of cost or market price could not be properly applied in this case due to the nature of the stock-in-trade, which consisted of work in progress, that is, partially completed buses with no selling market.

It should also be noted that this case was argued in 1960 and the decision was handed down at the end of March 1961. On 16 November 1960, the Institute of Chartered Accountants in England and Wales issued its Recommendation on Accounting Principles 22, Treatment of Stock-in-trade and Work in Progress in Financial Accounts, which replaced Recommendation X. For the purposes of the Recommendation 'cost' means 'all expenditure incurred directly in the purchase or manufacture of stock and ... of the overhead expenditure as appropriately carried forward in the circumstances instead of being charged against the revenue of the period in which it was incurred'.²⁵⁵ In May 1975 the Institute of Chartered Accountants in England and Wales issued SSAP 9, which advocates the use of the absorption method of costing only.²⁵⁶

It is submitted that the *Duple Motor Bodies Case*²⁵⁷ does not stand for the proposition that the direct cost method of valuing stock-in-trade, under the lower of cost or market rule is, per se, a better method of valuation than the full absorption cost method. Nor

²⁵⁴ Ibid 573.

²⁵⁵ See above.

²⁵⁶ See above.

²⁵⁷ *Duple Motor Bodies Ltd v Ostime; Duple Motor Bodies Ltd v Inland Revenue Commissioners* (1961) 39 TC 537.

does it stand for the proposition that the direct cost method is, per se, an acceptable method for valuing stock-in-trade for income tax purposes. The true situation can be summarised by once again referring to Lord Reid's comment that the relevant finding of the Commissioners 'may mean that one or other method will produce a true figure depending on the nature of the business, and that seems to accord with the 'Recommendations' of the Institute'.²⁵⁸ And later Lord Reid summarised the problem to be resolved by the courts: 'the real question is, what method best fits the circumstances of a particular business'.²⁵⁹ These would seem to be the determinative factors underlying the decision of the House of Lords.

The accounting literature of the time shows that there was considerable support for both the direct cost method and the absorption cost (on cost) method for determining cost of stock-in-trade—this is supported by the evidence given in this case. It is interesting to note that in the United States²⁶⁰ and Australia²⁶¹ the question of 'direct cost' versus 'absorption cost' has also been addressed and it was found that the absorption cost method should be used. Unlike *Duple Motor Bodies* the taxpayers in those cases were large scale manufactures using production line production.

B *Methods of Determining Cost: Cost Flow Assumptions*

In addition to these general principles, which have the underlying decision rule of the 'lower of cost or market price', the United Kingdom courts also considered the appropriateness of various cost flow assumption used for ascertaining the cost of stock-in-trade. These cases are considered below.

1 *The Base Stock Method for Determining Cost*

Under the base stock method it is assumed that a minimum quantity of trading stock (base stock) is necessary at all times in order to carry on business. The base stock is valued at cost current at the time when the base stock was established. Inventories in excess of the base stock are valued in accordance with some other method, for example, First in First Out (FIFO), or average cost. Ian M Bowie explains the use of the base stock method as:²⁶²

also applied to work-in-progress as well as its raw materials, is founded on the principle that a business requires always to hold in stock a certain basic quantity of stock which is more in the nature of a fixed asset than a current asset. For example, an estimate may be made of the minimum pipe-line stocks plus a

²⁵⁸ Ibid 570.

²⁵⁹ Ibid 572.

²⁶⁰ *Photo-Sorties Inc v Commissioner of Inland Revenue* 66 FTC 85, 577; and *Waukesha Motor Company v United States of America*, 71 FTC 85, 954.

²⁶¹ *Philip Morris Ltd v FCT* (1979) 10 ATR 44; 79 ATC 4352.

²⁶² Ian M Bowie, 'The Basis of Valuation of Stock and Work-in-Progress' (October 1954) *The Accountants' Magazine* 570–92, 573–74.

reasonable reserve stock, the total of which would be considered to be the base stock which should always be held if economic production is not going to be interrupted. It is held that that portion of the stock which constitutes this base stock should be valued at the *cost of the equivalent quantity of stock originally purchased at the commencement of the business, or at the cost of the equivalent quantity of stock on hand when the base stock method of valuation was first introduced*. By so doing, in times of rising prices the increased cost of replacing the base stock is written off to profit and loss account and accordingly that portion of the capital of the business which was utilised in providing the base stock remains intact. [Emphasis added]

The base stock method of valuing stock-in-trade was considered by the United Kingdom Court of Appeal in the case of *Patrick (HM Inspector of Taxes) v Broadstone Mills Ltd*,²⁶³ on appeal from the decision of Vaisey J, at first instance.

Broadstone Mills Ltd were engaged in the business of cotton spinning, and at all stages of the manufacturing process quantities of cotton were either on the machines or waiting beside them, ready to take the place of cotton on the machines. These two amounts of cotton were referred to as the 'fixed process stock' and the 'spare process stock' respectively. These two classifications of stock together were classified by the company as their 'base stock' when calculating the value of their stock-in-trade for income tax purposes.

The 'fixed process stock' was valued at the 1920 balance sheet price, and just how this 1920s cost price was computed was unknown when the dispute arose, and was heard by the court in 1953. The remainder, that is, the 'spare process stock' was carried in the accounts at an arbitrary figure of 28d per pound weight.

Evidence given to the Commissioners, and accepted by the court, showed the base stock method was widely accepted in the industry, though according to an assessor who specialised in the industry, the method was rapidly becoming less popular, with now only 11.5 per cent using the base stock method. The Commissioners found the base stock method was 'one of the methods recognised in this particular trade of cotton spinning and is in accordance with sound commercial practice'.²⁶⁴

Mr T B Robson, a chartered accountant, and a member of the Council of the Institute of Chartered Accountants, who was a partner in the firm of Price Waterhouse & Co, gave expert evidence on behalf of the taxpayer. Vaisey, noted that Mr Robson:²⁶⁵

nowhere in his evidence ... shows any but a very grudging approval of what is surely a very strange notion, nor does he really commend it as an appropriate basis for an assessment to Income Tax.

²⁶³ *Patrick (HM Inspector of Taxes) v Broadstone Mills Ltd* (1953) 35 TC 44, Singleton, Birkett and Hodson LJ.

²⁶⁴ *Ibid* 51.

²⁶⁵ *Ibid* 56.

The expert evidence in this case, which was accepted by the judge at first instance, Vaisey J, and the members of the Court of Appeal, disclosed the base stock method, which was adopted by the company, was a recognised and accepted method of valuing stock-in-trade in the industry and might well be a recognised and accepted method of some commercial purposes. However, it did not reflect the true income of the year and consequently was not an appropriate valuation method for income tax purposes, particularly when arbitrary prices had been used. No part of the stock-in-trade could either be treated as a fixed asset, as the company had attempted to do, or brought into account at an arbitrary figure.

In the Court, Singleton LJ, was greatly concerned with the use of arbitrary figures, and made the following comments with respect to this point:²⁶⁶

How it is possible to get accuracy in any account by taking an arbitrary figure I do not know ... I do not follow the reason for any arbitrary price at all in a matter of this kind ... you cannot get at the true position unless you take actual figures as distinct from arbitrary figures.

Singleton LJ could not find any justification for using a figure lower than either 'cost' or 'market' when the prices of the company's stock-in-trade were actually continually rising.²⁶⁷ His Honour then expounded his criteria for evaluating accounting methods and stated his rule for valuation, (as quoted above), and concluded that:²⁶⁸

The Company's method of accounting does not meet these requirements for the relevant year. They have more stock, purchased out of income, than their trading account shows, and other stock is not taken at the right figure.

Birkett LJ added the following comment with respect to the expert evidence given to the Court:²⁶⁹

he nowhere says: In my view this system produces an accurate result in that it provides the full profits for the year of assessment. I think that Vaisey J, was to that extent justified in commenting on the evidence of Mr Robson.

Perhaps I may refer to what Lord Porter said in *Ryan v Asia Mill Ltd* (1951) 32 TC 275 at 296:

Moreover what may be prudent accountancy for a company is not necessarily the correct method of ascertaining the proper assessment for Income Tax.

²⁶⁶ Ibid 64–65.

²⁶⁷ Ibid 64.

²⁶⁸ Ibid 68.

²⁶⁹ Ibid 71.

Hodson LJ agreed with the judgments of Singleton and Birkett LJ, and thus the base stock method of valuing stock-in-trade was found to be inappropriate under the circumstances.

This is because first, the values attributed to the stock-in-trade in question were in no way related to the actual value or cost of the cotton which made up the 'spare process stock' and the 'fixed process stock'. Secondly, even if the original values of these stocks had been used, it was not the same cotton which was originally purchased by the company. That is, in this case, the underlying cost-flow assumption, that a fixed amount of stock always remained in these two classes of stock, was not supported by the facts.

The application of the base stock method of valuing stock-in-trade can be summarised as follows. Prima facie it would appear that the base stock method of valuing stock-in-trade is not an appropriate method, unless it describes the actual stock-flow situation, and the actual costs of the current stock are used. In such cases the amount of base stock is a part of circulating capital, that is, on revenue account, and is not a part of the fixed capital, and thus would have to be brought into account in determining the profit of the company for the period. The evidence before the court (11.5 per cent of the particular industry at time of the case)²⁷⁰ and from Table 5 below indicates some 8.5 per cent of authors referred to the use of the base stock method. Evidence to the Tucker Committee indicated that there was the belief that stock-in-trade should be valued according to the custom in the trade. Mr B M Berry in his evidence advocated the use of the base stock method.²⁷¹ The Base Stock method is mentioned immediately after para 5 of the discussion of cost in Recommendation X of the Institute of Chartered Accountants in England and Wales, as one of the 'other methods' of valuation.²⁷² It is noted that there is 'limited application' of this method in the United Kingdom.

TABLE 5 – USE OF THE 'BASE STOCK' AND 'RETAIL INVENTORY' METHODS

Valuation Methods referred to	1931 to 1940	1941 to 1950	1951 to 1959	Total
The lower of cost or market rule	89	47	41	177
Cost	37	28	19	84
Cost or below	6	3	2	11
Below cost	5	0	0	5
Base stock	7	6	7	20
Retail inventory	9	11	6	26
Number of authors: net of multiple authors by decade	115	67	53	235

2 Last in First Out

²⁷⁰ Detailed above.

²⁷¹ Berry for the International Chemical Co Ltd, reported in 'Taxation of Profits - Foreign Profits; Stock Valuations; Group Accounts - Tucker Committee's Fourth Public Hearing' (1 April 1950) *The Accountant*, 355-58, 58.

²⁷² Published in *The Accountant* (16 June 1945), 302-03.

The Last In First Out (LIFO) method of valuing stock-in-trade was considered by the Judicial Committee of the Privy Council in the Canadian case of *Minister of National Revenue v Anaconda American Brass Ltd.*²⁷³ The relevant provisions of the Canadian Income Tax Legislation provided that tax was to be levied on the net profits of a taxpayer, which was defined as being:

the annual net profit or gain ascertained and capable of computation as being the profits from a trade or commercial or financial or other business.

Their Lordships concluded after an examination of these provisions that both the Canadian and United Kingdom income tax legislation are in this respect founded upon the principles enunciated by Lord President Clyde in *Whimster & Co v Commissioners of Inland Revenue*.²⁷⁴

The company did not in fact keep actual records of the metal they used in their operations, but they did keep records of the physical quantities of the metal used, and of its opening and closing stock, along with its purchases and the prices paid for the purchases from time to time.²⁷⁵ The company was, as such, not using the LIFO method as a consequence of the physical flows of their stock, but was, instead, using an arbitrary assumption as to the flows of their stock, which in no way reflected the actual stock flow of the company. Their Lordships summarised the company's situation as follows:²⁷⁶

it did not know and could not ascertain ... in respect of all the metals which it used during the year what price had been paid for them or in respect of all the metals which it had at the end of the year what price had been paid for them. Yet in order to determine its annual profit or gain for the year 1947 it is necessary to ascribe the proper cost to the metals In the absence of knowledge an assumption or estimate must be made and it is at this stage that the difference between the parties arises.

During the year in question, 1947, there was a rapid increase in the price of copper, and it was in this year the taxpayer first adopted the LIFO method for taxation purposes, although it had used this LIFO method for its own purposes for some time prior to this date. The effect of the company's adoption of this method of valuing their stock of metal during a period of rising prices was described by their Lordships:²⁷⁷

²⁷³ *Minister of National Revenue v Anaconda American Brass Ltd* [1956] AC 85; (1956) 2 DLR (2d) 1; [1956] 1 All ER 20, Viscount Simon, Lords Oaksey, Reid, Keith of Avonholm and Sornervell of Harrow.

²⁷⁴ *Whimster & Co v Commissioners of Inland Revenue* [1956] AC 85, at 100.

²⁷⁵ *Ibid* 96.

²⁷⁶ *Ibid* 96–97.

²⁷⁷ *Ibid* 98.

The result is obvious. By attributing the higher cost to the metals processed and the lower cost to those retained in stock the company was able to show far lower profits. ... The question is whether the new method is permissible for income tax purpose.

Their Lordships concluded that in such circumstances the LIFO method was an unacceptable method of valuing the company's stock-in-trade for income tax purposes, on the basis that:²⁷⁸

the present case shows that under the LIFO method, if the business continues and stock is carried forward, substantial purchases may never come into the profit account at all.

There is no room for theories as to flow of costs, nor is it legitimate to regard the closing inventory as an unabsorbed residue of cost, rather than as a concrete stock of metals awaiting the day of process. It is in their Lordships' opinion the failure to observe, or, perhaps it should be said, the deliberate disregard of, facts ... which vitiates the application of the LIFO method to the present case. It is the same consideration which makes it clear that the evidence of expert witnesses, that the LIFO method is a generally acceptable, and in this case the most appropriate, method of accountancy, is not conclusive of the question that the court has to decide ...

Their Lordships concluded the LIFO method did not comply with the prescription of the *Income Tax Act*, despite the fact that the LIFO method, or some variant of it, may be appropriate for corporate or other purposes of a trading company. However, the figures which such a method produced represented 'neither market value nor its actual cost' but, rather, a far lower amount, which represented the cost of similar stock purchased by the taxpayer company many years earlier and which it no longer possessed.²⁷⁹ There is, as their Lordships pointed out, a significant and important distinction between 'what is permitted for tax purposes and what prudent businessmen may think fit to do'.²⁸⁰

Given the similarity of the Canadian and United Kingdom legislation it is the author's view that the use of the LIFO method should not be used for valuing stock-in-trade. This is on the basis of their Lordships' discussion and their findings, the LIFO method is, prima facie, inappropriate for the valuing of stock-in-trade, unless it actually reflects the physical flow of stock. The figures do not reflect either the cost of the stock on hand or the value of the stock and, as such, do not comply with the basic rule that requires stock-in-trade to be valued at the 'lower of cost or market price'. The method, therefore, should not be adopted for taxation purposes, unless the stock flows of the company are actually on a LIFO basis, adequate records are kept of actual purchase prices, and these are matched to flows of the stock. It should be noted that here we are

²⁷⁸ Ibid 102.

²⁷⁹ Ibid.

²⁸⁰ Ibid 103.

talking about the use of an arbitrary cost flow assumption. If the actual flow of materials was on a first in first out basis then there would be no objection to the use of the LIFO method as it would accurately represent the cost of the stock-in-trade.

There is little discussion of the use of LIFO in the accounting literature of this time, however there was a debate on the LIFO versus FIFO in the mid-1940s.²⁸¹ The debate seems to have been initiated by K A Lacey.²⁸² The LIFO is mentioned in a footnote immediately after para 5 of the discussion of cost in Recommendation X of the Institute of Chartered Accountants in England and Wales, as one of the 'other methods' of valuation.²⁸³ It is noted that there is 'limited application' of these methods in the United Kingdom.

3 Conclusions as to Determining Cost

From the above discussion it can be seen that the United Kingdom courts have always taken a wide view as to the costs which have to be included to determine the cost of stock-in-trade for income tax purposes. It is the total consideration to be given for the acquisition of the stock-in-trade which is relevant. However, in *Duple Motors* they refused to lay down as general principle whether or not the direct costing or absorption cost method should be used for income tax purposes. In addition the courts will not tolerate the use of arbitrary cost flow assumptions. The cost flow assumption used must reflect the actual flow of the stock-in-trade.

²⁸¹ See 'Rip Van Winkle', 'Valuation of Stock-in-Trade' (12 January 1946) letter to the editor *The Accountant* 14; Thomas H Barker, 'Valuation of Stock-in-Trade: LIFO and FIFO' (21 July 1945) letter to the editor *The Accountant* 34; G A Bauer, 'Profits and Stock Valuation' (2 March 1946) letter to the editor, *The Accountant* 116; Roy Beck, 'Valuation of Stock-in-Trade: LIFO and FIFO' (18 August 1945) letter to the editor, *The Accountant* 83-84; H A Briscoe, 'Valuation of Stock-in-Trade: LIFO and FIFO' (29 September 1945) letter to the editor *The Accountant* 156; H A Briscoe, 'Valuation of Stock-in-Trade: LIFO and FIFO' (10 November 1945) letter to the editor *The Accountant* 232-33; F G, Dawes, 'Profits and Stock Valuation' (2 March 1946) letter to the editor *The Accountant* 115; K A Lacey, 'Commodity Stock-valuation and Inflation' (10 February 1945) *The Accountant* 59-60; K A Lacey, 'Profits and Stock Valuation' (30 March 1936) letter to the editor *The Accountant* 171; see also KA Lacey, letter of same title in *The Accountant* (15 December 1945) 291-95, and (2 March 1946) 115; K A Lacey 'Valuation of Stock-in-Trade: LIFO and FIFO' (20 October 1945) *The Accountant* 194; Harry Norris, 'Valuation of Stock-in-Trade: LIFO and FIFO' (21 July 1945) *The Accountant* 34-35; A Pakenham-Walsh, 'Profits and Stock Valuation' (2 March 1946) *The Accountant* 115-16; K M Parry, 'Valuation of Stock-in-Trade: LIFO and FIFO' (21 July 1945) *The Accountant* 34; Stanley C F Pinhorn, 'Profits and Stock Valuation' (26 January 1946) *The Accountant* 46; The Editor, 'Stock Valuation' (15 December 1945) *The Accountant* 290-91.

²⁸² K A Lacey, 'Commodity Stock-Valuation and Inflation' (10 February 1945) *The Accountant* 59-60; 'Profits and Stock Valuation' (30 March 1936) *The Accountant* 171; 'Profits and Stock Valuation' (15 December 1945) *The Accountant* 291-95; 'Profits and Stock Valuation' (2 March 1946) *The Accountant* 115; 'Valuation of Stock-in-Trade: LIFO and LIFO' (20 October 1945) *The Accountant* 194.

²⁸³ Published in *The Accountant* (16 June 1945) 302-03.

XIV CONCLUSIONS

The basic rule for determining the value of stock-in-trade for income tax purposes is the lower of cost or market rule. The lower of cost or market rule is to be applied to each item or group of items individually and not with respect to the total stock-in-trade. That 'cost' means the actual cost of acquiring the stock-in-trade, which includes all the consideration given for such acquisition. The cost flow assumptions on the base stock and LIFO method do not represent the cost of stock-in-trade, unless they describe the actual physical flow.

The words 'market value' or 'market' mean the realisable value of the stock-in-trade in the market in which it would normally be sold, without deductions. In exceptional circumstances, where there is no market selling value and the historical cost of the stock-in-trade bears no relation to its current value, then cost of having the stock-in-trade delivered on the balance date can be used as a surrogate.

Finally, the use of the retail inventory method is not an acceptable method of determining cost, except when used to determine the actual cost of the stock-in-trade. Proper adjustments must be made for mark ups and mark downs, and the gross margin used must be the real gross margin.

It is clear that while the accounting profession managed to convince the courts that the usual method of valuating stock-in-trade was the use of the lower of cost or market rule, the courts have regularly rejected accepted accounting practice with respect to how it is applied and what the term 'market value' means.

APPENDIX 1

TABLE 4 – MEANING OF MARKET VALUE IN LOWER OF COST OR MARKET RULE – NET OF MULTIPLE AUTHORS BY DECADE

	1901 to 1910		1911 to 1920		1921 to 1930		1931 to 1940		1941 to 1950		1951 to 1959		Total	
Realisable value	4	33.3	14	41.2	13	22.8	26	29.2	13	27.7	10	24.4	80	28.6
Net realisable value	0	0.0	4	11.8	4	7.0	8	9.0	17	36.2	13	31.7	46	16.4
Replacement cost or price	3	25.0	13	38.2	16	28.1	35	39.3	22	46.8	16	39.0	105	37.5
Market value or price	11	91.7	22	64.7	47	82.5	59	66.3	31	66.0	30	73.2	200	71.4
Lower of replacement price and realisable value	0	0.0	0	0.0	3	5.3	4	4.5	4	8.5	0	0.0	11	3.9
Lower of replacement price and net realisable value	0	0.0	0	0.0	0	0.0	0	0.0	3	6.4	0	0.0	3	1.1
Number of authors using the lower of cost or market rule	12		34		57		89		47		41		280	

APPENDIX 2

Stock Certificates letter to the Editor of *The Accountant*

The following is copy of a letter which appeared in the same issue of *The Accountant* requesting a form of balance sheet to be supplied to the Surveyor of Taxes¹²⁰:

The following is the correspondence referred to in our weekly note:-

To the Editor of the Standard.

SIR, - I received this morning the following remarkable communication, which I enclose for your perusal, from the Surveyor of Taxes for this district:-

“6, Head-street, Colchester, April 27, 1886.

INCOME TAX RETURNS.

Schedule D.

SIR, - As these Returns will shortly be under consideration, it would aid the Commissioners in making an equitable assessment upon you if you would kindly prepare and forward to me, within fourteen days from this date, a debtor and creditor account, according to the subjoined form, for each of the past three years.

Yours faithfully,

R.G. HEDGEMAN, Surveyor of Taxes.

Mr. F.W. Friend, Hosier, &c, Colchester.

Year ended.*	* Enter date.
Stock at beginning of year.	Sales during the year.
Purchases during the year.	Stock at end of year.
Gross Profit.	
Trade Expenses, viz.:-	
- Wages, &c., giving amount	
under each head.	
Net profit, £.	

¹²⁰ Friend, F.W. letter to the Editor of *The Standard*, reproduced in *The Accountant*, 8th May 1893, at page 279.

This was enclosed in an envelope bearing the usual superscription, "On Her Majesty's Service." Has the Surveyor any legal warrant for this most inquisitorial, not to say impertinent, inquiry, which I understand has been received by most of my fellow-tradesmen? Personally, I may say that I have paid my income tax for many years without appealing against the assessment, although considerably surcharged, rather than submit my business affairs to the criticism of a committee composed possibly of my neighbours.

I am, Sir, your obedient servant,

F.W. FRIEND.

Alma House, Colchester, April 28.

APPENDIX 3

STOCK CERTIFICATES FORMS

Stock Certificates type A:¹²¹

Stock.

State on what basis this stock was valued.

Has any reduction been made from the values so obtained before arriving at this amount?

Was the same basis adopted in previous years?

Have you certified that this figure includes the value of stock, the cost price of which has been charged against Revenue but which has not been actually delivered?

In arriving at the above figure, has any consideration been given to any change in prices or values since the above date?

Does this figure include any outlay incurred in connection with the stock, such as carriage?

Please state what steps you have taken to verify the quantities, values and calculations, leading up to the above figure.

Stock Certificates type B:¹²²

Accounts. One year ended We hereby certify that the whole of our stock on hand on the is shown in our Stock Sheets produced to and amount to £

We further certify that the Stock is valued at cost, or market price if under cost, on the same basis as hitherto, and that no deductions have been made from the value of the Stock in arriving at the above figures, which represent its total value to the best of our knowledge and belief.

We further certify that to the best of our knowledge and belief all transactions relating to the business of are correctly entered in the books of account during the period to which have been produced to Messrs and that we know of no other transactions which ought to be included and which would affect the Balance Sheet and Trading Account of the Company, or which should be brought into an account of the Company's dealings.

We further certify that no reserves whatever have been created (whether by writing down Stock, Book Debts, or otherwise) beyond those disclosed on the face of the Balance Sheet sent to the Surveyor of Taxes.

Dated thisday of 191 .

To be signed by an Acting Partner in a firm or a Managing Director of a
Limited Company

¹²¹ 'Auditors', *Stock Valuation*, letter to the editor, *The Accountant*, 19th December, 1921, page 848.

¹²² *Minutes of Evidence, The Royal Commission on The Income Tax*, HMSO, 1920, at page 531.

TAX REFORM AND THE USE OF OVERSEAS TAX MATERIALS IN AUSTRALIA

COLIN FONG

Colin Fong is a part time lecturer at the University of New South Wales and a research librarian at the University of Sydney Law Library.

INTRODUCTION

One of my first assigned jobs as a library assistant at the University of Sydney Law Library was to file the Commerce Clearinghouse (CCH) US *Standard Federal Tax Reporter*. I must have been destined to continue working in the tax area because many years later, I am still working in the tax area. I cannot say filing loose-leaf pages of a service, which I never saw anyone use, was any stimulation to that job.¹ I think the only persons using this loose-leaf service were lawyers working on matters for the big end of town. The subscription costs certainly weren't borne by them. Later on, I used to encourage library staff by reminding them, whilst loose-leaf filing, that they were updating the law!

Back then the CCH US *Standard Federal Tax Reporter* was over 10 volumes, whereas the local CCH *Australian Federal Tax Reporter*, was only a few volumes.² Now the tide has turned and the local reporter resembles the US version of 30 years ago. The familiar black and gold binders have been prominent in many professional offices of accountants, lawyers and tax academics. The rival publisher, Australian Tax Practice, has a similar number of volumes for its income tax service.

Are overseas materials used much in contemporary Australian tax research? The materials being used and the problems in acquiring the same will be examined. This paper focuses on legal materials though other materials are relevant, for example, international accounting standards.

Of particular interest I noted the CCH *Daily Email Alert* for 9 December 2003, which featured the following headlines:

- Austria: Taxation Bill 2003 passed
- Austria: Real Estate Investment Fund Act comes into effect
- Denmark: Changes to joint taxation rules
- Malaysia: Liberalisation of Foreign Investment Committee Guidelines
- Philippines: Tax incentives under Barangay Micro Business Enterprises Act

¹ One of my diary entries reads: 'Vol 5 and 6 CCH took about 5 minutes each to file ... Volume 9 took about 3 hours (monotonous)'.

² Now in 12 volumes plus ancillary volumes such as the *Australian Federal Income Tax Reporter*, *Bills*, *Australian International Tax Agreements* etc.

On the next day, were the following foreign stories:

- Luxembourg and the EU Savings Tax Directive
- UK tax legislation facing challenge in the ECJ
- Denmark: Changes to thin-capitalisation rules
- France: Finance Bill 2004 adopted
- Germany: Proposed tax changes for 2004
- Malaysia: 2004 Budget measures and economic stimulus package
- US Fed maintains expansionary monetary policy

Prior to these dates, I don't recall much interest in overseas jurisdictions.

I THE ASPREY AND MATHEWS REPORTS

The 1970s were marked by blatant tax schemes such as the bottom of the harbour schemes. The Asprey Report, formally known as the Report of the Taxation Review Committee, was commissioned by the federal government in 1972, and its report was published in 1975. Amongst the many recommendations of the Asprey Report, was a recommendation of the introduction of an Australian value added tax (VAT). Something the federal government followed up on, 25 years later. Obviously overseas models of VAT were examined.

Chapter 16 dealt with company income tax; Chapter 17 dealt with international aspects of income taxation; Chapter 23 dealt with capital gains tax and Chapter 27 dealt with taxation of goods and services. Notably there were comparisons with overseas jurisdictions such as the United Kingdom, Canada and the OECD. The report has been out of print for many years, but since July 2003 it is now available on the web at <http://setis.library.usyd.edu.au/oztexts/parsons.html>. Unfortunately the timing of the release of the Asprey Report was caught up with the political turmoil of 1975, including the Dismissal of Gough Whitlam as the Prime Minister, and hence shelved.

The Mathews Report on Inflation and Taxation³ was commissioned to make recommendations regarding adjustments, which should be made to taxable income for business taxpayers so as to remove the distortions arising from inflation. There was some legislative response, which dealt with cost of sales valuation adjustment.

These reports were preceded by earlier government reports on taxation: Kerr (1920), Ferguson (1932), Spooner (1950), Ligertwood (1961). The Kerr Report dealt with wartime expenditure, state/federal rivalry, welfare agencies, churches and social security. The Ferguson Report dealt with simplification, standardisation involved in the tax debate. There was a debate on how much you can spend and this depends on how much you can raise, with different lobby groups entering the picture. Put also into the picture, the Treasury mindset which was distrustful of business.

³ *Report of the Committee of Inquiry into Inflation and Taxation*, Canberra, Australian Government Publishing Service, 1975.

II TAX REFORM IN THE 1980s

Tax reform was often equated with tax cuts. This period was a mixed one, consisting of both the federal Coalition Government from 1975–83 then the Australian Labor Party Government from 1983–96. One noticeable feature was the escalating growth of income tax legislation. The 1980 edition of the *Australian Income Tax Assessment Act*, was one volume.⁴ The 1982 edition of the *Australian Income Tax Assessment Act* was in two volumes, including the regulations, Rating Acts, international agreements and other legislation.

By 1985, this had become three volumes, then by 1989 consisted of four volumes (as Volume 1A, 1B, 2 and 3). Notable was the *Reform of the Australian Tax System*, statement by the then Treasurer on 19 September 1985, announcing momentous changes to the Australian tax system including capital gains tax, fringe benefits tax, controlled foreign corporations legislation, etc.⁵

In July 1985 the Tax Summit was held which tried to set a national agenda on tax reform with many different parties and organisations in attendance.⁶ This was preceded by the *Reform of the Australian Tax System: Draft White Paper*.⁷

III TAX REFORM IN THE 1990s

This period was a mixture of the Australian Labor Party Government from 1983–96, then the federal Coalition Government from 1996 onwards.

The Tax Law Improvement Project (TLIP) was an ideal, with initial proposals of replacing the *Income Tax Assessment Act 1936* (ITAA36) with a new *Income Tax Assessment Act 1997* (ITAA97). The ITAA97 was enacted, however the ITAA36 still remains in force then as it does today. TLIP was followed by A New Tax System (ANTS) in 1998, then the Ralph Review of Business Taxation in 1999 (Ralph Review). In July 1999, the GST legislation was passed, with major amendments by the federal houses of parliament. Following this were the introduction of GST rulings and call centres. In 1999 with respect to the Ralph Review, the specific anti-avoidance measures were announced, along with several retrospective measures.

The growth in legislation has not abated, and now the CCH and ATP versions of the income tax legislation are each five volumes, and these volumes are much thicker than the ones of the late 1980s. Having said this, noticeably between 1999–2003 there was a decline in the number of tax bills introduced from around 70 to about 30–40.

⁴ *Australian Income Tax Assessment Act* 14th ed, North Ryde, NSW, CCH, 1980.

⁵ Available from the Australian Parliament Hansard website <http://www.aph.gov.au/hansard/hansreps.htm> then click on View HTML versions 2003 to 1981 then within 1985 look for 19 September 1985.

⁶ National Taxation Summit, Record of proceedings, Canberra, Australian Government Publishing Service, 1985.

⁷ *Reform of the Australian Tax System: Draft White Paper* Canberra, Australian Government Publishing Service, 1985.

Note the following contemporary comments:

Report after report for the commonwealth has earnestly rehashed Adam Smith's taxation golden rules of equity, economy and simplicity, and government after government has piled tax on tax, concession on concession, and ruling on ruling to create a 10,000-page monster that no practitioner can master.⁸

"We've got the Taxation Act of 13,000 pages. I would say, if I were the treasurer, I want that reduced by 50 per cent in three years. That's your KPI [key performance indicator] – do it!" he spits.

"You can do these things if you really put your foot down. Of course, you'd have every vested interest saying you can't. There'd be lawyers and tax accountants and specialists and the taxation Commissioner all out with their worry beads saying we can't do it, minister. Well, you can do it. Just make it happen!"⁹

IV TAX REFORM POST-2000

The move to tax reform has not abated. The new millennium was marked with the introduction of a goods and services tax, reforms to corporate taxation, etc. Fortunately, we had a lot of research on which to base our goods and services tax with overseas models such as those in the United Kingdom, Canada, Europe, and New Zealand.¹⁰ By examining the Ralph Review, we can discern the use of overseas materials in the compilation of the discussion papers and final report. One of the objectives of the Ralph Review was to improve competitiveness and efficiency and to provide a secure source of revenue. Other aims were to enhance stability of tax arrangements, to improve simplicity and transparency and to reduce costs of compliance.¹¹

From 2000, the GST started, PSI rules started along with non-commercial losses. There were personal tax cuts, PAYG, BAS and ABNs. The Board of Taxation was established.

During 2001 we had the small business 'simplified' tax system, uniform capital allowances, thin capitalisation, debt/equity rules and company tax cuts. In 2002 we had value shifting, consolidations and imputation changes. During 2003, the Inspector-General of Taxation commenced work, financial arrangements were codified, and small

⁸ Editorial, *Australian Financial Review*, 10 May 2004, 62.

⁹ Michael Short, 'Morgan Hungry for More Reform', *Australian Financial Review*, 17 May 2004, 69. An interview with Hugh Morgan.

¹⁰ Useful local and overseas publications dealing with either GST or VAT, are listed in C Fong, 'Research Guide to GST 2003' (2003) 19 *Australian Tax Forum* 287–326.

¹¹ A McCLeary, 'Objectives of the Ralph Review of Business Taxes', Paper Presented at the Australasian Tax Teachers Association Conference, Flinders University, 30 January 2004. No written paper issued.

tax rate reductions. Still to come are international tax reforms and private company loans.¹²

Discarded along the way have been:

- Alternative minimum tax
- Business tax charter
- Entity tax – Option 2
- Imputation credits for foreign dividend withholding tax (DWT)
- Expatriate tax improvements
- Business tax charter
- Retrospective proposals
- Discretionary trust proposals
- GST on food
- An integrated tax code¹³

V SOME DIFFICULTIES IN FINDING OVERSEAS MATERIALS

Sometimes there are difficulties in finding materials on overseas subscription websites. Recently I was asked to find *McNiven v Westmoreland Investments*. During December 2003, I went onto Lexis keying in ‘mcniven v westmoreland investments’ in the UK Cases, Combined Courts Library and could only locate the Carnwath J decision in the Chancery Division, as reported in *The Times* 19 August 1997, (transcript), hearing and judgment date of 24 July 1997. Ironically, I tried the British and Irish Association Legal Information Institute (BAILII) and found the 2001 House of Lords decision at <http://www.bailii.org/uk/cases/UKHL/2001/6.html>

This is no different to missing information on local databases. In *Taxation of Australia* was a four-part article, yet the online version via the Taxation Institute of Australia only yielded three of the four parts. Likewise the Australasian Legal Information Institute holds the *University of New South Wales Law Journal* back to 1997. I was disappointed to discover a forum, ‘Legal perspectives on the state of the Australian tax system’ (2000) 23 (2) *University of New South Wales Law Journal*, is not there.

VI THE LINGO PROBLEM!

There are many difficulties in finding overseas materials for tax research purposes. One of the many difficulties is the language barrier. The following was posted on the International Law Librarians discussion list, on 8 December 2003, and is typical of many people’s enquiries:

One of the professors here is looking for cases and/or legislation of EU member countries that recognize, or do not recognize, same-sex unions. I found several in the UK on Lexis, but had trouble with the France databases since they are in French.

¹² Above n 11.

¹³ Ibid.

If you know of any relevant cases or statutes that are either available in English, or that you can summarize in English for me, please pass along the citations. Thank you for your help

On the same discussion list, posted 12 December 2003, was the following:

For those interested in English translations of the civil codes of European countries, there is a new English translation of the Greek Civil Code made available by its publisher.

<http://www.ant-sakkoulas.gr/en/catalogue/>

Some of us in our research have found useful materials only to find the material is not in English. There are many translation websites such as <http://translator.go.com> or <http://babelfish.altavista.com/translate.dyn> or <http://www.FreeTranslation.com> however whether they can translate tax technical materials is another thing. Sometimes large firms have translations of various documents but these are not enough as they are often restricted to internal staff or to their clients.

You may have found a reference by doing a web search using a search engine such as Google or Alta Vista. Or you may have seen a reference in a journal, book or conference paper. Sometimes you may be fortunate in having someone with the requisite language skills in your school, department or faculty. Other times, by serendipitous fortune, you may have some students with the appropriate language skills.

Sometimes there are publications that translate the original into English, including, for example, the following:

China Law and Practice

Chinese Law and Government

International Legal Materials

Soviet Law and Government

The loose-leaf service, *China Laws for Foreign Business*, published by CCH, is one of the notable services that provides an English translation to all relevant Chinese business legislation.

In bilingual Canada, we are often fortunate in being able to see both the French language version alongside the English translation and vice versa.

VII THE USE OF THE INTERNET

There are now many sources to find tax information. How can you tell these sources are genuine and accurate? The major legal and tax publishers have reliable websites. What about the numerous spam emails regarding lowering your mortgage, or tax planning advice? There is no shortage of tax websites. Ones associated with universities are often more authoritative than ones which may be a cover for shonky businesses.

VIII AustLII, BAILII, WorldLII AND ALL THAT JAZZ

The Australasian Legal Information Institute (AustLII) commenced in 1995. In the past few years, AustLII personnel were instrumental in establishing the British and Irish Legal Information Institute (BAILII) and other websites such as the Hong Kong Legal Information Institute (HKLII); the Pacific Legal Information Institute (PacLII); the South African Legal Information Institute (SAFLII) and the World Legal Information Institute (WorldLII). The latter have been useful tools in providing links to many overseas web sites, many in English and many in the country's native language. One of the advantages of these is the one stop shopping environment. Here you can find a myriad of sources, without having to go to numerous websites.

These sites also allow you to search under subject or country. So you can find numerous world tax sites from one portal.

VIX SUBSCRIPTION DATABASES AND WEBSITES

There are many subscription databases and websites covering overseas tax materials. One of the problems I encounter in teaching legal research is the over reliance on Google search engine to find information. Google cannot search the contents of subscription websites. Likewise, many search engines cannot penetrate other websites. For example, if I was looking for my telephone number, assuming it is publicly listed, then if I put my name into Google, I won't find it. However, if I put my name in the electronic Australian White Pages <http://www.whitepages.com.au> I will find it.

Recently, in looking for the High Court of Australia judgment in *Commissioner of Taxation v Hart*¹⁴ on Google, I found references to the High Court of Australia transcript of the case, numerous commentaries on the case but could not find a reference to the High Court of Australia full text of the judgment!

X INTERNATIONAL TAX

International tax was in the past often perceived as the poor cousin to domestic taxation. This situation has changed with various government reports, discussion papers and commentaries on Australia and international tax.

One of the earliest commentaries on Australian international tax in book format was by E F Mannix titled *International Transactions and Australian Income Tax: Being a Commentary on Division 13 of the Income Tax Assessment Act 1936, Together with the Text of the Legislation*.¹⁵

¹⁴ *Commissioner of Taxation v Hart* (2004) 78 ALJR 875; (2004) 206 ALR 207; (2004) ATC 4599; (2004) 55 ATR 712; [2004] HCA 26.

¹⁵ E F Mannix, *International Transactions and Australian Income Tax: Being a Commentary on Division 13 of the Income Tax Assessment Act 1936, Together with the Text of the Legislation* (1982).

A major statement made by the Hon Paul Keating, as federal Treasurer, was delivered on 12 April 1989, titled *Taxation of Foreign Source Income: An Information Paper* and also formed part of the *Economic statement*, April 1989.

Commentaries, apart from the sections in the various loose-leaf and electronic services by Australian Tax Practice¹⁶ and CCH include:

R L Hamilton, R L Deutsch, and J Raneri, *Guidebook to Australian International Taxation*.¹⁷

L Burns, *Controlled Foreign Companies: Taxation of Foreign Source Income*.¹⁸

More recently, the Board of Taxation issued their *International Taxation: A Report to the Treasurer*.¹⁹ Volume 1 consisted of The Board of Taxation's recommendations and Volume 2 consisted of the *Board of Taxation Consultations with the Community – Summary of Submissions*.

On the horizon is Lee Burns's proposed book, *Australia in International Tax Law*.²⁰

A number of completed PhDs and SJDs focussed on international tax and or comparative tax law,²¹ such as:

Author, Title of thesis, Institution, Supervisor/s, date of completion. * indicates SJD

John Azzi, *The Role of CFC Legislation in Protecting Australia's Domestic Income Tax Base*, University of Sydney Faculty of Law, Prof Richard Vann and Lee Burns, 1995.*

Lindsay C Celestin, *Formulary Approach to the Taxation of Transnational Corporations: A Realistic Alternative?* University of Sydney Faculty of Law, Prof Richard Vann, 2000 http://setis.library.usyd.edu.au/adt/public_html/adt-NU/public/adt-NU20020917.133138

Hugh Compston, *The Electoral Impact of Tax: A Comparative Study of Sweden and Australia*, Australian National University, 1990.

¹⁶ M H Wachtel, and P Anderson, *International Tax Foreign Investment Funds* (1993). (A reprint of commentary included in Butterworths *Australian Tax Practice: Commentary*.)

¹⁷ 7th student ed, St Leonards, 2001. Also see their loose-leaf service, with the same title.

¹⁸ L Burns, *Controlled Foreign Companies: Taxation of Foreign Source Income* Melbourne, Longman Professional, 1992

¹⁹ Board of Taxation, *International Taxation: A Report to the Treasurer* Canberra, 2003.

²⁰ Lee Burns, forthcoming *Australia in International Tax Law* Amsterdam, International Bureau for Fiscal Documentation (expected 2006).

²¹ Extracted from 'Australian and New Zealand Tax and Related PhDs and SJDs Completed and in Progress', in *ATTA News* March 2004 <http://www.orange.usyd.edu.au/atta/newsletter.htm>

Peter Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems*, Cambridge University Faculty of Law, Prof John Tiley, 1995, IBFD Publications, 1996.

Murray H Hustler, *Tax Haven Use and Control: A Study of Tax Haven Use by Australian Public Companies and the Development of Controlled Foreign Company Legislation in Australia*, University of Sydney [1993?].

Elaine Lawrence, *Framework Investigations for Harmonizing Global Taxation of Internet Commerce*, Deakin University School of Computing and Mathematics of the Faculty of Science and Technology, 2000.

Treerat Nualnoi, *Tax Policy Reforms in Thailand: A Computable General Equilibrium Approach*, Australian National University, 1993.

Kibuta Ongwamuhana, *The Taxation of Income from Foreign Investments: A Tax Study of Some Developing Countries*, University of Adelaide, 1989; Deventer, Kluwer, 1991.

Nabil Orow, *General Anti-Avoidance Rules: A Comparative International Analysis*, University of New South Wales Faculty of Law, Prof Bob Deutsch and Sir Anthony Mason, 1999, London, Jordans, 2000.

Dale Pinto, *The Continued Application of Source-Based Taxation in an Electronic Commerce Environment*, University of Melbourne Faculty of Law, Prof Graham Cooper, 2002, *E-commerce and source-based income taxation*, IBFD Publications, 2003.

Samson Mamau Polome, *Export Instability, Investment Risks and Mineral Taxation in Papua New Guinea*, Australian National University, 1987.

This area of law is in a state of flux due to the recent introduction of the *New International Tax Arrangements Bill 2003* (Cth).²² This was foreshadowed in the federal budget 2003.

XI CIVIL LAW SOURCES

Australia, being a common law jurisdiction, has tended to use common law precedents in the development of its case law. However, because, as the famous saying goes, 'no man is an island',²³ Australia must consider developments occurring in various civil

²² *New International Tax Arrangements Bill 2003* (Cth). Introduced in the House of Representatives on 4 December 2003.

²³ John Donne, Meditation XVII, (1572-1631), from *Devotions Upon Emergent Occasions*.

'All mankind is of one author, and is one volume; when one man dies, one chapter is not torn out of the book, but translated into a better language; and every chapter must be so translated ... As therefore the bell that rings to a sermon, calls not upon the preacher only, but upon the congregation to come: so this bell calls us all: but how much more me, who am brought so near the door by this sickness. ... No man is an island, entire of itself ... any man's death diminishes me, because I am involved in mankind; and therefore never send to know for whom the bell tolls; it tolls for thee.'

law countries, in particular Europe. Back in 1993 Australia adopted the European Commission Directive on Product liability, which is embodied in Part VA of our *Trade Practices Act 1974* (Cth).

One of the legal journal indexes relevant to finding civil law taxation information is the *Index to Foreign Legal Periodicals*.²⁴ This has been going since 1964 and is available electronically. Fortunately it is in English, however, unfortunately some of the articles it indexes are not in English.

XII NETWORKING CONTACTS

Australian academics and the tax profession were for many years insular in their approach to networks. With the advent of cheaper airfares, this has meant many tax academics have had opportunities to spend study leave abroad or to attend overseas conferences. Overseas academics are also finding Australia an attractive place to spend time to either attend a conference,²⁵ or to do research.²⁶ There appear to be a number of Australian tax academics who both present at and attend the Tax Research Network Conference, held annually in the UK.

Sometimes, there are advertisements about professional conferences in, for example, Aspen, Colorado or the Greek islands. I recall a tax partner in a major law firm once revealed the Inland Revenue Service, in the United States, took a dim view of a professional conference held aboard a cruise ship, where it held that the prime purpose of the time aboard was not professional. Another time, I sat in on some sessions of the International Bar Association when it was last held in Sydney. I noticed some officious gentlemen who I later discovered were from the US Inland Revenue Service, ensuring US delegates were actually attending conference sessions, and not just admiring the sights of Sydney.

In the past, Atax has organised conferences whereby German delegates visited Sydney and Canberra then later Australian delegates visited Potsdam, Germany.²⁷ During 2003, the Fourth Annual Global Conference on Environmental Taxation: Experience and Potential, and the International Fiscal Association 57th Congress were both held in Sydney. In early 2004, the World Tax Conference was also held in Sydney.

Courtesy of <http://phrases.shu.ac.uk/meanings/257100.html>

²⁴ *Index to Foreign Legal Periodicals*, published by the Institute of Advanced Legal Studies, University of London, in co-operation with the American Association of Law Libraries, 1964.

²⁵ Note the biannual Tax Administration Conferences, which have been organised by Atax, University of New South Wales. The Environmental Taxation Conference, was held in May 2003, The International Fiscal Association Congress 2003 was held in Sydney, during August–September and the 4th World Tax Conference, 25–27 February 2004.

²⁶ The Australian Taxation Studies Program (Atax) has an annual fellowship awarded to visitors from overseas. Likewise San Jose University has an annual fellowship awarded to visitors from overseas as well.

²⁷ H G Petersen, and P Gallagher, (eds) *Tax and Transfer Reform in Australia and Germany*, Berlin, Berliner Debatte Wiss Verl, 2000 (Australia Centre Series Vol 3, University of Potsdam); *GST 2000: Australian law and European experience*, Coogee, NSW, ATAX, 2000.

There are numerous email discussion lists one could join and contribute to. I am a member of both a local Australian and New Zealand law librarians' discussion list and an international law librarians' discussion list. On the 23 December 2003, I posted the following query:

One of my colleagues is after the English translation of the following French tax case, Conseil d'Etat, Case SA Schneider Electric, which was decided I think in early 2001 and mid-2002. It dealt with controlled foreign corporations and double taxation agreements.

There is a series, *International Tax Reports*, which I do not have access to, which may have reprinted the case. I have found numerous commentaries on the case.

Just prior to Christmas 2003, I received a reply from a law librarian who generously provided an unofficial translation of the case.²⁸

During an ATTA conference, one of the speakers discussed taxation of foreign source income and, during the session, one of the delegates informed the speaker of a US source the speaker did not know about.²⁹

XIII LOCAL AND OVERSEAS COURSES

There is a myriad of courses Australians can attend either locally or overseas regarding comparative tax law and/or international tax law. Here is a sample of courses offered. This is by no means complete.

A Australian

Atax, the University of New South Wales Master of International Tax, from 2005. Prior to this, there are many international tax subjects available via the Master of Taxation. <http://www.atax.edu.au>

University of Melbourne, Faculty of Law, Graduate Diploma in International Tax; Master of International Tax
<http://graduate.unimelblaw.com.au/gradlaw2003.nsf/docs/4FU88W119?OpenDocument&ExpandView>

University of Sydney, Faculty of Law, Master of Taxation.

²⁸ The original French version of the case can be found at http://www.conseil-etat.fr/ce/jurispd/index_ac_ld0215.shtml

²⁹ Martin Feldstein, and Charles Horioka, 'Domestic Saving and International Capital Flows,' (1980) 90 (358) *Economic Journal* 314–29. There has been subsequent writing on this topic: <http://ideas.repec.org/p/wpa/wuwpit/9904001.html>.

B Overseas

Boston University Graduate Tax Program
<http://www.bu.edu/bulletins/gtax/item06.html>

Harvard University International Tax Program
<http://www.law.harvard.edu/programs/itp/core.html>

International Bureau of Fiscal Documentation.

International Tax Center, Leiden, LLM Program in International Taxation
http://www.itc-leiden.nl/center_courses.htm

New York University School of Law International Tax Program for Foreign Students
<http://www.law.nyu.edu/programs/tax/acprograms/intl>

Vienna University of Economics and Business Administration Postgraduate
International Tax Law <http://www.international-tax-law.at/welcome.shtml>

See also:

Comparative & foreign law guides

http://www.llrx.com/comparative_and_foreign_law.html

International tax sites <http://www.pinkernell.de/global.htm>

International Tax Law on the Web <http://www.lemaitre.de/english/index2.html>

International Tax Resources

<http://www.taxworld.org/OtherSites/International/international.htm>

United States Inland Revenue Service Department of the Treasury *Income Tax Treaties*
<http://www.irs.gov/businesses/corporations/article/0,,id=96739,00.html>

XIV EXAMINING THE CURRENT JOURNALS

Taking a sample of current journals, I decided to look at what foreign material was being cited in the current journals received by the Atax Library.

(2004) 19 (2) *Australian Tax Forum*. Cited primarily Australian materials with some reference to Singapore, UK, US and OECD materials.

(2004) 33 (2) *Australian Tax Review*. Branson, C 'The International Exchange of Information on Tax Matters and the Rights of Taxpayers', had 88 footnotes, of which 86 cited overseas materials. Morfuni, VA 'Legal Professional Privilege and the Government's Right to Access Information and Documents' cited a few UK cases, a Canadian case, a US and a UK legal textbook.

(2003) 6 (2) *Journal of Australian Taxation*. Some overseas materials cited and this particular issue featured mainly domestic topics.

(2003) 13 *Revenue Law Journal*. This issue cited overseas material mainly from the UK, US, Canada and the OECD.

(2004) 7 (5) *Tax Specialist*. Cited mainly Australian materials. Noticed one reference to OECD material.

(2004) 39 (2) *Taxation in Australia*. Cited mainly Australian materials.

From the above sample, it appears overseas materials tend to be cited and referred to in the tax academic journals rather than the practitioner oriented ones. Various OECD reports and drafts have cited many Australian provisions and cases such as the *Acts Interpretation Act 1901* (Cth) and *Thiel v Federal Commissioner of Taxation*.³⁰

XV CONCLUSION

This essay attempts to show the myriad of sources available to the researcher interested in overseas materials, which have been used in both Australian tax reform and in tax research. The generation prior to World War II concentrated on developments in the United Kingdom, whereas the post-war generation began to be open to developments in many countries.

Developments in the United States, Europe and elsewhere are likely to be places where tax reform will yield many useful ideas for consideration in our country. The challenge of finding these materials has been made much easier with the advent of the Internet, and the need to be constantly aware of recent developments.

³⁰ *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR 338 and available from http://www.austlii.edu.au/au/cases/cth/high_ct/171clr338

FURTHER READING

- S Chase, 'Navigating the Sea of EU Information' (1999) 7 *Australian Law Librarian* 162–74.
- J Chen, 'Use of Comparative Law by Courts: Australian Courts at the Crossroads', in U Drobnig, and S van Erp, (eds) *Use of Comparative Law by Courts* (Proceedings of the 14th International Congress of Comparative Law, Athens, 1997) The Hague, Kluwer Law International, 1999, 25–57.
- S Dorsett, and L Godden, *Guide to Overseas Precedents of Relevance to Native Title*, Canberra, Native Title Research Unit, Australian Institute of Aboriginal and Torres Strait Islander Studies, 1998.
- C Fong, 'Researching Comparative Corporate Taxation' (2002) 5 *Tax Specialist* 142–49.
- A M Gleeson, *Global Influences on the Australian Judiciary*, Australian Bar Association Conference, Paris, 8 July 2002. http://www.hcourt.gov.au/speeches/cj/cj_global.htm
- M Ibusuki, 'Possibility of Translated Legal Database for Asian Countries', in *Law via the Internet 2003*, 5th Conference on Computerisation of Law via the Internet, University of Technology, Sydney, 27 November 2003.
- R Lefler, 'A Comparison of Comparison: Use of Foreign Case Law as Persuasive Authority by the United States Supreme Court, the Supreme Court of Canada, and the High Court of Australia' (2001) 11 *Southern California Interdisciplinary Law Journal* 165–91.
- I Mayfield, 'EU Legal Information on the Internet' (1998) 29 *Law Librarian* 234–38; 'EU Legal Information on the Internet: An Update' (2000) 31 *Law Librarian* 14–17.
- R M Mersky, and J Pratter, 'Comparative Observations on Doing Legal Research in Australia and the United States' (1999) 7 *Australian Law Librarian* 175–81.
- R J Mooney, 'Hands Across the Water: The Continuing Convergence of American and Australian Contract Law' (2000) 23 *University of New South Wales Law Journal* 1–37.
- I Nemes, and G Coss, 'Ch 9: An International Perspective' *Effective Legal Research*, 2nd ed Sydney, Butterworths, 2001, 422–39.
- P Overy, *How to Research the EU: A Guide for Students*, Manchester, European Information Association, 2000 (EIA Quick Guide No 16).
- J Rehberg, and R D Popa, (eds) *Accidental Tourist on the New Frontier: An Introductory Guide to Global Legal Research*, Littleton, Co, Fred B Rothman & Co, 1998.
- M Roznovschi, *Guide to European Legal Databases*, Update 5
<http://www.llrx.com/features/europenew.htm>
- R Smyth, 'Judicial Robes or Academic Gowns?: Citation of Secondary Authority and Legal Method in the New Zealand Court of Appeal', in R Bigwood, (ed) *Legal Method in New Zealand: Essays and Commentaries*, Wellington, Butterworths, 2001, 101–25.
- A Sweeney, (Librarian, Webmaster, & Information Officer at the European Commission Delegation in DC) created a guide to the 'Best European Union Law Websites' at
<http://www.eurunion.org/infores/BestLawSites.HTM>
- P Von-Nessen, 'Use of American Precedents by the High Court of Australia 1901–1987' (1992) 14 *Adelaide Law Review* 181–218.
- R Watt, 'Ch 6: Finding the Law in New Zealand, Canada and India'; 'Ch 7: Finding the Law in the United States of America'; 'Ch 9: The Legal Materials of the European Union', *Concise Legal Research*, 5th ed, Leichhardt, NSW, Federation Press, 2004.

APPENDIX A

A List of Some Overseas Tax Texts, Loose-Leaf Services and Electronic Services

Canada

Canadian Master Tax Guide, Toronto, CCH Canadian Ltd, (annual).

D G Duff, *Canadian Income Tax Law*, Toronto, Edmond Montgomery, 2003. Published In Association with The Canadian Tax Foundation.

F B Gorman, *Canadian Income Taxation: Policy and Practice*, 2nd ed, Toronto, Carswell, 2001.

S Hanson, *Canada Tax Manual*, Scarborough, Ont, Carswell, 1990. (Loose-Leaf)

P W Hogg, J E Magee, and J Li, *Principles of Canadian Income Tax Law*, 4th ed, Scarborough, Ont, Carswell, 2002.

V Krishna, *Fundamentals of Canadian Income Tax*, 7th ed, Scarborough, Ont, Carswell, 2002.

R Pound, *Stikeman Income Tax Act Annotated*, 36th ed, Scarborough, Ont, Carswell, 2004.

D M Sherman, *Basic Tax Guide for Lawyers 2003–2004*, Scarborough, Ont, Carswell, 2003.

D M Sherman, *Practitioner's Income Tax Act*, 26th ed, Scarborough, Ont, Carswell, 2004 (semi-annual).

France

C J Mesnooh, *Law and Business in France: A Guide to French Commercial and Corporate Law*, Dordrecht ; Boston, M Nijhoff, 1994.

Germany

R Amann, et al *German Tax Guide*, Neuwied, Luchterhand, The Hague, Kluwer Law International, 2001.

Japan

Y Gomi, *Guide to Japanese Taxes*, 5th ed, North Ryde, NSW, CCH, 1992/93

International by arrangement with Zaikei Shôhō Sha, Tokyo, c1992

Ishi, H *The Japanese tax system*, 3rd ed, New York, Oxford University Press, 2001

New Zealand

G A Harris, *New Zealand's International Taxation*, Auckland, Oxford University Press, 1990.

New Zealand Master Tax Guide, CCH (annual)

G W Scully, and P J Caragata, (eds) *Taxation and the Limits of Government*, Boston, Kluwer Academic Publishers, c2000.

United Kingdom

P Baker, *Double Taxation Conventions and International Law*, 3rd ed, London, Sweet & Maxwell, 2001 (Loose-leaf).

British Master Tax Guide, Bicester, Oxfordshire, CCH Editions (annual).

G Morse, and D D Williams, *Principles of Tax Law*, 4th ed, London, Sweet & Maxwell, 2000.

Halsbury's Laws of England, 4th ed, Vol 23: 'Income Taxation', London, Butterworths, 1991.

J Schwarz, *Tax Treaties: UK Law and Practice*, London, Sweet & Maxwell, 2001.

J Tiley, *Revenue Law*, 4th ed, Oxford, Hart Publishing, 2000.

P Whiteman, et al *Whiteman on Income Tax*, 3rd ed, London, Sweet & Maxwell, 1989 with annual supplements.

United States

R E Andersen, *Foreign Tax Credits*, RIA.

P Briger, M Burge, and C H Lowell, *US International Transfer Pricing*, 2nd ed, Warren Gorham & Lamont.

D K Dolan, *US Taxation of International Mergers*, RIA.

J Governale, and C Lowell, *US International Taxation: Practice and Procedure*, RIA.

M J Graetz, *Foundations of International Income Taxation*, New York, Foundation Press, 2003.

International Tax Guide US Income Taxation, West Group (Loose-leaf).

International Tax Transactions, West Group (Loose-leaf).

International Transfer Pricing: OECD Guidelines, RIA (web updates).

J D Kuntz, and R J Peroni, *US International Taxation*, RIA, (Loose-leaf).

E Larkins, *International Applications of US Income Tax Law*, Hoboken, New Jersey, John Wiley & Sons, 2003.

M M Levey, *US Taxation of Foreign-Controlled Businesses*, RIA.

C Lowell, et al *US International Taxation: Agreements, Checklists and Commentary*, RIA.

2005 US Master Tax Guide, Chicago CCH, (annual).

Multi country

In addition to the master tax guides mentioned above, there are also master tax guides for Hong Kong, Singapore, China etc.

H J Ault, et al *Comparative Income Taxation: A Structural Analysis*, The Hague, Kluwer Law International, 1997.

Foreign Tax Law, Ormond Beach, Florida <http://www.foreignlaw.com> Full consolidated legal text of over 100 countries translated into English.

P A Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems*, Amsterdam, IBFD Publications BV, 1996.

T Ito, and A O Krueger, *The Political Economy of Tax Reform*, Chicago, University of Chicago Press, 1992.

K Messere, (ed) *The Tax System in Industrialized Countries*, Oxford; New York, Oxford University Press, 1998.

A A Tait, *Value-Added Tax: Administrative and Policy Issues*, Washington, DC, International Monetary Fund, 1991.

A A Tait, *Value Added Tax: International Practice and Problems*, Washington, DC, International Monetary Fund, 1988.

Tax Burdens: Alternative Measures, Paris, OECD, 2000.

Taxes and Investment in Asia and the Pacific, Amsterdam, International Bureau of Fiscal Documentation, 1978.

Victor Thuronyi, *Comparative Tax Law*, The Hague, Kluwer Law International, 2003.

Victor Thuronyi, (ed) *Tax law and Drafting*, Washington, DC, Vol 1, 1996, Vol 2, 1998.

Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paris, Organisation for Economic Co-Operation and Development, 2001.

K Van Raad, (ed) *Materials on International and EC Tax Law - Edition 2003-2004*, Leiden, International Tax Center, 2003. (Parts of the text in English and French.)

APPENDIX B

A List of Overseas Tax Journals Available Electronically in Full Text³¹

ABI Inform (Proquest)

There is some duplication with Accounting & Tax (Proquest)

AICPA Tax Division Newsletter

Assessment Journal

Australian Tax Review (1/3/91–1/12/96)

Computer Law and Tax Report

Consolidated Returns Tax Report (1/1/92–1/6/92)

CPA Client Tax Letter

Ernst & Young Washington Tax Reporter (1/11/92–1/11/94)

Executive Briefing/Coopers & Lybrand (1 Dec 1991–1 Dec 1992)

Fiscal Notes /the Comptroller of Public Accounts

Fiscal Studies

Internal Revenue Bulletin

International Tax Digest (1/11/92–1/10/97)

International Tax Journal

International Tax Report (1/9/91–1/11/97)

International Tax Review

Journal of Property Tax Management (Spring 1998–Spring 2001)

Journal of State Taxation

Journal of the American Taxation Association: [journal of the Tax Section of the American Accounting Association.](#)

[National Tax Journal](#)

Practical Tax Lawyer

Property Tax Journal (1/6/92–1/12/93)

Standard Federal Tax Reports: Taxes on Parade

State Tax Review

Tax Adviser

Tax Executive

Tax Foundation's Tax Features

Tax Management Compensation Planning Journal

Tax Management Estates, Gifts, and Trusts Journal

Tax Management Financial Planning Journal

Tax Management International Journal

Tax Management Memorandum

Tax Management Real Estate Journal

[Taxes](#)

Taxline

World Tax Report (1/9/97–1/7/98)

³¹ Parts of this were originally published in C Fong, 'Facing Some Certainties and Uncertainties in Life: Taxes and Corporations!' (2003) 18 (9) *Online Currents* 20–26.

Business Source Premier (Ebsco)

Proceedings of the Annual Conference on Taxation
Taxation for Accountants
Journal of Property Valuation & Taxation
Journal of Taxation
International Tax Journal
Journal of International Accounting Auditing & Taxation
Journal of Corporate Taxation
Tax Executive
Corporate Business Taxation Monthly
Journal of State Taxation
Journal of the American Taxation Association
National Tax Journal
International Tax Review
Tax Adviser
Controller's Tax Letter
Internet Tax Advisor
NBER/Tax Policy and the Economy
Assessment Journal
Journal of Economic Literature
Journal of Economic Perspectives
Journal of Finance
Journal of Financial Planning

Emerald

Corporate Governance: the International Journal for Effective Board Performance
Managerial Law

Expanded Academic Index ASAP

Berkeley Journal of International Law (formerly *International Tax & Business Lawyer*)
National Tax Journal
Tax Executive

Hein Online

American Journal of Tax Policy
Florida Tax Review
Tax Law Review

Lexis

Most of these relate to US taxation. The following are available via the different libraries. If uncertain type in journal by searching Find a Source.

Tax journals selected from the various academic law reviews:

Akron Tax Journal
American Journal of Tax Policy
Estate Law Review
New York University Tax Review
NYU Annual Institute on Federal Taxation
Quinnipiac Probate Law Review
Tax Law Review
University of Florida Tax Review
Virginia Tax Review

American Bar Association

Practical Tax Lawyer
Tax Lawyer

Aspen Publishers

Journal of Property Tax Management
Journal of State Taxation

BNA (Bureau of National Affairs)

BNA Daily Tax Report
BNA Daily Tax News and Development Update
BNA Tax Management Compensation Planning Journal
BNA Tax Management Estates, Gifts and Trust Journal
BNA Tax Management Financial Planning Journal
BNA Tax Management International Journal
BNA Tax Memorandum
BNA Tax Management Multistate Tax Report
BNA Tax Management Real Estate Journal
BNA Tax Management Transfer Pricing Report
BNA Tax Management Weekly Report
BNA Tax Management Weekly State Tax Report

Tax Analysts:

E-Commerce Tax eReport
Estate Tax eReport
Estate Tax Report
Exempt Organization Tax Review Magazine
Insurance Tax Review Magazine
Letter Ruling Review Magazine
State Tax Notes Magazine
State Tax Today
Tax Notes International
Tax Notes Today
Tax Notes Weekly
Tax Practice and Controversies
Worldwide Tax Daily

Miscellaneous:

Canadian Current Tax
Journal of Property Tax Management
Journal of Taxation of Financial Institutions (Delta Hedge Publications)
Journal of Taxation of Investments (Delta Hedge Publications)
Practical Tax Strategies
Tax Adviser

Accounting & Tax (Proquest)

Although this database lists these as having full text, some of them may not have much full text, for example, *Canadian Tax Journal*.

Canadian Tax Journal
Corporate Business Taxation Monthly
Corporate Taxation
Internet Tax Advisor
Journal of New York Taxation
Journal of Property Valuation and Taxation
Journal of Taxation of Financial Institutions
Journal of Taxation of S Corporations
Taxation for Exempts
Taxation for Lawyers
Taxline
United States. Internal Revenue Bulletin

LegalTrac
National Tax Journal
Tax Adviser
Tax Executive

ScienceDirect

Journal of International Accounting, Auditing & Taxation

Westlaw

Akron Tax Journal

American Journal of Tax Policy

Australian Tax Review

BNA's International Tax Monitor

Federal Bar Association Section of Taxation Reports

Florida Tax Review

Houston Business and Tax Law Journal

International Tax Journal

International Tax Review

Journal of Corporate Taxation

Journal of International Taxation

Journal of Multistate Taxation

Journal of Partnership Taxation

Journal of Real Estate Taxation

Journal of Taxation

Journal of Taxation of Employee Benefits

Journal of Taxation of Exempt Organizations

Practical Tax Lawyer

Practical Tax Strategies

Tax Law Review

Tax Lawyer

Tax Management Compensation Planning Journal

Tax Management Estates, Gifts, and Trusts Journal

Tax Management Financial Planning Journal

Tax Management International Journal

Tax Management Memorandum

Tax Management Real Estate Journal

Tax Management Transfer Pricing Report

Tax Management Weekly Report

Tax Management's Weekly State Tax Report

Taxation for Accountants

Virginia Tax Review

Acknowledgement: To Victor Barajas, internee from Mexico City, with Atax during early 2004 for making some suggestions.

REMINISCING THE TAXATION PRIORITIES IN INSOLVENCY

CHRISTOPHER F SYMES

Christopher F Symes is a Senior Lecturer in Corporate Law, Flinders University, Adelaide.

I INTRODUCTION

Corporate insolvency law provides different methods for assisting creditors who deserve some priority or special treatment. In an insolvent winding up of a company, not all debt is going to be met from the realisation of the company's assets and the common law and, since the late 1900s, statute has chosen some creditors to be legitimately favoured for payment by the liquidator. Employees' wages and liquidation expenses are the most obvious areas expressly identified by statute although both the tax due by the company and tax deductions withheld by the company also have been 'favoured' by past legislators for special treatment.

In 2005, the special treatment of employees' wages and tax debts and deductions upon insolvency varies greatly from that of the past. Today, we have a Commonwealth administrative scheme that attempts to contribute to unpaid wages and other employee entitlements. Such treatment occurs while there remains a statutory priority for employee wages and entitlements in the Commonwealth *Corporations Act*. In tax law, we have ensured that company directors make payments of tax debts to avoid personal liability, and have given the taxing authorities powers to estimate taxes in an attempt, inter alia, to reduce unpaid taxes should insolvency occur.

The statutory priority of the Commonwealth to receive a priority payment in corporate insolvencies was abolished from 1 November 1979,¹ apart from tax instalment deductions and withholding tax.² These amounts were still a priority until 1 June 1993. Earlier the Crown's right to priority in bankruptcy was removed from 4 March 1968.³

This paper reminisces about the special treatment tax received when insolvency of the corporate taxpayer occurred, and concludes that Australian legislators acted with foresight in the 'early' removal of the tax priority. The United Kingdom has recently followed the Australian example, a decade later.

¹ Act No 134 of 1980.

² Sections 221 YU and 221P of the *Income Tax Assessment Act 1936* (Cth).

³ Act No 50 of 1966.

II A HISTORY OF PRIORITY

The first *Companies Act* in England in 1862 did not expressly mention the Crown (and by implication taxes) as being entitled to any special distribution upon the insolvency of the company. However, *Re Henley & Co*⁴ in 1878 provides the first authority that the Crown is entitled to be paid out of assets in priority to all other creditors.⁵ By 1923, in the UK, the Crown's priority in the winding up of a company was taken away except in certain circumstances.⁶

1 *Australian Colonial Times*

Australian corporate legislation dates back to colonial times, and priorities for employees' wages upon insolvency are found in such statutes as those from 1860.⁷ However, the priorities section in these early statutes remains silent on such matters as tax debts.⁸ For example, the 1892 *Companies Act* in the SA colony provided in s151 for employees' wages of up to 25 pounds to have priority upon insolvency but no mention is made of tax debts. The Crown was not bound by this Act.⁹ Despite this, a number of cases held that 'the prerogative of the Crown to require payment of debts owing to it in priority to the claims of creditors in equal degree is not taken away'.¹⁰

As with other insolvency priorities granted by statute, the history of such Australian treatment is rooted in English statutes. The *Preferential Payments in Bankruptcy Act* (UK) 1888 provided in s 1 that:

in the distribution of the property of a bankrupt, and in the distribution of the assets of any company being wound-up under the *Companies Act*, 1862, and the Acts amending the same, there shall be paid in priority to all other debts (a) All parochial or other local rates due from the bankrupt or the company at the date of the receiving order, or as the case may be, the commencement of the winding-up, and having become due and payable within twelve months next before that time, and all assessed taxes, land tax, property and income tax assessed on the bankrupt or the company up to the 5th day of April next before the date of the receiving order, or as the case may be, the commencement of the winding-up, and not exceeding in the whole one year's assessment.

Priority for taxes, therefore, was given the highest ranking and there was a cap of one year's assessment. In *re HJ Webb & Co*,¹¹ it was held that since the passing of the 1888

⁴ *Re Henley & Co* (1878) 9 Ch D 469.

⁵ Other cases supporting this include *Re Bonham Ex parte Postmaster General* (1879) 10 Ch D 595; *Re Oriental Bank Corporation* (1884) 28 Ch D 643; *West London Commercial Bank* (1888) 38 Ch D 364; *Exchange Bank of Canada v Reg* (1886) 11 App Cas. 157.

⁶ Murray CJ in *Re Millingen's Limited* (1934) SASR 72, 82 distinguishing the case of *Food Controller v Cork* (1923) AC 647.

⁷ *Insolvent Act 1860* (SA).

⁸ *Insolvent Act 1860* (SA), s 145.

⁹ *Re Commonwealth Agricultural Service Engineers Ltd* (1928) SASR 342.

¹⁰ *Re Millingen's Limited* (1934) SASR 72, 82 (Murray CJ).

¹¹ *Re HJ Webb & Co* (1922) 2 Ch D 369.

Act, the authority for Crown priority (*re Henley*) ceased to be directly applicable. The Crown's right to a priority was abrogated by the *Companies (Consolidation) Act* (UK) 1908.

Australian Colonial laws for taxation were introduced gradually during the 18th century. In SA, the colonial founders touted that it would be a place of 'few or no taxes to pay'.¹² For a while, this was the case as government expenditure was met from the land funds, yet the colony became the first to introduce income tax, land tax and probate and succession duties in 1876. The first comprehensive income tax in Australia was levied under the *Taxation Act 1884* (SA). Other colonies followed suit in the 1890s¹³ and, while companies were contemplated as taxpayers (for example, in the Tasmanian Act of 1894 ten pence in the pound was levied on the incomes of companies), their insolvency and the resultant failure to pay taxes was not a feature of this colonial legislation.

2 *Post Federation Times: Companies Act 1934–35 (SA)*

A number of States around 1930 drafted new companies legislation (NSW in 1936, Vic in 1928, Qld in 1931) and included, for the first time, a priority for tax. Section 279 (1) of the *Companies Act 1934–35* (SA) provided that subject to some subrogation issues: in a winding-up there shall be paid in priority to all other debts after costs, liquidator's remuneration, and expenses of or incurred in the winding-up ... [employees priorities then] ... (d) all assessed land tax and income tax assessed prior to the relevant date and having become due and payable within the preceding twelve month, but not exceeding in the whole one year's assessment.

There were possible two reasons for the inclusion of a tax priority. Firstly, the legislative changes were following recent UK companies' legislation changes with the imperial legislation expressly mentioning tax debts in its list of priorities.¹⁴ Secondly, Federation had given the Commonwealth a general power of taxation and the *Income Tax Assessment Act* of 1915 had been enacted to provide additional revenue for Australian involvement in World War 1¹⁵ and, with companies being a popular choice of business structure, they became a substantial proportion of taxpayers.

3 *From 1961–90*

In the early 1960s, the states agreed to attempt greater uniformity of corporate legislation. Section 292 of the *Uniform Companies Act 1961*, known in SA as *Companies Act, 1962–74* (SA), gave priority to taxes. The section read:

¹² P A Howell, 'Constitutional and Political Development 1857- 1890' in *The Flinders History of South Australia, Political History* ed D Jaensch (Wakefield Press, 1986, Adelaide) 172.

¹³ I Vanden Driesen, and R Fayle, 'History of Income Tax in Australia' in *Australian Taxation: Principles and Practice*, ed R Krever, (Longman Professional, 1987) 28.

¹⁴ Other jurisdictions such as Malaysia followed the UK companies legislation and still have an expressed priority for tax.

¹⁵ G Lehmann, and C Coleman, *Taxation Law in Australia* 2nd ed (Butterworths, Sydney, 1991) 7.

292. (1) subject to the provisions of this Act, in a winding up there shall be paid in priority to all other unsecured debts ... (e) fifthly, the amount of all municipal or other local rates due from the company at the relevant date and having become due and payable within the twelve months next preceding that date, the amount of all land tax and income tax assessed under any Act or Act of the Commonwealth before the relevant date and not exceeding in the whole one year's assessment ...

Later, s 441 of the Companies Code, which was the main Commonwealth–State cooperative corporate legislation operating in Australia between 1981–90 provided for tax priority payments. The section read as follows:

Section 441 Priority Payments

Subject to the following provisions of this Subdivision, in the winding up of a company the following debts shall be paid in priority to all other debts: ... (h) eighth –

- (i) all amounts of rates, being rates that are, or are in the nature of, municipal or other local rates (other than rates imposed by an Act of the Commonwealth or a law of the Australian Capital Territory) that were due and payable at the relevant date and the liability for which accrued within the 12 months that next preceded that date;
- (ii) all amounts of income tax that were assessed under any Act or Act of any other State or law of a Territory other than the Australian Capital Territory before the relevant date, not exceeding in the whole one year's assessment;
- (iii) all amounts of land tax that were assessed under any Act or Act of any other State or law of a Territory other than the Australian Capital Territory before the relevant date, not exceeding in the whole one year's assessment;
- (iv) all amounts of pay-roll tax (other than pay-roll tax imposed by an Act of the Commonwealth) that were due and payable at the relevant date ...

The *Income Tax Assessment Act 1936* (Cth) provided an order of priority for tax due in the winding up of a company and referred to the order of priority in the *Bankruptcy Act 1966* (Cth) but not company legislation because it was state based. Hence, the need for the abovementioned company legislation provisions. In s 221 of the *Income Tax Assessment Act 1936* (Cth), which is the section that dealt with tax due (not to PAYE deductions or withholding tax deductions), the Commonwealth accepted payment after the costs of the winding up and employees' wages. A different arrangement existed in s 221P and 221YU which dealt with PAYE deductions not yet paid to the Commissioner and withholding tax deductions not yet paid to the Commissioner. In those sections, the priority is expressed as an absolute one, over all other debts.¹⁶

The *Crown Debts (Priority) Act 1981* came into operation in July 1982 and this short act provided that the Crown, in right of the Commonwealth, would be subject to State and Territory laws with respect to priority. Section 3 provided that

¹⁶ H Mason, and J S O'Hair, *Australian Company Law* (2nd ed McGraw Hill, Sydney, 1973) 351.

notwithstanding any prerogative right or privilege of the Crown in right of the Commonwealth, the Crown in right of the Commonwealth is subject to any provision of a law of a State or Territory- (a) relating to the order in which debts or liabilities of a body (whether corporate or unincorporate) are to be paid or discharged; (b) relating to the avoidance of preferences received by creditors of a body (whether corporate or unincorporate) ...

Section 4 excused sections 221P, 221YHJ or 221YU of the *Income Tax Assessment Act 1936* (Cth) from the operation of this Act and the Companies legislation.

III LAW REFORM COMMISSIONS

The Australian Law Reform Commission conducted a most extensive inquiry into insolvency in 1987–88 and this culminated in the Harmer Report. The Report recommended the removal of the tax priority¹⁷ and the main arguments in favour of the removal were:

- That the ATO may allow taxation debts to accumulate without prejudicing its position and this may disadvantage other unsecured creditors who may not know that the group tax is owed.
- That the ATO had no incentive to recover payment in the normal commercial manner.
- These taxation debts are relatively insignificant from the point of view of total government receipts but may be critical to a particular creditor.
- The abolition would not be significant in terms of total revenue.
- The ATO should obtain no greater priority than any other person claiming in respect of debts misappropriated by an agent (the agent is the insolvent company).
- There would be a reduction in litigation.¹⁸

Public policy issues suggest that there is a clear public interest in ensuring that taxes are collected in an efficient manner and that the government revenue is not jeopardised. Balanced with this is the strong community view, according to the Harmer Report, that the ATO's priority should be abolished and so the Harmer Report recommended this course of action.

There had been no priority for unpaid income tax since 1980, when the *Crown Debts (Priority) Act 1981* (Cth) abolished it as a priority debt. Notwithstanding that, until 1993, the Commonwealth did retain some priority in relation to some tax liability.¹⁹ Eventually, the federal government took up the recommendation and Parliament enacted the *Insolvency (Tax Priorities) Legislation Amendment Act 1993*.

¹⁷ An earlier report in 1978 by the Senate Standing Committee on Constitutional and Legal Affairs had recommended the total abolition of all Crown priority, *Priority of Crown Debts*. (Known as the Missen Report.)

¹⁸ ALRC General Insolvency Inquiry Report No 45 (the 'Harmer Report') para 738–41.

¹⁹ Keay McPherson, *The Law of Company Liquidation* (4th ed, 1999, LBC, Sydney) 604 where he is referring to s 221P of ITAA.

IV THE INFAMOUS SECTION 221P²⁰

Section 221P of the *Income Tax Assessment Act 1936* (Cth) provided that:

Where an employer makes a deduction for the purposes of this Division ... from the salary or wages paid to an employee and refuses or fails to deal with the amount so deducted in the manner required by this Division ... he shall be liable, and where his property has become vested in, or where the control of his property has passed to a trustee the trustee shall be liable to pay the amount to the Commissioner.

The court in *Commissioner of Taxation v Barnes*²¹ established that s 221P applies whether the defaulting employer either remains in control of the whole of his property or the whole of that property has vested in or passed under the control of a 'trustee' including a receiver.

Then, in *Smith & Judge v Deputy Commissioner of Taxation*,²² Brinsden J in the Western Australian Supreme Court held that a secured creditor could not avoid the section by simply electing not to appoint a receiver and allowing a liquidator to administer in insolvency. In such cases, the liquidator having the necessary control pursuant to his or her appointment, takes subject to the Commissioner's priority.

Sutherland and Lee, writing in 1985, suggested that the principles by which s 221P applied had not been easy and that the position at that time was 'far from settled as secured creditors devise new techniques in an attempt to avoid the Commissioner's priority'.²³ Most of the litigation arose from the interpretation of the phrase 'control' of the company's property. *Barnes's Case* held that 'control' must be over all the company's property, subject to any assets specifically charged, otherwise control does not pass to the trustee.²⁴

Section 221P was said to have few friends and many critics.²⁵ Menzies J in *Commissioner of Taxation v Card* said the section was 'an incredibly ill-drawn section';²⁶ Brinsden J in the *Smith & Judge Case* said the extent of the operation of the section remained 'a matter of considerable uncertainty and the section clearly calls for

²⁰ A number of helpful articles tried to explain the intricacies of s 221P: C Y Coleman, 'The Commissioner of Taxation's Advantage Over Other Creditors on Insolvency', paper presented to ALTA 46th annual Conference, 12 July 1991, UWA; C Coleman, 'The Commissioner's Advantage' (1992) 26/6 *Taxation In Australia* 318; G Sutherland, and B Lee, 'Secured Creditors v Federal Commissioner of Taxation Priorities under s.221P of the Income Tax Assessment Act' (1985) 17/5 *Commercial Law Association Newsletter* 87; D T Brealey, 'Section 221P of the Income Tax Assessment Act; A Garrotte for the Secured Creditor?', (1987) 5 *Companies and Securities Law Journal* 12.

²¹ *Commissioner of Taxation v Barnes* (1975) 133 CLR 483.

²² *Smith & Judge v Deputy Commissioner of Taxation* 78 ATC 4561.

²³ G Sutherland, and B Lee, 'Secured Creditors v Federal Commissioner of Taxation Priorities under s.221P of the Income Tax Assessment Act' (1985) 17/5 *Commercial Law Association Newsletter* 87, 90.

²⁴ *Commissioner of Taxation v Barnes* (1975) 133 CLR 483, 499; and above n 23.

²⁵ Above n 23, 91.

²⁶ *Commissioner of Taxation v Card* (1963) 109 CLR 177, 194.

amendment'.²⁷ Gibbs J in *Barnes* said the section 'presents considerable difficulties of construction'.²⁸

The effect of s 221P was to make the liquidator liable to pay out of the property that passes under his or her control the amount of any tax deductions from the salary or wages of an employee to the Commissioner of Taxation. These were amounts that had not been made in the statutorily prescribed manner by the company. Section 221P (2) made this amount payable in priority to all other debt, whether preferential, secured or unsecured, but this was qualified by s 221P (3) to the extent of permitting prior payment of the costs and expenses of winding up where these were payable in priority to all other debts in the winding up. Since, by virtue of s 556 (1)(a) of the Corporations Law (now the *Corporations Act*), the expenses of winding up are payable as a priority, it followed that the effect of s 221P (3) was to relegate any amount due under s 221P to the status of second priority in winding up. However, such a high priority meant that, in most estates, the Commissioner received what was owed or, if not, at least more than any other creditors.

As a trade off for abolishing any priority, a regime for dealing with unremitted group tax deductions was introduced in 1993 at the time of the abolition of the priority and it is contained in Div 8 of the *Income Tax Assessment Act 1936* (Cth). The Division empowers the Commissioner of Taxation to begin recovery proceedings much sooner than was permitted previously. Division 9 of the *Income Tax Assessment Act 1936* (Cth) applies specifically to companies and has the potential of imposing penalties on company directors. As a consequence of the operation of ss 222AOB and 222APB, duties are imposed on directors to cause their company either to comply with payment obligations, enter into a payment agreement, appoint an administrator under Pt 5.3A of the *Corporations Act* or initiate the winding up process.

V THE LEGISLATORS' VIEWPOINTS ON TAX PRIORITIES IN INSOLVENCY

It is helpful, in light of what has transpired since 1993, to review the parliamentary debates that preceded the removal of tax priorities.

In 1993, Senator McMullan introduced the Insolvency (Tax Priorities) Legislation Amendment Bill to the Senate. In his second reading speech, he said the new legislation was abolishing the existing priority of the Commissioner of Taxation for debts in relation to certain unremitted amounts. The changes meant that the Commissioner would be able to recover the unremitted amounts more quickly through an estimation process and it would encourage company directors to face emerging problems as soon as possible.

The 1993 legislation would treat debts due to the Commissioner arising because of a failure to remit amounts deducted in a similar manner to debts payable to other unsecured creditors.

²⁷ *Smith & Judge v Deputy Commissioner of Taxation* 78 ATC 4561, 4565.

²⁸ *Commissioner of Taxation v Barnes* (1975) 133 CLR 483, 498.

Senator McMullan remarked that the removal of the Commissioner's priority was essential to the smooth operation of the scheme of voluntary administration introduced under new insolvency provisions of the Corporations Law in June 1993. He added that 'any loss of revenue from abolishing the priority will be offset by the revenue recovered under the new recovery regime'. And he went on to point out to the Senate that 'the revenue recovered belongs to employees or payees and has been deducted but not remitted to the Commissioner as required by law'.²⁹

Senator Watson, during debate in the Senate, suggested that there were three limbs to this Bill.³⁰ Firstly, it sought to ensure that employees' entitlements and the rights of unsecured creditors, which might otherwise have been lost, are protected. He observed such

is a good measure. This is a change that is sustainable for the pragmatic reason that the Consolidated Revenue is better able to sustain a reduction of the proceeds from an insolvency administration than employees or unsecured creditors might be. The pain caused to employees who have been left with nothing after the collapse of their employer and to unsecured creditors who have had to write off huge losses because of the failure of a major debtor should not be underestimated.³¹ Unfortunately though, we now know that this was not the effect. The media reports during 1999 and 2000, of the failure in the system to meet employee entitlements, demonstrated that the changes of 1993 did not alleviate the 'pain'.³²

Senator Watson's second limb was that the abolition of the priority would remove 'what may have been a cause of the new voluntary administration scheme falling into a heap almost immediately upon its introduction'.³³

Perhaps this contributed to the success of the voluntary administration scheme. The priority's abolition or its maintenance has not been the subject of research into the voluntary administration success but practitioners and academics acknowledge the scheme as a success.³⁴

Senator Watson's third limb was that the legislation will provide by way of a new estimates procedure a more effective way of collecting unremitted amounts held by entities on behalf of the Commissioner as unpaid tax collectors. It would also provide 'a means to force company directors to confront insolvency problems before being tempted to use deducted amounts as emergency working capital'.³⁵ Again, the more recent reported experience of employees missing out on entitlements suggests that

²⁹ Hansard, Australian Senate, Wednesday 19 May 1993, 879–80.

³⁰ Hansard, Australian Senate, Wednesday 26 May 1993, 1296.

³¹ Ibid.

³² For example, the losses of entitlements for employees at Cobar Mines, National Textiles and later the Ansett failure.

³³ Hansard, Australian Senate, Wednesday 26 May 1993, 1296.

³⁴ For example, Philip Crutchfield in the foreword to *Crutchfield's Corporate Voluntary Administration* (3rd ed, 2003) expresses the view that the 'perceived' success has been noted by UK legislators.

³⁵ Hansard, Australian Senate, Wednesday 26 May 1993, 1296.

unscrupulous directors continued to use employee entitlements as ‘emergency working capital’.³⁶

The Australian Democrats, through their leader, Senator Kernot, supported the new legislation. During the debate, Senator Kernot observed that the new legislation was ‘designed to protect the revenue’.³⁷ She said that ‘the reason for the abolition is probably industrial in nature. We are aware that last year there were some vigorous complaints from various unions about the unfair nature of the priority’. She went on to cite the building and textile industry as major instances where workers do not get paid. In light of this, she said that the legislative measure was ‘fair to employees and other creditors’.³⁸

Senator Kernot showed clarity in her understanding of what the legislation was attempting to achieve. In supporting the move to make directors remit the amounts of tax to the tax office, she observed ‘the principle here is quite simple. At no time is the tax ever the property of the directors; it is the income of the worker and it is claimed by the government as a prepayment of an employee’s tax liability for the year. If the directors do not fulfil the duty to remit the money to the Tax Office, basically they are committing theft’.³⁹ These may seem strong words, suggesting that the company and its directors are thieves, yet in 2000 legislation was passed making some director behaviour relating to deprivation of employee entitlements subject to criminal consequences.⁴⁰

In the House of Representatives, Mr Rocher, (the member of Curtin), explained the need for new legislation:

as the situation now stands these arrangements can cause considerable hardship for employees as a result of an insolvency because the ATO’s priority means that there is little or nothing left for employees and other creditors following the payment of these outstanding taxes.⁴¹

Mr Rocher concentrated on the position that the ATO would be in after the legislation stating that ‘[t]his will put the Tax Office on an equal footing with other creditors, as might be expected’.⁴²

Mr Rocher was prepared to support the legislation because one of the many problems he saw with the existing arrangements was that the size of the debts owed to the Tax Office was allowed to grow to ridiculous proportions. He suggested this was because the Tax Office was so slow to recoup the money that was owed by the insolvent entity. Under the existing legislation, the ATO had no incentive to take quick and decisive action in these cases because its priority under the existing arrangements guaranteed

³⁶ Behaviour that has been hard to prove; and failures like Oakdale Mines and National Textiles had satisfactory resolutions to their much publicised collapses.

³⁷ Hansard, Australian Senate, Wednesday 26 May 1993, 1297.

³⁸ Ibid.

³⁹ Hansard, Australian Senate, Wednesday 26 May 1993, 1298.

⁴⁰ *Corporations Law Amendment (Employee Entitlements) Act 2000*.

⁴¹ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1125.

⁴² Hansard, Australian House of Representatives, Thursday 27 May 1993, 1126.

that it would get its money regardless of the consequences this might have for other creditors and, most importantly, employees.⁴³

Mr Swan (Lilley) stated that, in his opinion, 'it is simply a false economy to put the Commissioner of Taxation ahead of employees and other small businesses in terms of insolvency'. He saw the insolvent company as being given two choices: to enter a voluntary administration or a wind up voluntarily. Either way, it means 'that the company does not continue ... to accumulate huge debts to the Taxation Office, thereby prolonging and creating an even bigger problem for itself and for its employees.'⁴⁴

Mr Rocher provides justification for the change to the legislation because while the unpaid funds which are the subject of this Bill are not assets of the company, there is always the temptation for companies to make use of deductions on behalf of employees as emergency working capital which can be ultimately disastrous for the employees.⁴⁵

Later, he spoke of these provisions in the new legislation as 'intended to prevent the use of PAYE money being used as emergency working capital'.⁴⁶ It could be observed that employee entitlements continue to be used as 'emergency working capital' and, so, the removal of the tax priority merely diminished the amounts available to the companies engaging in this practice.

Mr Bevis (Brisbane) noted that

regrettably, employers faced with a liquidity problem have in some cases found the need or the desire to hold onto that money and not remit it to the Tax Office. Equally regrettably, it would appear that for some time the Tax Office has not been particularly efficient in its perusal, policing and collection of that money...

He concluded that

employers who decide to solve their short-term liquidity problems by dipping into the employees' pocket, which is effectively what they do when they hold onto that group tax, should face the force of the law. It is not their money, never was, never will be and should not be held by them on behalf of the employees out of the employees' income. It should be seen fairly and squarely in that light.⁴⁷

He finished his contribution to the debate by acknowledging that they are employees' wages. Employers should never have used them for any purpose other than payment of tax. Those employers who did that were not only breaking the law but also breaking the confidence and trust that their employees had in them on those occasions where it has occurred.'⁴⁸

⁴³ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1127.

⁴⁴ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1131.

⁴⁵ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1127.

⁴⁶ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1128.

⁴⁷ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1134.

⁴⁸ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1135.

Mr Rocher (Curtin) also saw the crucial benefit for the voluntary administration of the change to the legislation. He thought that
creditors will not agree to the use of this (voluntary administration) procedure if the only or principal beneficiary for such an arrangement is the Australian Taxation Office because of its priority under existing arrangements. Clearly the ATO needs to be put on an equal footing with other creditors to permit some entities to trade out of difficulty and do so effectively.⁴⁹

He summarised that the new legislation would afford employees a greater measure of protection than was available under the current arrangements. Clearly, this was not enough protection, given the developments in the late 1990s and the subsequent need to change the Corporations Law to add directors' duty to prevent misuse of employees in insolvency⁵⁰ and the Employee Entitlements Support Scheme fund that was set up in 2000.

Mr Swan (Lilley) was convinced that employees 'will have much improved prospects of being paid their outstanding wages. For that reason alone it is an historic reform ... [it] gives workers and others a better go.'⁵¹ Yet, in hindsight, it was not much 'better' than the situation described in parliament and the media at the end of the 1990s.

Mr Bevis (Brisbane) claimed that:

in the past it has been a sad fact that, with the priority claim the Commissioner of Taxation has on those moneys, those employees left without a job and little resources to support themselves found themselves unable to get their wages, long service leave and other entitlements to which they were due.⁵²

Arguably, this situation did not change until 2000 with the implementation of the Employee Entitlements Support Scheme (EESS).

Mr Cadman (Mitchell) spoke of the prime objective of the legislation: that of getting the Commissioner of Taxation 'in the queue with other creditors when a bankruptcy occurs'.⁵³ He bemoaned that the
Commissioner of Taxation ... has got into the queue ahead of those with claims for the first payment of wages and salaries. In that way workers' rights have been denied, as have the rights of a whole range of people—whether they be suppliers, people leasing property, landlords or others—who come together when there is difficulty in the company...⁵⁴

Mr Williams (Tangney), representing the Liberal opposition, conceded that the 'taxation debts of insolvents are insignificant in terms of total government receipts'.⁵⁵

⁴⁹ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1127.

⁵⁰ *Corporations Law Amendment (Employee Entitlements) Act 2000* (Cth).

⁵¹ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1130.

⁵² Hansard, Australian House of Representatives, Thursday 27 May 1993, 1134.

⁵³ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1136.

⁵⁴ *Ibid.*

⁵⁵ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1132.

He even conceded that 'the amount foregone by a private creditor may be the difference between the creditor surviving or failing.'⁵⁶

Mr Swan (Lilley) suggested that

it is pretty hard to find many people who have a bad word to say about [the removal of the legislation]. Let us say goodbye and good riddance to the old legislation and welcome the new legislation as a very substantial reforming achievement.⁵⁷

In summary, the concerns during 1993 were the slow debt recovery by the ATO, the wish to make corporate rescue legislation work and to assist employees to be paid wages and other entitlements owing from failed corporate employers. So, with the benefit of hindsight, the corporate rescue legislation has been a tremendous success but it would not be possible to attribute this to the removal of the tax priority. The assistance that the removal provided for employees was probably minimal. Since 2000, the government has needed to introduce two administrative schemes (EESS and GEERS⁵⁸) to pay employee entitlements. This suggests that it was a major problem seven years after the removal of essentially all tax priorities. Whether debt recovery by the ATO has been speeded up by removing the tax priority is debatable, and hard to ascertain from available public records.

VI UNITED KINGDOM REMOVAL OF THE TAX PRIORITY IN 2003

In the United Kingdom, revenue authorities used bankruptcy law as a form of debt collection for unpaid taxes. The government used the bankruptcy laws to both collect back taxes, and so that they could seize assets ahead of small creditors at the bottom of the priority list. Carruthers and Halliday suggest it was somewhat to the government's surprise that it discovered how unfair most other players judged the taxman's special advantages.⁵⁹

In 1982, the Cork Committee⁶⁰ began with the presumption that all preferences (priorities) should be abolished. Preferences worked against principles of equity and harmed the weakest creditors and preferences diverted resources from reorganisations.

Carruthers and Halliday⁶¹ express it this way:

taxes are equivalent to the property rights of the state. ... the mechanisms of fiscal extraction ... become critically important in the capacity of the state to carry out one of its most basic functions. Its capacity to capture lost or delayed

⁵⁶ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1134.

⁵⁷ Hansard, Australian House of Representatives, Thursday 27 May 1993, 1130.

⁵⁸ General Employee Entitlements and Redundancy Scheme.

⁵⁹ B G Carruthers, and T C Halliday, *Rescuing Business The Making of Corporate Bankruptcy Law in England and the United States* (Clarendon Press, Oxford, 1998) 223.

⁶⁰ Report of the Review Committee (Chairman Sir Kenneth Cork), HMSO London, *Insolvency Law and Practice*, (1982), para 1397.

⁶¹ Above n 59, 240

revenues should not have been impaired in the area of bankruptcy law for the state was not only the most powerful of creditors, but the ultimate arbiter of the rules by which all creditors played. As a referee, it could enhance its capacity as a player.

They further observe that this position presented not just a 'fiscal asset' to the state but a 'political liability' as well.⁶²

The state could not maintain the priority because the government could not get any sympathy from the private sector over its long delays in collecting back-taxes. Carruthers and Halliday suggest that 'such rank inefficiency merely confirmed to private creditors that government needed stronger incentives to keep abreast of taxpayer delinquency'.⁶³ This type of credit slackness was a luxury the unsecured creditor could not afford and, so, it was not surprising that they had no sympathy for the state.

Furthermore, there is not a direct link obvious to creditors that the state, in missing out on taxes, will not produce expenditure in health or education or defense. For the state to argue from a position of keeping a priority, they had a fight with every other creditor and all stakeholders. Carruthers and Halliday suggest consumer groups, professionals, the finance industry and major business groups would all stand against such an argument.⁶⁴

Finally, the *Enterprise Act 2002* (UK) s 251 removed the Crown priorities with respect to Inland Revenue and Customs and Excise and Social Security contributions previously found in Schedule 6 of the *Insolvency Act 1986* (UK). It basically puts into effect the abolition of Crown preference. An earlier White Paper⁶⁵ committed the government to abolish the Crown's preferential status and to ensure the benefit went to unsecured creditors of companies that have floating charges. Prior to the change, in force since 2003, the Crown could claim its debts from an insolvent company ahead of secured creditors who held floating charges. Obviously, they would also claim before unsecured creditors. The priority debts were previously in ss 386 and 387 and schedule 6 of the *Insolvency Act 1986* (UK) and so included debts due to both the Inland Revenue for 12 months prior to the relevant date, and social security contributions for the 12 months prior to the relevant date.

What remains in the *Insolvency Act 1986* (UK) is priority status for contributions to occupational pension schemes (superannuation in Australia), remuneration of employees for the relevant period, and levies on coal and steel production under the European Coal and Steel Community Treaty.

The *Enterprise Act 2002* (UK) also removes the Secretary of State priority in the *Employment Rights Act 1996* (UK) and so will no longer be paid in priority to other preferential claims by former employees.

⁶² Ibid.

⁶³ Ibid.

⁶⁴ Ibid.

⁶⁵ White Paper is available on www.hmt.gov.uk/mediastore/otherfiles/26.pdf June 2001.

Ms Hewitt (Secretary of State for Trade and Industry) in the Second Reading debates in the Commons stated that ‘the bill will abolish the Crown’s preferential rights to recover unpaid taxes ahead of other creditors. That too will bring real benefits to unsecured creditors’.⁶⁶ She said that, with measures that contribute towards refining the Insolvency Service’s financial regime ‘[ensuring] that money does not flow, in effect, from the coffers of the creditors into the coffers of the Treasury’, the two provisions will make up to 110 million pounds⁶⁷ available for distribution to all creditors.⁶⁸

Mr Borrow (South Ribble), in welcoming the removal of Crown preferential status, said it was ‘crucial’ not only to many employees in companies that currently lose out because the Crown takes the first cut of any resources left in insolvency, but to many other small businesses that are dependant as creditors on the business that is going into bankruptcy (liquidation). He said that, if the Crown had not been a preferential creditor, some failed companies in his constituency might well have received enough from businesses that went into liquidation to enable them to survive instead of finding that the scale of loss incurred was just enough to push them into bankruptcy (liquidation) too.⁶⁹

Dr Cable (Twickenham) said the government should proceed with caution in removing the Crown’s prerogative because if the Inland Revenue continues to operate in the same way regarding itself more or less as driven by a need to get at assets before other creditors the same problems will arise.⁷⁰

Mr Page (South West Hertfordshire) supported this, suggesting ‘we must take care to discover whether the actions of the Crown will precipitate a more rigorous collection method, which may, in turn cause businesses to have to close much sooner’.⁷¹

Mr Ross Cranston (Dudley) [but also a well known commercial law academic] said that it was ‘altruistic of the government to abolish it (the priority) and ‘magnanimous behaviour’.⁷²

As we can see from these excerpts the debate is very similar to the one held in the Australian federal parliament ten years earlier.

⁶⁶ Hansard, Commons, 10 April 2002, 53.

⁶⁷ When this was mentioned in the House of Lords, Lord Sainsbury said it was 115 million pounds! Hansard, 2 July 2002, 143.

⁶⁸ Hansard, Commons, 10 April 2002, 53.

⁶⁹ Hansard, Commons, 10 April 2002, 68.

⁷⁰ Hansard, Commons, 10 April 2002, 68.

⁷¹ Hansard, Commons, 10 April 2002 68.

⁷² Hansard, Commons, 10 April 2002, 97.

VII CONCLUSION

This paper reminisces on the special treatment tax received when insolvency of the corporate taxpayer occurred and is purely of historical interest to Australia. Yet, Australian legislators acted with foresight in the 'early' removal of the tax priority during the period from 1970 through until 1993. The United Kingdom has recently followed the Australian example, some ten years since our final attempt to remove the priority.

As a postscript, it is interesting to note a recent case that questions the absolute removal of tax as an insolvency priority. In *Deputy Commissioner of Taxation v Dexcam Australia Pty Ltd (in liq)*,⁷³ the DCT had been a creditor in Dexcam's Deed of Company Arrangement (DOCA) and had participated in the deed including submitting proofs of debt. The DCT had submitted amended proofs of debt which took into account the purported application of the PPS credits and interest under s 221YHG ITAA and s 13(1) of the *Tax Interest Act* (Cth). Dexcam went into liquidation in January 1998 after the DOCA was terminated. As we have discussed, the *Insolvency (Tax Priorities) Legislation Amendment Bill 1993* abolished the priority enjoyed by the Commonwealth conferred by ss 221P, 221YHJ, 221YHZD and 221YU of the *Income Tax Assessment Act 1936* (Cth). The Bill was to abolish debts due to the Crown in the right of the Commonwealth and made specific reference to the above four sections. Finn J in the *Dexcam Case* observed that there was nothing in the language of the legislation to suggest a legislative purpose beyond those four sections. This leaves s 221YHG which was not expressly subject to the abolition. It was a provision that required the Commissioner to apply various tax credits in payments of other tax or designated debts of the person otherwise entitled to those credits.

In particular, the Australian legislative moves of 1993 in removing the tax priority in insolvency administration form an interesting study in the larger discipline, that of 'distribution', which is said to be the most complex issue in insolvency. Distribution has been a feature of the employee entitlements in insolvency debate that has 'exploded' in Australia since such high profile insolvencies as Cobar Mines, National Textiles and Ansett. Had those legislative moves of 1993 not been taken, the tax priority would most certainly have been sacrificed by the federal government in an attempt to placate those in the Australian society calling for a more fair distribution of an insolvent company's assets.

⁷³ *Deputy Commissioner of Taxation v Dexcam Australia Pty Ltd (in liq)* (2003) FCFA 148.

NOT ANOTHER TAX

ELFRIEDE SANGKUHL

Elfriede Sangkuhl is a doctoral candidate at the University of Western Sydney.

Why would anyone in Australia advocate the introduction of another tax? Australia already has a complex range of taxes and the last thing most Australians would say they need is yet another tax. Despite this, this paper is proposing a tax, called the Tobin tax, be imposed on foreign currency transactions.

The aim of a Tobin tax is to actively distort resources away from speculative currency dealing by imposing a small flat tax on all currency trading. The success of the tax would be measured not by how much revenue it raises but by how little revenue it raises.

The Tobin tax would be a good tax because, as it operated to reduce currency speculation, it would strengthen the control that the Australian government had over Australian monetary policy. Other countries that elected to levy a Tobin tax and join the Tobin Tax Zone (the Zone) would also regain control over their monetary policy. American economist, James Tobin,¹ first proposed the introduction of a small tax on foreign currency transactions in 1972 in order to slow what he predicted would be an enormous growth in foreign currency speculation after the collapse of Bretton Woods² and the 'freeing' up of currency trading and floating of currency. Tobin was ahead of his time and his fears of the instability the currency gambling would engender have since been realised at the corporate, national and regional level.

¹ Krugman P, 'Vale James Tobin' published by the Evatt Foundation (22 March 2002) <http://evatt.labor.net.au/news/105.html>. James Tobin 1918–2002, was a professor at Yale University, a Nobel laureate and an advisor to John F Kennedy. Tobin was the economist credited with bringing Keynesian economic ideas to America. Tobin is remembered for two main policy ideas, firstly, as the force behind the Kennedy tax cuts that purportedly started the economic boom of the 1960s. Secondly, Tobin was the first to propose a small tax on foreign currency transactions to discourage currency speculation, the subject of this paper.

² J Eatwell, and L Taylor, *Global Finance at Risk: The Case for International Regulation* (Polity Press, UK 2000) 1. The Bretton Woods system to manage global finance was determined in 1944 in Bretton Woods, New Hampshire. 'A fundamental aspect of the system was that exchange rates between major currencies were fixed in terms of the [US] dollar, and the value of the dollar was tied to gold at a US guaranteed price of thirty-five dollars per ounce.'

I CORPORATE CURRENCY CRISES: AWA AND THE NAB

A The AWA Debacle: Lessons Not Learnt

AWA Ltd (AWA), an Australian based public company and electronics group, had the dubious honour of being one of the 'first losers of the modern era with a \$35 million loss through bets on the foreign exchange markets'.³

In 1987 these foreign exchange losses resulted in a public dispute between AWA and its auditors over who was responsible for the foreign exchange dealing losses. The reported losses in the legal proceedings were stated to be \$49.8 million.⁴ The court case assigned responsibility for the undetected actions of a single employee who had turned two years reported profits into losses. The courts apportioned the blame between AWA's chairman of directors and AWA's auditors.⁵

This early example of gambling on foreign exchange fluctuations should have been an example to corporations with foreign exchange desks. They should have been aware of the risks involved in uncontrolled gambling with company funds and on the duties of board members to regulate such gambling if the corporations include this as part of their normal operations.

B The NAB Debacle

The NAB currency trading loss debacle of 2004 demonstrated that, 17 years after the AWA currency trading losses, the management of the NAB did not fully recognise the dangers of currency speculation.

The currency trading losses at the NAB were revealed by a whistleblower⁶ in January 2004. The currency losses at that stage were estimated at \$180 million. NAB's General Manager of Group Corporate Affairs, Robert Hadler, assured the reporter that even without the actions of the whistleblower, 'I think our systems would have picked it [the illegal trading and associated losses] in due course'.⁷ The losses had been building, undetected by NAB management, for four months when revealed to NAB management, not by NAB internal control systems, but by a whistleblower. The reporter did not question Robert Hadler as to the meaning of the term 'in due course', and when that might have been. Two weeks after the radio interview⁸ the currency trading losses were confirmed at \$360 million.

³ L Hunt, and R Heinrich, *Barings Lost: Nick Leeson and the Collapse of Barings plc*, (Allen and Unwin, Australia 1996) 23.

⁴ *Daniels and Others (Formerly Practising as Deloitte Haskins & Sells) v Anderson and Others* (1995) 37 NSWLR 438, 444.

⁵ *Ibid* 439.

⁶ S Long, 'Whistleblower Reveals NAB Currency Scandal' *ABC Online*, AM, Wednesday 14 January 2004. <http://www.abc.net.au/am/>

⁷ *Ibid*.

⁸ S Kemp, 'NAB Currency Probe Widens', *The Age*, 28 January 2004. <http://www.theage.com.au/articles/2004/01/27/1075088028390.html>

Two months after the losses were made public⁹ the industry regulator, the Australian Prudential Regulation Authority, had found that the NAB had ‘shoddy internal controls over its currency trading arm’.¹⁰

C National and Regional Currency Crises

Economists at the Federal Reserve Bank of St Louis defined a currency crisis ‘as a speculative attack on a country’s currency that can result in a forced devaluation and possible debt default’.¹¹ Even the International Monetary Fund (IMF) recognises the fact that currency crises are caused by ‘speculative attacks’¹² on currencies caused by ‘the unreasoned panic in financial markets’.¹³ Even though the attack on a currency does not stem from any reasoned analysis of the economy under attack the result of the subsequent panic is real. The damage done by unreasoned panic is permanent damage to a country’s economy as the two following examples show.

1 Korea

The Korean currency crisis in late 1997 resulted in the Korean won depreciating by 112% against the US dollar while the stock of foreign exchange reserves went down from 22.3 billion to a mere 3.8 billion US dollars bringing the country to the brink of sovereign default. More than 17,000 companies went bankrupt including eight conglomerates in 1997.¹⁴

This crisis was caused by the flight of speculative capital out of Korea. The flight of capital was caused by panic, not by any underlying problems with the Korean economy that was growing strongly at the time of the crisis.

In Korea, the panic caused the GDP growth rate to fall from 7 per cent before the crisis to a decline in the GDP of –5.8 per cent after the crisis.¹⁵ The GDP growth rate recovered after the crisis but ‘the level of GDP remains permanently below its initial trend after the crisis’.¹⁶

⁹ S Rochfort, ‘Reveal All on Fiasco, NAB Told’, *The Age*, 22 March 2002.

<http://www.theage.com.au/articles/2004/03/21/1079823239811.html?from=storyrhs>

¹⁰ Ibid.

¹¹ A J Chiodo, and M T Owyang, ‘A Case Study of a Currency Crisis: The Russian Default of 1998’, *The Federal Reserve Bank of St. Louis*, November/December 2002, 7.

¹² IMF Staff, *Currency Crises The Role of Monetary Policy*, published by the World Bank, March 1988. <http://www.worldbank.org/fandd/english/0398/articles/0150398.htm>

¹³ Ibid.

¹⁴ D Park, and C Rhee, *Currency Crisis in Korea: How Has It Been Aggravated?*, <http://plaza.snu.ac.kr/~rhee5/data/kcrisis4.pdf> 31 December 1998, 2.

¹⁵ J-W Lee, and C Rhee, ‘Macroeconomic Impacts of the Korean Crisis: Comparison with the Cross-Country Patterns’ (2002) 25 *The World Economy* 539–62. <http://ssrn.com/abstract=312949>

¹⁶ Ibid.

2 Mexico

In 1994 the Mexican economy was enjoying 'economic growth, which averaged 3.1% per year between 1989 and 1994. In 1993 inflation was brought down to single-digit levels for the first time in more than two decades'.¹⁷ Yet, in December 1994 when the peso was devalued by 15 per cent, it precipitated a 'financial crisis'.¹⁸ This crisis 'wiped \$US75 billion off Mexican securities held by foreigners'.¹⁹ As a result there was a panicked 'exodus of capital'.²⁰

What Mexico had done was to liberalise their economy so that banking and investment rules were deregulated. This allowed for the operation of private banks and for a large influx of foreign investment in the Mexican economy.²¹ 'The Mexican currency crisis, unlike many others in Latin America, was not the result of irresponsible fiscal behaviour.'²² It was the result of allowing the economy to become dependent on 'massive ... short-run foreign capital inflows'²³ which became capital outflows in what was called a 'financial panic'.²⁴ These foreign capital inflows were given a boost when the US Congress approved North American Free Trade Agreement (NAFTA) with Mexico.²⁵ The panic meant that Mexico had to accept a '\$52 billion international support package intended to forestall a default and to bolster confidence in the Mexican economy'.²⁶ The Mexican economy had been strong and growing before the crisis caused by speculators.

3 The Australian Position

The Australian economy is enjoying strong economic growth relative to many developed economies with 'an average annual growth rate of 4.0% from "real" GDP from 1992 to 2001, it is higher than any of the 'G7'²⁷ countries'.²⁸ The Australian economy also shares with Mexico the fact that it has:

¹⁷ F Gil-Diaz, 'The Origin of Mexico's Financial Crisis' (1998) 17: 3 *The Cato Journal* 1–10, 1.

<http://www.cato.org/pubs/journal/cj17n3-14.html> Gil-Diaz is the former Vice Governor of the Bank of Mexico.

¹⁸ Ibid.

¹⁹ Above n 3, 30.

²⁰ Ibid.

²¹ J Sachs, A Tornell, and A Velasco, *The Collapse of the Mexican Peso: What Have We Learned?*, National Bureau of Economic Research (1999) 24. http://www.nber.org/crisis/mexico_agenda.html

²² Ibid 16.

²³ Ibid 21.

²⁴ Ibid 15, 17.

²⁵ Above n 17, 4.

²⁶ Above n 21, 18.

²⁷ The 'G7' group of countries, also referred to as the 'G8', consists of the major industrial democracies of France, the United States, Britain, Germany, Japan, Italy and Canada. Russia has been included in the G7 discussions since 1991 and will become a full member in 2006. (http://www.g7.utoronto.ca/what_is_g8.html)

- deregulated the banking sector
- privatised many utilities
- deregulated its currency trading and capital flows
- negotiated a Free Trade Agreement with the United States.

The Australian economy is just as vulnerable as the economies of Mexico and Korea to the actions of currency speculators.

4 *The Asian Currency Crisis*

An example of regional currency related speculation was the Asian currency crisis of 1997. This 'lowered the world growth projection for 1998 by one percent and increased worldwide unemployment by 10 million'.²⁹

The Asian currency crisis was precipitated by the 'floating of the Thai baht on July 2 [1997] and consequent 35 percent decrease in its international value prompted a generalized currency attack on almost all the Southeast Asian currencies'.³⁰ The countries most seriously affected by the Asian currency crisis were Thailand, Indonesia, Malaysia and Korea³¹ and '[t]hese countries contain about one-tenth of Asia's population'.³² The 'serious economic dislocation',³³ that had occurred in these four countries did in 1998 transmit 'economic contraction, currency depreciation and reduction in imports',³⁴ in other major economies, including the Philippines, Singapore, China and Hong Kong.³⁵

What caused the currency crisis in Thailand and how did the crisis in Thailand infect its neighbours?

At the time of the Asian currency crisis newspaper commentators were blaming 'crony capitalism', an unhealthy closeness between government leaders and business leaders, for the crisis. A simple Google search linking crony capitalism to the Asian currency crisis resulted in 7580 'hits'. However, after the dust of the crisis had settled, the IMF concluded that the Asian currency crisis occurred despite 'several decades of

²⁸ D Trewin, *2004 Year Book Australia*, No 86, (Australian Bureau of Statistics, Canberra 2004), 763.

²⁹ Peter DeFazio, and Paul Wellstone, congressmen, *US Congress Concurrent Resolution on Taxing Cross-Border Currency Transactions to Deter Excessive Speculation (H.Con.Res.301)*, introduced on 11 April 2000. www.ceedweb.org/iirp/ushousereres.htm

³⁰ M F Montes, *The Economic Miracle in a Haze*, (Asia Society Publications, December 1997) 1. http://www.asiasociety.org/publications/asean_miracle.html

³¹ R Garnaut, 'The East Asian Crisis' *East Asia in Crisis: From Being a Miracle to Needing One?* (eds R H McLeod and R Garnaut) (Rutledge, London 1998) 7.

³² *Ibid.*

³³ *Ibid.*

³⁴ *Ibid.*

³⁵ *Ibid.*

outstanding economic performance³⁶ and ‘even though government budgets were broadly in balance and inflation rates were modest’.³⁷ In other words, the crisis happened despite, as economists say, good economic fundamentals.

Three Asian countries not affected by the currency crisis were Vietnam, China and India. These very different economies share the fact that they impose heavy controls on their capital movements.³⁸ Capital controls can give rise to other problems, some of which are listed below:

- the emergence of a black market in the currency being controlled,
- the cost of imposing controls, and
- problems in attracting foreign investment.

An alternative to capital controls is a free market in currencies but with speculation being ‘controlled’ by the imposition of a Tobin tax.

D *The Tobin Vision*

There are two ways of protecting economies from currency speculators. One is the imposition of currency controls with its attendant disadvantages, and the other is controlling the volume of currency speculation. Some of the disadvantages of imposing currency controls are:

- the potential emergence of a black market in the currency being controlled,
- the cost of imposing controls, and
- problems in attracting foreign investment if potential investors don’t have the confidence of free capital mobility.

Since the deregulation of Australia’s currency market in the 1980s, currency speculation here has grown so that now 49 out of every 50 foreign currency transactions are purely speculative.³⁹ This is typical of the experience in other countries. This level of gambling with the foreign exchange makes the currency, and therefore the underlying ‘real’ transactions, vulnerable to artificial fluctuations in currency values.

Tobin’s suggested imposition of a very small tax of 0.2 per cent on currency transactions would have a negligible effect on commodity trade and long-term foreign investment. In 1996 a group of economists, supported by the United Nations Development Programme, conducted studies into the feasibility of the Tobin Tax.⁴⁰ In the prologue to the book, where the results of these studies appeared, Tobin wrote:

Most disappointing and surprising, critics seemed to miss what I regarded as the essential property of the transactions tax—the beauty part—that this simple, one parameter tax would automatically penalise short-horizon round trips, while

³⁶ IMF Staff, *Recovery from the Asian Crisis and the Role of the IMF*, an Issues Brief, <http://www.imf.org/external/np/exr/ib/2000/062300.htm> June 2000, 2.

³⁷ Ibid.

³⁸ Above n 31, 4.

³⁹ Stilwell Frank, *Changing Track*, (Pluto Press, 2000) 226

⁴⁰ M U I Haq, I Kaul, and I Grunberg, (eds) *The Tobin Tax Coping with Financial Volatility* (Oxford University Press, New York, 1996) ix.

negligibly affecting the incentives for commodity trade and long-term capital investments. A 0.2% tax on a round trip to another currency costs 48% a year if transacted every business day, 10% if every week, 2.4% if every month. But it is a trivial charge on commodity trade or long-term foreign investments.⁴¹

A Tobin tax has been resisted because of the fear that such a tax would push currency transactions into tax havens.⁴² However, there would be no revenue or economic loss to nations like Australia because currency transactions that are based on a 'real' sale or purchase could not move offshore because the good or service is either being sold from Australia or to Australia. Furthermore, corporations could be affected by loss of what they consider to be profitable trading in currencies unless they have had an AWA or NAB experience, or have not learnt from the experience of these companies.

1 *Tax Evasion*

Patomaki believes that using the possibility of tax evasion as an argument against imposing the tax is fallacious because it does not make tax evasion right or imposing the tax immoral.⁴³ With foreign exchange ('forex') players either inventing financial substitutes for currency transactions, and/or locational substitutes for booking forex trades,⁴⁴ tax evasion could be a serious problem. Tax evasion could make the imposition of the tax ineffective; however, if forex players invent financial substitutes, the tax could be extended to cover the new financial instruments.⁴⁵ If the tax is not universal when it starts, which it won't be, then members of the Tobin Tax Zone (the Zone) 'can make the banks residing in the tax-free areas pay a higher tax on cross-border credit to non-residents of the Zone. This should prevent banks from transferring funds to the rest of the world for forex purposes'.⁴⁶ Quiggan suggests that separating the Zone from the rest of the world could be 'an advantage in the context of internationally supported prudential regulation'.⁴⁷ He suggests countries that choose to operate outside the Zone and their accompanying regulations do so 'in the knowledge that they would not have access to the IMF if things went wrong'.⁴⁸ Financial institutions that chose to operate outside the Zone 'would be unable to borrow from central banks or the institutions operating within their prudential control'.⁴⁹

Considering the IMF analysis of the causes of, and the detrimental effects of, currency speculation on countries and regions, this would probably become IMF policy.

⁴¹ Ibid xi.

⁴² Ibid 227.

⁴³ H Patomaki, *Democratising Globalisation: The Leverage of the Tobin Tax* 139.

⁴⁴ Ibid 137.

⁴⁵ Ibid 139.

⁴⁶ Ibid 155.

⁴⁷ John Quiggan, 'The Fall and Rise of the Global Economy' in C Sheil, (ed) *Globalisation: Australian Impacts* (UNSW Press, Australia 2003) 8. <http://evatt.labor.net.au/publications/books/12.html>

⁴⁸ Ibid.

⁴⁹ Ibid.

The members of the Zone could also enforce the international consequence of Tobin tax evasion attempts by corporations.

II CONCLUSION

The major danger of massive unregulated currency speculation is loss of sovereignty. When countries cannot defend their currency they effectively lose control of their national monetary policy. The volume and volatility of unregulated currency flows can threaten national currencies with devaluation, higher interest rates and financial crises. This can lead to nations suffering low economic growth, increases in unemployment and inability to implement domestic policy.⁵⁰

Concern about protecting national economies from speculative attacks on currencies has led to the Tobin tax being introduced in Canada,⁵¹ while also being actively considered in the United States and by the European Union.

On 11 April 2000, a private members' Bill was introduced to the US Congress entitled 'US Congress Concurrent Resolution on Taxing Cross-Border Currency Transactions to Deter Excessive Speculation'.⁵² In September 2003, 30 members of the European Parliament and 10 members of national parliaments from 15 countries published an open letter calling for the introduction of a Tobin tax.⁵³ This was after the issue of a Tobin tax was raised at the European Parliament in June 2000.⁵⁴

Recent advocacy for the introduction of a Tobin tax is a signal that even the largest economies are not immune to the negative effects of currency speculation and are dealing with the need to protect their currencies from attack by speculators. International activity pressing for a Tobin tax is the beginning of a global response to a global problem. Australia should ready itself for admission into the Zone when introduced by either the European or European/American countries by legislating for the Tobin tax now (as Canada has already done). The Tobin tax is the only well regarded proposal gaining international credibility, which may control currency speculation without the reimposition of currency controls.

⁵⁰ Ibid.

⁵¹ *Tobin Tax Motion Passes in Canada's Parliament*, Centre for Environmental Economic Development, www.ceedweb.org/iirp/canadames.htm. The Canadian Parliament set the rate of tax at 0 per cent until it is adopted by other countries.

⁵² Peter DeFazio, and Paul Wellstone, congressmen, *US Congress Concurrent Resolution on Taxing Cross-Border Currency Transactions to Deter Excessive Speculation (H.Con.Res.301)* introduced 11 April 2000, www.ceedweb.org/iirp/ushoueres.htm

⁵³ *World Parliamentarians Call for a Tobin Tax* <http://tobintaxcall.free.fr/>

⁵⁴ *Capital Tax, Fiscal Systems and Globalisation Intergroup*, preparatory note to the first inter-parliamentary meeting on the Tobin tax at the European Parliament on 28 June 2000.

ENTITY TAXATION: THE INCONSISTENCY BETWEEN STATED POLICY AND ACTUAL APPLICATION

BRETT FREUDENBERG

Brett Freudenberg is a Lecturer in the Griffith Business School, Griffith University.

I BACKGROUND TO THE PROPOSALS

In 1998 when the government announced its proposal for a new tax system in its White Paper, *Not a New Tax, A New Tax System* (ANTS),¹ it perceived there were a lot of inadequacies with the Australian tax system. The emphasis the government put on selling its reforms can be seen in the title of its paper, which tried to reassure Australians of the government's overall aims.

One of the proposals contained in the White Paper was for the introduction of a new consistent entity regime for the taxing of income and distributions, known as entity taxation.² The justifications put forward by the government for this recommendation was to provide simplicity, clarity and fairness, while also addressing techniques highlighted by the High Wealth Individual Taskforce (HWIT).³

This paper will examine the concerns that led to the government's proposals, and what these proposals entailed. The paper will then critique the government's initial justifications for its proposals by analysing the submissions lodged in response to the government's Exposure Draft Bill. The paper will then determine whether there was any consistency between the government's stated policy objectives and the actual application of the proposals. This analysis is important in explaining the government's lack of success in implementing these reforms, as the government needs to appreciate that there needs to be consistency between its stated objectives and the actual legislation. Otherwise any proposed reforms can be easily discredited and shown to be lacking by comparing the reforms against their stated objectives.

¹ Australia, The Howard Government's Plan for a New Tax System, *Tax Reform: Not a New Tax, a New Tax System* (1998) Canberra, AGPS.

² Ibid.

³ Ibid 114.

A The Popularity of Discretionary Trusts

Discretionary trusts⁴ have been increasingly adopted in Australia as an alternative business structure,⁵ with 39 per cent of trusts in the property industry, 29 per cent in finance, insurance, real estate and business service industry, and 6 per cent in the retail trade and primary production industry, respectively.⁶

Prior to the government's announcement of possible reforms in August 1998 there had been a 28 per cent increase in the number of trust taxpayers over a five-year period.⁷ In the same period there was a 20 per cent increase in company taxpayers, and partnerships decreased by nearly 5.5 per cent.⁸

Additionally, of the trusts registered as taxpayers, 72 per cent identified themselves as discretionary trusts.⁹

Since the government's initial reform announcements in August 1998, there has been a sharp decrease in the number of new trust taxpayers being registered, with only a 0.5 per cent increase in 1998–99,¹⁰ and actually a 0.01 per cent decrease in 1999–2000.¹¹ Company taxpayers grew by 2.2 per cent in 1998–99,¹² and then decreased by 3 per cent in the 1999–2000 year.¹³ Partnerships decreased by 4 per cent in 1998–99,¹⁴ and then decreased by a further 2 per cent in 1999–2000.¹⁵

⁴ Discretionary trust refers to a trust where the allocation or division of the beneficial interest in the trust property and income is left to the discretion of the trustee. The trustee has the power to decide how to apportion both the income and capital of the trust amongst the beneficiaries from a defined class in the trust instrument. There is no guarantee that a particular beneficiary will get anything. The entities involved in a discretionary trust include the trustee, the settlor and the beneficiaries (objects), with the beneficiaries being classified as either income or corpus depending upon their potential entitlement.

⁵ Cooper and Lybrand and the Property Council of Australia, *The Taxation of Trusts: Dispelling the Myth* (1997). <http://www.propertyoz.com.au/data/national/advoc/subs/971119tt.pdf>.

⁶ Australian Taxation Office, *Taxation Statistics 1998–99: A Summary of Taxation and Superannuation Statistics* (2001) Canberra, AGPS. [ATO 2001]

⁷ *Ibid* 89. According to statistics from the Australian Taxation Office, there has been a 28 per cent increase in the number of trust taxpayers between the 1994 financial year to the 1998 financial year.

⁸ *Ibid*.

⁹ The Board of Taxation, *Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer* (2002) AGPS, Canberra, 25. Reference is to lodged tax returns for the 1998–99 year.

¹⁰ Above n 6, ATO 2001.

¹¹ Australian Taxation Office, *Taxation Statistics 1999–2000: A Summary of Taxation, Superannuation and Industry Benchmark Statistics 1999–2000 and 2000–01*, (2002) Canberra, AGPS. There have been no figures released since the announcement of the withdrawal of the reforms in February 2001; it will be interesting to see if the negative growth continues, or whether there will be a turn around. It remains to be seen how the Treasurer's announcement in February 2001 will affect the future growth of trusts, as the figures are not yet available for the 2001 year. [ATO 2002]

¹² Above n 6, ATO 2001, 89.

¹³ Above n 11, ATO 2002.

The popularity of discretionary trusts can be traced to a number of factors, including: the cost of establishing a trust structure is less than a company; they can be an effective means of protecting business assets, while ensuring that the assets can be retained within a family group.¹⁶ In contrast to these commercial and family considerations, many have regarded trusts, especially discretionary trusts, suspiciously. This is because discretionary trusts are considered vehicles for facilitating large-scale tax minimisation.¹⁷ This concern, in part, can be traced to the fact that little is known about the precise use of trusts, as there are no general disclosure laws applying to them.¹⁸

Tax minimisation can occur as effective control can remain with the person who transferred the income and assets to a discretionary trust, while that person still enjoys the tax benefits of splitting income with beneficiaries who are family members.¹⁹

1 *Distributions of Tax-Preferred Amounts*

Another tax minimisation strategy available to discretionary trusts includes the ability of tax-preferred amounts to flow through to discretionary beneficiaries.²⁰ Tax-preferred amounts describe amounts that are not included in the trust estate's calculation of net income pursuant to the *Income Tax Assessment Act 1936* (ITAA36) s 95. These tax-preferred amounts may arise due to a number of reasons, including asset revaluations, capital gains concessions,²¹ accelerated depreciation for plant and equipment purchased prior to 21 September 1999,²² and the small business 15-year exemption amount.²³ A detailed list of tax-preferred amounts is contained in Table 1.1 below. Companies and fixed trusts do not enjoy the ability to distribute these amounts without adverse tax consequences to the same extent.

¹⁴ Above n 6, ATO 2001.

¹⁵ Above n 11, ATO 2002.

¹⁶ Taxation Institute of Australia, (1998) 'Taxation of Trusts and Other Entities' 1:5 *The Tax Specialist* 281, 281.

¹⁷ Australian Council of Social Services, *Review of Business Taxation: ACOSS Response to First Discussion Paper*, Information Paper 990204 (1999) at <http://www.acoss.org.au/media/1999/ip990204.pdf>.

¹⁸ Senate Official Hansard, *Parliamentary Debates*, Monday 23 March 1998, Canberra, AGPS, 1020, (Senator Murray).

¹⁹ Australia, *A Strong Foundation* (Ralph Report No 1), (1998) Canberra, AGPS, 12.

²⁰ *Ibid.*

²¹ Such as the CGT asset being acquired prior to 20 September 1985: Sub-section 104-10(5) ITAA97.

²² Division 42 ITAA97.

²³ Section 152-105 ITAA97.

Table 1.1 Tax-preferred amounts

<p>Tax-preferred amounts may arise because of:</p> <ul style="list-style-type: none">■ Asset revaluations;■ Capital gains concessions (such as the CGT asset being acquired prior to 20 September 1985);²⁴■ Division 43 capital works;²⁵■ Accelerated depreciation for plant and equipment purchased prior to 21 September 1999;²⁶■ Small business 15-year exemption amount;²⁷■ Small business further 50 per cent reduction amount;²⁸■ Depreciation concessions for small businesses electing to be part of the simplified tax system;²⁹■ Environmental expenditure deductions;³⁰■ Water care deductions;³¹■ Amounts sheltered because of carried forward losses;³²■ Amounts sheltered because of indexation of CGT assets' cost bases;³³ and■ Capital gains discount amounts.³⁴

²⁴ Section 104-10(5) ITAA97.

²⁵ Division 43 ITAA97.

²⁶ Division 42 ITAA97.

²⁷ Section 152-105 ITAA97.

²⁸ Section 152-205 ITAA97.

²⁹ Division 328 ITAA97.

³⁰ Section 43-20 ITAA97.

³¹ Sub-division 388-A ITAA97.

³² Division 36 ITAA97.

³³ Division 114 ITAA97. Note indexation is now frozen from September 1999.

³⁴ Division 115 ITAA97.

II THE REFORM PROPOSALS

A A New Tax System

In recognition of perceived inadequacies in the tax system, the government set out on an ambitious tax reform agenda to revolutionise the Australian taxation system in 1998 with its ANTS White Paper.³⁵ Included in the White Paper was the proposal to reform the taxation of trusts, to be known as entity taxation.³⁶

With this proposed system, the government hoped it would provide simplicity, clarity and fairness, while also addressing techniques highlighted by HWIT.³⁷ The inadequacies the government observed included the fact that exactly the same investment achieved very different tax treatment depending upon the collective business structure adopted.³⁸ The government considered that this meant wealthier individuals, having access to legal and accounting advice, could target particular investments and structures.³⁹ By doing this, wealthier individuals could take advantage of the differences in tax treatment, and minimise the amount of their tax.⁴⁰ The government concluded that this meant that the rest of the community subsidised the wealthier investor.⁴¹ If this conclusion were correct, then the principle of vertical equity⁴² would be violated.

The entities to be covered by this proposed single regime were companies, fixed trusts and discretionary trusts. The government considered that these entities should be

³⁵ Above n 1. Some aspects of this reform agenda included, together with the introduction of a goods and services tax, the simplified imputation system (involving the full franking of all dividends distributed by entities), the refund of excess imputation credits for individuals, moving towards a 30 per cent company tax rate, and extending capital gains tax rollover relief for small businesses.

³⁶ *Ibid*, Australia, Chapter Three, *Appendix A: The Time Line of Reforms*. Details the chronology of events that occurred from the government's initial announcement of this reform measure to date.

³⁷ *Ibid* 114.

³⁸ *Ibid* 107. Such as companies, trusts and life insurers.

³⁹ *Ibid* 108.

⁴⁰ *Ibid*.

⁴¹ *Ibid*.

⁴² Vertical equity is achieved when taxpayers are taxed according to their ability to pay: R Vann, 'Australia's Policy on Entity Taxation' (2001) 4:3 *The Tax Specialist* 120, 120. This is reflected in the adoption of progressive marginal tax rates for individuals in Australia. The tax rates for Australian resident taxpayers are currently: 0–6000 nil; 6001–20000 17%;

20 001–50 000 30%, 50 001–60 000 42%, and 60 001 plus 47%. It is proposed that these tax rates be altered from 1 July 2003 to: 0–6000 nil, 6001–21 600 17%, 21 601–52 000 30%, 52 001–62 500 42% and 62 501 plus 47% in Treasury, *Budget Measures 2003–2004*, (Budget Paper No 2), (2003) AGPS, Canberra, 31. However, the use of progressive marginal tax rates in Australia may be superficial. This is because tax avoidance by high-income taxpayers reduces the effectiveness of marginal tax rates: G Cooper, (ed) *Tax Avoidance and the Rule of Law* (1999) IBFD Publications BV, Amsterdam, 64. An analysis of tax incidence over the years tends to show that wealthier individuals simply do not end up paying the expected high marginal rates: G Cooper, (ed) (1999) *Tax Avoidance and the Rule of Law* (1999) IBFD Publications BV, Amsterdam, 257.

subjected to consistent treatment, as they all offered investors the prospect of limited liability.⁴³

The government expressed that pursuant to the current taxation methodology, beneficiaries of discretionary trusts were enjoying the best of both worlds. This was because the government considered that these beneficiaries could benefit from limited liability, as well as the flow through of tax-preferred amounts.⁴⁴

A similar flow through of tax-preferred amounts could not occur for companies. This is because such distributions from a company would be in the form of an unfranked dividend,⁴⁵ which the shareholder would be fully assessed on.

Neither could fixed trusts enjoy the flow through of tax-preferred amounts, as fixed beneficiaries would generally be taxed on a delayed basis.⁴⁶ This is referring to the application of CGT event E4,⁴⁷ under which a fixed beneficiary's cost base would be reduced to the extent of the tax-preferred distribution, resulting in a larger capital gain on the disposal of the fixed interest.⁴⁸ This statement by the government fails to acknowledge that there are some exceptions that allow for tax-preferred amounts to actually flow through to fixed beneficiaries. These exceptions include amounts deducted for capital works,⁴⁹ excluded exempt income⁵⁰ and the small business 15-year exempt amount.⁵¹

The government identified sole traders and partnerships⁵² as being able to access tax-preferred amounts also. Though for sole traders and partnerships, the government considered that this was not adverse, since these entity types directly bore the liability for losses in their businesses.⁵³

⁴³ Above n 1, 113. There is some doubt as to whether this assumption of limited liability is in fact correct, a flaw that could directly undermine the government's justification for unified treatment. This is because courts have held that beneficiaries, at least those who have full capacity, can be personally liable to indemnify the trustee for those liabilities which are properly incurred and which relate to administration of the trust for the benefit of the particular beneficiary sought to be made liable: see *JW Broomhead (Vic) Pty Ltd v JW Broomhead Pty Ltd* (1985) VR 891. This issue is beyond the scope of this paper.

⁴⁴ Above n 1.

⁴⁵ A possible exception to this is when the distribution is made as part of a liquidator's distribution, then there may be a flow through of pre-CGT profits: ITAA36 s 47A.

⁴⁶ Above n 1, 109.

⁴⁷ Section 104-70 ITAA97.

⁴⁸ Section 104-70 ITAA97.

⁴⁹ Up until 1 July 2001. Section 104-70 ITAA97.

⁵⁰ Sub-section 104-71 ITAA97.

⁵¹ Sub-section 104-71 ITAA97.

⁵² Except for limited partnerships: which are already taxed as companies under Division 5A ITAA36.

⁵³ Above n 1, 109.

The central thrust of the government's proposed regime was that taxable income derived by the affected entities should be subject to the same tax rate at the entity level. For a trust it meant that the taxable income of the trust estate would be taxed in the hands of the trustee.

The government's proposal also envisaged that tax-preferred amounts⁵⁴ would, if distributed, be subject to tax at the entity level, in that tax-preferred amounts retained by an entity would not be taxed as income but would if distributed.⁵⁵ This new tax on distributions of tax-preferred amounts was to be known as deferred company tax.⁵⁶ While the recipient of such a distribution would be assessable on it, the recipient would have the benefit of imputation credits.⁵⁷

The government stated that these proposals would, when combined with the refund of excess imputation credits, mean little effective change to the income tax liabilities for most existing beneficiaries of private trusts.⁵⁸ This was based on the government's belief that income would still be able to be split amongst beneficiaries, and therefore assessed at their individual rates.⁵⁹

It is submitted that this statement is itself an example of the inconsistency between the government's stated policy intention and the actual application of the proposals. This is because the proposed measures would involve a fundamental change in the tax liabilities for beneficiaries. In particular, distributions of tax-preferred amounts under the measures would now be assessable. This is in stark contrast to their current accepted treatment. Indeed, under the proposed measures, the government changed what was meant by assessable income for a beneficiary of a discretionary trust. Furthermore, given the complexity of the proposals, it is not clear how the goals of simplicity and clarity were going to be achieved.

After announcing its platform of potential reforms in ANTS in August 1998, the government referred them for further consideration to the Review of Business Taxation Committee.⁶⁰ This committee became known as the Ralph Committee, after its chairman, Mr John T Ralph AO. The Ralph Committee's brief was to review the proposals, take public submissions and formulate recommendations for the government.⁶¹

⁵⁴ Income that does not fall as part of taxable income. Refer to the *Glossary of Terms* for a precise definition of this in relation to discretionary trusts.

⁵⁵ J Glover, 'Taxing Trusts: Entity v Conduit – An Assessment' (1999) 2:4 *The Tax Specialist* 194, at 196.

⁵⁶ *Ibid.*

⁵⁷ Above n 1, 113.

⁵⁸ *Ibid.*

⁵⁹ Above n 55, 196.

⁶⁰ Commencing 27 October 1998.

⁶¹ Above n 19, Overview Chapter.

B Ralph Committee's Recommendation

After releasing a number of reports and taking extensive submissions from the public, the Ralph Committee gave the government its fourth report, *A Tax System Redesigned*,⁶² in July 1999. This report contained recommendations, as well as draft legislation in respect to reforming the taxation of trusts. The Ralph Committee concluded that the best way of addressing tax avoidance and promoting fairness was to put in place a consistent and comprehensive approach to business taxation.⁶³

This comprehensive business taxation system would govern fixed trusts, non-fixed trusts, life insurers, cooperatives, companies and limited partnerships, and would be known as the 'unified entity taxation system',⁶⁴ a system similar to that originally proposed by the government.

However, the Ralph Committee didn't recommend adopting the deferred company tax, as originally proposed by the government.⁶⁵ Additionally, the Ralph Committee noted that the diametrically opposed proposition to the unified entity regime, which would allow tax-preferred amounts to flow through companies, was not feasible from a revenue viewpoint.⁶⁶

The Ralph Committee agreed with the government's proposed profits first rule applying to distributions from entities to members.⁶⁷ This rule effectively meant entities would be treated as distributing all retained profits before distributing contributed capital. The Ralph Committee envisaged that the advantage of this rule would be that entities could not defer tax on retained profits, or stream contributed capital and profit in accordance with members' tax profiles.⁶⁸ An additional benefit of this would be that specific anti-avoidance provisions dealing with dividend streaming,⁶⁹ and capital streaming⁷⁰ could be repealed, leading to more simplicity.

⁶² Australia, *A Tax System Redesigned* (Ralph Report No 4) (1999) Canberra, AGPS.

⁶³ *Ibid*, para 34.

⁶⁴ *Ibid*, Overview Chapter, para 276.

⁶⁵ *Ibid*, para 281. This was because the Ralph Committee accepted submissions that such a tax would impact adversely on the after tax profits of Australian companies, leading to negative perceptions by investors and consequently affecting the ability of companies to raise capital. This perceived adverse impact was due to companies having greater income tax expense because of the imposition of the deferred company tax. This was because amounts not previously subject to tax would be taxable for the company, thereby resulting in lower after tax profit. Previously, such distributions of tax-preferred amounts by a company would be in the form of an unfranked dividend, representing that no company tax had been paid on the amount.

⁶⁶ *Ibid*, para 277 of Overview.

⁶⁷ *Ibid*, para 294 of Overview.

⁶⁸ *Ibid*, para 294 of Overview.

⁶⁹ Sections 160AQCBA and 177EA of ITAA36.

⁷⁰ Sections 45, 45A, 45B and 45C of ITAA36.

C Government's Response

A further inconsistency between the government's stated policy justification and its actions can be illustrated by the difference between its stated and actual response to the Ralph Committee's recommendations.

1 Stated Justifications

The Treasurer released to the public the Committee's fourth report, *A Tax System Redesigned*, on 21 September 1999, together with a press release indicating, among other things, the government's acceptance of the proposed unified entity taxation regime.⁷¹ Though in recognition of the demand on businesses at the time associated with Year 2000 compliance issues and the introduction of the GST, the commencement date of the proposed regime was to be deferred until 1 July 2001.

The government stated that its justification for supporting the reforms was because the reforms would provide a more consistent taxation treatment of business entities and their members, while being fairer, simpler and having greater integrity.⁷²

2 Government's Actions

However, over time it appeared that the government's belief in a more consistent taxation treatment of business entities wavered. This is because over a year later, on 11 October 2000, when the government released its own Exposure Draft Bill for entity taxation, the measures only applied to non-fixed trusts.⁷³ The term 'unifying' was a stark omission from the title of the government's Exposure Draft Bill.

Some identified the omission of 'unified' in the Exposure Draft Bill's title as an indication of a departure from the ideals espoused by the Ralph Committee.⁷⁴ Instead of providing uniform rules for a number of entities, entity taxation now appeared to be specific anti-avoidance provisions addressing concerns about the taxation of non-fixed trusts only.

The Press Release accompanying the Exposure Draft Bill noted that the exclusion of companies, fixed trusts, limited partnerships and cooperatives⁷⁵ meant that there would be no requirement for the introduction of a collective investment vehicle regime.⁷⁶ What this referred to was the fact that since the excluded entities would continue to be taxed under their current methodology, there would be no requirement for a 'carve out' to occur for collective investment vehicles.

⁷¹ Treasury, 'The New Business Tax System' (Treasurer Press Release No 58, 1999).

⁷² Ibid, Attachment K.

⁷³ Treasury, 'Taxing Trusts Like Companies and Simplified Imputation Rules: Exposure Draft Legislation' (Treasurer Press Release No 95, 2000).

⁷⁴ P Drum, *The New Business Tax System: Entity Tax Exposure Draft – Comments of CPA Australia*, (2000), at http://www.cpaaustralia.com.au/01_information_centre/1_0_0_0_home.asp, at 3.

⁷⁵ They would retain their current taxation treatment.

⁷⁶ Above n 73.

Apart from this comment, no other precise explanation was provided for the exclusion of these entities from the provisions. However, the government did consider that the Exposure Draft Bill would achieve greater consistency in the taxation of entities, while minimising compliance and restructuring costs.⁷⁷

This conclusion was doubted by many submissions, since these submissions questioned how consistency between entities could be achieved by the introduction of additional legislative requirements for just one entity type. Some commentators stated that the Treasurer's claim that the purpose was to create 'equal treatment' for all business entities was clearly false, as partnerships and many types of trusts were not touched.⁷⁸

It is submitted that the Exposure Draft Bill is a clear illustration of inconsistency between the government's stated policy objectives and the actual operation of the proposed legislation. This is particularly the case in relation to the government's claim that the measures would 'achieve greater consistency in the taxation of entities'. How can this be the case when the Exposure Draft Bill introduced complicated rules applying to only one type of entity? Furthermore, and more importantly, it is submitted that this lack of consistency between the government's stated justification and its actual Exposure Draft Bill meant that the government could have undermined its own reform measures. This inconsistency made it easy for the Exposure Draft Bill to be criticised by reference to the government's own stated policy objectives, leaving little room for the government to defend its proposals.

The provisions of the government's entity taxation will be reviewed below, focussing in particular on whether they would have addressed distributions of tax-preferred amounts by discretionary trusts. Following this, a detailed critique of the Exposure Draft Bill will be undertaken—in particular the profits first rule—in order to examine whether there was any consistency between the government's stated justifications and the envisaged operation of the Exposure Draft Bill. The submissions received by the government in response to the release of its Exposure Draft Bill will be used as the basis of this critique.

⁷⁷ Ibid.

⁷⁸ I Spry, 'Taxation: Why the Attack on Family Trusts?', (2000) at http://www.newsweekly.com.au/articles/2000nov4_tax.html

III ENTITY TAXATION: AN OVERVIEW

Apart from the entities to which it applied, the government's Exposure Draft Bill drew heavily on the Ralph Committee's own draft legislation⁷⁹ that accompanied its report *A New Tax System Redesigned*. The government's Exposure Draft Bill also included the notions of a profits first rule,⁸⁰ a slice rule,⁸¹ non-commercial loans,⁸² contributed capital,⁸³ and a wide definition of distributions.⁸⁴ Set out below is a brief summary of how the proposed entity taxation system as detailed in the government's Exposure Draft Bill was to operate. The proposed entity taxation system is then considered as to whether it would have taxed distributions of tax-preferred amounts by discretionary trusts.

1 *Non-Fixed Trusts*

As the legislation only applied to non-fixed trusts, the pivotal concept in the Exposure Draft Bill was the meaning of non-fixed trusts. To this end the Exposure Draft Bill adopted the definition of 'non-fixed trust' and 'fixed trust' from the trust loss measures in Schedule 2F of ITAA36.⁸⁵

The precise scope of this definition is yet to be subject to judicial review, and some commentators claim that trusts which are traditionally considered to be fixed trusts would in fact be regarded as non-fixed trusts according to this strict definition.⁸⁶

For the purposes of this paper it is assumed that discretionary trusts as defined would clearly fall within the definition of a non-fixed trust, and therefore would have been subject to the proposed regime.⁸⁷

⁷⁹ Titled: A New Tax System (Income Tax Assessment) Bill 1999 (Cth).

⁸⁰ Sub-division 154-A in A New Tax System (Income Tax Assessment) Bill 1999 (Cth), and then Sub-division 157-B in Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁸¹ Sub-division 154-D in A New Tax System (Income Tax Assessment) Bill 1999 (Cth), and then Sub-division 157-E in Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁸² Section 154-40 in A New Tax System (Income Tax Assessment) Bill 1999 (Cth), and then section 157-115 in Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁸³ Sub-division 153-B in A New Tax System (Income Tax Assessment) Bill 1999 (Cth), and then Sub-division 157-C in Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁸⁴ Sub-division 960-C in A New Tax System (Income Tax Assessment) Bill 1999 (Cth), and then Section 960-126 in Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁸⁵ Sub-section 272-5(1) Schedule 2F ITAA36.

⁸⁶ Especially if the trust deed allows some discretion to the trustee as to whether to distribute or not. For a more precise discussion of these issues refer to: K Rooke, 'Fixed and Non fixed Trusts' (2001) 4:4 *The Tax Specialists*, 211.

⁸⁷ By the Exposure Draft Bill adopting this definition, it provided some consistency in the assessment acts, a consistency that too many times is lacking. For example a number of provisions dealing with small business adopt different measures to establish whether a small business exists. In Division 152 ITAA97 \$5 million net CGT assets is used, while for access to the simplified tax system the measure is annual turnover of less than \$1 million is used (that is, Division 328 ITAA97). However, the definition of non-fixed trust could mean a broader application of the measures than intended. Also because of the

2 Trustee Paying Income Tax

In contrast to Division 6,⁸⁸ under the proposed entity regime a discretionary trust would be liable to pay tax on its taxable income.⁸⁹ The calculation of taxable income for the trust would be similar to the calculation of net income under s 95.⁹⁰ Accordingly, such a calculation of taxable income would not itself incorporate any increment in value of an appreciating asset held by a trust recognised by an asset revaluation, nor other tax preferred amounts.

Under the proposals, a trust paying tax on its taxable income would generate franking credits. These credits would then be able to be passed on to beneficiaries by the allocation of franking credits to most distributions.⁹¹ However, pursuant to the 45-day holding rule, it appeared that franking credits would only be able available to beneficiaries of discretionary trusts that had made a family trust election.⁹²

uncertainty about the definition, it could create uncertainty as to whether a trust is a non-fixed trust or not—a fundamental differentiation, since the application of the Bill centred on this.

⁸⁸ ITAA36.

⁸⁹ Section 153-5 and s 9-1 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth). This is in contrast to the practice under Division 6 where income of the trust estate is generally assessed to a presently entitled beneficiary.

⁹⁰ ITAA36.

⁹¹ Section 153-5, Divisions 160 and 161 of Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁹² Sub-section 160APHL(10) ITAA36. Pursuant to the 45-day holding rule, discretionary trusts and their beneficiaries are deemed to have a delta of negative one in respect of shares acquired from 1 January 1999: sub-section 160APHL(10) ITAA36. 'Delta' is a financial calculation that measures the relative change in the price of shares and the price of a related hedging arrangement, such as an option or other derivative. A derivative with a positive delta indicates that its price is expected to rise and fall relative to the underlying security. Whereas a negative delta indicates the movement of the derivative will be in the opposite direction to the movement of the underlying security. R Deutsch, M L Friezer, I G Fullerton, M M Gibson, P J Hanley, and T Snape, *Australian Tax Handbook* (2003), 1013.

Having a delta of negative one is important in determining whether the 45-day holding rule has been satisfied to enable the utilisation of franking rebates attached to franked dividends: Section 160APHL ITAA36. This is because days with materially diminished risk, ascertained as days where a taxpayer's net position of deltas in respect of shares held is less than 30 per cent, are excluded in the 45-day count: Section 160APHO ITAA36. With a delta of negative one, discretionary trusts and their beneficiaries are deemed to have no risk in holding shares, therefore limiting their ability to utilise franking credits. Exception for trusts that have made a Family Trust election: Section 160APHL ITAA36.

However by a trust making a family trust election, the trust and its beneficiaries are deemed to hold shares at risk, and therefore satisfy the 45-day holding rule. Though a trust making such an election is effectively limited to making distributions to only the statutory family as defined: Section 272-90 Schedule 2F ITAA36, as distributions outside this group are subjected to tax at 48.5 per cent. Known as Family Trust Distribution Tax: Division 271 of Schedule 2F ITAA36.

Accordingly, the assertion by the government that franking credits could pass to beneficiaries may be of limited application. This would mean that a discretionary beneficiary would not get a credit of the tax paid at the trust level, unless a family trust election was made.

3 Distributions to Members

The next determination would be whether there had been in fact a distribution to a member,⁹³ either of money, property or credits.⁹⁴ The term 'distribution' extended beyond its normal meaning and included excessive remuneration and eligible termination payments made to beneficiaries. Also the term encompassed loans to beneficiaries on non-commercial terms⁹⁵ or a forgiven commercial loan.

4 Determining Source of Distribution: Profits First Rule

An integral part of the proposed entity taxation regime was the profits first rule. This rule, amongst other things, sought to make most distributions (including distributions of tax-preferred amounts) by discretionary trusts taxable. The way the profits first rule achieved this was to provide that any distribution from a discretionary trust would be made from available profits first, rather than capital.⁹⁶ If there were available profits,⁹⁷ then the distribution would be assessable income for the recipient.⁹⁸ Pursuant to entity taxation, 'available profits' were calculated by deducting from the net market value of the assets held by the non-fixed trust the accounting provisions, contributed capital and prior taxed amounts.⁹⁹ This calculation occurred just prior to distribution being made by a non-fixed trust. Accordingly, key components of 'available profits' are the concepts of 'net market value',¹⁰⁰ 'accounting provisions',¹⁰¹ 'contributed capital',¹⁰² and 'prior taxed amounts'.¹⁰³

⁹³ Beneficiary.

⁹⁴ Section 156-20, Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁹⁵ Not in respect of employment of the beneficiary. These were similar to Division 7A ITAA36 that applies to non-commercial loans from private companies to shareholders, though there were some inconsistencies, such as the date of which the appropriate interest rate was determined.

⁹⁶ An asset revaluation reserve distribution would generally be regarded for trust law purposes as from capital (corpus).

⁹⁷ Section 995-1 defines this if Division 157 provides that it is from profits: Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁹⁸ Section 154-5 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁹⁹ Section 157-85 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁰⁰ Pursuant to entity taxation this was defined as the difference between the market value of the non-fixed trust's assets and the amount of the trust's liabilities at a point in time: Section 157-85(1) Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁰¹ The accounting provisions that were able to be deducted were limited to provisions for depreciation, annual leave, long service leave, and the amortisation of intellectual property and trademarks: Sub-section 157-85(1) Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁰² Pursuant to entity taxation the concept of contributed capital was espoused to be comparable to the share capital of a company: Explanatory Memorandum [EM] accompanying the Exposure Draft New Business Tax System (Entity Taxation) Bill 2000, para 6.2. It was basically the contributions made to a non-fixed trust to create or to increase the value of membership interest in the trust, including amounts settled: EM para 6.7.

¹⁰³ These are amounts that have been taxed under sections 97, 98, 99 and 99A ITAA36: Section 154-55 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth). Or when ultimate

Consequently, if a discretionary trust having available profits at that time distributed a tax-preferred amount, then the beneficiary would indeed be assessed, unless the distribution fell within one of the exceptions.

The exceptions to the profits first rule included: if the distribution was of a prior taxed amount;¹⁰⁴ or in relation to a member's interest being terminated or reduced (known as the slice rule);¹⁰⁵ or from a CGT advantaged asset.¹⁰⁶ It is unlikely these exceptions would have encompassed distributions of tax-preferred amounts except for CGT advantaged assets.

If a trust did not have available profits at the time of the distribution, then the distribution would be treated as from contributed capital,¹⁰⁷ up to the balance of the trust's contributed capital account. For a beneficiary receiving a distribution from contributed capital, the taxation consequences would be dealt with under the CGT provisions.¹⁰⁸

The Explanatory Memorandum (EM) accompanying the exposure draft noted that for discretionary beneficiaries a distribution of contributed capital would remain tax-free.¹⁰⁹ Although for this to be the case, two new conditions had to be satisfied if the beneficiary's membership interests had a zero cost base. It is submitted that this would have been the case for most beneficiaries of discretionary trusts. This is because discretionary beneficiaries would not generally have paid or given any property for

beneficiary tax has been paid: Division 6D ITAA36. Though this was not possible if applied to a beneficiary's benefit by crediting the beneficiary's loan account.

¹⁰⁴ Section 157-40 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth). These are amounts that have been taxed under sections 97, 98, 99 and 99A ITAA36, or when ultimate beneficiary tax has been paid.

¹⁰⁵ Section 157-45 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth). Pursuant to entity taxation, this was the second broad exception to the profits first rule. It arose when there was a distribution to a taxpayer as part of a process that results directly in either a fixed membership interest ceasing to exist, or proportional rights attaching to a fixed membership interest being reduced. Additionally, the slice rule could apply to a distribution to a taxpayer with a non-fixed trust membership interest if the distribution was made as part of a process for the interest ceasing to exist because of the termination of the trust. In the circumstances that the slice rule operated, the member's share of contributed capital needed to be calculated: EM, para 4.44. If the member's share of contributed capital was equal or greater than the distribution, then the distribution was regarded as being entirely from contributed capital. If the member's share in contributed capital were less than the distribution, then the deference would be treated as from taxed or untaxed profits: EM, para 4.44.

¹⁰⁶ Section 157-55 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth). CGT advantaged assets encompassed realisations of CGT assets acquired prior to 20 September 1985, discount capital gains (on assets held on trust as at 23 December 1999), frozen indexation components (though indexation is frozen from September 1999), the small business 15-year exemption and the small business 50 per cent active asset reduction.

¹⁰⁷ Section 157-20 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁰⁸ Section 154-10 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁰⁹ Explanatory Memorandum accompanying the Exposure Draft New Business Tax System (Entity Taxation) Bill 2000, para 5.15.

being a discretionary beneficiary.¹¹⁰ Additionally, even if the market value substitution rule applied,¹¹¹ the market value of a discretionary beneficiary's interest, whether a normal or a default beneficiary, would be nil or minimal.¹¹²

Accordingly, the two additional conditions would have been pertinent to ensure that discretionary beneficiaries were not taxed on distributions of capital. While not in the Exposure Draft Bill, the EM outlined these two additional conditions:

- (a) that the member receiving the distribution of contributed capital is part of the same family group as the family trust; and
- (b) only individuals or members of the family group have contributed capital to the family trust.¹¹³

It is unlikely that many discretionary trusts could have satisfied these two additional requirements, thereby negating the government's assertion that returns of contributed capital would remain tax-free. This appears to be another illustration of the inconsistency between the government's statements and the actual operation of the Exposure Draft Bill.

5 The Solution to Tax-Preferred Distributions?

It is not disputed that the proposed entity tax system would have achieved the government's goal of addressing concerns of the Tax Office and Treasury regarding the use of discretionary trusts to make tax-free distributions of tax-preferred amounts. This is because if the profits first rule under entity taxation had been introduced, then distributions of tax-preferred amounts by discretionary trusts would have been likely to be assessable for the receiving beneficiary.¹¹⁴ This is because unrealised gains of assets held by a trust would have increased the available profits of the trust, and therefore led to the conclusion that the distribution to the beneficiary was assessable. The only apparent exception is the distribution of a CGT advantaged asset provided certain time frames were met.

Why then did the government back-down from this apparent solution to the distribution of tax-preferred amounts by discretionary trusts? Particularly if the reforms, as originally postulated in 1998, introducing entity taxation provided simplicity, clarity and fairness.¹¹⁵ It is submitted that the reason for this backdown was the lack of consistency between the government's stated justifications and the actual operation of

¹¹⁰ Sub-section 110-25(2) ITAA97.

¹¹¹ Section 112-20 ITAA97. This potentially applies as the beneficiary gave nothing for being included as an object of the discretionary trust.

¹¹² *Chief Commissioner of Stamp Duties (NSW) v Buckle* 98 ATC 4103, 4104. It was acknowledged in *Leedale (Inspector of Taxes) v Lewis* (1982) 3 All ER 803, per Lord Fraser of Tullybelton at 814, that actuarial or market value of interests would be impossible in the case of discretionary interests.

¹¹³ EM, para 5.115.

¹¹⁴ This is on the presumption that the trust would have had 'available profits'.

¹¹⁵ Above n 114.

the Exposure Draft Bill. The submissions received by the government will be analysed to ascertain whether this was the case or not.

IV THE SUBMISSIONS: OUT TO GET TRUSTS¹¹⁶

Although the new entity tax regime professes to treat trusts and companies in the same way, the reality is that they share the same tax rate and not much else. A simplified tax regime may have been John Ralph's aim, but once it has gone through the political process, the result is that companies and trusts will continue to have rules specific to their structures.¹¹⁷

In the three-week period for submissions,¹¹⁸ the government received written submissions from over forty entities dealing with the non-fixed trust regime and the proposed dividend imputation system.¹¹⁹ It is submitted that such a three-week period was far too limited considering the complex nature of the proposed reforms.

Statements in the submissions varied from specifying that entity taxation should not be introduced at all,¹²⁰ to those highlighting that only technical amendments need occur.¹²¹

The submissions that contained statements about the profits first rule, referred to a number of issues. In particular, they addressed the key components of the profits first rule—being 'non-commercial loans from beneficiaries', the calculation of 'available profits', 'contributed capital' and 'prior taxed amounts'. It is these concerns, among others, that will be analysed to evaluate the profits first rule, as to whether it achieved its stated justifications of providing simplicity, clarity and fairness.¹²²

A Non-Commercial Loans From Beneficiaries

¹¹⁶ Comment made by tax lawyer Tony Riordan in respect of the Tax Office's position for the introduction of the trust loss measures in M Laurence, 'Family Trusts Under the Hammer' (1996) *Business Review Weekly* (26 February 1996) 42, 43. It is submitted that the entity tax regime demonstrated the same attitude.

¹¹⁷ R Bowerman, 'Tax Planning 4: Investing Through a Company' *Personal Investor* (February 2000).

¹¹⁸ Above n 73.

¹¹⁹ The Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth) not only contained the measures for non-fixed trusts, but also the proposed new simplified imputation system.

¹²⁰ National Tax and Accountants Association [NTAA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000) at <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹²¹ Pitcher Partners [PP], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000) at <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹²² Above n 1.

One of the major criticisms about entity taxation was the legislative deeming as contributed capital of non-commercial loans from beneficiaries to non-fixed trusts (loans-in). The consequence of such a legislative deeming was that the repayment of the loan by the trust would be regarded as a distribution, and therefore subject to the profits first rule.

This legislative deeming, which was a new concept for taxation measures, appeared to be necessitated to maintain the integrity of the profits first rule. This is because under the entity tax regime, debt financing by a beneficiary would have had better tax outcomes than equity financing. In the absence of the legislative deeming, if a beneficiary loaned money to a discretionary trust, then the beneficiary would only be assessable on the interest component and not the repayments of principal by the discretionary trust. Whereas, because of the profits first rule, if a beneficiary contributed equity to a discretionary trust, then the repayment of that equity would be subject to the profits first rule. This could mean that the entire payment of equity may have been regarded as from profits, and therefore assessable for the beneficiary. Normally the repayment of equity would not be regarded as ordinary income, though it may have CGT consequences.

However, this legislative deeming appeared to have harsh consequences, especially for small businesses, and was difficult to rationalise as necessary to address tax-planning practices of high wealth individuals. There was to be a deemed contribution of capital when a member or associate made a non-commercial loan to a non-fixed trust, and the loan was not fully repaid within 12 months of the end of the loan year.¹²³ Depending upon the precise date of the loan made by the beneficiary to the trust, this could have given nearly two years for the repayment of the loan, before being deemed to be contributed capital.¹²⁴

In submissions, statements were made that it was unclear, in regard to the supposed policy intention, why the mere repayment of a loan to a member should be treated as a distribution.¹²⁵

Parties also stated in submissions that non-commercial loans from beneficiaries were a vital tool to aid small businesses in continuing operations or just staying afloat,¹²⁶ and that they were an extremely common source of working capital funding for businesses.¹²⁷ It was submitted that in most cases non-commercial loans were a

¹²³ Section 157-115 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹²⁴ For example if a loan was made by a beneficiary to a trust on 1 July 2001, the trust would not need to repay the loan until 30 June 2003, before it would be deemed to be contributed capital.

¹²⁵ Arthur Andersen [AA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹²⁶ Australian Chamber of Commerce and Industry [ACCI], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹²⁷ Above n 121, PP.

legitimate dealing between family members, and were provided interest-free to the trust to ensure the on-going operation of the business.¹²⁸

Indeed these observations are correct prior to the proposed entity taxation regime. However, if the entity taxation regime were introduced, these loans would have been tainted as possibly trying to avoid the profits first rule. The reality was that the profits first rule would make debt financing a problem. Accordingly, the government's proposal of entity taxation would have created more uncertainty, and compliance costs, contrary to its stated aims.

It was observed that this flexible financing had been carried on by small and medium trusts for years, and it provided a flexible and economical way for these businesses to finance their survival and growth.¹²⁹ The treatment of these loans as contributed capital contradicted the substance of the transaction and the taxing of the repayment of these loans would have constituted double taxation.

It was submitted that double taxation occurred because members would have first paid tax on earnings before lending the funds to the non-fixed trust, and then the second taxation would have occurred on the repayment of these loans.¹³⁰ It is questionable whether the government had considered such consequences and whether such a result is justified. It appears that the profits first rule would have led to more problems than it proposed to solve.

Another observation made was that for many small farm businesses, the business property is owned by a discretionary trust for asset protection and family succession purposes, while the individual family members in partnership carried on the actual business. A consequence of such an operating structure was that a bank would generally only lend money to the partnership if the trust guaranteed the loan, as the trust holds the valuable business reality.¹³¹

If the partnership defaulted under the loan and the bank called on the guarantee, the payment by the trust to the bank would have been treated as an unfranked assessable distribution to the individuals.¹³² What could be observed in these circumstances is that the reason the partnership defaulted on the loan was because it was unable to afford the repayment of the loan, and now in addition to this the partners will have a

¹²⁸ Above n 126, ACCI. See also: Institute of Chartered Accountants in Australia [ICCA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹²⁹ Above n 121 PP. See also: Pricewaterhousecoopers [PWC], (*Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, 2000), at <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>; and National Institute of Accountants [NIA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000), at <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹³⁰ Above n 121, PP.

¹³¹ Above n 120, NTAA.

¹³² Section 156-175 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

significant debt to the tax office on the deemed distribution.¹³³ It is highly questionable whether such a result is fair.

In other submissions it was queried whether the repayment of an affected loan would actually reduce the loan balance of the ‘creditor’ in the balance sheet of the trust.¹³⁴ This was because if the trustee of the trust understood that it was making a payment of principal reducing the non-commercial loan, the recipient would receive an assessable distribution to the extent that the trust had available profits. In such circumstances, the recipient may not accept that the payment was a reduction of the principal, but rather akin to interest.¹³⁵ Accordingly, in addition to the added complexity to the taxation laws, entity taxation could have made commercial dealings more perplexing.

Additionally, this treatment of non-commercial loans would immediately distort horizontal equity between companies and non-fixed trusts in relation to member-to-entity loans.¹³⁶ This inconsistency is diametrically opposed to the original intention of the government when it initially proposed entity taxation under ANTS.¹³⁷ The government had envisaged that more consistency would be achieved for the taxation of a number of entities. These proposals as espoused in the Exposure Draft Bill singled out non-fixed trusts for the implementation of harsh rules—harsh rules that appeared to be aimed more at eradicating non-fixed trusts, than at establishing a more consistent taxation regime.

¹³³ Above n 121, PP.

¹³⁴ Cowell Clarke Lawyers [CCL], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹³⁵ Ibid.

¹³⁶ Above n 125, AA.

¹³⁷ Above n 1.

B 'Available Profits': Taxes Unrealised Gains

A number of the entities lodging submissions felt that the calculation of 'available profits' was unacceptable, as it would result in the taxing of unrealised gains.¹³⁸ This concern was because in calculating available profits it was neither the book value nor the tax value of assets, as was proposed under the tax value method, which was taken into account. Instead the asset's market value was utilised. Such a calculation brought to account any unrealised increases in the value of assets held by the trust.

Additionally, the value of many assets could fluctuate regularly,¹³⁹ resulting in unrealised gains being astronomical. In such circumstances members receiving repayments of loans or distributions of capital could pay significant tax.¹⁴⁰ If the market value then decreased significantly, essentially tax could have been paid on non-existent profits. Such a result was thought to be inequitable,¹⁴¹ especially if there was a subsequent realisation of a loss on the asset.¹⁴² This was particularly harsh when one considers that such losses would be trapped at the trust level, and not distributable to beneficiaries.

It was also highlighted that Australia's taxation system has always been based on the taxation of realised gains, so the introduction of the profits first rule just for non-fixed trusts was seen as inequitable.¹⁴³ This submission is not totally correct in relation to trading stock.¹⁴⁴ However, this submission is particularly accurate when compared to the proposed tax value method, which has now been subsequently abandoned.¹⁴⁵ This is because the tax value method based the calculation of taxable income on changes in the tax value of assets, and not their market value. Pursuant to the proposed tax value method the net income of a taxpayer would have been calculated as:¹⁴⁶

¹³⁸ Above n 120, NTAA. See also CPA Australia, *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>. See also above n 120 NTAA.

¹³⁹ Above n 120, NTAA. See also: Master Builders Australia [MBA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁴⁰ Above n 120, NTAA. See also above n 139, MBA; and above n 138, CPA.

¹⁴¹ Above n 120, NTAA. See also above n 139, MBA; and above n 11, ATO 2002.

¹⁴² William Buck (Vic) Pty Ltd, *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁴³ Above n 120, NTAA.

¹⁴⁴ This is because a taxpayer at the end of the income year can elect the value of trading stock to be based on its market selling value: Sub-section 70-45(1)(a) ITAA97.

¹⁴⁵ Treasury, 'Government Decides Against the Tax Value Method', (Treasurer Press Release No 48, 2002).

¹⁴⁶ Section 5-55 *Draft Legislation Tax Value Method Prototype #3*, 5 December 2001, at http://www.taxboard.gov.au/content/tvm_index.asp.

$$[Receipts - Payments] + [(Closing\ tax\ values\ of\ assets - Opening\ tax\ values\ of\ assets)] - [(Closing\ tax\ value\ of\ liabilities) - (Opening\ tax\ value\ of\ liabilities)]$$

It was contended that an entity which was a going concern would never have been able to access contributed capital.¹⁴⁷ CPA Australia considered this enormously harsh and unacceptable, especially when compared to the rules that apply to companies who are able to perform share buy-backs.¹⁴⁸ This highlights yet another inconsistency that would have been introduced into the tax system if the proposed entity taxation system were implemented.

PKF Australia Ltd submitted that for going concerns this would mean that a distribution of corpus of the trust would be treated as a distribution of profits even when there were no realised profits in the trust. This would be of particular relevance for discretionary trusts that are required to make corpus distributions to beneficiaries under the terms of the trust instrument.¹⁴⁹ This statement is valid, and displays how it was difficult to rationalise the government's stated intention of entity taxation being the 'taxation of distributions on the basis of their economic substance'.¹⁵⁰

It is submitted that this proposition by the government is misleading, since the profits first rule regards most distributions, regardless of their substance, to be from profits. Additionally, the profits first rule had far greater implications than the proposed tax value method,¹⁵¹ as the tax value method did not try to tax unrealised gains. Also the profits first rule would lead to inconsistencies between the treatment of a distribution at trust law compared to taxation law. For at trust law a distribution may have been from corpus, though under the profits first rule it could be regarded as from profits.

It was also highlighted that any form of distribution out of a pre-CGT asset revaluation must be treated as a taxable distribution, even though a distribution out of the realised pre-CGT reserves would be exempt.¹⁵² Such inconsistencies are again hard to comprehend given the government's stated objectives.

The calculation of available profits would mean the taxation of income would be accelerated, as the beneficiary would be assessable on an amount that the trust itself

¹⁴⁷ Above n 138, CPA.

¹⁴⁸ Ibid.

¹⁴⁹ PKF Australia Limited, *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁵⁰ Sub-section 157-10(1) Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁵¹ Above n 62.

¹⁵² Above n 128, ICCA.

would not be taxable on.¹⁵³ This is referring to the fact that even under the entity taxation regime, the trust in calculating its 'net income' would not have included unrealised gains.

Consequently, the inclusion of unrealised gains in available profits ignores the fact that such profits are not available to a non-fixed trust until the asset is actually realised.¹⁵⁴

Another complication highlighted by KPMG was that when the income was unrealised and untaxed in the hands of the non-fixed trust, no imputation credits would be available for a distribution sourced to those profits.¹⁵⁵ Accordingly, the receiving member would not have the benefit of imputation credits to decrease their tax payable on receipt of the distribution.

Also, it was submitted that a consequence of the profits first rule could be that it forces the realisation of assets to be able to pay the tax liability.¹⁵⁶ This realisation may not be the best economic opportunity. The National Institute of Accountants submitted that these situations could occur when the trust deed requires the trustee to distribute out of corpus.¹⁵⁷ This is highlighting that a corpus beneficiary, under the profits first rule, would be assessed on a corpus distribution, which may be in-specie. Consequently, for the beneficiary to be able to pay the income tax assessed on the distribution, the beneficiary may have to sell the corpus asset it had received.

Additionally, the profits first rule introduced the concept of 'anticipated profits' in the circumstances that available profits and contributed capital were exhausted.¹⁵⁸ The effect of the concept of 'anticipated profits' was that profits that may never materialise would be taxed.¹⁵⁹ Again this result is hard to justify when the government's stated objective of the profits first rule was to tax distributions on their economic effect, rather than their legal form.¹⁶⁰

¹⁵³ KPMG, *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

See also: S Page, *Submission in response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

See also: AICD, *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁵⁴ Above n 153, KPMG.

¹⁵⁵ Ibid.

¹⁵⁶ Above n 129, NIA.

¹⁵⁷ Ibid.

¹⁵⁸ Section 157-20 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁵⁹ Above n 121, PP.

¹⁶⁰ Sub-section 157-10(1) Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

C Tax-Free into Taxable

In addition to this acceleration, potentially tax-free distributions would be turned into taxable distribution,¹⁶¹ which was seen as unacceptable.¹⁶² The reason why this was unacceptable was due to the inconsistency of treatment. An exception to the profits first rule was the distribution of certain capital gains if distributed within 12 months.¹⁶³ However, until these capital gains were actually realised by the trust they would be taken into account to ascertain 'available profits'. Consequently, in an unrealised form, these gains increased the possibility that a distribution would be assessable for a receiving beneficiary.

The profits first rule would have achieved this because 'available profits' would have included, amongst other things, the market value of assets acquired prior to 20 September 1985.

Pitcher Partners stated in their submission that this result would mean the concessional treatment that was promised to entities in respect of pre-CGT assets might be rendered a nullity by the actual operation of the profits first rule.¹⁶⁴ In particular, the available profits for a trust would be overstated in circumstances where the pre-CGT assets constituted a large part of the net market value of assets of the entity.¹⁶⁵

The Taxation Institute of Australia stated that this result was unfair. This is because it meant artificial profits, which on realisation would not be assessed, would have been treated as distributed and thus be assessable before a capital distribution could be made.¹⁶⁶

D Double Taxation

Some regarded the profits first rule as a defacto wealth tax,¹⁶⁷ and highlighted that on the eventual sale of the trust's assets, that the trust would be liable for tax on the realisation. This would mean there would be double taxation.¹⁶⁸

¹⁶¹ National Farmers' Federation [NFF], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁶² Ibid.

¹⁶³ Section 157-225 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth). See also above n 161 NFF.

¹⁶⁴ Above n 121, PP.

¹⁶⁵ Ibid.

¹⁶⁶ Taxation Institute of Australia [TIA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)* (2000), at <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁶⁷ Above n 161, NFF. See also: Mike Stephens and Associates [MSA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)* (2000). at <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁶⁸ Above n 167, MSA; above n 138, CPA; above n 153, KPMG; above n 121, PP.

The way in which double taxation could occur was illustrated by the following example contained in the National Farmers' Federation's submission:

When a distribution was made out of actual capital from the trust to a member, it may nevertheless be deemed to come out of unrealised gains and be taxable in the hands of the member. Upon the actual sale of the asset by the trust, the trust would be taxed on the capital gain even though the unrealised gain had already been taxed in the member's hands.¹⁶⁹

This double taxation would occur because available profits include unrealised gains, and then the actual distribution of proceeds from the realisation of the gain would be assessable to the beneficiary, albeit franked.¹⁷⁰

The Australian Chamber of Commerce and Industry stated that this double taxation would reduce the incentive to invest.¹⁷¹ Such a submission could be valid, as recently there have been calls to allow for the flow through of tax-preferred amounts for mining companies to encourage investment in the mining sector.¹⁷² It is submitted that the profits first rule's operation would have been harsher than the classical system in relation to dividends that existed for companies prior to the introduction of the Australian imputation system in 1987.

E Reliance on Accounting Records

The concession for non-fixed trusts being able to rely on accounting records to ascertain available profits was questionable. This was because accounting records will almost never disclose any internally generated goodwill, and rarely show the current market value of land, buildings or share portfolios.¹⁷³

It was highlighted that the calculation of 'available profits' would be required for every deemed distribution, as well as normal distributions.¹⁷⁴ Furthermore, these costly valuations would still be required when a distribution was not entirely out of available profits.¹⁷⁵

¹⁶⁹ Above n 161, NFF.

¹⁷⁰ Above n 139, MBA; above n 167, MSA; above n 161, NFF.

¹⁷¹ Above n 126, ACCI.

¹⁷² N Wilson, 'West Digs in to go with Tax Flow', *The Australian*, 21 March 2003, 38.

¹⁷³ Above n 134, CCL.

¹⁷⁴ J Morgan [JM], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁷⁵ Above n 120, NTAA.

A consequence of this is that a trustee could be required to determine available profits a number of times during a year if multiple distributions were made,¹⁷⁶ thus increasing compliance costs as valuations could be required.

Additionally, concern was expressed about the legislative exception that allowed accounting records to be sufficient evidence for the distribution being regarded as being out of available profits. This exception operated when the accounting records indicated that book profits were greater than the distribution amount.¹⁷⁷ The National Institute of Accountants questioned whether this legislative exception would override the trustee's obligations to members, which could still require valuations to determine the available profits.¹⁷⁸

In other submissions problems were outlined in ascertaining the market value of assets, especially when the assets had not been realised on the open market.¹⁷⁹ Intellectual property assets such as trademarks, patents, copyright and designs were provided as an example. In an unrealised form the 'market value' of such property can span a very large range. Due to this variability of value, Cowell Clark Lawyers expressed concern about the non-fixed trust rules giving rise to a plethora of tax cases based on valuations.¹⁸⁰

This imprecision about market value is a valid concern, and is especially confounding when the beneficiary's taxation treatment depends upon it. The implications for relying on incorrect valuations would lead to beneficiaries either incorrectly including or excluding amounts from their assessable income. Questions of culpability in such circumstances would be complicated. The complication of valuations is illustrated by the Tax Office's review of valuations relied upon for the utilisation of the margin scheme under the GST legislation.¹⁸¹ The ramifications of any changes of such valuations are expected to be complicated and adverse for the parties involved in the transactions.¹⁸²

Additionally, CPA Australia submitted that it was inequitable that prepayments were to be included in assets and therefore the calculation of 'available profits' when they are not legally recoverable debts.¹⁸³ The reason that a prepaid expense could be included in available profits is that pursuant to accounting standards prepayments are assets, representing a future benefit.¹⁸⁴ Their inclusion does appear unnecessarily harsh, since

¹⁷⁶ Above n 138, CPA.

¹⁷⁷ Sub-section 157-85(2) Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁷⁸ Above n 129, NIA.

¹⁷⁹ Above n 134, CCL.

¹⁸⁰ Ibid.

¹⁸¹ Division 75 of *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

¹⁸² M Newnham, 'Tax Office Plays Scrooge', *The Age*, 23 December 2002, 3.

¹⁸³ Above n 138, CPA.

¹⁸⁴ Australian Accounting Research Foundation and Australian Accounting Standards Board. (1995). *Statement of Accounting Concepts SAC 4 – Definition and Recognition Criteria of the Elements of Financial Statements*, Melbourne, at paragraph 14.

prepayments only represent book assets, with no particular tangible assets underlying them.

F Similar Rules do not Apply to Companies or Fixed Trusts

Pricewaterhousecoopers stated that the fact that the profits first rule would not apply to companies or to fixed trusts, made the stated reason for taxing trusts at odds with the entity tax regime.¹⁸⁵

Other entities in their submissions highlighted that the treatment of unrealised capital gains would not apply to companies and fixed trusts.¹⁸⁶ Nor would the non-commercial loans and guarantees from beneficiaries¹⁸⁷ apply to companies and fixed trusts.¹⁸⁸

It was stated in submissions that the entity tax regime would impose special rules on non-fixed trusts, dramatically increasing complexity and creating new distortions to Australia's taxation system.¹⁸⁹ The result of this would be to severely disadvantage many small businesses that use a non-fixed trust entity structure.¹⁹⁰

The inconsistencies between non-fixed trusts and companies was illustrated by noting that although non-fixed trusts will be taxed at the same rate as companies, the process for calculating the trust's and member's tax position, would be quite different from the treatment of companies and their shareholders. Consequently, the National Institute of Accountants concluded that the original aim of reducing inconsistency and complexity would not be achieved by the proposed measures.¹⁹¹

This inconsistency was also observed by KPMG in the government's suggestion that the mandatory application of the profits first rule to non-fixed trusts merely replicated the rules applying to corporate entities. KPMG validly submitted that the profits first rule went a lot further than the anti-avoidance provisions in ss 45 to 45C of ITAA36.¹⁹²

Additionally, companies would still be able to distribute capital to shareholders in circumstances where the distribution is, in effect, not in substitution of a dividend. Such ability would not apply if the profits first rule applied to companies.¹⁹³ In comparison non-fixed trusts would have no opportunity to return capital to their members, other than where no profits existed or on the extinguishment of the

¹⁸⁵ Above n 129, PWC.

¹⁸⁶ Above n 139, MBA; above n 126, ACCI.

¹⁸⁷ Above n 126, ACCI.

¹⁸⁸ This is set to change with the new debt/equity rules to commence from 1 July 2004.

¹⁸⁹ Above n 129, NIA.

¹⁹⁰ Ibid.

¹⁹¹ Ibid.

¹⁹² Above n 153, KPMG; above n 161, NFF.

¹⁹³ Above n 161, NFF.

membership interest.¹⁹⁴ It is submitted that may be it was this 'extinguishment' of discretionary trusts that was in fact the underlying aim of the entity tax regime, and not the consistent taxation treatment between different entity types.

G Move Away from High-Level Principles

CPA Australia made an insightful point in its submission as it felt the Exposure Draft Bill was devoid of the high level principles espoused in the *Review of Business Taxation Report*.¹⁹⁵ CPA Australia stated that the high-level attributes of the original unified entity regime had been lost in the process and the Exposure Draft Bill proposed a separate, complex regime for non-fixed trusts. The Exposure Draft Bill had failed to provide the horizontal equity originally sought.¹⁹⁶

An important component of creating horizontal equity in the tax system is that the entity structure through which a business is operated, or an investment is made, should not produce different taxation consequences when all other things are equal. The National Institute of Accountants thought it was clear that the Exposure Draft Bill did not create horizontal equity, and in fact worked against it.¹⁹⁷ This is a valid observation because, if the entity tax regime had been introduced, it would have added complexity and a special class of rules just for non-fixed trusts.

V THE WITHDRAWAL AND THE LESSONS LEARNT

It is submitted that the submissions received by the government in response to the Exposure Draft Bill highlighted on numerous occasions the inconsistencies between the government's stated justifications about entity taxation and its actual operation. Accordingly, there was grave doubt as to the substance behind the government's justification for the proposed amendments providing simplicity, clarity and fairness. It may be that this inconsistency led to the government withdrawing the entity taxation proposal, as the government found it especially difficult to defend the proposals in light of its inconsistencies.

After considering the submissions, the government announced on 27 February 2001 that it no longer intended to proceed with entity taxation in its current form.¹⁹⁸ Instead the government referred the issue to the newly created Board of Taxation (the 'Board') for further consideration.¹⁹⁹

¹⁹⁴ Ibid.

¹⁹⁵ Above n 74.

¹⁹⁶ Ibid.

¹⁹⁷ Above n 129, NIA.

¹⁹⁸ Treasury, 'Entity Taxation' (Treasurer Press Release No 8, 2001).

¹⁹⁹ Ibid.

Newspapers reported that the government gave no reason for the change of heart, and that it was believed that entity taxation proved too complicated to implement, attracted too much opposition from the investment industry, and made too little difference to revenue.²⁰⁰

Statements made by the Treasurer on the withdrawal of the Exposure Draft Bill support the comments concerning complications and opposition from the investment industry.²⁰¹ However, the cost to revenue did not appear to be minimal. In the federal budget in May 2001, the Treasury noted that the loss of revenue due to the withdrawal of the proposed entity taxation system was estimated to be \$1.1 billion over four years.²⁰² While consistent with this, the Treasurer's initial estimate in February 2001²⁰³ appears to play down the loss of revenue. This is because it only disclosed the 2002 financial year loss of \$110 million alone, and did not disclose the impact for future financial years.

Indeed the Treasurer's press release detailed that a great number of the submissions received raised technical problems, particularly in relation to distinguishing the source of different distributions, and valuation and compliance issues, which meant that the draft legislation was not workable.²⁰⁴

It is interesting that the Treasurer stated that the Exposure Draft Bill was 'unworkable'. This raises concerns about the initial considerations put into its drafting by the legislative division of the Tax Office. There appears to have been an apparent breakdown of adequate consideration for the practical operation of the proposed entity tax system. This is notable when it is considered that the responsibility for the design of tax laws and regulations has, with effect from 1 July 2002, been transferred from the Tax Office back to the Treasury. The reasons stated for this transfer of staff and responsibility were to bring the accountability for tax policies and legislative design more directly under Ministerial control.²⁰⁵

It is worthwhile to contemplate what influence the draft entity tax bill experience had on the government's decision. The decision to transfer staff and responsibility to the Treasury was based on a report by the Board. The Board's report to the government made no direct mention of the entity taxation experience, but it did state:

The perception is that the ATO's dual responsibility for instructing on the drafting of tax legislation and for administering that legislation results in legislation that is overly biased towards meeting the compliance and

²⁰⁰ A Kohler, A 'Down for the Count', *Australian Financial Review*, 21 October 2000, 3.

²⁰¹ Above n 198.

²⁰² Treasury, *Budget Measures 2001-2002*, (Budget Paper No 2, 2001), Table 1: Revenue Measures since the 2000-01 MYEFO.

²⁰³ Above n 198. In the Treasurer's announcement of the withdrawal of entity taxation, \$110 million was stated as the cost of lost tax revenue for the 2001-02 financial year.

²⁰⁴ Above n 198.

²⁰⁵ Treasury, 'Reforms to Community Consultation Processes and Agency Accountabilities in Tax Design', (Treasurer Press Release No 22, 2002).

administrative objectives of the ATO. This is seen as producing *unnecessary complexity and compliance cost burdens* to taxpayers.²⁰⁶ [Emphasis added]

This is not the first time the Tax Office has come under criticism for its drafting, as it was felt that in relation to the trust loss measures the Tax Office had its own agenda and the legislation it drafted did not reflect the Treasurer's initial announcement of the measures.²⁰⁷ The Treasurer's conclusion that the entity taxation system was unworkable appears to be correct. This was highlighted by the numerous technical problems outlined in the submissions. These technical problems included:

- (a) how market value was to be determined for assets that had not been previously realised;
- (b) what 'assets' were to be included;
- (c) how contributed capital could be allocated to sub-accounts for discretionary trusts, and
- (d) why unrealised gains on CGT assets acquired prior to 20 September 1985 should be taken into account in determining 'available profits', when if they are realised they could be distributed tax-free to beneficiaries.

Others expressed there were more political reasons in the Treasurer's announcement, as stated by Senator Cook who suggested that the decision was made:

in order to get him past the election, in order to get him past the vociferous complaints of the coalition partner, the National Party, and obviously in order to get him past the vociferous complaints of the many frontbenchers of the government who are beneficiaries from family trusts. ... There is a conflict within the government in not honouring its commitment on ANTS.²⁰⁸

For the time being it appears that the comprehensive tax reform of discretionary trusts has been defeated. This is because the Board concluded that there were no compelling arguments to closely align the tax treatment of discretionary trusts and companies.²⁰⁹ Remember that this was the purported underlying premise of entity taxation. Indeed, the Board recommended that the government should retain the current flow-through treatment of distributions of non-assessable (tax-preferred) amounts by discretionary trusts.²¹⁰ This was because the Board considered that any attempt to remove these tax advantages for classes of trusts delineated either by size, type or complexity, carried the risk of being arbitrary and unfair.²¹¹ It is not clear from the Board's report what the arbitrary and unfair risks were.

²⁰⁶ The Board of Taxation, *Consultation with the Community on the Development of Taxation Legislation: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer*, (2002) 19.

²⁰⁷ Senate Economics Legislation Committee, Taxation Laws Amendment (Trust Loss and Other Deductions) Bill 1997, Family Trust Distribution Tax (Primary Liability) Bill 1997, Family Tax Distribution Tax (Secondary Liability) Bill, Medicare Levy Consequential Amendment (Trust Loss) Bill 1997, Canberra, AGPS, per Mr Leibler at 86.

²⁰⁸ Senate Official Hansard, 'Parliamentary Debates: Tuesday, 6 March 2001', per Senator Cook at 22589.

²⁰⁹ Above n 9, 1.

²¹⁰ Ibid.

²¹¹ Ibid 14.

However, the Board did recommended changes to s 109UB ITAA36 to improve its effectiveness and remove unfairness.²¹² In particular, the Board identified how asset revaluation reserve distributions could be used to circumvent the operation of Division 7A.²¹³

The government, on releasing the Board's report, announced it would legislate to rectify faults in s 109UB in Division 7A, as identified by the Board in respect of asset revaluation reserve distributions, which has now been done pursuant to Schedule 8 of *Tax Laws Amendment (2004 Measures No 1) Act 2004* (Cth).²¹⁴

It is notable that the government was silent in respect of the Board's recommendation to retain flow-through.²¹⁵ Though, through conversations with the Treasury, it is understood by the author that the government will follow this recommendation for now.²¹⁶

The government found that the profits first rule under entity taxation was quite unacceptable to a persuasive part of its constituency.²¹⁷ In fact, complexities with the profits first rule would have made compliance with the rule extremely difficult. Such complexities need to be acknowledged, as when tax laws are complex and taxpayers cannot understand them (let alone their professional advisors) then taxpayers are unaware of their obligations. This can mean taxpayers inadvertently do not comply with the tax laws,²¹⁸ a position that is not in the best interests of the tax system.

²¹² Ibid 1. The unfairness referred to is that the deemed loan under section 109UB ITAA36, unlike a real loan made by a private company, cannot be: (a) repaid by year end; or (b) be structured within the minimum terms to avoid the application of Division 7A.

²¹³ Ibid, 16. The Board also observed that a trustee performing an asset revaluation reserve distribution could circumvent the operation of s 109UB even when a discretionary trust had an unpaid distribution to a private company. The Board saw that this circumvention could occur by an asset revaluation being performed, the trustee then making a tax-free distribution of corpus to a beneficiary—known as an asset revaluation reserve distribution—and the beneficiary then lending the corpus distribution back to the trust. This process meant that the trustee was indebted to the beneficiary, rather than the beneficiary being indebted to the trustee. Accordingly, the subsequent act of the trustee repaying the loan to the beneficiary would not come within the ambit of s 109UB, nor be assessable to the beneficiary.

²¹⁴ On 19 February 2004, some 14 months after the Board's initial recommendations, the proposed amendments were introduced into the House of Representatives—contained in Sch 8 of Tax Laws Amendment (2004 Measures No 1) Bill 2004 (Cth). The Bill was passed by the Senate in June 2004, received Royal Assent on 29 June 2004 and Sch 8 commenced on the date of Royal Assent.

²¹⁵ Treasury, 'Taxation of Discretionary Trusts' (Treasurer Press Release No 81, 2002).

²¹⁶ In response to another recommendation the Australian Taxation Office has released a Taxation Ruling detailing that interest is not deductible for trusts borrowing money to fund an asset revaluation reserve distribution: Commissioner of Taxation, Australian Taxation Office, *Taxation Ruling TR 2003/9: Income tax: Deductibility of Interest Expenses Incurred by Trustees on Borrowed Funds Used to Pay Distributions to Beneficiaries*.

²¹⁷ K Schurgott, Structuring for 2002, (2001) 35:11 *Taxation in Australia* 597, 600.

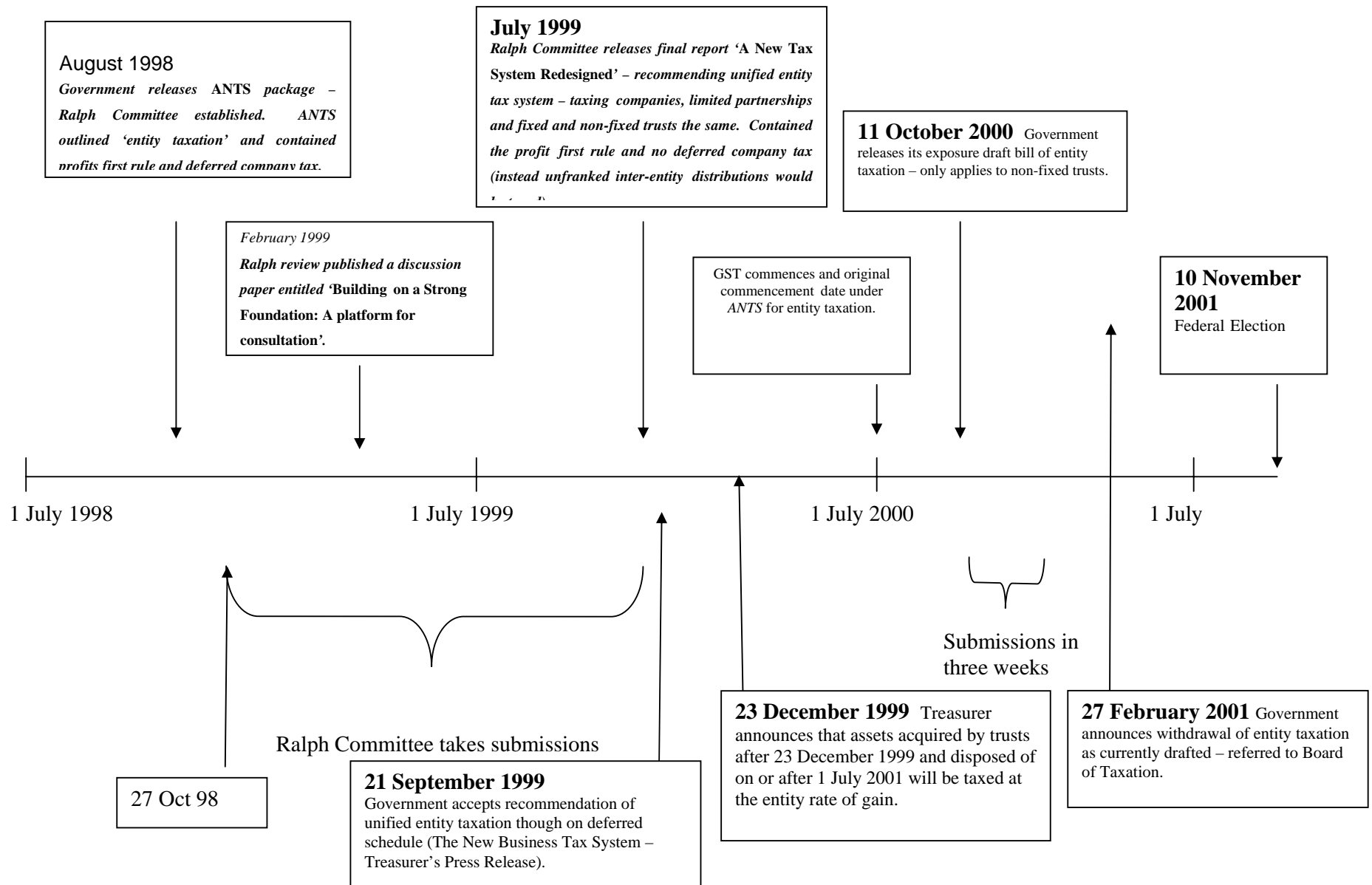
²¹⁸ Above n 120, NTAA.

The government must acknowledge and take into account the lessons it learnt from the failed attempt to introduce entity taxation. These lessons include, but are not limited to: the government should not introduce draft reforms that are ‘unworkable’, which have ‘technical problems’ and are ‘complex’.²¹⁹ Additionally, and perhaps more importantly, there needs to be consistency between the government’s stated policy for proposed reforms, and the way that those proposals in fact operate. If there is no consistency between these two factors, then the government provides opportunity for valid criticisms to be made of reform proposals using the government’s own stated policy objectives. The government’s stated policy goals for entity taxation was for simplicity, clarity and fairness. Unfortunately, as events unfolded it became clear that there was little or no substance behind this rhetoric. It is submitted that it was the lack of consistency between stated policy and actual legislation that was the main cause for the demise of entity taxation proposals.

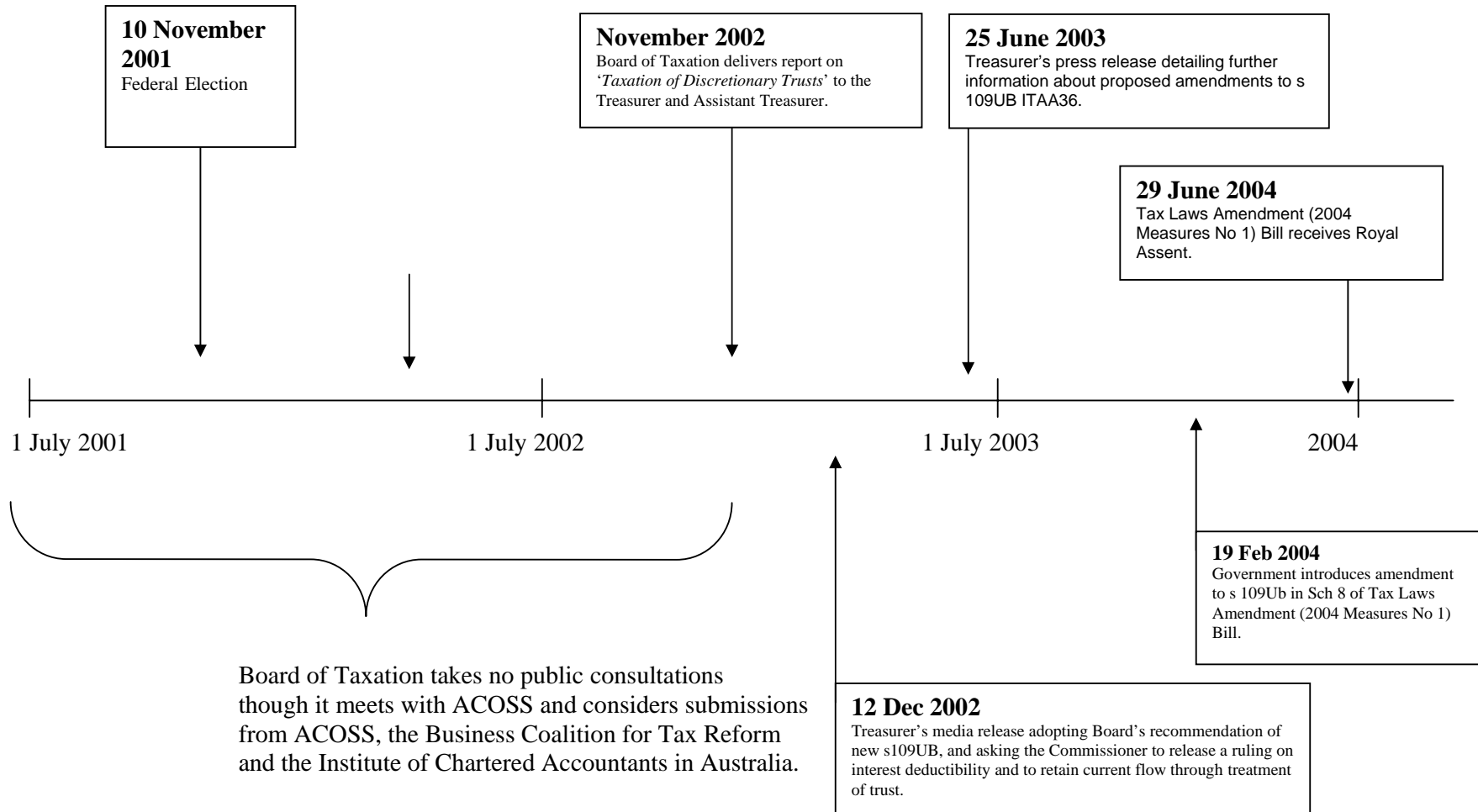
For the Australian taxation system to progress, the government needs to acknowledge and ensure that there is indeed substance behind its policy justifications for reform and the provisions it implements. It is with this consistency that the overall Australian tax system will be improved.

²¹⁹ These are just the problems that the Treasurer referred to in withdrawing entity taxation. Above n 198.

Appendix A: Time Line of Reforms



Appendix A: Time Line of Reforms



AN APPRAISAL OF RESEARCH-LED TEACHING IN THE CONTEXT OF TAXATION: CAN BOTH TEACHER AND STUDENT BENEFIT?

MARGARET McKERCHAR

Margaret McKerchar is an Associate Professor of Taxation at Atax, Faculty of Law, University of New South Wales.

I INTRODUCTION

The University of Sydney¹ has adopted a vision of research-led teaching to strategically position itself in relation to international best practice. In doing so, a range of priorities, criteria, indicators and reviews have been established, in addition to benchmarking relationships with other leading universities in the United Kingdom and Australia. This paper presents an overview of these developments and against this background, provides an analysis from one ‘coal face’: the teaching of taxation law. Based on personal reflection, it explores the positive outcomes of research-led teaching for both student and teacher and strategies by which it can be practised as we adapt to (and prepare students for) our changing world.

II STRATEGIC PRIORITY OF THE UNIVERSITY OF SYDNEY

The current Strategic Plan of the University of Sydney (USYD) identifies research-led teaching as being a priority. Specifically, Goal 1.3 is as follows:

“to provide curricula informed by current research, scholarship, creative works and professional practice and be responsive to the needs of the many communities served by the university and result in graduates well equipped to contribute successfully to the global society in which they live and work”.

There are other goals related to research-led teaching, but Goal 1.3 clearly establishes the important relationship between research and *what* we teach (curricula) and *how* we teach (scholarship). To assist in the achievement of this priority, a Working Group has been established by the Institute of Teaching and Learning (ITL) with the endorsement of the University’s Academic Board and of the Pro-Vice-Chancellor (Teaching and Learning). The Working Group, which met four times in 2003, is comprised of a number of ITL staff members and a representative of each of the faculties of the University.

¹ The author was previously employed at the University of Sydney.

To digress slightly, the interest in research-led teaching in a broader context is not a new or even recent development. Considerable literature exists on the relationship between teaching and research throughout the 1990s² and indeed in the 1980s³. However, an analysis by Hattie and Marsh⁴ of 58 studies concluded that the relationship, in terms of research productivity improving teaching effectiveness, was unproven in spite of its many supporters.

In recent years, universities throughout the world have undergone profound changes in funding patterns and accountability. Ylijoki⁵ refers to this as academic capitalism, a new culture that promotes market-orientation and competition in both research and teaching. This academic capitalism extends to Australia.

In Australia we have seen the Commonwealth Government become increasingly assertive in university affairs since the late 1980s, including the more recent enunciation of national priorities and the advocacy of management practices to which universities are expected to adhere. In this respect, USYD will undergo its Australian University Quality Assurance (AQUA) audit in 2004 at which evidence is required to demonstrate that teaching that is underpinned by research and scholarship. Karmel⁶ argues that the higher education sector has become subject to centralist direction and that this has promoted uniformity rather than diversity. He argues that government policy has been built on subjective assumptions about the nature of universities and calls for a major rethink.

Meanwhile, Australian universities have had to focus on the pursuit of the Commonwealth's national objectives, and the same time, differentiate themselves in a competitive marketplace. At USYD, a research-extensive university, the strategy has been to stress the research base of the educational experiences of both undergraduate and post-graduate students, and this has led to the emphasis that has been placed on research-led teaching.

Thus it could be said that at USYD we are in a revival phase in terms of the priority given to research-led teaching, in response to market forces and government

² For example, see Shore, B Pinker, S and M Bates 'Research as a Model for University Teaching' (1990) *Higher Education* 19 21-35; Ramsden, P and I Moses 'Associations Between Research and Teaching in Australian Higher Education' (1992) *Higher Education* 23(3) 273-295; and Brew, A 'Research and Teaching: Changing Relationships in a Changing Context' (1999) *Studies in Higher Education* 24(3) 291-301.

³ For example, see Centra, J 'Research Productivity and Teaching Effectiveness' (1983) *Research in Higher Education* 18(4) 379-389; and Elton, L 'Research and Teaching: Sybiosis or Conflict' (1986) *Higher Education* 15(3-4) 299-304.

⁴ Hattie, J and H Marsh 'The relationship between research and teaching: A meta-analysis' (1996) *Review of Research in Education* 66 507-542.

⁵ Ylijoki, O 'Entangled in academic capitalism? A case-study on changing ideals and practices of university research' (2003) *Higher Education* 45 307-335.

⁶ Karmel, P 'Higher education at the crossroads: Response to an Australian ministerial discussion paper' (2003) *Higher Education* 45 1-18.

intervention. However, on staff we have many strong proponents of research-led teaching as a means to improving teaching effectiveness. Whether or not it is the best means to the end, we are not alone, with the Universities of Oxford, UCL and Edinburgh being amongst those universities with whom we are developing benchmarking relationships.

The commitment to research-led teaching at USYD is more than just window-dressing nor is it limited to just a few contexts. It is the expectation across all disciplines is well promulgated, reviewed and consistently reinforced. This is perhaps made more evident by reflecting on the policies and practices that have been developed as part of achieving the priority.

III WORKING PARTY OF THE INSTITUTE OF TEACHING AND LEARNING

Given the emphasis on accountability, considerable attention has been given by member of the Working Party to developing criteria and performance indicators by which to measure progress towards reaching the priority. The key criteria are:

- Student awareness of and active engagement with research
- Academic staff capacity to integrate research and teaching
- Curriculum designed to engage students in a variety of research-based activities, induct them into the research community and develop their awareness of research
- Departmental encouragement for aligning research and teaching
- Faculty support and encouragement for strengthening the nexus between research and teaching
- College recognition and support for the development of the links between research and teaching
- University commitment to the development of strong relationships between teaching and research

Drawing on the work of Hattie⁷, the Working Party has developed a range of performance indicators for each criteria, though these are still in a trial phase. For example, the performance indicators for academic capacity to integrate research and teaching include the:

- Proportion of teaching staff with PhD or research record (2.1);
- Proportion of higher degree research supervisors who are active researchers (2.2); and
- Proportion of senior and active researchers engaged in first and second year undergraduate teaching (2.3).

⁷ Hattie, J “Performance indicators for the interdependence of research and teaching’ (2001) in *Towards Understanding the Interdependence of Research and Teaching: Occasional Papers from the Vice Chancellor’s Forum on the Research Teaching Nexus*, Massey University, Palmerston North, NZ, pp.50-52.

ITL staff have run seminars on research-led teaching and the Working Party has circulated a range of papers to stimulate discussion and improve staff awareness and understanding of the University priority. For example, in May 2003 the Working Group released a statement explaining the difference between research-led teaching and the scholarship of teaching.

“Research-led teaching needs to be distinguished from the scholarship of teaching. Research led teaching is about making our teaching and our students’ learning more research-focussed – in terms of what we wish our students to learn, whilst the scholarship of teaching is about drawing on and contributing to research and scholarship about the way we teach and learn within our disciplines..... Research-led teaching emphasis the partnership of academics and students as they engage in the critical challenge of open exploratory inquiry.”

The Working Party has been documenting evidence of research-led and scholarship-led teaching practices in their discipline context and gathering information from other sources within the University regarding students’ experiences of research. In addition, the Academic Board of the University has been conducting reviews of Faculties throughout 2002 and 2003, again documenting evidence of good practice in teaching.

IV FACULTY REVIEW VISITS BY ACADEMIC BOARD

Every Faculty underwent a review visit by the Academic Board in 2002, with follow up visits scheduled to all Faculties by the end of 2004. The approach of the Board has been deliberately collegial and transparent, and based initially on a self-appraisal by the Faculty. The review visits included interviews with staff and students at both undergraduate and postgraduate level and encompassed both coursework and research programs.

The Faculty reviews have highlighted disparity in approaches and strength of evidence in teaching practices. In general, research-led teaching was strongest in the sciences, arts and education and weakest in economics and business. Students’ perception of what staff do in regards research has been very mixed. (This being one of the key criteria for judging research-led teaching). For example, agriculture students saw research as something staff did in their holidays. Engineering students believed it would be good if staff talked about their research. First and second year science students felt staff thought them incapable of benefiting from engagement with cutting edge research. In general, it did not appear that students were disinterested in the research interests of staff, but were unaware of the specific of the areas of interest that staff had.

Other policies and practices of Academic Board whereby the emphasis on research-led teaching is evident include teaching awards (at both University and Faculty level), scholarship funds (awarded to faculties on the basis of demonstrated scholarship in teaching) and promotion criteria for academic staff.

V A PERSPECTIVE FROM THE 'COAL FACE'

Life as an academic at the coal face is not easy. If you are interested in making a career out of your toil, then there are a great many expectations placed on you – and toil you will! You will be chasing research grants, getting your work published, and doing the research itself. You will have classes to run, teaching materials to prepare and a never-ending load of marking. You will be available to help students on a wide range of matters. You will be active on committees within the University, your profession and the community. If you are lucky, you will have a life! Why do academics do this? It can only be for a love of what we do – for in the case of tax academics, there are many other options that would offer far greater financial rewards.

From my perspective, the best part of the job is that to a large extent you have some control over your destiny. Do you want to focus on teaching, research, service or administrative activities? Do you strive for balance? Do you seek outside consultancies (and monetary rewards)? Do you want to research either in the scholarship of teaching or within your discipline area (or both)? Do you want to research alone or as part of team – from your own discipline or across disciplines? Academics do have some freedom in these choices, depending on what they want to make of their career.

In practice, for many academics finding the right balance in fulfilling these expectations is extremely challenging. Many would regard research and teaching as in conflict with each other – given constraints of both time and energy. Certainly staff at USYD cannot afford to ignore either – whether interested in promotion or not (performance by individuals is monitored annually). Both research and teaching are important requirements (you must be outstanding at one or the other), neither can be let lapse. Can there be merit in making them work together? Many academics do this by engaging in research on teaching – this is an obvious pathway. Perhaps more challenging is the combination of discipline-based research and teaching. Can they be made to work and how?

VI BENEFITS FOR TEACHERS

Before proceeding, perhaps there needs to be more of a case made for embarking on this pathway – in particular, for those academics who are not driven by promotion. Why bother? There are two real areas of potential that need to be considered. Firstly, there is your own job satisfaction. Can you feel better about yourself and your work by considering a different approach to your teaching? Are you feeling tired and stale? Research-led teaching does offer you the possibility of rejuvenation in terms of both curriculum design and teaching strategies.

Many tax academics are alone in their Faculties in this subject area. Interaction with students becomes a rewarding and challenging part of the job. Getting students curiosity aroused also provides stimulation for you. You have common ground to explore – while your peers on staff are not usually all that interested in tax (unless they want specific advice on a personal matter and then they seek you out). Who else is going to listen to your love of taxation so avidly?

VII BENEFITS FOR STUDENTS

And what about your students? Can research-led teaching enhance their learning and their interest in the subject (beyond what do they have to do to pass this semester)? Although not proven, many of us could provide examples based on our own experience, both as students and as teachers. Depending on the strategies employed, research-led teaching can allow students to develop transferable skills in inquiry and problem-solving. It can stimulate their curiosity in the subject and their motivation to learn. Ideally you want them to have a life-long interest in the subject, to see its relevance to their everyday lives and to have acquired skills that they can draw on in the future giving the changing nature of taxation. Simply transferring knowledge is not enough. Apart from producing a well-rounded, better equipped and more capable graduate, you may also generate more honours or postgraduate students, and research assistants. Research-led teaching can be a win-win situation! You have to consider how to best to implement it given your constraints and the needs of your students.

VIII APPROACHES TO INTEGRATION OF RESEARCH AND TEACHING

There are two main threads to integration of research and teaching, though they do not represent alternatives as such. Both can be used together effectively and yes, you are probably already engaging in at least the first without having necessarily made a conscious decision to do so. Firstly, you can consider how to build your research into the curriculum and to increase student awareness of what you do as a researcher. The second thread is by engaging the student in research activities.

The first thread is an obvious one. To give examples from my own research and teaching – the study of tax history, the development of tax policy, the complexity of tax law, basic principles of a good tax system – all areas of research interest to me, and they lend themselves very readily to helping students understand our tax system. I've also recently done research on the history of agriculture and the development of tax policy in respect of primary producers – again an area quite readily integrated into my teaching. If you consider your own areas of research interests, I am sure you will be able to list examples of how you do build your own knowledge and understanding into your teaching.

This would also include keeping abreast of changes to law, new rulings and recent decisions. For example, the recent case of *Stone v FCT*⁸ could keep students occupied for some time debating the relative merits of the decision and exploring issues such as ordinary income, carrying on a business, and being engaged in a hobby.

To improve student awareness of your research activities you could keep an up-to-date personal web page including a list of your publications, or provide a list of references (including your own work) and links to electronic journals with the unit outline at the beginning of the semester. Many tax academics are also writers of textbooks which are

⁸ [2003] FCAFC 145.

commonly prescribed to their students. You could also consider distributing relevant conference papers to students, or at least making them readily available.

The other thread to explore is engaging students in research activities (and at USYD this is an expectation, as far as possible, and a measurement indicator). There are many ways to approach this. For example: the setting of assignments that are research orientated and allow student choice – on a point of law, as opposed to a numerical answer is an obvious possibility. These don't need to be complex (and tax lends itself to the study of unknowns!) – a simple question can still allow a curious student to explore the possibilities, collect the evidence and think critically in formulating a response. Evaluations by students of this strategy used this semester have included comments such as these:

“the assignments made me research and discover a lot of information on taxation”

“helped me explore an are of interest and gained knowledge through this”

“it was undertaken in a way that relates to society and business as opposed to just practical”

There are numerous possibilities for learning activities that can provide the basis for assessment. For example, students can present essays, class presentations, debate, case reviews, international comparisons, or critique the legislation. You could set individual work, group work, include peer assessment or self-assessment. Students could be writing for their own journals, or co-authoring with you. They could be presenting seminars to staff and or students, or being part of other networks (such as student groups within professional bodies, or part-time students doing a presentation at their place of employment). On-line delivery opens up further possibilities including contributions to discussion forums.

Providing choice and different types of activities allows them to choose topics of interest to them and to develop a wider range of skills – and it's a lot more interesting to mark too! For example, you could give a framework of what you expect and how the work will be marked including technical accuracy, use of supporting evidence, coherence of argument and ability to present both sides, the formation of a well-rounded conclusion.

There needs to be a balance of activities and these will need to take into account the size of the cohort and the available resources (including your time). It's really up to the academic to decide how you want to teach and what it is you expect students to learn.

IX CONCLUSIONS

While the hard evidence in support of research-led teaching being the means to improving teaching effectiveness has been elusive, many writers and academics have a belief in the link. This belief, in principle, appears to be independent of government intervention in higher education, but undoubtedly the latter has not been without influence. If you believe knowledge needs to be shared, then sharing what you have

discovered through your own research appears to be a natural step in the process of improving teaching effectiveness. Not only should research-led teaching be more rewarding (at least in terms of job satisfaction if not in terms of promotion) for the teacher, it is also a performance requirement at USYD. Students' responses to the strategy appear positive both in terms of the immediate learning and the skills they have acquired for the longer-term. Perhaps the ultimate test is - would I still take this approach if I had a choice - on reflection the answer is definitely yes!